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Private Equity Litigation Practice Alert

Representation and Warranty Insurance Developments

Representation and Warranty insurance ("RWI") provides coverage for financial losses resulting from breaches of representations and warranties by target companies or sellers in purchase agreements. RWI protects an insured from unanticipated (unknown) losses that may arise after a transaction closes and preserves deal value by shifting some of the risk of loss to an insurer for a predetermined cost. Over the past decade, RWI has become increasingly commonplace in deals across the global M&A industry. The prolonged sellers' market over the past decade has created natural pressure to execute transactions quickly, and RWI is increasingly seen by market participants as a deal facilitator that helps negotiations proceed more smoothly. This article explores the RWI coverages typically provided, the increasing popularity of the product, and issues that have arisen in disputes among policyholders, insurers, and the parties asserting the false representations or warranties.

I. What Is RWI?

In general, RWI is a policy purchased to indemnify the insured against certain breaches of representations and warranties in a merger or acquisition agreement. Representations and warranties are statements of fact made to the buyer about the entity for sale and are routinely the product of heavy (and contentious) negotiations by both parties in an M&A deal.[1] RWI policies generally track the liability and indemnity provisions in the underlying acquisition agreement. Many types of breaches of representations and warranties can occur in a standard transaction, such as misrepresentations related to financial statements, under-reported tax burdens, failures to comply with laws and regulations, and misrepresentations with respect to material contracts or counterparties.[2]

RWI insurance is available to both buyers and sellers. A buyer-side RWI insurance policy (which comprises approximately 90% of such policies), allows the buyer to recover directly from the insurer for losses arising from covered breaches of the seller's representations and warranties. A seller-side RWI insurance policy, by contrast, will pay or reimburse the seller for losses related to its own innocent, unknown, or accidental breaches.

Policyholders must be aware, however, that RWI insurance is not intended to cover any and all breaches in the course of an M&A deal; it is frequently limited by coverage definitions and exclusions. Although it may protect against unknown or unintentional breaches of representations and warranties, RWI insurance typically does not extend to, for example, covenant breaches, post-closing statements and price adjustments, or disputes related to other contractual obligations that may arise. Moreover, RWI policies routinely exclude liabilities known to the insured at the time the policy was purchased, and also exclude specific categories of losses and liabilities enumerated in the policy, such as asbestos-related claims, underfunded pensions, payment of taxes, employment-related liabilities, collectability of accounts receivable, forecasts and forward looking statements, and interim breaches occurring after signing but before closing. Other policies will have exclusions specific to the deal or the risks associated with the insured (e.g., excluding fraud or intentionally criminal acts from a seller-side policy). Nor will RWI insurance protect the buyer against extraordinary losses beyond the coverage limits (the risk of which can be allocated to the seller in an indemnity provision or remain with the buyer in a "no survival" deal).

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[1] *See* D. Stephen Antion and Philip Lang, *Representations and Warranties Insurance: An Innovative Solution,* 28 No. 10 WJDEC 1, 2013 WL 6159323, at *1 (Nov. 25, 2013).

[2] *See* Am. Intl Grp., Inc. ("AIG"), *M&A Insurance - The New Normal?,* at 6, https://www.aig.com/content/dam/aig/america-canada/us/documents/insights/aig-mandaclaimsintelligence-2018-r-and-w.pdf.

The coverage provided by RWI often has a meaningfully longer survival period than a seller is customarily willing to provide through a traditional indemnity. It is customary for an RWI policy to cover breaches of general representations for as long as three years (compared to 12 to 18 months under a seller's indemnity) and of fundamental representations for twice as long (often six years).[3]

II. History of RWI

Although some form of R&W coverage has been available in the United States since the 1990s, early policies were sometimes seen to inhibit, rather than facilitate, transactions because of the due diligence required to underwrite such policies. Today, insurers underwrite the product faster, in part by reviewing the parties' due diligence. Insurers often review the buyer's due diligence under the reasonable assumption that the buyer—because of pricing risk—has a strong incentive to undertake a thorough examination of the company it is purchasing. As a result, what was once a multi-week, if not multi-month, process has typically been significantly shortened.[4]

However, insurers will often designate certain areas as "enhanced due diligence areas," such as wage and hour matters, cyber security and privacy, products liability, professional services liability, condition of assets, and unaudited financial statements. Such designations, although not blanket exclusions, will signal underwriting concerns to the buyer regarding these areas and can lead to an increased focus on the buyer's diligence findings before final RWI sign-off occurs.

RWI is a particularly useful tool considering how breaches of representations and warranties were handled prior to the rise of RWI insurance. Absent RWI insurance, a typical M&A deal required placing a portion of the purchase sum in escrow as collateral (usually 5-10% of the total transaction value, held back for anywhere from six to eighteen months)[5] in the event of the seller were found to have breached its representations and warranties. In such cases, the buyer would file a claim to recover a portion of the escrowed amount or make a claim directly against the seller in the event of a material breach. The size and duration of the escrowed amount was frequently a source of contention and delay during M&A negotiations.

Today, however, R&W insurance has increasingly supplanted the use of escrowed funds as an affordable and less contentious alternative for indemnification against potential breaches in many M&A deals. Some deals require that R&W insurance be purchased as a condition of closing in addition to an escrow agreement, whereas other deals opt to eschew escrow provisions entirely.[6] For example, rather than demand an indemnity and escrow provision of $10 million for a $100 million deal, the buyer (or seller) can obtain a R&W insurance policy with a $10 million coverage limit. The insured would pay a premium *(e.g.,* $300,000) and be responsible for a deductible *(e.g.,* $1 million) covering the first losses in the event of a breach. Frequently, the terms of the R&W insurance allows a "drop down" of the deductible amount, usually a 50% reduction, set to occur 12 months after closing when an indemnity provision expires, and often parties will agree to split evenly the first losses subjected to the deductible (meaning, in this example, the buyer's risk of losses for R&W breaches would be limited to $500,000 in the first 12 months, and to $250,000 thereafter).

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[3] *See* Sean J. Griffith, *Deal Insurance: Representation & Warranty Insurance in Mergers & Acquisitions*, https://ir.lawnet.fordham.edu/faculty_scholarship/973/.

[4] *Id.*

[5] *See* Matt Keefe, *A Primer: Reps & Warranties Insurance, Edgepoint,* https://www.edgepoint.com/article/A-Primer-Reps-Warranties-Insurance.

[6] As an example, in November 2017 Diplomat Pharmacy Inc. disclosed that it would not require an indemnity and escrow agreement from the seller in a $595 million merger transaction, but would instead rely on separately purchased R&W insurance of up to $57 million in the event of a breach. *Diplomat Pharmacy Inc. Form 8-K,* 2017 WL 05484118 (Nov. 16, 2017). By contrast, a $218 million acquisition in 2016 required both an indemnity escrow and a supplemental $22 million buyers-side R&W insurance policy, with costs split by both buyer and seller. *Cimpress NV Form 8-K,* 2016 WL 07189173 (Dec. 13, 2016).

Typical limits under RWI policies today are 10% of deal value. The typical RWI premium is 3% of limits, with the typical deductible set at approximately 1% of deal value. Individual insurers generally cap coverage at between $25 million and $50 million, but limits in excess of $350 million are available by stacking policies, and coverage of up to $1.5 billion is achievable.

III. Prevalence of RWI

RWI has become an increasingly attractive option in M&A deals, with nearly half of M&A deals in North America using RWI today.[7] RWI allows the parties to increase the maximum indemnity (because clients can purchase as much insurance as they feel necessary) and it provides the buyer with a path to extend the survival period of the purchase agreement's representations and warranties. It also eliminates the post-credit collection risk that a buyer may face in the event of multiple sellers, foreign sellers, or insolvent sellers. And it may provide recourse where no seller indemnity is possible, such as in the case of public company sales or in bankruptcy or distressed situations.

Both buyer-side and seller-side RWI policies offer unique benefits to participants in an M&A deal while reducing the burdens and complications associated with a traditional escrow approach. RWI enables buyers, for example, to maximize protection against the risk of losses for RWI breaches (usually for a longer period than a typical indemnification agreement) and to reduce potential collection concerns from sellers for such breaches. In addition, a buyer with RWI can agree to provide more funds to the seller at closing, providing a competitive advantage against other offers using a traditional escrow process. RWI also allows buyers to render their bids more attractive at auction and reduces the complexities of negotiating indemnification agreements with sellers. Those in the RWI industry also suggest that RWI may protect key relationships (such as with management following the acquisition) and, if the RWI policy is the buyer's sole recourse, it encourages the seller to provide a more complete representation and warranty package than it would otherwise offer.

Likewise, sellers reap benefits from RWI because the product typically reduces negotiations (and potential liability) over post-closing obligations and indemnity provisions, while increasing the amount of funds for closing, funds that would otherwise be held back in escrow. A seller-side policy often covers the amount the seller would otherwise pay to the buyer for a breach and the costs of defense as well, and can offer a "clean exit" from the investment or company.[8]

The clear advantages of RWI have led to explosive growth in use of the product over the past five to ten years, attracting new underwriters entering the marketplace and offering increasingly competitive terms to RWI purchasers. In 2018, for example, approximately twenty different underwriters offered RWI, and more than 1,200 "middle-market" M&A transactions included RWI.[9] And, "Despite 2020 being a volatile year, AIG's global M&A insurance team [alone] underwrote over 700 policies."[10] Moreover, AON estimates there will be 950 RWI policies totaling $45 billion for 2021.[11] As competition among insurers has increased, average premiums and deductible amounts have fallen; one market estimate found that premiums are now generally

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[7] M&A Insurance: *Changing the Global Landscape,* Aon, https://www.aon.com/m-anda-riskinreview/index.html (hereinafter, *"Changing the Global Landscape"*).

[8] Indeed, some M&A deals now expressly limit a buyer's options for recovery on a breach to proceeds from the insurance policy.

[9] *See A Closer Look at the Middle-Market MeA Picture,* The M&A Lawyer 20 No. 5 M&A Law. NL 4 May 2016); *see also* David F. Birke and Craig P. Warnke, Spotlight on R&W Insurance, New York Law Journal (Oct. 26, 2018), https://www.law.com/newyorklawjournal/2018/10/26/spotlight-on-rw-insurance/.

[10] *See M&A: Elevated Claim Levies Put Focus on Due Diligence,* AIG 2021 Mergers & Acquisitions Claims Report, https://www.aig.com/content/dam/aig/america-canada/us/documents/business/management-liability/aig-manda-2021-r and-w.pdf.

[11] *See Changing the Global Landscape, supra* n.7.

priced below 3% of coverage limits (down from 3% to 4% in past years) whereas deductibles are now on average 1% or less of the total deal value (down from 1.5% to 2%).[12]

Many observers credit the popularity of RWI in private transactions to the fact that such deals are typically between two private equity firms. On the sell side, RWI may boost the PE firm's IRR (internal rate of return) by avoiding escrow accounts, which reduce IRR by delaying the return of proceeds. On the buy side, RWI also may be favored because, given the relatively short time horizons for which PE firms hold portfolio companies (less than six years on average), overpaying for the portfolio company may threaten to reduce the PE fund's IRR at exit. Because fund managers are compensated based on IRR, they may favor RWI as a means to protect IRR and to insulate managers from non-diversifiable loss.[13]

IV. Claims Under RWI

As with any insurance product, the rise in popularity of RWI has resulted in a corresponding increase in claims. One estimate reflects that claims are submitted by an insured in connection with 10% to 15% of RWI policies issued;[14] another large insurer found that in recent years, a claim was submitted in nearly one out of five (19.4%) of their policies covering deals worth more than $700 billion. The insurer further found that the bigger the deal, the more likely claims would be submitted (24% for deals valued over $1 billion) and for the highest amounts ($19 million on average). Even so, nearly half of the claims received by the insurer in 2020 were for between $1 million to $10 million in losses, and more than a quarter of the claims were for between $10 million to $25 million in losses.[15] Approximately half of the claims were also submitted after 12 months, which is when most escrow funds are released. In practice, the vast majority of claims (74%) under RWI policies are made within the first 18 months of closing—typically after the first audit is conducted by the new owner.[16]

According to AIG, the following categories of RWI-triggering incidents are the most common: financial statements (21% of claims); tax (19%); compliance with laws (16%); material contracts (12%); employee related (8%); intellectual property (7%); operations related (5%); and environmental (3%). Whereas financial statement claims are the most predominant, material contracts are among the largest claims: "The top 6% of material contracts claims account for 63% of loss dollars paid on those claims."[17] Such claims may result in losses in excess of RWI limits, emphasizing how critical it is to identify issues prior to closing for buyers.

V. Litigation Involving RWI

Litigation between the insurer, the insured, and/or the breaching party is relatively rare. Many policies include mandatory arbitration for disputes and choice of law provisions restricting the insured's options for seeking relief in court. Experts have attributed the relative infrequency of RWI-related litigation to several additional issues. A study recently conducted by a professor at Fordham Law School reports that RWI claims are typically settled by direct negotiation with insurers, without formal arbitration, mediation, or adjudication, in part because insurers have tended to pay claims more easily than seller-indemnitors.[18] Nevertheless, court

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12 *See* Jeffrey Chapman, Jonathan Whalen, and Benjamin Bodurian, *Representations and Warranties Insurance in mem Transactions,* Harvard Law School Forum on Corporate Governance and Financial Regulation (Dec. 11, 2017), https://corpgov.law.harvard.edu/2017/12/7.

13 *See supra* n.3.

14 *See supra* n.9.

15 *See supra* n.2 at 4.

16 AIG, *Taxing Times for M&A Insurance* at 4, https://www.aig.coni/content/dam/aig/america-canada/us/documents/insights/aig-manda-claimsintelligence-2019-r-and-w.pdf.

17 *See supra* n.10 at 3. Note, material contracts occur in "all regions[,] [i]n film EMEA, they made up 51% of claimed losses during the 2016-2019 period, up from 23% in the 2011-15 period."

18 *See supra* n.3.

decisions that have considered RWI policies demonstrate the importance of carefully negotiating such policies' terms and exclusions.

The most notable case involving RWI to date is *Ratajcak v. BeaVg Solutions Limited,* 870 F.3d 650 (7th Cir. 2017). There, the sellers obtained an RWI insurance policy with a $10 million coverage limit and a $1.5 million deductible as part of the sale of their protein supplement company. The buyers later discovered that the contents of the company's product were intentionally misrepresented to third-party customers. Several third-party lawsuits were filed, and the RWI insurers ultimately refused to indemnify the sellers in those cases for a $10 million settlement amount paid to the buyers before they filed suit. The district court ruled in favor of the insurers, and the Seventh Circuit affirmed, finding that the terms of the RWI insurance policy did not cover the settlement (or other lawsuits) for multiple reasons. First, the Seventh Circuit held that "[i]nsurance coverage usually depends on the nature of the victims' claims," and the claims asserted against the seller reflected fraudulent statements and intentional omission of material facts outside the scope of the policy, not a covered breach of a specific representation or warranty. *Id.* at 655-66. Second, the court noted that the sales contract capped damages for misrepresentations beyond certain enumerated "Fundamental Representations" (such as those made by the sellers) at $1.5 million in damages, whereas the deductible for the sellers RWI was $1.5 million as well; thus, the Seventh Circuit held that even if the RWI policy covered some or all of the claims at issue, no indemnification was required because the damages cap matched the deductible. *Id.* at 656. Third, the sellers had failed to obtain the insurer's pre-approval of the settlement as explicitly required by the policy, thus the insurer had no obligation to indemnify based on an agreement it did not review or approve. *Id.*

Other litigation has explored the intersection between RWI and the terms of purchase agreements. For example, *JAC Holding Enterprises, Inc. v. Atrium Capital Partners, LLC,* No. 12-cv-15450 (E.D. Mich.), which settled before the district court ruled on the pending motions for summary judgment, involved a dispute in which the buyer claimed the seller had to indemnify it for amounts not recovered under an RWI policy because the damages at issue were the product of fraud or other intentional misconduct. Another case, *Moxie Holdings, Inc. v. PAE Holding Corp.,* No. CL 18003721, 2019 WL 4897124 (Va. Cir. Ct.), found that purported misstatements in a sale agreement concerning two governmental contracts may constitute breaches of contract (and thus fall within the RWI policy) or fraud (and thus represent claims for which the seller may retain liability). And *WPP Group USA, Inc. v. RB/TDM Investors, LLC*, No. 656825/2019, 2021 NY Slip Op 30160(U), **3-5 (N.Y. Sup. Ct.), allowed a $40 million claim against an RWI provider, determining that it was "ambiguous" whether—pursuant to the terms of the purchase agreement—the seller was required to refresh its current-year projections prior to closing and, it was "a question of fact" whether the RWI provider was responsible for damages flowing from any such failure to update.

Some RWI cases have looked at liability for events that occurred during the interim period prior to the sale's closing. In *Zayo Grp., LLC v. Latigs Holdings, LLC,* No. 12874-VCS, 2018 WL 6177174 (Del. Ch. Nov. 26, 2018), the Delaware Chancery Court determined that the RWI provider was not liable because the seller did not actually breach a provision in the purchase agreement that required disclosure of the cancellation or termination of material customer contracts in the interim period before closing; the court determined that the contracts at issue were either fully performed (and thus had expired) or were converted in a non-material way (such as from annual to month-to-month). *Id.* at *14.

In light of the growing prevalence of litigation, parties may elect to manage litigation risk preemptively. Adverse Judgment Insurance may be obtained to guard against or eliminate deal-breaking exposures. And, Judgment Preservation Insurance protects against reversal on appeal or a reduction of damages, allowing plaintiffs to lock in some or all of a damages award, retaining immediate benefits pending final review.

VI. Insurers' Subrogation Rights

RWI policies often allow the insurer who pays a claim to pursue recovery from the breaching party, typically the seller. In the context of a buy-side policy (the most predominant form of RWI), the insurer would

step into the shoes of the buyer to pursue the seller for providing false or misleading information. Subrogation thus shifts risks *ex post* back to the seller. However, subrogation in the context of RWI has thus far been relatively rare. Part of the reason is practical: Underwriters often agree to a waiver of subrogation rights except for instances of the seller's fraud.[19] Subrogation would otherwise give the insurer the right to step into the buyer's shoes in pursuing the seller for its losses, thus nullifying any benefit to the seller of the RWI policy. RWI carriers also may agree to limit or waive subrogation rights against customers and suppliers. Accordingly, the vast majority of respondents to the Fordham study (83%) reported never having been in a situation in which the insurer asserted subrogation rights; for those that had, the subrogation occurred only where there was clear evidence of fraud.[20] However, many industry observers still believe that the continued presence of subrogation rights in the event of fraud enhances the insurer's position in the event of a dispute.

VII. Future of RWI

At least two major issues involving RWI are likely to play out in the coming years:

First, although this was once presented as an explicit exclusion, RWI policies are now typically silent on the issue of losses relating to diminution-in-value ("DIV") or multiplied damages. Such damages measure losses not by the amount of the loss caused by the breach itself, but instead by the effect of the loss on the value attributed to the target business at the time of the acquisition. Thus, if the buyer were to pay 8x EBITDA for the target, it would multiply its direct loss by a factor of eight to claim DIV/multiplied damages (because the consequence of the breach was the mispricing of the acquisition). Industry observers have noted that the market has settled upon an uneasy state concerning DIV/multiplied damages, where policyholders may believe that such damages are implicitly covered by their policies and carriers are at least willing to let them present their case for multiplied damages.[21] If and when the M&A market hits a rough patch, this contractual interpretation issue may rise to the forefront of litigation and will have significant implications for the industry given that it may profoundly affect the size of buyer recovery and the scope of insurer liability.

Second, some scholars[22] have argued that there are long-term questions regarding the viability of RWI policies, especially in the event of a downturn in either the deal market or the underwriting cycle. They have asserted that three fundamental flaws underlie the policies:

- RWI, by transferring risk away from the contracting parties to an insurer, introduces a moral hazard into the M&A space, as it reduces the impetus for the contracting parties to exchange information fully in the deal itself (which otherwise might trigger a "knowledge" exclusion to policy coverage), and may lead to less careful representations, a less comprehensive diligence process, and greater risk embedded in the deal.

- Because the transacting parties have superior access to information, as compared to an insurer, and alternative means of risk management (such as self-insurance), deal efficiency is not the likely driver behind the decision to purchase RWI. Rather, the use of RWI might be the result of adverse selection, where those in the riskiest deals obtain such policies and parties in the

[19] Sellers now demand such provisions in purchase agreements. A commonly used version states: "Buyer shall cause such R&W Policy to expressly include a waiver by the insurer of any and all subrogation rights against Seller and its Affiliates and their respective officers, directors, and employees (other than arising from Fraud)."

[20] *See supra* n.3. Some jurisdictions, such as Delaware, will not allow parties to bargain away subrogation rights where fraud is present. *See Abry Partners V, L.P. v. F&W Acquisition, LLC,* 891 A.2d 1032,1064 (Del. Ch. 2006) ("To the extent that the Stock Purchase Agreement purports to limit the Seller's exposure for its own conscious participation in the communication of lies to the Buyer, it is invalid under the public policy of this State.").

[21] *See supra* n.3.

[22] *Id.*

safest transactions do not. Over time, this will affect the accuracy of risk-pooling and the stability of coverage.

- The imposition of liability, through a purchase agreement's representations and warranties, has long been seen as the key to creating credible commitments in M&A. When sellers are themselves no longer liable for incomplete or inaccurate disclosures and do not have to maintain a cash escrow account following closing to cover potential indemnification, buyer confidence in the information the buyers receive may decline. Over the long run, RWI may actually inhibit efficient contracting or lead to perverse incentives for PE firms that create market distortions. Moreover, if the M&A market stops expanding and RWI coverage begins contracting, the transacting parties may rediscover the credible commitment problem at the heart of RWI and begin abandoning the product.