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Representations and warranties insurance: a relevant deal tool for acquisition finance?

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The current acquisition environment is largely incompatible with some financial contingencies, and a buyer's ability to exit an acquisition agreement if financing is not available at closing is very limited. As such, the creditworthiness and financial standing of a potential purchaser will be closely scrutinised by the seller, and in any business acquisition, notably in a share deal, the financing strategy needs to be clearly shaped from the outset by the purchaser while structuring the deal to ensure the availability of necessary funds to consummate the acquisition.

What then is representations and warranties insurance ('R&W insurance'), also known as warranty and indemnity insurance, and what role can it play in acquisition finance?

R&W insurance aims to cover the so-called transaction risk inherent in the acquisition of companies, that is, the risk of default in the event of incorrect or false representations or warranties provided by the seller in share purchase agreements (SPAs), transferring these risks in whole or in part to an insurer as a risk mitigation tool.

R&W insurance has emerged over the last few years in the Portuguese insurance market, and players (ie, insurers, brokers and lenders) are becoming more acquainted and familiar with the potential of this insurance product.

From a lender's perspective, the target's financials are extremely important because the company is expected to be an asset that will generate the returns necessary to repay the loan taken out for the acquisition. R&W insurance may provide a way for the purchaser to gain support from lenders, to the extent that, with R&W insurance, an added layer of comfort is built into the risk matrix. As such, R&W insurance not only constitutes a deal facilitation tool within the acquisition, but also may play a role in providing additional coverage for a buyer in satisfying the lending banks. Consequently, lenders are becoming increasingly aware of the advantages of this bespoke insurance product.

From a credit risk perspective, underwriting R&W insurance can play a significant role in acquisition finance in cases, for instance, where a purchaser has already negotiated with an insurer for R&W insurance (as so-called 'stapled' insurance) and, as such, may obtain better financing with the lenders.

Below, we describe the main features of R&W insurance.

Three reasons are typically given for the growth of R&W insurance: first, the time involved to negotiate this insurance product has decreased significantly in recent years; second, the premiums payable by the policyholder have fallen; and third, M&A practitioners are increasingly familiar with R&W insurance, recognising it as another tool in negotiating SPAs.

As with the acquisition finance process, R&W insurance is tailor-made, that is, adjusted to the circumstances of each transaction. Both the policyholder and insurer must agree on the exact definition of the risk covered.

The use of representations and warranties, as a risk distribution mechanism in SPAs or indemnities contractually agreed between the parties and clauses envisaging breach of representations and warranties by the seller, are in and of themselves not sufficient to fully mitigate transactional risk. In fact, after the completion of a typical SPA, the seller maintains not only its contractual liabilities, which it wishes to minimise, but may also have to maintain additional guarantees required by the buyer in acquisition transactions (eg, bank guarantees on first demand, the withholding of part of the purchase price by the buyer during a warranty period, and escrow arrangements), which the seller hopes to avoid.

R&W insurance provides an alternative that the parties – either the buyer or seller – can negotiate with an insurer, involving documentation that, although increasingly standardised, follows in each jurisdiction the specificities inherent to the respective insurance market.

The insurer's (parallel) participation in the transaction should occur as early as possible, avoiding delays to the completion of the acquisition and, above all, allowing an examination of the so-called due diligence material, namely the due diligence report. The insurer will want to examine the representations and warranties – and any indemnities – contained in the SPA and to comment on them.

An insurer usually enters the business acquisition process once the due diligence report has been concluded. Negotiations over the SPA will thus already be well advanced. A broker, not infrequently, directs a quote request to a set of insurers in order to insure the risk. Once the insurer is selected, the insurer, assisted by consultants, initiates its own due diligence in order to determine the risk to be covered by R&W insurance.

Without prejudice to the buyer being able to cover its risk through other supplementary or alternative instruments, there are several advantages that can arise for the buyer from the use of R&W insurance, besides obtaining support from the relevant lenders:

- the buyer ensures that any harm that may result from a breach of the representations and warranties given will be effectively repaired within the insured limits regardless of the seller's financial situation;
- any 'friction' between the parties during negotiations is reduced, particularly where the seller severely reduces its liability or the claim period;
- it introduces the possibility of cash-out schemes, which are often an essential condition for the seller to carry out the transaction;
- the seller maintains its presence in the acquired company either by means of rollover equity or by continuing to perform relevant functions at the management level;
- the buyer has an interest in protecting the post-acquisition business relationship;
- the use of R&W insurance preserves the buyer's position in a competitive sale process, with the insurance being used strategically; and
- any claim will be addressed to the insurer.

From the seller's perspective, R&W insurance presents the following advantages:

- if the seller is a private equity fund, R&W insurance allows for a clean exit, that is, the selling price of the company can be immediately distributed to investors with reduced or no tail liability and without the need to make traditional escrow arrangements, requiring the freezing of monetary funds within a specific period of time;
- increased certainty regarding the risk exposure on conclusion of the sale and purchase of a company, reducing or eliminating the risk from specific representations and warranties;
- in multiple vendor situations, where there is a reduced degree of knowledge or control over a target company, the seller would normally have joint and several liability at the level of the SPA, but can obtain several liability through R&W insurance;
- the insurance improves the bargaining position of the seller, who will be in a position to require the immediate payment of all or part of the purchase price; and
- the insurance allows the seller, in a competitive sale process, to include documents in the transaction and to propose R&W insurance to potential buyers from the outset.

As a rule of thumb, the R&W insurance coverage period begins with closing the transaction, but nothing prevents the parties from agreeing for it to commence on signing. Typically, on the seller's side in R&W insurance, the terms of the policy reflect the survival period of the representations and warranties set out in the SPA. The policy of the buyer tends to prolong and extend this period.

Without prejudice to the application of the back-to-back principle, it is no less true that insurers will tend to exclude inappropriate risks, in the context of the policy, not providing cover in R&W insurance for the purchaser's known risks as listed in the data room, due diligence report or disclosure letter annexed to the SPA; the fraud or wilful misconduct of the policyholder or insured person; in the case of R&W insurance of the seller, any purchase price adjustments; risks not legally insurable; other contractual obligations; environmental issues; any pending litigation; or modifications to the SPA without the agreement of the insurer.

The current practice is the payment of a single insurance premium at the time of concluding R&W insurance, which is non-

renewable. As a rule, a deductible is agreed in line with the amounts agreed in the SPA. It is a claims-made policy.

R&W insurance as a risk allocation mechanism is not a 'magic formula' for any process of business acquisitions. It is a safe type of insurance that had its origins in international insurance practices, and whose steps into the national insurance market will be slow, but (certainly) consistent. It remains to be seen how interest in this insurance product will develop in the Portuguese insurance market and how lenders will recognise the importance of R&W insurance within their decision-lending process.