

OVERVIEW OF REP AND WARRANTY INSURANCE

OCTOBER 2019 | JOHN SCHREINER AND DAVID GARRIGUS

OVERVIEW

We will cover these common question about representation and warranty insurance:

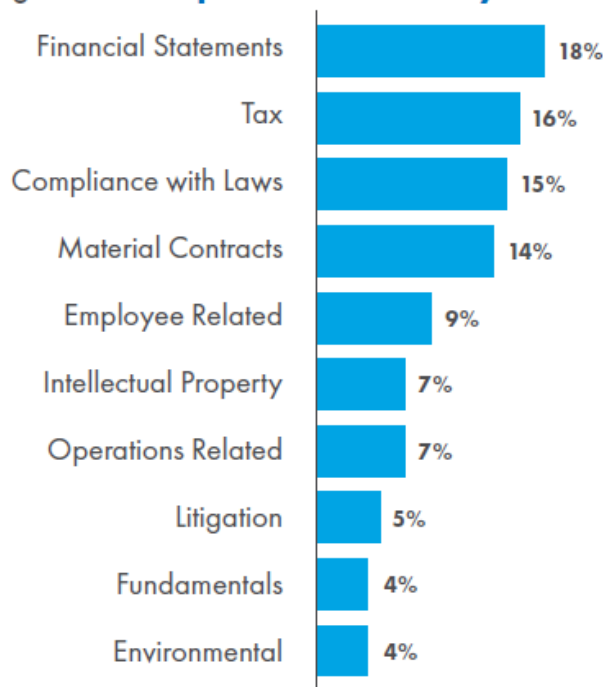
1. What is it?
2. Why would I use it?
3. How much does it cost?
4. What is covered? What is not covered?
5. Do carriers actually pay on these policies?
6. What is the process and how long does it take?
7. How does use by Private Equity buyers differ from use by Strategics?

REPRESENTATIONS & WARRANTIES INSURANCE OVERVIEW

R&W insurance provides coverage for financial losses resulting from breaches of representations and warranties made by the target company or the sellers contained in the purchase agreement.

Generally all representations are covered, including the accuracy of financial statements, compliance with tax, employee benefit and employment laws, threatened or pending litigation, and ownership / non-infringement of intellectual property. Environmental matters may be best covered separately.

Fig 4 R&W Reported Incidents by Breach Type – GLOBAL TOTAL



Source: AIG 2018 Report

REPRESENTATIONS & WARRANTIES INSURANCE CONSIDERATIONS

Buy-Side Considerations:

- Increases maximum indemnity / extend survival period for breaches of representations and warranties - policies often survive for longer periods than in the underlying acquisition agreement
- Alternative to some or all seller indemnity
- Protects key relationships to the extent sellers remain involved in the business
- Elimination of seller post-closing credit risk / ease indemnity concerns
- May distinguish bid in competitive situations

Sell-Side Considerations:

- Distribute sale proceeds to reward investors or pay down existing debt
- Reduce contingent liabilities
- Protect passive sellers from unintentional breach of R&W
- Eliminate obstacles to completing the sale, which expedites the sale and potentially increases the return

R&W INSURANCE TERMS

Limits:

- Often aligned with escrow/holdback requirements
- Limits available from \$1M to \$500M+

Pricing

- Generally 3-4% of policy limits, however pricing can be as low as 2%
- Surplus lines taxes and fees apply in addition to the policy premium

Retentions:

- Generally 1-2% of Enterprise Value, split between the buyer and seller, however deductibles can be slightly lower (such as 0.75% of EV)
- May be reduced in half after 12 months
- May be eliminated for true fundamental representations

Policy Term:

- Generally 3 years for General Representations
- Generally 6 years for Fundamental and Tax Indemnity

Due Diligence Fee:

- Generally \$35,000-\$40,000 payable upon selecting an insurer
- May be as low as \$15,000 on smaller transaction sizes (under \$50M)

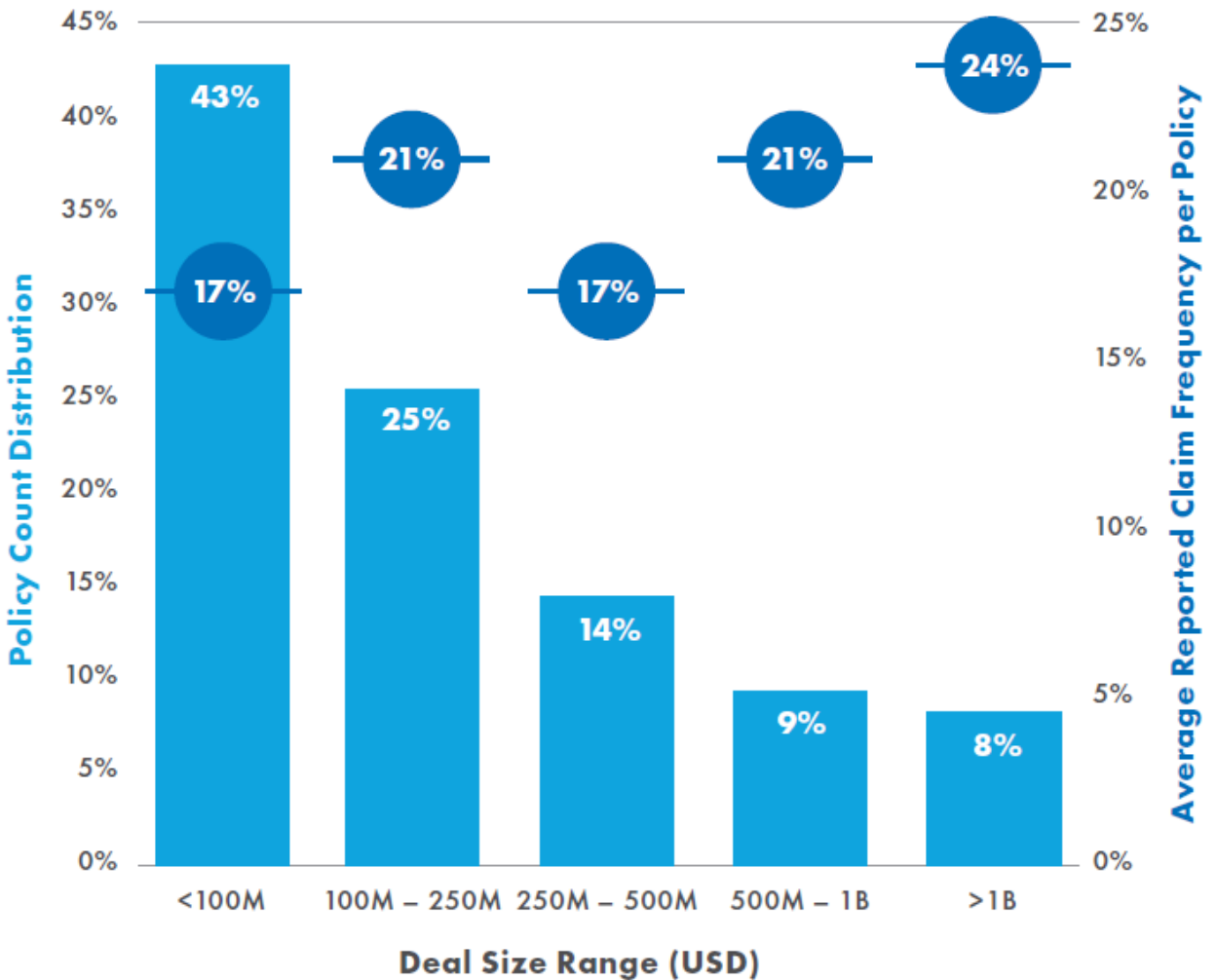
R&W INSURANCE TERMS



Common Exclusions:

- Issues Known to Buyer
- Purchase Price Adjustments
- Covenants & Forward Looking Statements
- Underfunding or withdrawal liability to a benefit plan or pension
- Uninsurable Fines or Penalties
- Transfer Pricing
- Collectability of A/R

R&W INSURANCE CLAIMS 2018 AIG REPORT

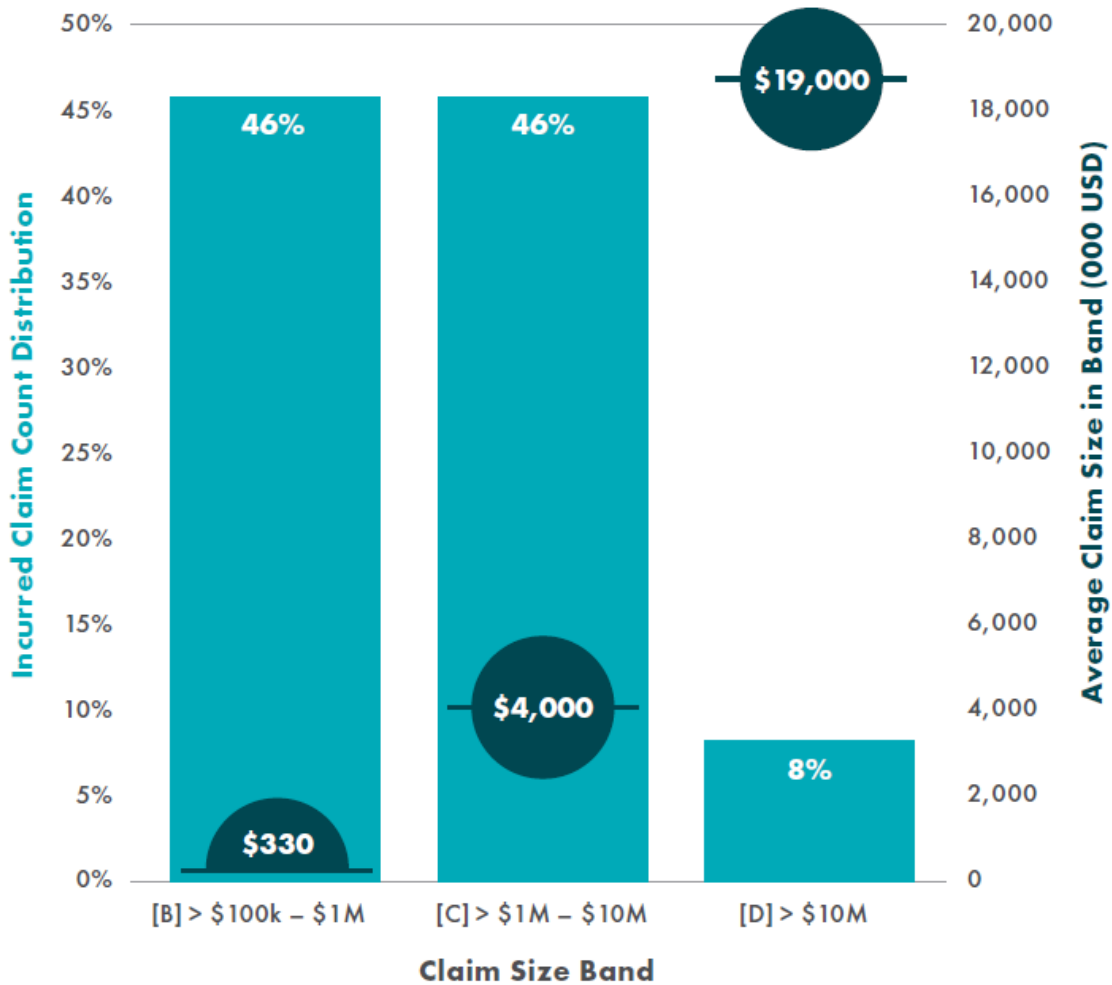
Fig 1 R&W Reported Claim Frequency by Deal Size





-  Average Distribution of Policy Count
-  Average Reported Claim Frequency per Policy

R&W INSURANCE CLAIMS 2018 AIG REPORT

Fig 2 R&W Material Claims – Distribution of Counts and Average Size by Claim Size Band



 Average Distribution of Material Incurred Counts

 Average Historical Severity (000 USD)

R&W INSURANCE MARKETPLACE

There is a robust marketplace for Representations and Warranties insurance. The following insurers are a sample of key insurers.



R&W INSURANCE TIMELINE

Phase 1: Carrier Selection

1. Solicit Non-Binding Indications of Terms and Pricing from insurers. Requirements at this phase generally include:
 - Draft Purchase / Sale Agreement (PSA)
 - Audited financials or unaudited financials with a Quality of Earnings Report.(QoE)
2. Select underwriter from indications presented

Phase 2: Underwriting

1. Pay insurer diligence fee - payable upon entering underwriting
2. Grant underwriter access to the data room and legal, financial, tax and other diligence reports.
3. Conference call with deal team and advisors - generally 90-120 mins in length
4. Policy negotiations - done in parallel with underwriting

Phase 3: Closing/Post-Closing

1. Final versions of purchase agreement, disclosure schedules and a No Claims Declaration (NCD) provided upon signing
2. Payment of 10% deposit premium upon signing, with the balance due upon closing. 100% of premium is payable upon closing (may be aligned with signing)
3. Any remaining “open items” due to the insurer within the time specified

R&W INSURANCE DILLIGENCE

Underwriter diligence reviews generally include the following:

- Financials (audit, QoE, etc.)
- Tax
- Intellectual Property
- Compliance with FLSA and employee classification requirements
- Employee Benefits
- Environmental
- Legal/Regulatory compliance including import/export, trade compliance
- Contracts (government, supplier, customer, etc.)
- Regulatory
- Information Technology
- Insurance
- Industry Specific Reviews (Healthcare, Product Liability, etc)
- Condition of Inventory/Assets/Obsolescence
- Collectability of accounts receivable

Diligence can generally be completed in as few as 7-10 days.

USE TRENDS AMONG PRIVATE EQUITY AND STRATEGIC BUYERS

- Representations and Warranty Insurance is ubiquitous in the private equity world. If you are competing with a private equity buyer, you are almost certainly competing with a buyer that is offering limited or no seller recourse. Although adoption has been slower among strategic buyers, R&W Insurance is becoming much more common in strategic deals. Most strategic buyers are willing to consider the concept and many have “done it once.”
- Underwriting will include a review of Buyer’s diligence process. Strategic buyers may benefit from implementing a more formal due diligence report/summary than might otherwise be typical for the Buyer.

David Garrigus | Executive Vice President



David Garrigus joined HUB in 2019 as Executive Vice President and MAPS Practice Leader. In this role David leads the management liability, professional liability and Cyber teams of HUB Midwest. David joined HUB from a national brokerage where he worked as a senior management and professional liability broker of large and complex risks. David previously worked at Ironshore Insurance Company as the Midwest Regional Manager of management and professional liability, and before that spent 8+ years as a broker.

David is a regular speaker at industry events, including educational programs, panels, and client symposiums. Notably, David was a panelist at the RIMS Hines Symposium titled "Cyber Risk: Protecting Your Assets", and has authored pieces including "One Size Does Not Fit All: A More Focused Approach to Healthcare D&O Insurance Contract Construction" published by the American Health Lawyers Association. David has twice won Risk & Insurance Magazine Power Broker Awards. David is an active member of the Economic Club of Chicago, InfraGard Alliance (public-private partnership with the FBI on Cyber-security), and the Association for Corporate Growth. David has served on the board of the Insurance Industry Charitable Foundation and has actively supported other organizations including Bernie's Book Bank and City of Hope's Insurance Industry Council.

David earned his MBA in Economics and Strategic Management from the University of Chicago Booth School of Business, and his BS in Business Finance from Miami University in Ohio.

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John Schreiner | Partner



John Schreiner focuses his practice on providing counsel to closely held established and emerging companies for their daily business needs. He also represents private and public companies in mergers and acquisitions, divestitures, private equity financings, corporate governance, commercial contracting and general business matters. John has a wide breadth of industry experience, with a particular focus on food and beverage manufacturers and distributors, outdoor industry retailers and manufacturers, providers of mobile and web-based services, and biotechnology and medical products and device companies.

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Throughout his career John has made a commitment to his community, volunteering as a guardian ad litem in dozens of minor child guardianship matters before the Cook County Probate Division, organizing and leading fundraising efforts for various conservation organizations and volunteering with a number of community based programs.