Representation and Warranty Insurance Can Be a Leg Up, but May Not Be a Silver Bullet

Jeff Poss and Neil Townsend at Willkie Farr & Gallagher LLP talk to Preqin about RWI, and when investors need – and don't need – it

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Representation and warranty insurance ("RWI") has become a "must have" for many US and European private equity sponsors looking for a remedy solution where there is no or limited post-closing recourse to sellers. Indeed, as the volume of deal-making has reached unprecedented levels over the past 12 months, brokers have reported that demand has resulted in RWI underwriters frequently declining business.

The attractiveness of these policies is clear. Standardized underwriting processes have put downward pressure on pricing and have allowed bidders to offer quitclaim sales, giving them a leg up on the auction process. Additionally, having an RWI policy in place may decrease sale process timelines.

However, the frequency with which RWI has been deployed recently has also exposed the limitations of the product. Below we explore the most common questions and misconceptions private equity sponsors have around RWI. Furthermore, we provide guidance on how advisors can help their clients analyze whether RWI is appropriate for a particular transaction, and set out solutions, alternatives, and realities that sponsors should consider when faced with these or similar circumstances.

1. If sponsors want to pre-empt an auction process, or otherwise demonstrate to a seller that they can move rapidly to execute binding documents, will the RWI process impede them from doing so?

Even for businesses in industries which bear few or no endemic risks, RWI underwriters require detailed due diligence exercises to provide meaningfully broad coverage. In situations where a sponsor needs to act with speed, or in circumstances where conducting fulsome diligence is otherwise difficult, we recommend that sponsors carefully consider their approach to RWI.

Sponsors should consider whether diligence can be tailored to address specific business and legal risks. Additionally, sponsors should evaluate their level of comfort with the risk level to determine whether RWI needs to be in place at signing, or whether underwriting can occur between signing and closing. Equally, sponsors may wish to consider whether the target's existing insurance policies cover any of the specific areas of concern (potentially rendering RWI unnecessary), or whether such target policies cover areas not covered by targeted RWI.

2. The retentions on RWI policies can be significant, particularly on larger transactions, meaning the only claims worth bringing are sizeable. These claims often involve accounting or contractual interpretations. Will RWI underwriters exploit the complexity of these types of claims and the nuances in the policy such that coverage is just effectively an 'invitation to negotiate'?

Ultimately, RWI policies are 'long tail,' and many underwriters are only just starting to see claims on past policies. How those claims are dealt with will shape the future of the RWI market. Rupert Newman,

a European RWI broker at Paragon, notes that "an underwriter's claim experience should be right at the top of the list when selecting an underwriter, and is a matter both attorneys and brokers can and should advise upon at the outset."

Most frequently, the debate between insureds and underwriters is not whether a particular warranty has been breached, but rather the extent of the loss associated with that breach. When engaging with underwriters on this point, insureds need to demonstrate, in detail, how the asset was valued. This means that upfront work can save significant time during a claims process. Equally, when placing the policy, attention should be paid to policy 'add-on features.' For example, in the context of a large transaction, a sponsor may wish to consider paying additional premium for baskets which 'tip,' allowing recovery of all loss where the deductible is exceeded and not merely the excess.

Sponsors may also choose to negotiate an arrangement with the seller whereby the seller and the buy-side sponsor share the retention amount. However, this approach does change the dynamic with the seller, which now has exposure for breaches of representations and warranties, and accordingly is likely to be more aggressive in negotiations.

3. Given the high cost of RWI premiums and retention, how can sponsors make the most of these products, particularly in large transactions for healthy companies, if claims are mainly focused on faulty financials or long-term, uncertain litigation at the enterprise level?

RWI is not the appropriate tool for every transaction. If, following diligence, "big-ticket" items appear to be the only risks worth covering, sponsors should consider pursuing their recourse only for breaches of the fundamental representations, such as title to and transferability of the shares being purchased, and perhaps certain critical tax items.

Supplementary coverage can be negotiated with the seller in the purchase agreement via specific debt-like and/or working capital items that are included in the purchase price adjustment mechanics, together with associated escrow or hold-back mechanics. These solutions may help provide the purchaser with certainty of recovery in the event of the crystallization of a risk item. This approach, however, may diminish the attractiveness of a bid in a competitive auction in which one or more competing bidders are willing to rely exclusively on RWI.

4. Should RWI be pursued if many of the risks inherent to the target business are either insured by other commercial policies, or excluded from RWI as a result of the risks being 'known'?

In this scenario, the RWI broker's experience can be put to particularly good use. Providers of insurance diligence should be able to assist in undertaking a detailed evaluation of the risk profile of the business to identify where there may be gaps in the scope or dollar value of coverage. The outcome of this type of analysis may suggest that a focused RWI policy is sensible. Alternatively, the conclusion may be that supplementing existing business insurance coverages post-completion, or taking out specific policies in respect of known risks (e.g., known environmental or tax risks), provides sufficient risk mitigation. If these solutions are not cost-effective or otherwise available, sponsors may reasonably conclude that existing insurance coverages are sufficient, and that RWI does not add meaningful protection for the cost of premium and retention.

While RWI will undoubtedly remain a prevalent feature of M&A deal-making across North America and Europe, experienced legal advisors should prioritize guiding their clients towards making educated decisions about where and how the product is best used, rather than merely assuming it is the panacea for meaningful purchaser recourse.

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