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Guide to Representations & Warranties Insurance

2023 Edition



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The use of representations and warranties insurance (RWI or R&W) has become increasingly mainstream; it is used in an estimated 75% of private equity transactions and 64% of the time by larger strategic acquirers. Woodruff Sawyer's R&W team presents this comprehensive look at this facet of coverage.

9 Reasons to Use Representations & Warranties Insurance

RWI is now a well-established tool in the merger and acquisition (M&A) toolbox for both private equity and strategic buyers. Broad coverage and competitive pricing have been the theme for 2023. RWI has been widely adopted because it can be used to:

- 1. Use Profit From a Sale More Quickly:** R&W insurance can reduce or remove escrow for a M&A transaction, which allows the seller to either reinvest, realize, or more quickly distribute the proceeds they receive. It also allows the buyer to offer a quicker, cleaner process, which matters a great deal in a seller's market. Now that it is more established, R&W insurance has become a requirement for many sellers who are backed by private equity or venture capital.
- 2. Avoid Post-Close Conflict:** Having spent a vast amount of time and money acquiring a management team as part of the M&A process, no buyer wants to fight an escrow battle or file suit against the seller. A buy-side policy can be written so the buyer can be made whole without attacking their new people.
- 3. Mitigate Concern Surrounding Seller Solvency:** If the seller is a smaller business that will cease to exist after the deal is done, there may not be an accountable party to pursue if/when a claim arises. A seller who backs up their promises with an A+ rated policy removes that concern. With a currently volatile economy, we expect this reason to become more pressing.

9 Reasons to Use Representations & Warranties Insurance

- 4. Streamline Negotiation:** As any seasoned practitioner of M&A will tell you, negotiating indemnification is often the most challenging and time-consuming aspect of a transaction. Using insurance as a security backstop against any breaches or unforeseen costs often makes for a quick and easy negotiation process.
- 5. Have an Extra Pair of Eyes:** While bringing a third party into a transaction may concern you, R&W underwriters genuinely have your best interests at heart. Neither party wants a problem post-close. A team that provides an impartial review of previous due diligence is a valuable contributor to the process. This can also potentially serve as a defense when a buyer is accused of not doing adequate diligence by other shareholders.
- 6. Choose Your Protection:** A buy-side policy allows the buyer to purchase a limit of their choosing without needing the seller to agree to the same amount of liability.
- 7. Gain Peace of Mind:** Many strategic buyers are buying assets with the intention of expanding their reach or offering. This strategy can mean entering territory where they have less experience. An R&W policy helps protect the buyer from what they don't know.
- 8. Present Competitively in an Auction:** Several years ago, private equity firms started buying R&W coverage because it helped them win bids. Increasingly, an offer to buy R&W is becoming table stakes in a transaction. A lack of understanding of the product could be costly for bidders.
- 9. Follow the Best Practice in Corporate Governance:** Litigation around M&A transactions is practically continuous. Having a strong RWI policy with robust limits can be a bulwark against claims of inadequate diligence and gives the buyer a chance to be made whole in the event of a problem arising post-close.

What is Representations & Warranties Insurance?

Key Elements of an R&W Policy

5 Main R&W Exclusions

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What Is Representations & Warranties Insurance?

R&W insurance is essentially a breach-of-contract coverage designed to enhance or replace the indemnification given by the seller to the buyer. In short, once the ink has dried on the merger or acquisition deal, R&W covers loss caused by any breaches of the seller's representations, whether it involves issues with their customer contracts, employment agreements, or the super-secret recipe of their product (i.e., intellectual property or "IP").

The indemnity package is usually the most contentious part of any merger or acquisition negotiation. R&W steps in to eliminate contention and provide everyone with a cleaner, faster, and safer deal.

R&W Insurance: The Current Underwriting Market

The RWI underwriting market has grown in the last two years. It was not too long ago that there were three or four markets writing this type of risk. At the time of going to press, there are currently 26 markets, with one new market already this year and two new markets last year. We believe this growth will level off, but there is certainly a thriving and competitive marketplace.

Who Uses Insurance in an M&A Transaction

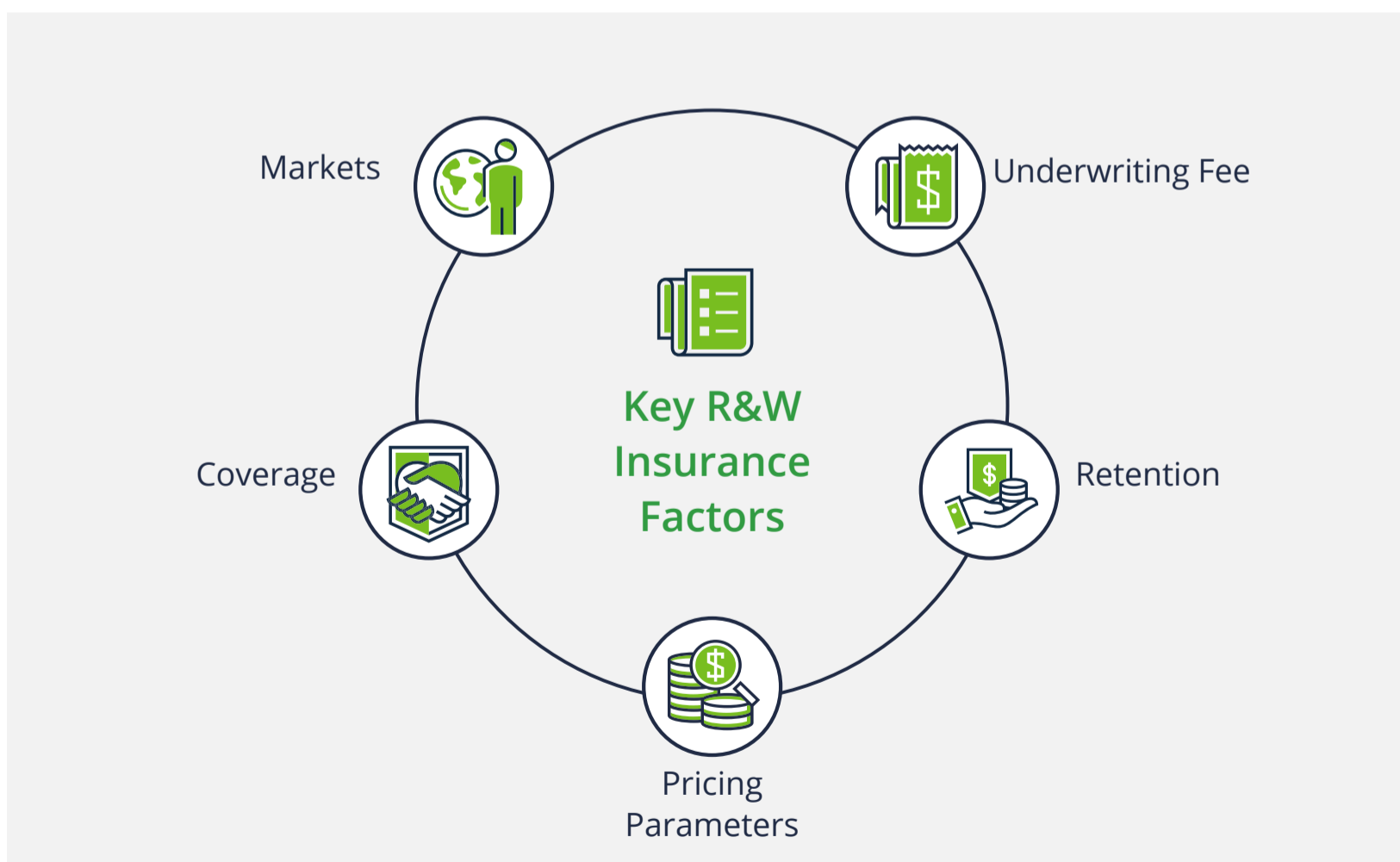
- Corporate buyers who want the ease RWI brings to the transaction and are seeking to maximize their attractiveness to potential sellers
- Private equity firms looking to maintain strong relationships with management post-close
- Private equity firms looking to close a fund and/or mitigate clawback risk
- Public companies looking to protect the balance sheet after they divest a subsidiary
- Private sellers looking for safeguards in a sale

What Problems Can RWI Address and How?

- Overcoming obstacles in the negotiation of the transaction
- Extending the life of the warranty or extending the dollar amount of protection
- Bridging the gap between the desires of the seller and the buyer
- Partially funding shortfalls in the escrow
- Achieving better investment returns and/or hastening access to funds
- Improving the financial standing of reps given by a distressed company

What Are Key R&W Insurance Factors?

- **Markets:** There are approximately 26 markets with a wide variety of appetites, experience, claims-paying history, and international capabilities. Picking the right one is a nuanced and deal-specific task.
- **Coverage:** Each contract is individually negotiated.
- **Pricing Parameters:** This is dependent on the size of retention/escrow and other deal factors; 2%–3.5% of coverage limits are required (e.g., \$10 million at \$200,000–\$350,000). The market has gone through some severe price fluctuations in the last year, so keeping up to date with pricing is an ongoing process.
- **Retention:** This is customized to the deal and we have seen the markets dropping this as well as pricing. Now, retention is usually 0.75% of transactions, dropping down to 0.5% after 12 months.
- **Underwriting Fee:** There is typically a \$30,000–\$45,000 non-refundable fee due at the time of legal review.



Changes in Premiums From 2022 to 2023

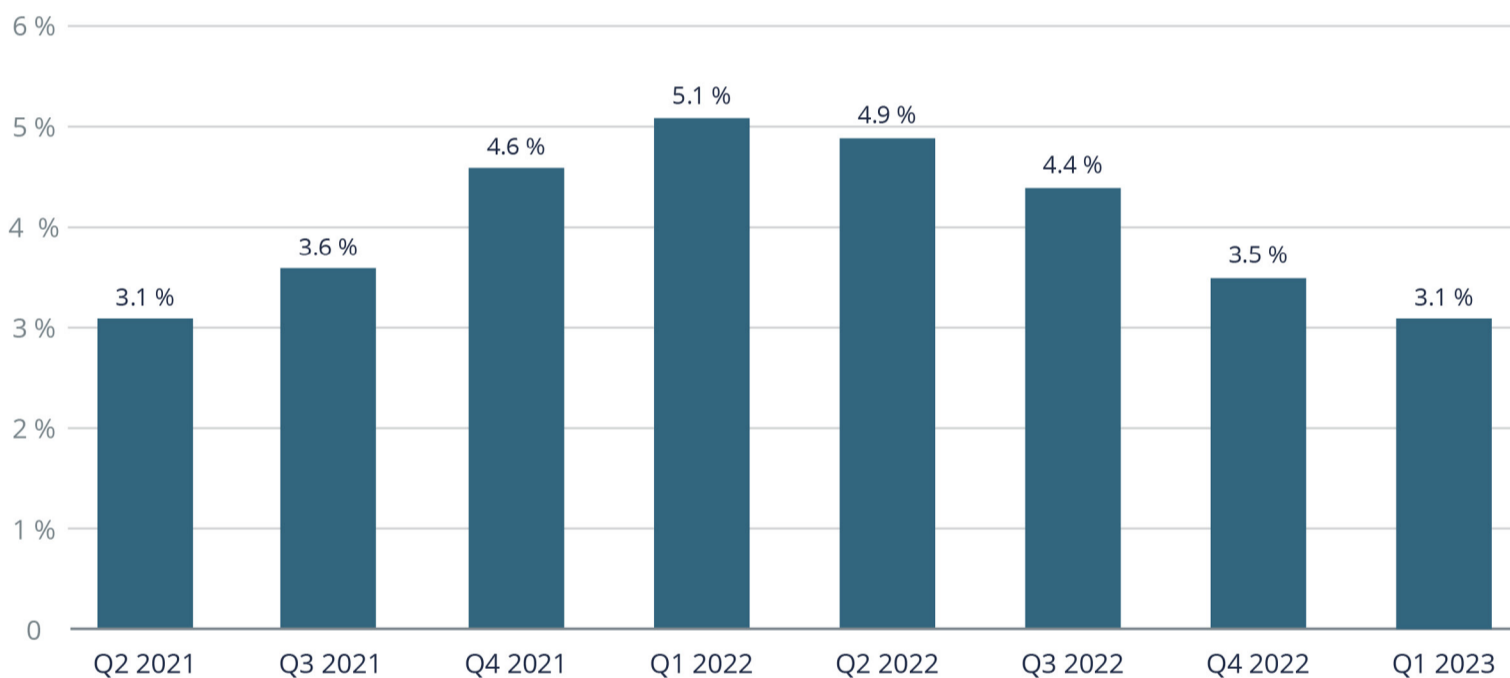
The changes we saw at the end of last year are beginning to erode further as the year progresses. As of June, standard rates are now running 2%–3% of the limit bought.

This is very good news for our clients and those needing reps and warranties insurance. The average number of quotes went through the roof and the premium prices we are seeing are on par with the beginning of 2018, if not slightly more competitive.



The lowest quote we have seen so far this year is **2%**, a return to 2018 in terms of pricing.

Average Rate as a % of Limit by Inception Quarter



Source: Woodruff Sawyer

Key Elements of an R&W Policy

Now let's walk through how R&W insurance works, how it's placed, and what it costs. We will also look at likely developments in the coming year.

1. The Typical Policyholder

While either buyer or seller can be insured, 97% of the policies placed are buy-side, protecting the buyer from any breaches of the seller's representations.

Here are five buy-side details that provide more explanation:

1. Buy-side policies have additional fraud coverage that sell-side policies can't provide.
2. The insured buyer can pick a coverage limit and survival period (i.e., the period for which the policy is in place) beyond what the seller is willing to give.
3. With this coverage, the buyer can avoid suing their newly acquired management team; should any breaches or misrepresentations come up, they can go directly to the carrier.
4. Buy-side policies allow the buyer to offer lower escrows or more competitive terms in an auction.
5. The insurance can replace distressed company indemnification with A+ rated indemnification.

2. How Underwriters Assess M&A Risk

When drawing up the R&W policy, underwriters evaluate:

1. The nature of the sale purchase agreement (SPA) terms and conditions. Examples of this include the definition of loss with regard to multiples and consequential damage language, single or full materiality scrapes, and sandbagging language. Underwriters prefer language that is not strongly in favor of neither buyer nor seller.
2. The nature of the specific warranties being given in the context of the transaction. For instance, IP warranties will be scrutinized more specifically in a tech deal than a manufacturing one. Buy-side policies allow the buyer to offer lower escrows or more competitive terms in an auction.
3. The quality of the due diligence. Underwriters wish to provide coverage for the unknown, so they are looking to “diligence the diligence.” With strategics increasingly using this, underwriters also want to ensure that it will be in a clear written report format, whether the diligence is done in-house or by external advisors.

3. Exclusions

While the insurance is designed to cover all warranties, certain exclusions are standard:

- Forward-looking warranties (e.g., sales projections, etc.)
- Purchase price adjustments
- The availability or usability of net operating losses or R&D tax credits
- Areas of coverage that are difficult to get, such as Foreign Corrupt Practices Act (FCPA) violations, union activity, underfunding of pensions, wage and hour violations, etc.
- Known issues

4. Placement Process and Timing for Coverage

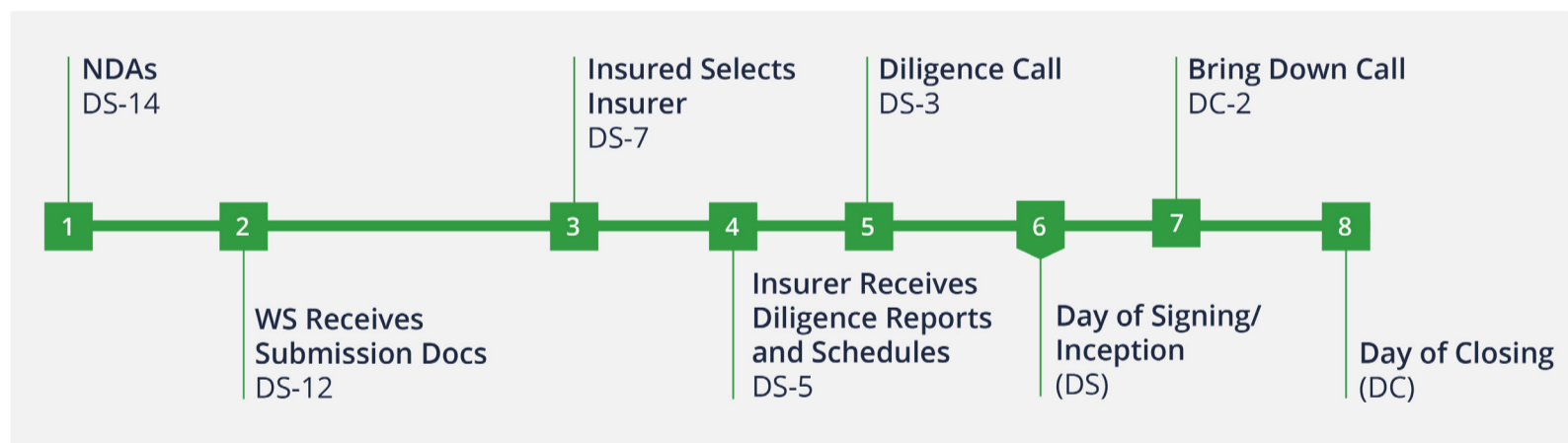
Placing R&W coverage is a two-part process:

1. **Initial non-binding indication occurs one week** after receiving the target financials, draft sale and purchase agreement, and any information memorandum that has been prepared by the seller. Underwriters provide initial indications on premium, retention, areas of concern, or heightened risk. This costs nothing.
2. **Underwriting requires a \$30,000–\$45,000 up-front “diligence fee.”** Underwriters and their counsel are granted access to the data room and begin reviewing the diligence reports and the disclosure schedules. It involves a two- to three-hour diligence call with underwriters, deal team members, and third-party diligence providers. Twenty-four hours after the call, underwriters will provide a draft policy and follow-up questions, if any. It doesn't make sense to start underwriting before the diligence is almost complete and a draft disclosure letter has been produced.

Securing R&W Insurance within the Deal Flow Timeline

Let's break down the insurance process a little more and see how it fits into the deal flow.

Step-by-Step Woodruff Sawyer Process



Note: “DS” is day of signing and “DC” is day of closing, and the numbers after them refer to how many days before those events take place. For example, “DS-12” means that 12 days before signing is when something needs to happen.

Securing R&W Insurance within the Deal Flow Timeline (Cont.)

1. NDAs (DS-14)

Woodruff Sawyer sends a non-disclosure agreement (NDA) to market for execution, and it is sent back with any redlines.

2. WS Receives Submission Docs (DS-12)

Insured sends Woodruff Sawyer the following: (i) draft agreement; (ii) target financials; and (iii) confidential information memorandum (CIM)/investor presentation. Woodruff Sawyer prepares the submission and sends it to the market.

3. Insured Selects Insurer (DS-7)

Woodruff Sawyer sends proposal to the insured. The proposal includes all markets approached, all prices quoted, and a line-by-line breakdown of comparison between the three most competitive offers. Insured selects insurer with which to proceed.

4. Insurer Receives Diligence Reports and Schedules (DS-5)

Once non-reliance letters (NRLs) are executed, the insured sends Woodruff Sawyer all diligence reports, the most up-to-date sale purchase agreement (SPA), and a draft of the disclosure schedules. Woodruff Sawyer schedules the diligence call.

5. Diligence Call (DS-3)

Diligence call with insured, insurer, and advisors. The insurer sends follow-up questions and an initial draft of the policy after the call.

6. Day of Signing/Inception (DS)

The insured sends Woodruff Sawyer: (i) signed/dated inception no claim declaration (NCD); (ii) execution copy of the agreement; (iii) execution copy of the schedules; and (iv) bind order. Coverage is bound.

7. Bring Down Call (DC-2)

Woodruff Sawyer schedules a bring down call with the insured and insurer.

8. Day of Closing (DC)


The insured sends Woodruff Sawyer signed/dated closing NCD. Post-close, the insurer issues the final policy after it receives (i) data room; (ii) closing volume; and (iii) premium.

5. How Pricing is Determined

The policy retention or deductible is expressed as a percentage of overall transaction size. The minimum for mid-size deals is 0.75% of the transaction, meaning a \$100 million transaction has a minimum \$750,000 retention. For larger deals, above \$500 million in enterprise value (EV), it's more common to see a 0.5% retention, which can be in the form of a seller's escrow, the buyer's deductible, or a combination of the two. A 0.75% retention drops down to 0.5% after 12 months, regardless of the size of the transaction. Those starting at 0.5% may not see a further drop.

Premium is expressed as a percentage of the limit of coverage bought and is not related to transaction size. As of June, premiums range from 2%–3% of the limitation of coverage. For example, a \$10 million limit would mean a \$200,000–\$350,000 one-time payment for a six-year policy. It's worth noting that currently, minimum premiums are running around \$100,000 for ordinary deals with \$3–\$5 million of limits requested.

There is a newly developed product offering a fully synthetic set of warranties that can quote limits of \$1 million.



Retentions
have decreased
to **0.75%–0.5%**
for all deal sizes.

5 Main R&W Exclusions

R&W insurance is continually evolving. There are four buckets of exclusions you generally find in a policy, as well as one common practice that functions similarly to an exclusion.

1. Conduct/Behavior Exclusions

The buyer is required to sign a “no claims” declaration at the start of a policy. If they make a false statement about what they know, that could potentially nullify any claim related to that fraudulent statement, if not the entire policy. Crooks beware, though: if the insured is the buyer, they are protected against any fraud by the seller but not against their own fraud.

A standard exclusion on a policy would be “any issue known prior to signing/closing,” or a similar version of that. Defining and interpreting this exclusion is a vital issue, and its breadth is highly dependent on the specifics of the language.

For instance, let’s say there is a piece of litigation related to licensing, and further diligence proves this to be an isolated incident. It would be reasonable to exclude that piece of litigation specifically but not licensing as a whole.

On the other hand, if diligence uncovered that this one piece of litigation was the tip of the iceberg, and the target company had a history of failing to apply for proper licenses, then the whole subject of licensing might be excluded.

2. Standard Exclusions

Net Operating Losses and Tax Credits

Net operating losses and tax credits have been an exclusion for a long time, although we have recently seen some shift in its application. This exclusion can now be dependent on the nature of the target and the amount of diligence around the area. Tax indemnity policies are also available to cover this more specifically if a favorable opinion has been written.

Wage and Hour

Long a standard exclusion, we're also seeing movement toward a more "case-by-case" attitude among underwriters. For example, we are more likely to see this applied to a deal in the retail space than in the software space.

Forward-Looking Warranties

While this remains in full force as an exclusion, we have seen a shift of onus. We now expect underwriters to draw attention ahead of time to those warranties which they believe have a forward-looking element, rather than having this be a potential guessing game.

Underfunding of Pensions

This remains a standard exclusion.

3. Deal-Specific Exclusions

Deal-specific exclusions refer to specific known issues or problems inherent in the industry for which underwriters will not accept liability, such as Medicare/Medicaid in healthcare (although it is increasingly possible to get coverage in this area) or FCPA in construction.

As with all exclusions, the tightness of the language is key and, as discussed above, getting granular on known issues is vitally important.

Try to identify the kind of breaches you are most likely to have—whether it's intellectual property (IP), cyber concerns, or environmental—to make sure your organization focuses their diligence to aid in removing those exclusions from the policy.

4. World Event Exclusions

In early March 2020, exclusions related to COVID-19 (including any resulting COVID-19 sickness, SARS-CoV-2, or any mutation or variation thereof) started **showing up in R&W policies**.

Since then, we have also seen the addition of exclusions relating to **Russia's invasion of Ukraine** and the collapse of Silicon Valley Bank.

5. Deemed Deleted/Altered Language

This is not, strictly speaking, an exclusion, but it functions in much the same way. We are seeing an increase in deemed deleted/altered language. In this way, the underwriter can take a scalpel instead of a hammer to a particular representation or warranty rather than excluding the whole thing. A good example is the addition of a knowledge qualifier so that a representation read “to the knowledge of the seller” rather than as a flat representation. Obviously, this would only be for the purposes of the policy and wouldn’t impact the agreement at all.

Structuring Your Program in Different Ways

We've talked about standard retentions and premiums, but what if you want something a little different?

High Retention/Deductible

You can certainly save serious premium dollars if you are willing to take on a much higher deductible. In certain tech deals where intellectual property (IP) was a primary concern, we have found more sellers willing to have a high-cash deductible for a limited time. Even if it's only for a year, a higher deductible will save a considerable amount of premium.

Fundamentals Only

Fundamental warranties are a little different from general warranties. On the simplest level, they cover ownership and the ability to sell. In other words, a breach of fundamental warranties would likely result in a catastrophic/total loss, as the buyer has bought something the seller was not legally entitled to sell.

However, these are rarely breached and usually well documented during the due diligence phase. As a result, coverage for only the fundamentals is substantially less expensive. Insureds typically use this approach when they are comfortable with the general representations but require certainty with the fundamentals.

We have seen a trend to include several items within fundamentals, such as IP, employee matters, tax, etc., which changes the nature of the risk and broadens it considerably. The price savings will be significantly reduced as a result.

Time Escrows

Another way to save substantially on the premium is through the concept of the time escrow. In this case, you structure the deal with a 10% cash escrow, which is returned after 12 months. The insurance is structured to only kick in a year later, once the cash escrow has been returned. Any claims pending against the escrow will be excluded from the policy. Still, it's a way of maintaining the escrow's value while giving relief to the seller at lower premiums.

Choosing Limits

One question we often hear is: “How much do people generally buy?” The answer to that varies greatly, depending on the size and nature of the deal. We also look at the question: “What’s the smallest amount of coverage that makes sense and will that change?”

Currently, the average limit of insurance is roughly 10% of the overall transaction size. So, in a \$100 million transaction, a \$10 million limit would be the average. However, statistics can oversimplify, and the purchased limit varies from deal to deal.

There are two things to consider:

- **The nature of the deal:** In a standard deal, the 10% rule is reasonable. The choice of a limit is often determined by what the buyer would have considered an ideal escrow amount. This is not the case, for instance, in an IP-heavy technology deal where a failure of the IP representation could decimate the value of the entire transaction. Such reps are often considered fundamental, and a much higher percentage limit may be sought to reflect this higher level of potential damage.
- **The size of the deal:** If a deal is on the larger end (over \$750 million), it’s entirely possible that the insured amount may be smaller than 10%, because even 5% still represents a large enough dollar amount to be material to any likely breach.

The appropriate limit is based on the specifics of your deal; there is no one-size-fits-all answer. This is another good reason to make sure your broker has experience with a broad range of deal sizes and industries.

Claims Trends

Halfway through 2023, we've found the rate of claims has been relatively consistent with previous years, while the number of claims has increased. This increase is largely attributable to the surge of M&A activity in 2021. However, we have seen interesting shifts emerging in the timing of claims noticed, types of claims filed, and areas insurers will expect heightened diligence in the future.

Timing of Claims Noticed

Historically, most claims have been noticed within the first year after binding. However, in 2022–2023, an increasing number of claims were noticed between 12 to 18 months post-close.

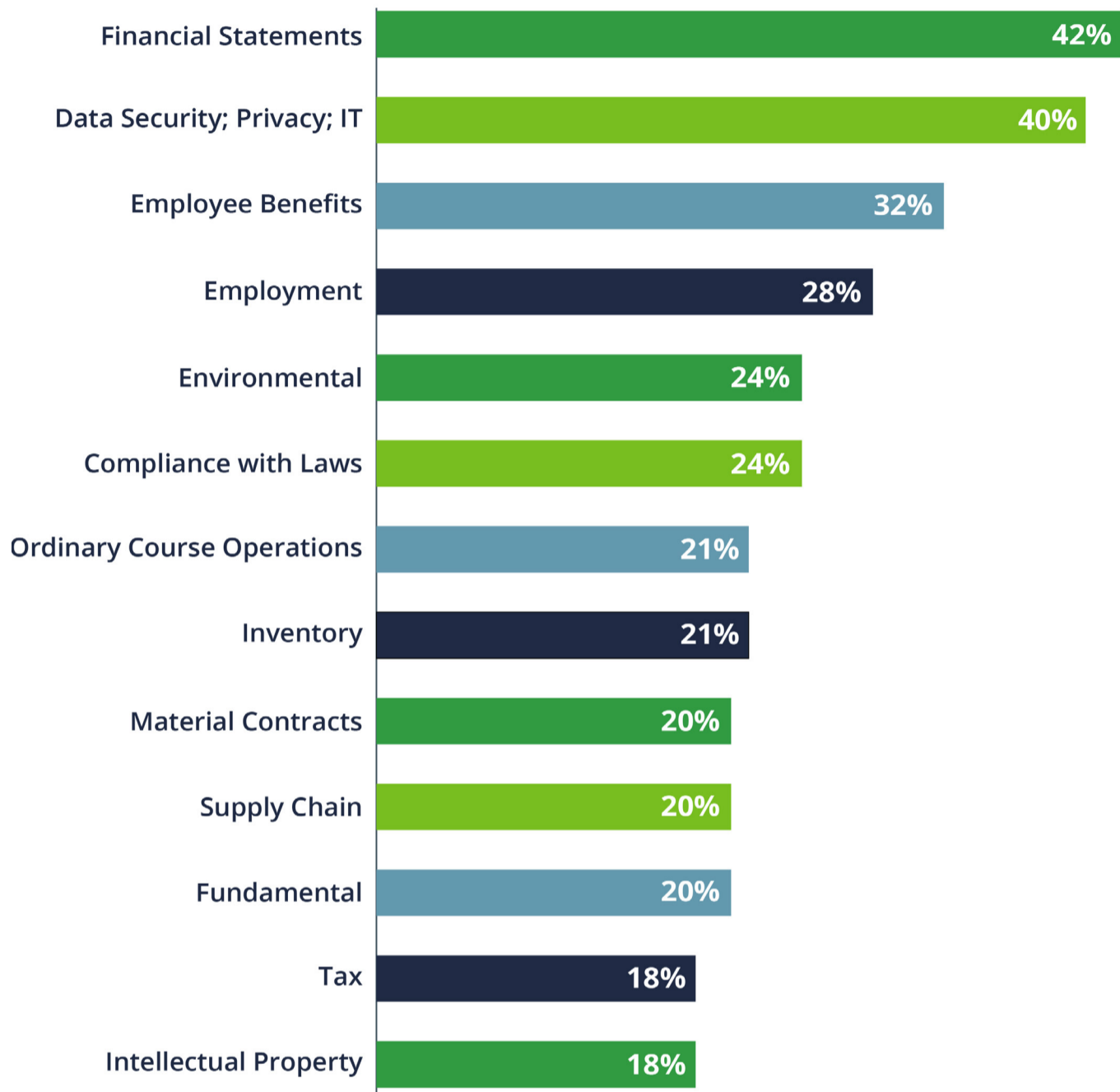
Types of Claims Filed

First-party, or indemnification, claims (where the insured brings a claim directly to the carrier) remain more common than third-party claims. However, third-party claims are on the rise for 2023 and will likely continue to uptick. Of the most frequently cited first-party claims, breaches of the financial and material contracts reps continue to involve the greatest potential for loss and are the claims most likely to exceed the self-insured retention (SIR), which is the portion of cost the insured must bear before the R&W policy responds.

Heightened Diligence

Data security/privacy breaches are hot on the heels of financial statements and material contracts. Carriers are increasingly concerned about the adequacy of cyber coverage, and buyers should expect this to be an area of heightened diligence. It is crucial that buyers understand the far-reaching implications of insurance diligence. In the haste of M&A deal flow, buyers can neglect to conduct adequate insurance diligence on the target company. Likewise, many purchase agreements lack clear and concise insurance representations by the sellers.

Types of Breaches Reported in RWI Claims



Note: Respondents were allowed to select more than one answer.

Source: Lowenstein Sandler RWI Insurance Claims Report 2023

Non-Compliance with Laws

Another notable trend is the high percentage of compliance with laws claims. While carriers have not yet compiled formal reports for 2023, they are consistently reporting an increase in claims related to compliance with laws.

One example of non-compliance is if the seller failed to obtain a needed permit before taking any actions that require one, such as new construction.

While non-compliance with laws is now one of the most numerous types of claims, the potential loss exposure is much less severe than with breaches of financial reps or material contracts. We are seeing most of these claims falling well within the SIR. However, while the claim usually falls within the retention, RWI policies have an aggregate retention, which is eroded by each covered claim. This means that while there is not likely to be a payout for a non-compliance breach, reporting these claims is still beneficial.

Condition of Assets Claims

Similarly, 2023 has marked a significant increase in condition of assets claims. The rise in such claims is not yet a trend but is of particular interest to insurers given that these breaches have the potential for high exposure to loss. For example, if an expensive piece of equipment needs repair, the insured suffers the cost not only of the repair/replacement of the equipment but also of the reduction in operations while the equipment is unusable or faulty. This is another area where insurers will likely require the insured to conduct heightened diligence prior to closing in the future.

Choosing a Specialty Broker

R&W insurance has been around in various forms for several years, both in Europe and the US. However, in the last five years, we have seen a major shift in its use and format. It is essentially a new but no longer emerging product.

This is true both in terms of the product itself and the markets that write it. Four years ago, there were six long-term, stable markets that wrote R&W in the US. Today, there are 26 and each market is different.

What to Look For—and Watch Out For

When picking an underwriter, terms and conditions and pricing matter, but also look out for the makeup of the team. Do they have insurance professionals as well as those with M&A experience?

- Does the underwriter manage a general agency? How long has it been underwriting?
- How committed is the underwriter to this space?
- How does the agency or underwriter handle claims, and what experience does it have with claims to date?

It's important to remember that some of this applies to brokers, which will help you pick the most appropriate market for your risk. Many brokers are new to this product or only handle it occasionally and don't have tenured relationships with the underwriting markets or depth of experience with the product.

Beware the "boutique broker" who only focuses on reps and places no other lines of coverage. Because R&W interrelates with all the company's insurance lines, all those coverages need to be reviewed by experts. You may need to put other insurance in place, so it's important to have a broker who can handle all aspects of your situation.

Woodruff Sawyer believes that clients are best served by having a team dedicated to R&W day in and day out, with access to broader resources that can review all your organization's insurance needs and present a holistic solution.

R&W insurance is a complex and fast-growing marketplace. It requires a dedicated insurance broker who understands this type of coverage and is backed by the resources to handle all insurance lines and questions that come out of a transaction.

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Additional Resources



2023 Private Equity & M&A Looking Ahead Guide

Provides predictions and advice on private equity risk management



D&O Board Education Resource Guide

Offers a roadmap for continuing education for board members



M&A Notebook

Covers IPOs, transactional insurance, SPACs and de-SPACs, and M&A



D&O Notebook

Covers D&O insurance, corporate governance, IPOs, and board issues



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