

Mergers & Acquisitions Insurance

By [Ingrid Sapona](#) | January 2019 | 22 minute ready



Transactional risk insurance is designed to facilitate mergers and acquisitions (M&A) and other business transactions. The insurance provides the participants to a deal with a way of transferring risks that might arise in connection with specific aspects of the transaction. Representation and Warranty (R&W) insurance is the most common transactional risk insurance. It provides the insured with protection against financial losses that can occur as a result of unintentional inaccuracies in representations (reps) or warranties made by the seller.

Two other products have also been developed to cover specific kinds of transactional risks: Tax Indemnity Insurance and Contingent Liability Insurance. This Trends Paper focuses on R&W insurance because it has the longest history and it's by far the most widely used in Canada, with 10-12 carriers writing it here. We will cover Tax Indemnity Insurance and Contingent Liability insurance in an upcoming Trends Paper.

R&W insurance, which was initially developed as an alternative way to protect sellers, transformed into a buyer's product when private equity realized "[the efficiency of using insurers' capital as a substitute collateral instrument.](#)" Over the past decade it's really taken off, as more-and-more clients understand [how the insurance works and they feel they can rely on it.](#) Another reason it's becoming popular is buyers are realizing that "for the price of an incremental premium increase, which can often be shared with the seller ... [they] can generally obtain more comprehensive indemnification coverage than what may generally be negotiated between the parties ... [with less friction and delay ... in the deal process.](#)"

The growth in the market for such insurance has brought increased competition and more carriers are entering the field. As a result, [premium prices \(and retentions\) are dropping](#) and coverage is becoming broader.

How R&W Insurance Works

R&W insurance [provides coverage for risks that are unknown at the time the policy is bound.](#) Exposures identified during due diligence are excluded from coverage. For risks the buyer uncovers during the due diligence process, the buyer and seller would be expected to negotiate price adjustments.

R&W insurance can cover a variety of types of representations a seller might make in a transaction. Two categories of reps and warranties generally are covered: general reps (also known as operational or business reps) and fundamental reps. R&W insurance covers financial losses, including costs associated with defending claims.

Some R&W policies exclude certain categories of losses, whether known or unknown to the buyer. For example, [some may exclude losses related to reps](#) about pension funding, transfer pricing, and knowledge of breaches by the insured's deal team. As well, it's not unusual to find exclusions for cyber security matters. According to Jason Stone of Aon's M&A Transaction Solutions, as the R&W product evolves, however, exclusions for cyber security are becoming rarer and if there's a large data/privacy concern, carriers would expect there to be an underlying cyber insurance policy and the R&W policy would sit in excess of the cyber policy and would be no broader than that underlying policy.

Under R&W policies, general reps are covered for three years from the date the deal closes while fundamental reps are covered for six years. The transaction agreement sets out what constitute fundamental and general representations. "For example, we've had clients say intellectual property has to be a fundamental rep because that's what our business is and that's what we're selling. In that case, the insurance will cover reps related to IP for six years, so long as the carrier agrees," says Stone.

The R&W policy also follows the terms of the underlying agreement with respect to the damages covered. So, for example, if the acquisition agreement is silent on the issue of damages, [the coverage will typically not exclude](#) direct, consequential, incidental damages, or losses based on diminution in value and a multiple of earnings.

Another unusual feature of R&W insurance is that insurers waive their rights to subrogation against the seller for everything except fraud. “Basically, what the insurance companies are saying is ‘we’ve had access to all the buyer’s diligence reports – tax, financial, legal opinions, and so on – and we’ve looked into it and they’ve looked into it and if one of us has missed something that’s going to be a big loss, then we haven’t done our job properly,’” says Stone.

Practical Application of R&W Insurance

Like other insurance products, R&W insurance is used for risk management. But, in the world of deal making, it’s also used strategically. To understand how and when it’s likely to be used, it’s necessary to first understand a bit about how M&A deals work.

Generally, in a merger or acquisition, the seller makes representations and warranties that the buyer relies on as a supplement to their own due diligence. The seller must indemnify the buyer with respect to the representations and warranties. From the buyer’s perspective, such indemnities provide only limited comfort, however, since there’s no guarantee they’ll be able to collect from the seller in the event there is a breach.

John Antonecchia, head of the M&A practice at BFL Canada, describes a basic transaction this way: “One company – the seller – is making representations to the buyer about what their company is. The buyer would say, ‘ok seller, I believe what you’re saying, but put some money where your mouth is’. Then the buyer will generally hold back a portion of the transaction proceeds – somewhere between 10% and 20% of the transaction value for maybe 18 months – until they’ve started to run the business and they can verify what the seller has said was true.”

Holding back proceeds provides some security and mitigates some risk for the buyer. But, from the seller’s perspective, it’s far from ideal because the seller will not get the full proceeds on closing. To eliminate the need for holdbacks or escrows, the seller may offer to include R&W insurance. Ed Markovich, senior vice-president of transactional risk with Chubb in New York, also points out that, “[Insurance is ultimately cheaper than leaving money behind](#) and provides buyers with protection for a longer period of time than what a seller would typically agree in an indemnity.”

In deals where the seller continues working for the buyer after the closing (not an uncommon situation in the sale of family-owned businesses, for example), R&W insurance can be especially beneficial because “[it preserves key relationships by mitigating the need for a buyer to pursue claims against management sellers](#)”.

R&W policies are also increasingly common in private equity deals where the seller is especially keen to distribute the deal proceeds to the owners. This can be the case, for example, [at the end of the life of a private equity fund](#).

In an auction scenario, bidders often use R&W insurance for strategic purposes. If a prospective buyer believes there are likely to be multiple offers at about the same price, they may incorporate R&W insurance in their bid to make it more attractive without having to raise their offer price. “We’re seeing very robust auctions going on. What I think the private equity folks have figured out is that they realize ‘we’re all going to value the target at approximately the same price’, so they think about how they can enhance their bid. There are a number of ways and one of them is to say, ‘look, we’re going to give you full consideration at closing – minus the cost of the insurance policy – because there’s going to be an insurance policy behind it,’” says Stone. And, in a seller’s market, like 2017 and 2018, it’s not uncommon for sellers to mandate that bids include R&W insurance, he adds.

The insurance can be purchased by the buyer or the seller. As for who pays the premium, Stone says that decision is usually part of the negotiation. “The buyer may say ‘we’ll pay for it but we’re getting you – the seller – off the hook and may look to negotiate other areas of the agreement more favorably for the buyer,’” he says.

[If the insured party is the buyer \(a so-called “buy-side” policy\)](#), the insurance reduces or eliminates the need for escrow because the insurance company indemnifies the buyer. If the seller is the insured party (a “sell-side” policy), the seller remains liable to the buyer for breaches, but the policy compensates the insured for covered losses. Buy-side policies are far more common.

The Underwriting Process

Typically, someone actively engaged in a transaction contacts a broker knowledgeable about transaction risk insurance. “Sometimes it’s the buyer, sometimes it’s the buyer’s counsel or the seller’s counsel who get us involved. Or, the seller’s investment banker may approach us and we end up getting introduced to the buyer. Sometimes it’s one of our clients. There are a lot of different ways we get introduced to a transaction,” says Antonecchia.

Stone says lawyers are his biggest source of referrals for R&W insurance, though sell-side investment bankers also come to him. “It’s pretty clear why investment bankers are interested in having R&W insurance in the transaction,” Stone says. “They don’t get paid till the deal actually closes and R&W insurance really facilitates closing,” he says.

To obtain quotes, Stone says the broker typically needs some sort of management presentation or narrative, the target’s (seller’s) financials, and a draft of the purchase agreement. The broker then puts together a submission that he or she takes to market, seeking upwards of 10 quotes. The quotes – or indications – include the quote and retention amount, the limits, and non-binding, high level terms.

The broker presents the indications to the client. If the client decides to go forward with the insurance, they choose an insurer and pay an underwriting fee from \$30,000 to \$50,000. The underwriting process starts “when exclusivity is given,” and the underwriting fee is paid. The carrier is given access to the transaction data room, as well as access to all third-party diligence reports. Depending on the situation, the underwriter may hire outside counsel to help them review the information. Before binding the policy, the underwriter will have a call with the insured and all the advisors. Because the parties to the deal are usually interested in moving quickly, the underwriting process is often on a fast track. “We’ve done it as quickly as five days, but it’s usually about two weeks.” says Stone.

R&W policies are tailored to the transaction and the parties take great care drafting the policy wording. [Definitions of what constitutes a breach](#), what costs and losses are covered, and the definition of knowledge are particularly important. Buyer’s counsel typically negotiates with the broker on the policy wording.

Coverage Amounts and Cost

R&W coverage is usually based on a percentage of deal value, up to a cap. On a \$100 million deal, for example, the policy limit normally will be 10% (\$10 million).

The premium is simply a percentage (these days about 2%-3%) of the policy limit. As well, most policies have a retention, which functions like a deductible. The retention is intended to ensure that the seller has “skin in the game,” explains Antonecchia. “There are retentions under all R&W policies,” says Stone. “It’s pretty much 1% of the value of the transaction. So, on a \$100 million deal, the retention will be \$1million. It can be split a number of different ways. For example, the buyer and seller could split it 50/50,” Stone says. Interestingly, some policies include a provision whereby the [retention drops on the first anniversary of closing](#).

Claims History

AIG, which has been offering R&W insurance since the late 1990s, [is on the forefront in terms of publishing information about their R&W insurance claims history](#). Over the years they have refined their claims analysis by, among other criteria, deal size, industry, and claim frequency by breach type. According to Mary Duffy, global head of M&A insurance at AIG, their aim in providing this information is to help clients. “[A]s we build and refine this claims data – it can be used to help clients and their counsel negotiate better deals. By better understanding where deals get tripped up, they may be able to refine the way they carry out their due diligence,” she says.

In AIG’s experience, claims are made on about one in five R&W policies. With respect to larger deals – deals over U.S. \$1 billion – the claim frequency approaches one in four policies written. AIG believes the high percentages with respect to larger deals is a reflection of the inherent complexities of large M&A transactions.

The materiality, or severity, of R&W claims is also noteworthy. For settlements in excess of U.S. \$10 million, for example, AIG’s average payout is about U.S. \$19 million. For claims in the U.S. \$1 million – U.S. \$10 million range, the average payout is about U.S. \$4 million. AIG

reports that nearly half of all material claims are in this mid-sized distribution (U.S. \$1-10 million)

“When a claim is big, it’s often very big,” says Stone. He explains the reason as follows: “Let’s say the claim is for a financial statement breach. The majority of buyers are buying based on a financial multiple, for example, an EBITDA multiple. If a financial statement rep has been breached because there was some non-recurring item in the income statements that everyone thought would be recurring, but then it isn’t and the result is a drop in the EBITDA number, the claim isn’t just for the first year loss but based on the multiple used to value the company,” he says.

As for what types of reps give rise to most claims, AIG says that the types of breaches that result in the most claims in North America relate to reps regarding compliance with laws (18%), financial statements (17%), and material contracts (14%).

AIG also reports that claims are being made “in a more timely fashion”, with about one-third of all claim notifications made in the first six months. As well, they’ve noticed that clients are presenting claims better. “It is obvious that the clients and their advisers making the claim have a better understanding of what the policy covers and what the insurer will need to see in order to evaluate the claim effectively,” says Duffy.

Conclusion

R&W insurance has been around for about 20 years, but over the past few years it has truly “come of age”. The number of transactions that rely on R&W insurance has been on a steadily rising trajectory. With more-and-more buyers and sellers (and their advisors) recognizing that R&W insurance can help smooth – and often speed up – the deal making process, insurers are also recognizing it’s a market they want to be in.

“The expansion of the underwriter base in the R&W insurance marketplace has been nothing short of remarkable. Just a few years ago, we could find that our clients had only one (or even no) option for a difficult-to-place risk, given the limited number of players in the market. That same risk today would likely attract multiple and attractive quotes from insurers,” says Craig Warnke, a managing director in Marsh’s transactional risk practice.

>>>>M&A Stats<<<<<

The latest figures available on mergers and acquisitions (M&A) are impressive. Worldwide, [for the first nine months of 2018 the value of M&A deals hit a record U.S. \\$3.3 trillion](#), according to Thomson Reuters. That’s the strongest first nine months since they started tracking M&A in 1980, though it should be noted that the third quarter was down 38% from the second quarter.

According to the Institute for [Mergers, Acquisition and Alliances \(IMAA\)](#), in 2018 there were just under 3,195 M&A transactions in Canada with a total deal value of U.S. \$194.5 billion. The number of transactions in 2018 is down from the all-time high of 3,612 in 2017, but the combined value of the 2018 deals is nearly U.S. \$30 billion more.

There's very little hard information about the percentage of M&A deals that include R&W insurance. "While it's difficult to put a precise percentage on the deals using R&W insurance, we can affirmatively state that it is simply market standard for middle-market M&A deals to feature a buyer-side R&W policy. The increase in usage of the product over the past two to three years in North America is tremendous and shows no signs of abating," according to Craig Warnke, a managing director in Marsh's transactional risk practice out of the U.S. Jason Stone of Aon's M&A Transaction Solutions estimates that in private M&A deals in North America, about 30-40% of the deals have R&W insurance.

John Antonecchia, head of the M&A practice at BFL Canada, estimates that in Canada, on transactions above \$25 million, probably 40% - 50% have used R&W insurance, and it's likely to be discussed on 80% - 90% of transactions in this category.

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