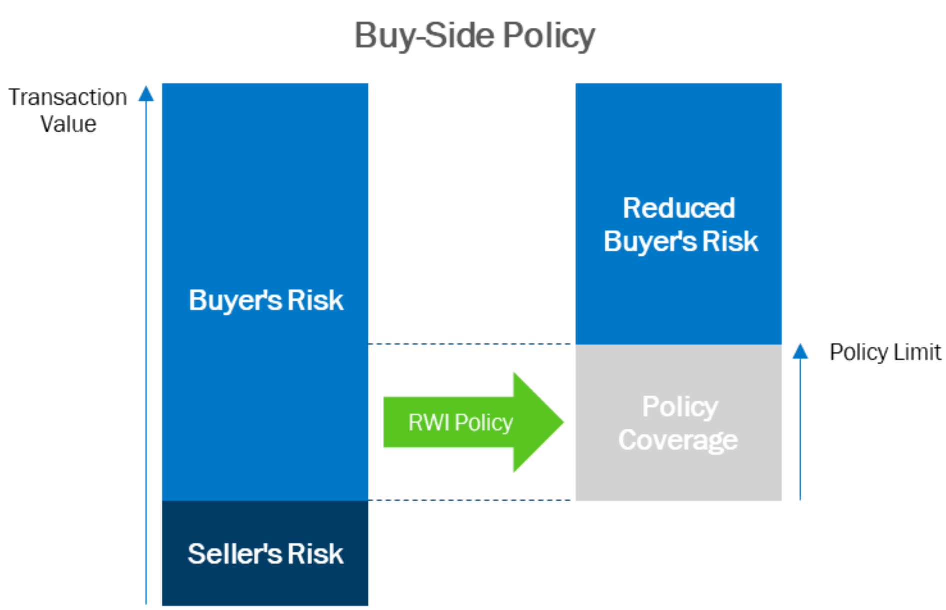
Leveraging Representations and Warranties Insurance in M&A Negotiations

Representations and warranties insurance ("RWI") has proliferated throughout the Canadian M&A marketplace in recent years as a tactical tool for M&A negotiations[i]. Robyn Weber, Vice President and Private Equity Practice Leader at HUB International, a North American insurance brokerage firm, spoke to us about RWI, their use cases, and her thoughts on where the value lies in these policies. From Robyn's perspective, a lot of clients in Canada have started to use RWI after being made aware of it during cross-border transaction discussions. Further, she notes that a decrease in RWI policy pricing has made them more applicable in transactions with smaller purchase prices, even as low as the $30 to $50 million range.

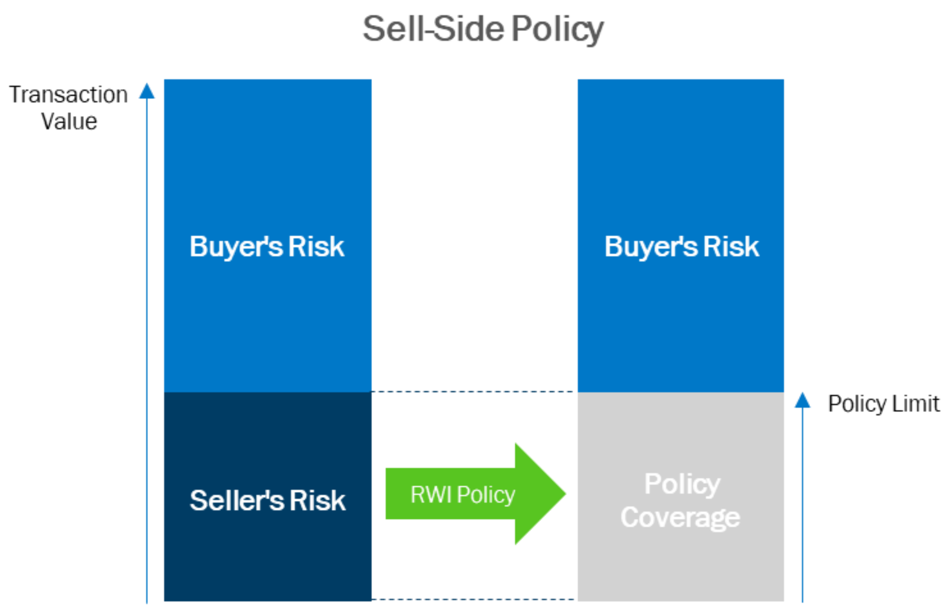
While we at Valitas are by no means legal experts, the increased use of RWI in recent years for managing risk in M&A processes has caught our attention. This article will focus primarily on the tactical applications of RWI policies and how they can be an effective tool in M&A negotiations.

But first, as a refresher, a brief overview of RWI and how it works. In a typical M&A transaction, negotiations occur between the buyer and seller to determine appropriate risk allocations. This often plays out in the form of representations and warranties, covenants, indemnities, and escrows among other risk-allocating mechanisms. Occasionally, buyers and sellers can't agree on a set of indemnities that fit their respective risk profiles and this derails the transaction process[ii]. RWI allow for the transfer of this risk to a third-party insurer, who underwrites these risks for a fee[iii].

In the case of a buy-side policy, instead of a buyer seeking indemnity from the seller for losses, the buyer makes the claim directly with the insurer. The diagram below illustrates how a buy-side policy reduces the risk the buyer bears in a transaction. It's important to note however, that the policy could theoretically cover 100% of the transaction value.



Alternatively, the seller can have a sell-side policy, in which case they will be reimbursed directly through the insurer in the event of a successful claim. The main difference in coverage between a buy-side and a sell-side policy is that a sell-side policy is capped by the amount of indemnity listed in the purchase and sale agreement, whereas a buy-side policy can be up to 100% of the transaction value as mentioned earlier.



Robyn mentions that to get the most out of RWI, buyers and sellers should start the conversation as early as possible. As an example, if both parties agree early on to use RWI, then the seller who was initially willing to give 20% indemnity/escrow can negotiate with the buyer to pay for a portion of the buy-side policy in exchange for reducing the 20% indemnity/escrow to only 5%. Often, sellers may even require the use of buy-side RWI in a competitive auction. Robyn describes the current landscape as "a pretty seller friendly market," explaining that "[sellers] are able to dictate RWI provisions right now."

Beyond shifting risk over to a third party, the benefits of RWI show up in a variety of ways for both the buyer and seller[ii]. A few core reasons are listed below.

Sell-side application:

- Proceed distributions – private equity or venture capital sellers looking to cap their indemnification exposure to free up proceeds for distribution (through a reduced holdback), typically near the end of the life of a fund
- Backstop comfort – when the negotiated indemnification package imposes an indemnity liability on the seller that exceeds what the seller is comfortable with
- Value creation – increased purchase price in exchange for enhanced representation, warranties, and indemnities (where some or all risk is shifted to the insurer)

Buy-side application:

- Distinguishing bids – accepting smaller escrows, lower indemnity caps, and shorter survival periods
- Management buyout – alternative to the buyer making claims against management
- Adding value – the opposite of value creation in sell-side applications; the buyer may negotiate a lower purchase price in exchange for reduced representations, warranties, and indemnities

RWI has been predominantly used by private equity buyers, but strategic buyer use is gaining traction. Robyn describes that the use of RWI "used to only be for the mammoth strategics who were doing larger deals. But we're seeing it more now in smaller strategic deals where the seller's advisors are letting them know these products exist."

The various applications of RWI can be seen through its uses in the following types of transactions, with a more thorough explanation of their impact in an article by Blakes:

- Distressed targets
- Competitive auctions
- Time-sensitive
- Cross-border
- Seller has a need for as clean an exit as possible with no holdbacks
- Multiple sellers with several liability
- Sellers with continued business relationships post-closing

There are however, situations where the use of RWI is not the most appropriate:

- Concerns over environmental liabilities, future adverse tax rulings, or pending litigations
- Perceived risk relating to post-closing purchase price adjustment
- Transaction value less than C$20 million or greater than C$2 billion

RWI has the added benefit of allowing buyers and sellers to quantify the risk, that being the cost of the insurance policy and the retention (otherwise known as a deductible). The typical uncertainty surrounding potential losses and liabilities can now be dealt with more appropriately between the two parties in the transaction. The lack of uncertainty ultimately reduces the back and forth that happens in negotiations and allows for a speedier close.

The combination of increased comfort with RWI policies, decreased costs, and increased protection has made RWI increasingly popular as a tactical tool in Canada[iii]. While RWI may not be for every transaction, there is merit to considering it as a solution to help bridge buyers and sellers with conflicting indemnity needs.

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[i] http://mcmillan.ca/Representation-and-Warranties-Insurance
[ii] https://www.stikeman.com/en-ca/kh/canadian-ma-law/representation-and-warranty-insurance-in-canada-a-tactical-alternative
[iii] http://www.blakes.com/English/Resources/Bulletins/Pages/Details.aspx?BulletinID=2149