Does reps and warranties insurance make sense for a search fund deal?
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By August Felker

Over the past 18 months or so, we've seen a notable uptick in inquiries from clients and friends in the search fund community regarding reps and warranties insurance (RWI). As such, I thought I'd pull together a post highlighting the basics of RWI, including the pricing, the coverage terms, and some practical discussion around what's needed in order to procure a quote. Special thanks – in no particular order -- to Raam Jani, Jon Herzog, Ed Markovich, Ivy Okoniewski, Heather Endresen, Jason Stuke and Larry Conrath who helped add valuable insights to this write-up.

The coverage basics

A RWI policy insures against certain breaches of the reps and warranties outlined in a purchase agreement as part of an M&A transaction. It can function as a stand-alone source of recovery for damages, or work in concert with traditional indemnification provisions. Policies can be purchased by the seller or the buyer – although, greater than 80% of the time the policy is in the buyer's name, which allows the seller to extract themselves from the claims process. Finally, and of particular note to the growing global search community, policies can be arranged for domestic and international transactions.

Typically, a RWI policy is priced in the range of 2 to 4% of the total insurance limit purchased, which is often the indemnity cap on a transaction. For smaller deals, like those seen in the search fund community, the minimum cost after premium, taxes and underwriting fees is in the range of $150k. There is a minimum retention (deductible) on each policy that roughly equates to 1 to 1.5% of the total deal value. Minimum premiums and retention levels can be an obstacle for smaller transactions -- more on this topic later on.

We've seen a jump in the number of insurance carriers participating in the RWI market. The traditional players include AIG, Chubb, and Lloyds of London – all of which are well-known, reputable insurance companies with strong track records of claims handling and service. There are also a handful of smaller, niche players in the market – many of which are developing bespoke offerings in related transactional liability products such as successor liability, contingent liability, and tax indemnity policies. Similar to general business insurance, RWI is purchased through a broker.

RWI is a non-standard insurance product, meaning that no two policies are alike. However, in general, policies are designed to pick-up coverage for breaches associated with financial statements, tax, title, contracts, intellectual property, data, and insurance. Common policy exclusions include scenarios involving purchase price adjustments, forward looking warranties or guidance (revenue projections, for example), underfunding of pensions, wage and hour claims, and usability of Net Operating Losses, to name a few. As far as the exclusions are concerned, in some cases alternative insurance products can be purchased to help fill the gaps.

State of the market

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RWI has been around for nearly two decades and there's been an established record of successful claim outcomes experienced by policyholders. The rising popularity of the coverage has helped to draw more insurance carriers to the market, which in turn has led to more favorable pricing, terms, and retention levels.

I interviewed several insurance industry leaders for this post, and nearly everyone I spoke to marveled at the rapid spread of RWI in private equity and, more recently, amongst strategic buyers.

Edward Markovich, who leads Chubb's RWI practice in New York, noted that Chubb has experienced "a 25 to 50% year-over-year growth – each of the past five years -- in submission activity and written premium."

Ivy Okoniewski, an M&A Underwriter from AIG, had a similar perspective. "In the past two years we have more than doubled our team, yet still we remain busy and continue to grow." AIG, like other carriers in the space, is ramping up their underwriting staffing to meet the demand in the marketplace.

Members of the search fund community are observing an increase in RWI too. Raam Jani, of McDermott Will & Emery LLP, noted that "with RWI moving down market into the enterprise value ballpark in which search funds typically play, RWI should continue to see increased utilization on both the buy-side and sell-side of search fund transactions."

I also spoke with Jon Herzog, of Goodwin Procter LLP, who said that "nearly all of the search fund exits we have worked on in the past 18 months have been to lower middle market PE firms. In those deals, we have been pretty successful in requiring the buyer to rely on RWI and forgoing the traditional 7-10% escrow structure which creates certainty of receipt and improves IRR."

RWI for Search Funders?

If you're a searcher in acquisition mode, there are several reasons to consider adding RWI to your deal toolkit. First and foremost, because you'll be able to draw on insurance in the event of a rep and warranty breach, you can request a lower than customary level of indemnification from the seller. This could help distinguish your offer in a competitive process, and ease tensions with the seller around indemnification negotiations. Also, from a practical perspective, the actual filing and collecting on a claim can be much smoother with an insurance company on the hook as opposed to pursing the seller, especially if the seller remains actively engaged with the business after closing. Finally, policies can be negotiated to outlast the survivability period by years longer than the underlying indemnity terms in the purchase agreement.

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If you're a searcher looking to sell your business, buying, or insisting on the buyer purchase, a RWI policy might be a smart move too. By freeing up escrow or hold-back monies you can have a "clean exit" and distribute those funds to your investor group.

Additionally, an RWI policy protects passive investors against future claims from the buyer. Raam thinks that RWI makes sense, especially from the investor perspective: "We have seen RWI used as a tool to allow search fund investors to receive essentially full distribution of proceeds from a sale transaction without having to sign up for direct indemnity obligations and/or extended escrows."

Before moving forward in pursuing a RWI policy for your deal, it's important to determine if the coverage makes sense financially. On smaller transaction sizes, where less than $5m of coverage is being sought, minimum premiums and the retention levels can be a substantial percentage of the overall insurance limit. And there is a lesser appetite in the underwriting community. In our discussions, the folks at Chubb brought up a good point regarding the challenge of insuring smaller deals: "From an underwriting perspective, the diligence materials that we're provided with on smaller deals can be less comprehensive than what we see on the larger transactions. As a result, it can be more difficult for our underwriting teams to get comfortable with particular risks, and thus the underwriting process is more arduous for all parties involved."

What's required to receive a quotation?
In nearly all cases, the underwriting process is broken down into two phases:

Phase 1 - Indication: Policy buyer provides CIM, draft transaction documents, and financials. Insurance company provides pricing indication and terms. This process can take roughly a week.

Phase 2 – Binding: The insurance company begins their own due diligence, which can include engaging their own internal and external experts. During this phase, policy wording and pricing is negotiated with the help of the buyer's insurance broker and legal counsel. There is also a non-refundable due diligence fee that the underwriter will collect prior to beginning phase 2, which is approximately $20k to $40k, depending upon the deal. Phase 2 can take 10 days or more.

Premiums and fees are due up front, but RWI can be financed as part of the transaction. Heather Endresen, of Live Oak Bank, told me that if an RWI policy makes sense on a given transaction, the premium could be included in an SBA financing package.

Please feel free to reach out to me at august.felker@hubinternational.com, or at (415) 425-6093 if you have any questions or are seeking additional information. Our team specializes in providing insurance solutions to the search community.

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Sources and Additional Resources

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