



## Assessing The Value Of Representations And Warranty Insurance

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During the past decade, it has become increasingly common for merger and acquisition transactions to include the purchase of representation and warranties insurance (RWI). Mergers and acquisitions typically involve parties making certain representations and warranties to each other about past or existing facts. These often are key components of a deal and can be heavily negotiated by the parties, who then rely on these statements as part of the basis for their decision to close.

It has been common for transactions to include an escrow or holdback account to fund the seller's potential indemnity or other obligations, including obligations that might arise from a breach of a representation or warranty. RWI can be an attractive substitute or supplement for such escrow arrangements.

RWI can help facilitate the closing of a transaction in several different ways. Either a buyer or seller can purchase RWI, but most often it is the buyer who procures the policy to protect against the risk of the seller's breach of representations and warranties. Sellers may prefer that a buyer procure RWI because it helps provide finality to the transaction, potentially reducing or eliminating the seller's indemnity obligations or other contingent liabilities. Having RWI also may reduce or eliminate escrow or holdback requirements that reduce the proceeds the seller otherwise would receive at closing. For that same reason, a buyer competing against other bidders might make an offer that includes RWI to enhance its attractiveness by immediately putting more money in the seller's pocket.

The buyer also can bolster its own financial protection by purchasing RWI in amounts greater than the seller otherwise might be willing to fund an escrow or holdback account. RWI can further help alleviate any concerns the buyer

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might have about the seller's solvency post-closing.

These and other benefits of RWI are well understood. There also are potential hazards if parties view RWI as a substitute for proper due diligence. Commentators have observed that RWI can create a "moral hazard" because it could reduce the amount of due diligence parties conduct to verify the assumptions and understandings on which a deal is based: "When a buyer or a seller purchases [RWI] they are paying the insurer to take on the risk instead of bearing it themselves. The potential problem is the uncertainty over their incentive to identify all of the risks." [1] Assuming parties are not lured into this trap, RWI is an available tool that can help get a deal done.

With RWI becoming more common, but still being a relatively new phenomenon, dealmakers may wonder about the likelihood that RWI will respond to a claim in the event one must be made. Evaluating that issue can be challenging. As one author has noted, "very limited information is available in the public domain regarding sustainability of the [RWI] product, as well as consistency and predictability of claims." [2]

Insurance brokerage firm Aon recently published a study of its experience with 340 claims made on 2,450 RWI policies it had placed in North America between 2013 and 2019. It concluded that 30 percent of these claims had been resolved and that 54 percent of claims remained active. Only 4 percent had been denied outright, but 12 percent were characterized as "inactive" (defined as no correspondence being provided in more than one year). The study found an overall percentage of claims being made on 22 percent of policies that had been placed between 2013 and 2017.

The Aon study noted an increasing number of claims being filed, with the percentage of claims noticed to insurers increasing from 18.6 percent on policies issued in 2014 to 25.3 percent on policies issued in 2016. Aon concluded that RWI insurers had paid \$350 million in excess of policy retentions under the policies that were the subject of the study, with an average claim payment of \$107 million in 2019. The study determined that 26 percent of all claims paid in 2019 exceeded \$10 million.

Although the figures in the Aon study represent the experience of only one broker, they offer a certain amount of encouragement to parties considering RWI policies, given that the percentage of outright claim denials appears to have been low. The percentage of claims that remain active, however, appears to show that the claims process may be complex and require negotiation or dispute resolution.

Insurer AIG publishes an annual Global M&A Claims Study that also provides some limited insight into claims experience. Like the Aon study, AIG's 2019 study found a general increase in the frequency and severity of RWI claims. It also observed an increasing number of claims being reported more than 24 months after closing of the transaction insured under the policy. AIG's 2020 study likewise found an increase in the frequency and severity of RWI claims. Neither AIG study contained information regarding the percentage of claims paid or denied, nor any information about the amount of money paid on claims.

While these published studies provide a limited glimpse into RWI claims experience, there still remains a great deal of uncertainty with respect to how disputed RWI claims are resolved. Many RWI policies have not yet even reached the end of their "life cycle" in terms of the period for which coverage was provided. In addition, many RWI policies contain provisions requiring disputes over coverage to be arbitrated. Any claims disputes resolved

through arbitration generally do not become public knowledge.

There have been few reported judicial decisions that interpret or apply RWI policy terms. The reported decisions that do exist deal primarily with disputes over issues such as whether the loss amount at issue exceeded the policy's self-insured retention, or whether alleged failure to comply with notice or consent-to-settle provisions barred coverage.

In the absence of guidance from courts, dealmakers considering purchase RWI would be wise to study carefully the provisions of any policy they are considering. Parties also should review a prospective policy as early as possible in the transaction process. The decision whether to purchase RWI should include a careful weighing of the likelihood of recovering from an insurer versus the likelihood of recovering from a seller or an escrow account established as part of the transaction. Ideally, this evaluation should be performed in consultation with experienced insurance coverage counsel who can advise the potential insured on key coverage terms and perhaps help guide the broker's negotiation of provisions tailored to the precise transaction at issue.

Parties also must not let the existence of RWI in a transaction induce them to forgo scrutiny of the representations and warranties that could be the subject of a claim. Many RWI claim disputes are likely to involve highly fact-sensitive disagreements about whether a representation or warranty was, in fact, breached. The drafting of agreement terms, therefore, could become critical to the outcome of a claims dispute.

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[1] Max Hyatt, "Warranty and Indemnity Insurance: Proliferation of Moral Hazard or Legitimate Risk Mitigation Tool?" 51 U.S.F. L. Rev. 127, 143 (2017) (internal footnote omitted).

[2] Rupesh Mishra, 20 Bus. L. Int'l No. 2 165, 177 (2019).