REPRESENTATION AND WARRANTY INSURANCE DEAL DYNAMICS: OPTIMIZING EFFICIENCIES AND CREATING WIN-WIN SITUATIONS

PART I: DUE DILIGENCE

This article is the first in a series of articles designed to provide guidance and spur further discussion among deal makers and transactional risk insurance market participants regarding the ways in which representation and warranty insurance and other transactional risk insurance products can continue to drive an improved and more efficient approach to merger and acquisition transactions.

This first article discusses structuring the due diligence process in order to efficiently achieve the goals of the parties to the transaction and the representation and warranty insurance provider.[1]

WHAT LEVEL OF DUE DILIGENCE IS EXPECTED BY THE DEAL PARTICIPANTS? WHAT LEVEL OF DUE DILIGENCE IS EXPECTED BY THE UNDERWRITERS?

Determining the scope of due diligence to be conducted before executing an acquisition agreement and closing a transaction has always been a discussion between buyers, sellers and their respective advisors. When representation and warranty insurance and other transactional risk insurance products are utilized, that discussion is expanded to include insurance brokers and underwriters involved in procuring and issuing deal insurance in order to maximize coverage and identify any potential coverage gaps.[2] The diligence process must be informed by current events (among other things), for example, beginning in 2020 the effects of the COVID pandemic, in 2022 the war in Eastern Europe, including legal compliance with recently imposed sanctions, and in 2023 exposure to bank

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[1] These goals tend to be more aligned than many might expect. While significant risk is transferred to the representation and warranty insurance provider, the policy retention and coverage limits generally result in the insured retaining some risk. Even the most efficient claim process involves time and cost in pursuing a claim and the potential for a denial of the claim or an imperfect damage assessment. As such, sophisticated deal makers generally prefer a robust diligence process that is designed to uncover issues which can be addressed by the deal teams before executing an acquisition agreement rather than procuring what might be viewed as broader insurance coverage due to a less thorough diligence process and thereby having to resort to making a claim against the representation and warranty policy to recover a loss that may have otherwise been discovered through a robust diligence process.

[2] Even with the involvement of these additional parties in the process, deals that involve representation and warranty insurance often proceed at a faster pace and can get finalized more quickly than deals with more traditional indemnity structures. A key commercial focus for transactional risk insurance market participants is ensuring that the underwriting process proceeds in parallel with the underlying transaction process.

failures, such as Silicon Valley Bank and Signature Bank, and the related risks associated therewith.

Agreeing on the scope of due diligence, taking into account the views of the representation and warranty insurance underwriter, is important because representation and warranty insurance shifts the risk of exposure resulting from unknown matters following a reasonable due diligence review conducted by the insured and its advisors from the Buyer to the insurance company. If a reasonable due diligence review is conducted and no issues are identified which impact the accuracy of the representations and warranties or pre-closing tax exposure, absent specific risks deemed outside the bounds of coverage,[3] coverage will generally be free of transaction specific exclusions.[4]

What constitutes a reasonable due diligence review of a particular area of risk is often analyzed by reference to what is considered market practice in light of the potential materiality of the risk being reviewed. In the vast majority of cases, underwriters accept a good faith determination by the parties and their advisors regarding the level of diligence to be conducted. However, in certain cases an underwriter may have a different perspective on the level of diligence that should be conducted in order to avoid a coverage exclusion. This can occur because underwriters are often assessing the materiality of a risk based on the amount of the policy retention while deal participants are often assessing materiality based on the total enterprise value of the transaction. In addition, underwriters have access to a large volume of transaction and claims data, not only in the representation and warranty insurance line but other relevant lines of insurance, which may influence the underwriter's perspective. The determination as to what is "material" and a reasonable or "market practice" diligence review then becomes the topic of significant conversation in the representation and warranty insurance underwriting process. It is key for deal participants, underwriters and brokers to have a mutual understanding and agreement early in the process regarding the level of diligence the deal parties and their advisors expect to conduct and the extent to which that meets the expectations of the underwriters and their advisors. If this understanding and agreement can be achieved before a non-binding indication letter or term sheet is executed between the potential insured and underwriter, the process will be more efficient and effective for all involved.[5]

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3 Quotes and non-binding indication letters obtained by deal participants from prospective insurers set forth the exclusions from coverage underwriters intend to impose regardless of due diligence findings.

4 Representation and warranty insurance policies contain certain standard exclusions such as loss arising from asbestos or polychlorinated biphenyls (PCBs), transfer pricing, amounts relating to unfunded or underfunded benefit plans and the applicability of existing NOLs in future periods. If the representation and warranty policy contains a pre-closing tax indemnity, matters disclosed on the schedules to the extent related to pre-closing taxes, transfer taxes and amounts accrued on the financial statements for pre-closing taxes (as updated in the ordinary course since the date of the last financial statements) are typically excluded from coverage under the pre-closing tax indemnity.

5 Many transactional risk insurance market participants view this process as the loss prevention service provided by the representation and warranty insurance provider. Just as in other lines of insurance where an initial assessment of risk is conducted and suggestions for mitigation are often provided to a potential insured, the representation and warranty insurance provider's suggestions for the approach to diligence may be similarly viewed.

PARTICULAR AREAS OF DISCUSSION REGARDING DUE DILIGENCE REQUIREMENTS

Set forth below are several issues that we have found tend to generate the most discussion regarding what level of diligence is appropriate.[6]

International Operations

When a business operates in multiple jurisdictions, it is important to determine whether each of the jurisdictions in which the target business operates requires the same level of diligence and whether local advisors are required to be engaged by the insured in each of these jurisdictions in order to avoid a coverage exclusion. Some underwriters use the percentage of overall revenue of the target business that a particular jurisdiction represents as a guideline as to the extent to which local diligence is required. However, even when percentage of revenue is used as a guideline, underwriters generally conduct additional analysis in order to gain an understanding of where the risks lie (and may require additional diligence if areas of additional risk are identified). Additional key considerations impacting the determination as to the extent to which local diligence is required are:

- the number of employees or service providers in a jurisdiction;
- the location of material customers or suppliers;
- the tax structure and related exposure in a jurisdiction;
- whether there are owned or leased properties or assets in a jurisdiction;
- the nature of the operations conducted in a jurisdiction; and
- the compliance history and perceived regulatory risk in a jurisdiction.

Often a path forward involves particular focus on certain aspects of local risk. It is also important to have an agreement as to what lien, judgment, litigation, title and bankruptcy searches or their corollaries are able to be and should be conducted in each relevant jurisdiction.

Material Contracts

The large volume of contracts entered into by businesses can make document review a particularly time consuming and cost intensive task. If something less than a review of all contracts is expected by the deal team, for example, if a materiality threshold will be utilized or only a sampling of contracts will be reviewed, it is important to determine the extent to which that can impact coverage. Getting all parties comfortable with the approach taken often involves discussion regarding:

- how materiality thresholds were derived and how they relate to potential exposure;
- the extent to which form contracts are used by the business at issue;

[6] The areas addressed in this article are not an exhaustive list. Depending on the risk profile of the target business, additional areas such as classification of employees and service providers, customer and supplier relationships and condition of assets and facilities are additional examples of topics which often result in a significant discussion as to the appropriate level of diligence.

- whether the business operates on long term contracts as opposed to short term contracts or purchase orders; and
- the size and method of choosing any sample of contracts to be reviewed.

Newly Acquired Businesses

When a target is a serial acquirer or has engaged in a recent material acquisition, the extent to which particular diligence focused on the newly acquired business or businesses is required should be discussed. Key considerations include:

- the length of time a business has been owned;
- the extent to which the business has been integrated into the larger business; and
- whether or not the newly acquired business has been included in the most recent audit of the target businesses' financial statements.[7]

To the extent a newly acquired business has not been fully integrated and included in the most recent financial statement audit, the diligence to be done on such newly acquired business should be discussed among the deal participants and the underwriters to determine what diligence on the newly acquired business will be required in order to avoid any coverage gaps or to understand the scope of any potential coverage gaps.

Owned Real Property

When a target business owns real property, it is important for deal participants and underwriters to agree on the extent to which a review of current title and surveys is required. When title insurance is being purchased or brought down, a comprehensive review of such documents will generally be conducted. Otherwise, key considerations include:

- the use of and location of the property, and its significance to the target business;
- the history of ownership; and
- the age of prior title and survey work (if any).

Environmental Risks

When representation and warranty insurance underwriters are willing to underwrite environmental risk on a business that has a potential significant environmental impact, environmental diligence including recent Phase I Environmental Site Assessments (Phase Is) and limited environmental compliance reviews (LECRs) are generally required. Where the extent to which the business involves hazardous materials or otherwise has an environmental impact appear somewhat less significant, agreement as to the approach to environmental diligence is important. Key considerations include:

- whether and when the target business has previously ordered Phase Is and LECRs which can be made available to the insured and underwriter,

[7] For acquisitions of new businesses of any significant size, underwriters will generally expect a review of the transaction documents, any representation and warranty policies bound in connection with the acquisition of the new business and an understanding of claims or other contingent liabilities such as earnouts or other additional purchase price requirements relating to the deal.

and whether any recognized environmental conditions (RECs) were identified in the Phase Is;

- whether desktop reviews can be conducted;
- the historical use of the property;
- whether the subject real property is owned or leased;
- the extent to which environmental liability is allocated to the target business through leases, other contracts or relevant law; and
- former sites or operations for which a target business may have contingent environmental liabilities.

Other Due Diligence Considerations

Beyond the scope of due diligence review for certain substantive areas of risk, deal participants, insurance brokers and underwriters should ensure they are in alignment on the proposed insured's allocation of responsibility for its due diligence review between an in-house team and outside advisors. In addition, it is important to discuss the extent to which due diligence findings will be documented. Many deal participants seek to save time and expense by limiting the written work product documenting due diligence efforts. Where parties expect less than comprehensive memoranda or reports from their due diligence teams, it is important to agree on what can be supplied to underwriters and their advisors. Red flag memoranda, less formal summaries, due diligence question and answer trackers or even due diligence call notes can be useful.

In order to avoid unexpected gaps in coverage and optimize efficiency, it is important to agree on the approach at the beginning of the underwriting process.

CONCLUSION

Allocating risk of a breach of or inaccuracy in a representation or warranty to an insurer changes the dynamic and analysis as to the scope of diligence a deal party might otherwise conduct. This dynamic has the potential to be quite beneficial as underwriters' due diligence requirements are based on a review of hundreds of transactions and claims data, some of which was not available prior to the advent of representation and warranty insurance. Representation and warranty insurers are also keenly aware of current events and the implication such events may have with respect to coverage matters. Involving the underwriter and the broker early in the process has the potential to improve due diligence processes and thereby increase the likelihood of identifying an issue prior to signing an acquisition agreement. The parties to the transaction then have an opportunity to negotiate a solution regarding how to allocate the risk between them or otherwise agree on a path to remediation of the risk. This in turn has the potential to increase efficiency in the deal process, increase certainty of closing and result in a win-win situation for deal makers and insurance market participants.

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