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Topping up RWI coverage in secondary deals

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The following article, titled 'Topping Up RWI Coverage In Secondary Deals,' was written by Jeff Clancy, Arash Farhadieh, and Matthew Block, Partners at Willkie Farr & Gallagher.

Representations and warranties insurance ("RWI") coverage has been available and sought in the context of GP-led secondary transactions for the last seven or so years, albeit in smaller numbers than sought today. Sponsors initially sought RWI coverage in the context of secondary transactions to speed up distributions to the selling fund's limited partners by avoiding purchase price holdbacks and reducing the likelihood of post-closing claims while also mitigating potential or perceived conflicts of interest of a sponsor having to seek monetary recourse against its selling fund and advisory client (with the RWI policy providing a potential recovery source in place of the holdback or indemnity and in place of the selling fund). The product later functioned as a way to provide as much of a clear exit, with no sell-side indemnity, as possible.

Because of this aforementioned utility, relative ease of execution and relative affordability of RWI policies in the context of GP-led secondary transactions, the uptake on the insurance has trended upwards over the course of the past five years with estimates ranging upwards of 50% of sponsors opting to obtain RWI to limit recourse overall. The remaining sponsors view the risk as remote, given the often limited package of representations and warranties offered in a secondary transaction (and the resulting more limited scope of RWI coverage) and ultimately not worth the added cost of the premiums, and opt to provide a more fulsome sell-side indemnity.

At the time of this article, premium pricing on general RWI coverage in a GP-led secondary transaction is approximately 1.7% - 1.9% of the amount of insurance purchased and most sponsors who obtain RWI coverage will obtain base coverage equal to 10% - 20% of the transaction's value.

There is a growing trend among certain secondary buyers to require sponsors to obtain additional top-up coverage (i.e., an additional layer of insurance on top of the 10% - 20% of transaction value base coverage) to cover breaches of fundamental representations and/or excluded obligations. Such top-up coverage can vary based on the specific requirements of the applicable secondary buyer, however it can range anywhere from the common 20% top-up to occasionally all the way up to the full purchase price. This additional layer of insurance is priced more cheaply per dollar of insurance than the base layer at approximately 50 - 75 bps of the added coverage limit sought, given the cover is more narrow and higher up the tower of insurance.

Ben Prebble at Howden notes that pricing on top-up coverage can be material relative to overall RWI costs: *"Given the additional top-up limit is generally at least 20% of the purchase price, even though the cost per dollar of top-up is far cheaper than the base layer of coverage, the large potential top-up limit of between 20% - 90% means the top-up costs may still be significant and could even be more expensive than the base layer of insurance. Whether such cover is good value for money turns on the structure of the* *selling fund(s), the transaction's risk profile, negotiation dynamics, and the sponsor and lead investor's plans post-closing."*

Accordingly, the structure of RWI and how much (if any) top-up cover is purchased should be considered early in negotiations. Since, as Prebble notes, depending on the transaction's and funds' structures, top-up cover may be more or less attractive.

If a breach of a fundamental representation ever resulted in a magnitude of damages intended to be covered by the additional layer of top-up coverage, the likely result of damages of such magnitude may well be due to fraud, in which case all bets are off and the buy-side could likely seek indemnity and other recourse directly against the selling funds and the sponsor, with the RWI insurers reserving seller-subrogation rights for fraud scenarios only. However, proving fraud and then enforcing (not to mention collecting on) such an indemnity against a selling fund or sponsor is of an entirely different character commercially and practically versus claiming against an insurance policy, which have historically paid out full limit losses for arguably fraudulent breaches of fundamental representations. The value of top-up coverage for excluded obligations should also be considered – the RWI market has paid claims for clawback (albeit on LP trades, not GP-led secondary transactions), and importantly RWI policies also cover defense costs, which may be more valuable in the context of excluded obligations than any final damages award, for example defending a claim from a selling limited partner, regardless of merit.

In addition, there isn't an established market practice on who bears the cost of this added layer of coverage. In a majority of transactions, the fees, costs and expenses of obtaining the insurance (including premiums thereon) are split 50/50 between the sell-side and the buy-side on the theory that the insurance benefits both sides. However, in connection with such additional top-up coverage, because it is often the buy-side requesting the added layer of coverage, it would seem appropriate for the buy-side to bear the cost of such additional coverage. That said, arrangements vary and the cost-sharing is a heavily negotiated point and such point should ideally be negotiated before long form documents are entered into.

Sponsors, buy-side and existing investors should weigh the utility of obtaining this added layer of coverage with the additional high cost of obtaining the coverage. Top-up coverage may be more appropriate in transactions where the selling funds cannot give a fulsome indemnity, there is known added risk in respect of one or more fundamental representations or excluded obligations, or if it would otherwise unlock or speed up negotiations, but absent such risk profile, the cost may not justify the added coverage.

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