Representations and Warranties Insurance: A Tool for Mitigating M&A Downside Risk

Acquiring Representations and Warranties Insurance is an often-overlooked strategic tool in the M&A toolbox, but one that can potentially benefit both those on the buy and sell side of a deal.

There is risk inherent in any transaction, and Representations and Warranties (or R&W) Insurance mitigates the risk that comes with valuing an asset that may have an unforeseen negative impact to that valuation following completion of the transaction (such as a financial statement error, unpaid tax or lien, for example) the seller may not have disclosed and wasn’t discovered during the due diligence process. With R&W Insurance, the buyer could seek compensation from the insurer of the transaction to offset the negative component of the deal.

Conversely, a seller could benefit as it would eliminate the need for the acquirer to place part of the purchase price in escrow in the event of such a post-close discovery – receiving virtually the entire purchase price at close. “The R&W product is meant to cover a buyer for damages that the buyer suffers as a result of a breach of representation for matters that are unknown to that buyer at the time of signing,” explains Gaurav Sud, Senior Managing Director for Aon Transaction Solutions.

Aon plc (www.aon.com/m-and-a-transaction) is a leading global professional services firm providing a range of risk, retirement and health solutions.

Here’s how it works: The insurance is typically placed concurrent with execution of the transaction. The underwriting of the policy will run in parallel with not only negotiation of the agreement but also completion of the buyer’s due diligence investigation, as the policy is very directly informed by the scope and results of that due diligence investigation. The insurer is typically engaged at some point prior to signing of the transaction (ranging anywhere from a few days to a few weeks or more) so the insurer can line up the coverage from the market, facilitate the underwriting and negotiate the policy with a view to lining everything up at the signing table.

While there is no actuarial model or similar type of analytics in this space (at least not yet), pricing tends to be more art than science. Very generally, pricing sits in the vicinity of 3-4% of the limit of liability sought. This is a one-time payment, meant to be allocated between the parties as they see fit/in keeping with the business deal, and there is no ongoing payment(s) for the life of the policy.

Sud estimates that over one-third of all private M&A transactions are now using R&W Insurance, which shows significant growth over the last half a decade. “It used to be a product that sat really on the fringes on the M&A landscape and was only used in very rare instances in a completely reactive way as recently as six or seven years ago,” he says.
According to Sud, acquirers are using the product not because they think the deal needs to be insured, or because there's some adverse diligence finding, but because the way the product is priced today and the way it's executed today allows for a more efficient way of doing a transaction. “So, it's a tactical tool, it's a strategic tool more so than a traditional insurance product,” Sud says.

In such a transaction, the seller is getting that clean exit for pennies on the dollar, the buyer that has downside protection. This enables both parties to focus on the meat of the transaction while the risk of misrepresentation, or the buyer not uncovering downside risk during due diligence, or the seller not telling the buyer something resides in the insurance market.