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Reps and Warranty Insurance: An Untapped Resource for Closing M&As

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Many types of insurance are viewed only as a form of protection against downside risk. But certain coverages can do much more than offer protection, they can actually offer a business advantage that allows companies to achieve success relating to an acquisition where it would otherwise not be possible. Such is the case with Reps and Warranty (R&W) insurance. R&W insurance provides coverage against financial loss caused by breaches of the representations and warranties made in the M&A agreement. While every business does extensive due diligence to verify information provided by their deal partner before closing, the fact is that any complex transaction contains a certain number of unknown risks and unforeseeable circumstances. Often these unknowns do not reveal themselves until well after a deal has closed. R&W insurance is particularly useful to buyers in these circumstances.

Unfortunately, awareness and use of this type of insurance remains relatively low. Insurance carriers have estimated that less than 20 percent of M&A deals in the United States utilize R&W insurance. But its use is on the rise, and with good reason. In many cases, R&W insurance can help push a proposed deal across the finish line. So why don't more companies take advantage of this tool? For one, because it is underused, there are a number of misperceptions in the marketplace about how it works and what it entails. Let's try to debunk those myths. But first we must understand when using R&W insurance makes sense.

> "R&W insurance is usually a deal maker, not a deal breaker."

WHEN SHOULD I CONSIDER R&W INSURANCE?

As with any type of coverage, R&W insurance does not make sense in all circumstances. Generally speaking, it should be used for deals with a value of more than $20 million as a baseline and $1.5 billion at the high end. It may still have a role to play in other deals, but this is the area in which policy owners will derive the greatest benefit. Deals that can benefit from R&W insurance are often fairly complex. In real estate deals for example, a single property transaction would not require R&W insurance. But when multiple properties or entire portfolios are involved R&W insurance should be strongly considered.

Also, while there are times when it makes sense for a seller to purchase R&W insurance, it is usually more advantageous to the buyer. For buyers, the purchase of this insurance can be used as a negotiating tool with sellers. It may eliminate the need for escrow accounts that a seller may be unable or unwilling to agree to. In some cases, buyers can get sellers to cover the cost of the R&W policy as an alternative to these measures. Even with an understanding of when to use this type of insurance, many businesses are still hesitant to use them. Below are some reasons you might hear for not purchasing R&W insurance.

- **Myth #1: "Securing this insurance will hold up my deal."**

  Only a few years ago, the market for R&W insurance was still relatively immature in the United States. This leads many people to assume that the process to secure this type of insurance is lengthy. That's always going to be a red flag when trying to negotiate a deal. Most deals take long enough and you cannot have insurance issues slowing up the deal. In fact, R&W insurance is relatively quick and easy to purchase today. More insurance carriers have entered this marketplace and most now have dedicated R&W teams. An experienced broker can help secure coverage within a much shorter time period then in the past. As outlined above, R&W insurance is usually a deal maker, not a deal breaker.

One other point to consider is that the earlier R&W insurance is secured, the easier the acquisition process. Often R&W insurance is only pursued after negotiations run into trouble. While success can still be achieved in this circumstance, having the insurance at the onset will avoid any potential problems this might cause.

- **Myth #2: "R&W insurance is too expensive."**

  This perception is again a remnant from a time when the R&W insurance market was not as mature. Today, a price range of 2 to 4 percent of the coverage limits is fairly common. This rate continues to become more competitive as compared to rates in the past. For large, complex deals this price is usually well worth protecting against the risk of a deal going south. An experienced broker should be able to negotiate favorable rates depending upon the exact circumstances of the deal.

- **Myth #3: "My due diligence was exhaustive, I just don't need it."**

  As mentioned, any complex deal is going to include a number of unknown risks. While your due diligence might be thorough, no amount can make a deal a sure thing. In fact, issues that arise after deals are completed are far more common than you might think. Data from AIG shows that one in seven of the R&W policies that they've issued globally have filed claims after a deal has closed. What's harder to know is how many deals without R&W policies also encounter problems. Either way, the number is concerning when considering the millions of dollars that are at stake if a deal is not successful.

  Additionally, it's not as if firms can decrease their chances of having a problem by focusing their due diligence efforts in a specific area. While issues related to financial statements account for the highest percentage of claims according to AIG, other types of claims related to taxes, contracts and intellectual property are also very common. Even if there was a specific trouble area for claims, focusing due diligence too much in one area can expose a firm to blind spots in other areas in a complex negotiation.

  R&W insurance is certainly not appropriate for every deal. However, firms should look at it closely before beginning any M&A negotiations. The benefits are significant and many of the perceptions that exist about the coverage are either untrue or outdated. R&W insurance can be acquired quickly and affordably. Most importantly, it can make the difference between a broken deal and a made deal that keeps both parties satisfied for the long term.

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