THE NEXT FRONTIER FOR REPRESENTATIONS AND WARRANTIES INSURANCE: PUBLIC M&A DEALS?

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Recent years have witnessed a surge in the number of M&A deals that use representations and warranties insurance ("RWI"). According to a recent study, in 2018 to 2019, 52% of private company transaction agreements referred to RWI, up from only 29% in 2016 to 2017.[1] Yet, despite its dramatic growth in the private company deal market, RWI has so far been almost entirely absent from public M&A transactions ("public company deals") in the U.S. The question is why.

One key difference between private and public company deals is the availability of post-closing recourse for the buyer. In private company deals, which typically involve the sale of a company by a small number of shareholders or the sale of a subsidiary by a large company, buyers expect sellers to indemnify them for breaches of reps. In contrast, in public company deals, where target companies are usually owned by many shareholders who trade

in and out of the shares in the public markets, there traditionally has been no post-closing indemnity, in part because of the view that there would be no one left to pay it. In recent years, we have also seen a rise in a type of blank check company called a special purpose acquisition vehicle ("SPAC"), which raises money in an IPO for the purpose of acquiring other companies.[2] Most "de-SPAC" transactions, whereby the public SPAC vehicle buys a private target, thus taking the target public, do not involve a seller that provides indemnification recourse (for a number of reasons, including dispersed share ownership). Thus, SPAC deals are another category, similar in some respects to a "public deal," where RWI can fill an indemnification gap.

Commentators, practitioners, and insurance carriers have suggested various reasons why RWI should not, or could not, be used in public company deals. We conclude that the use of RWI is possible in some public company deals, even though there may need to be some modest modifications to the product as it currently exists in private company deals. While this would require some evolution in thought and practice, the building blocks are already in place for the use of RWI in public company deals.

The Rise (and Rise) of RWI

RWI has arisen to supplement or replace the indemnification obligations traditionally imposed on sellers in private company deals. RWI was initially offered in the U.S. in the late 1990s as a way for sellers to offset some of their indemnification obligations, although it took over a decade to gain traction. The RWI market was initially driven by private equity buyers who sought insurance to make their offers more attractive to sellers in auctions. Soon, however, the use shifted to private equity sellers, who did not want to set aside investor money for potential indemnification obligations (or have to claw it back).

The use of RWI has since expanded, with both corporate and private equity buyers being frequent purchasers of the product. Insurers at first insisted that sellers continue to stand behind their reps, either by having the sellers bear at least a portion of the RWI retention or deductible, or by only issuing coverage in excess of a seller indemnity. Currently, however, insurers no longer insist that sellers must have "skin in the game," and regularly provide coverage in private company deals without a seller indemnity.

In large measure, the lack of public M&A RWI likely derives from the fact that public transaction agreements do not contain indemnification provisions to begin with, so there is no indemnification to supplement or replace. But the evolution of the RWI product away from a skin-in-the-game model to one in which sellers often have no post-closing recourse has opened up new possibilities. In many ways, private company deals in which sellers have no financial liability for breaches of their reps (other than for fraud, for which liability often cannot be limited as a matter of public policy) resemble public company deals, where sellers also generally face no financial liability for breaches of reps. This raises the question of whether there are opportunities to use RWI in public company deals in the U.S.

The Current Paradigm

Parties considering RWI's application in public company deals should understand how it currently is used in private company deals, including who purchases the insurance; how the transaction agreements impact RWI; the RWI process and due

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diligence; typical policy terms; and insurer protection mechanisms.

Insurance Purchaser

Although the buyer and seller can each obtain RWI, in recent years it has become typical for the buyer to purchase the insurance. This article assumes that the buyer is obtaining the insurance coverage.

Transaction Agreements

For the most part, insurers work with the transaction agreements that the parties negotiate. In other words, although insurers at times may suggest limitations to coverage based on how certain reps are drafted (which may cause further revisions to transaction documents), insurers generally insure (or exclude) the specific reps contained in the transaction documents as negotiated by buyers and sellers.

Therefore, insurers need to be cautious against a seller agreeing to overly broad or generous reps when the seller may be viewed as having nothing at stake. On the other hand, insurers also take comfort in knowing that buyers conduct careful due diligence even if there is recourse (whether from the sellers or RWI). This is partly because even if post-closing recourse is available, it is generally limited due to deductibles before, and caps (or policy limits) after, the recourse applies.

RWI Initiation Process and Due Diligence

The RWI process commences when a buyer contacts an insurance broker. After executing a non-disclosure agreement ("NDA"), the buyer supplies basic materials to the broker, such as a draft of the transaction documents and details about the transaction. The broker obtains NDAs from potential primary insurers, as well as indicative quotations. The buyer then selects the primary insurer. When necessary for additional capacity, the broker assists in constructing a tower of excess insurers to sit above the primary layer.

The potential insurers conduct due diligence, which primarily involves a thorough review of the buyer's due diligence. The insurers receive access to the data room and all the written due diligence reports created by the buyer and its advisors (subject to non-reliance letters).

If the insurers are satisfied that the buyer has done adequate due diligence regarding the seller's reps, the insurers provide coverage. If the insurers ultimately are not comfortable with the degree of due diligence conducted by the buyer on any of the seller's reps, the insurers may insist on exclusions to coverage. In addition, RWI insurance coverage typically excludes:

- Any breaches of reps of which the buyer's "deal team" (three to five key members of a buyer's due diligence team) had "knowledge" (typically defined as actual conscious awareness both of a particular fact and that the fact constitutes a breach, and not including imputed or constructive knowledge or a duty of inquiry).
- Any exceptions to the reps that are specifically listed on disclosure schedules, because the disclosure negates the potential breach.
- Coverage in certain risk areas (for example, any liability arising from asbestos, polychlorinated biphenyls, and underfunded pensions).

Common Policy Terms

Typically, buyers seek to bind insurance coverage as of the deal signing, because this provides

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coverage for pre-signing breaches that are discovered between signing and closing. In addition, obtaining the RWI and negotiating the policy terms before signing gives buyers the maximum comfort that insurance can be obtained on acceptable terms, before losing the alternative of asking sellers to provide an indemnity.

Common RWI policy terms include: (i) coverage for 10% of deal size (typically measured by enterprise value);(ii) retentions or deductibles around 0.5% to 1% of deal size (sometimes less for larger deals); (iii) three years of coverage for general reps; (iv) six or seven years of coverage for tax reps and fundamental reps that address core concepts such as title, authorization, and capitalization; and (v) a "materiality scrape," meaning that even though a rep may be qualified by a materiality qualifier, the RWI insurers are typically willing to provide coverage that removes the effect of this qualifier for the purposes of the insurance coverage.

Insurer Protection Mechanisms

RWI insurers seek to protect themselves in three fundamental ways, including through:

- **The diligence process**. Insurers push buyers to perform meaningful due diligence. Insurers carefully review due diligence reports, seek full disclosure of known liabilities on disclosure schedules (which are excluded from coverage), conduct lengthy due diligence calls with buyers and their advisors, and ask numerous follow-up questions.

- **Exclusions.** Insurers add exclusions to coverage for any known problems; if the insurers have not seen enough evidence of due diligence; or in certain areas that insurers perceive as inherently risky (for example, asbestos liability). Insurers may also limit coverage to serve as excess coverage to an appropriate underlying insurance policy (for example, in some deals, insurers may insist on the existence of underlying cyber insurance to serve as an initial layer of coverage for breaches of reps that relate to cyber issues, or on underlying environmental insurance as an initial layer of coverage for breaches of reps that relate to environmental issues).

- **Retentions and caps on liability**. Retentions in RWI are sizeable, usually around 0.5% to 1% of deal size (sometimes less for larger deals). Recent data from Aon shows that claims have been made in 25% of policies issued in 2016.[3] However, far fewer claims lead to payouts. Between 2013 and 2018, only 13% of claims in deals under $100 million in size led to a recognized loss above the retention (and therefore a collection), and that percentage was even lower for larger deals, in particular those above $500 million.[4] In addition, RWI policies usually have caps, with 10% of the deal value being the common limit.

The Public Option: Obstacles and Potential Solutions

So, can RWI also work in public company deals? RWI might have a unique role to play in providing insurance in these deals where no post-closing recourse is available from sellers, and no seller indemnification option is available as with private company deals.

In a typical public company deal, the bring-down condition (which refers to the "bringing down" of a seller's reps between signing and closing) is set at a very high level. Many large-cap pub-

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lic company deals require reps to be untrue in a way that would have a material adverse effect (“MAE”) before a buyer can terminate a transaction between signing and closing, although there are exceptions, especially for smaller deals and certain types of reps (usually fundamental reps, such as authority and capitalization, where a lower level of materiality often applies).

The definition of MAE is usually closely negotiated, and the language is critical. Generally, an MAE means that the reps must be so untrue that the target company has suffered a materially adverse change in its long-term profitability (often excluding industry- or economy-wide downturns, among other things). That means that if a rep is merely untrue, or even if it is materially untrue, but does not (by itself or together with other untrue reps) constitute an MAE, the buyer generally does not have a walk-away right before closing. And, because the reps expire as of closing, if the reps turn out to be inaccurate, the only post-closing recourse a public company buyer has is an action for fraud (which can be difficult to establish and has been uncommon in public company deals).

Some alternative structures, such as the use of contingent value rights (“CVRs”), function as holdbacks based on certain contingencies, but their use in public company deals is rare. Therefore, there is a clear gap that RWI may be able to fill in public company deals, provided that the obstacles to using it can be overcome.

Concerns about the use of RWI in the public context include:

- A belief that less due diligence is performed in public company deals and therefore insurers may have less comfort in the reliability of sellers’ reps.
- The possibility that insurers may view risk factors and other broad forward-looking statements in public company disclosure as known risks that would result in broad exclusions in the policy.
- A desire by insurers to avoid providing insurance against disclosure lawsuits by shareholders.
- The fact that reps in public company deals are more often qualified by an MAE standard, and the bring-down condition is more often set at a higher (for example, an MAE) standard. Offering materiality scrapes in these deals may therefore be too risky.
- The perception that because public company deals tend to be larger than private company deals, insurance is less useful because the dollar value threshold of the retention is larger (making reimbursement by the insurer less likely).
- The difficulty of arranging insurance before signing because of the enhanced need to preserve confidentiality.

While these concerns are legitimate, none of them should prevent parties from considering RWI for public company transactions.

Due Diligence and Public Disclosure

A belief persists that public company deals involve less due diligence than private company deals because:

- The materiality threshold for what matters to public company buyers is often higher than the materiality threshold in private company deals.
- The greater need for secrecy in public com-

pany deals means that these deals get done more quickly and with less disclosure and fewer seller employees available for due diligence and disclosure.

- There is already ample disclosure in the markets, including Securities and Exchange Commission ("SEC") documents and analyst reports, on which buyers can rely.

These factors may also result in buyers creating fewer written due diligence reports for insurers to review, which may dissuade insurers from providing coverage.

However, it is unclear to what extent buyers actually do less due diligence on public company targets, particularly when other factors (such as the deal size and timeline) are held constant. Given the lack of post-closing recourse, the need to avoid unknown liabilities (and rep breaches) increases the buyer's need to discover problems before closing. Further, the threshold for walk-away rights is often very high, which effectively moves the burden to discover problems mostly to the pre-signing phase, increasing the pressure for buyers to get the due diligence right.

Additionally, the availability of public company information (for example, in SEC filings) actually increases the due diligence available to the buyer and insurers, and has the added protection that a seller's SEC filings are:

- Vetted for potential securities law liabilities.
- Reviewed and certified by its directors and officers, as compared to the curated information that might appear in a buyer's due diligence report.

Even in situations where a public company buyer might be inclined to conduct less due diligence, if it knows it needs (or wants) to buy RWI, it would be likely to perform sufficient due diligence to enable the insurer to write the coverage. Additionally, if insurers believe that the materiality level for certain public disclosure is too high for them to rely on the disclosure for the purpose of issuing coverage (for example, because a relevant event may not trigger SEC reporting requirements but may lead to a breach that would be expensive for the insurer), it might be possible to have more targeted due diligence or a different contractual standard imposed through exclusions in certain areas. In any case, insurers writing RWI on a public company deal should be able to adapt to the different style of due diligence.

In some cases, the need for speed or reluctance to perform broad due diligence acceptable to RWI insurers might mean that a public company deal is not a good candidate for RWI. Nevertheless, RWI may still be appropriate for a large number of other public company deals.

Public Company Risks and Forward-Looking Disclosure

Certain broad reps that are specific to public company deals might present enhanced risks to insurers. One important category of these broad reps relates to compliance with public company reporting obligations, for example, the filing and accuracy of SEC reports, compliance with the Sarbanes-Oxley Act and stock exchange rules, and maintenance of relevant disclosure controls and procedures. Insurers may be wary of insuring against these kinds of public company risks, which may seem significantly more wide-ranging than the kinds of business-type risks that they are accustomed to insuring against in the private company context.

While public company reporting reps may pre-

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sent challenges, they should not prevent the use of RWI in public company deals. For example, the RWI market can develop a set of standard exclusions similar to the standard exclusions that are commonplace in private company deals. In the public company RWI context, the market may (or may not) evolve to exclude coverage for certain public company legal or disclosure compliance reps.

The development of this RWI exclusion may also be viewed as a natural extension of insurers' typical refusal to cover "10b-5 reps" in the private company context even if the parties include these reps in their transaction agreement. A 10b-5 rep is a rep that typically tracks the language of Rule 10b-5 of the Securities Exchange Act of 1934 ("Exchange Act"), a key antifraud provision that focuses on preventing materially misleading disclosure or omissions.

A related topic that may raise concerns about placing RWI in public company deals is the extent to which insurers may view risk factors and other generic forward-looking cautionary statement language contained in SEC filings as known risks resulting in exclusions under a policy's knowledge exclusion. Given the very broad risk factor and forward-looking statement disclosure that is typical in public company filings, if insurers tried to insist on adding exclusions on the basis of a buyer's knowledge of these broad statements of risk, it could strip the RWI policy of much value.

However, broad public company disclosure should not result in an unmanageable list of exclusions in RWI policies. In many public company deals, although disclosure in SEC filings is deemed to qualify the reps, generic risk factors often are not treated the same way, and insurers should not consider a buyer to have had knowledge of a risk solely because it was included as a risk factor. Rather, insurers should carefully review public disclosure and insist on excluding from coverage only sufficiently specific and detailed disclosure that presents a real known risk. In Australia, where RWI policies are sometimes used in public company deals, the policies often use language (either by way of the definition of loss or through language in the exclusions section) that makes clear that generic, forward-looking risk factors in public filings are not an exclusion from the policy.

Shareholder Litigation

In public company deals, selling shareholders sometimes allege that the company's disclosure is misleading and attempt to enjoin the merger or seek damages after it closes, either under state law (often in the Delaware Court of Chancery) or under Section 14(a) or 14(e) of the Exchange Act in federal court. In the event of a post-closing damages suit, selling shareholders often allege that they suffered damages by accepting an inadequate price because they were misled by deficient disclosure, and attempt to hold the seller's board or the seller, and sometimes the buyer, liable. Less commonly, the buyer's shareholders sue the buyer's board of directors alleging that the buyer overpaid for the target company (for example, the buyer's shareholders may claim to have been deceived about the target company's prospects).

A concern about the use of RWI in public company deals is that insurers likely would refuse to write insurance policies that may lead to a payout in certain of these types of commonplace shareholder litigation. The purpose of RWI historically has been to guard against operational risk, rather than the risk of the transaction itself, and so it is not surprising that insurers might prefer to avoid having to cover payouts in shareholder litigation.

Furthermore, shareholder litigation usually involves litigation over documents that, at the time of the signing of the deal, do not yet exist (for example, a proxy statement or registration statement). Any rep that covers information to be provided in the future resembles a covenant, rather than an ordinary rep. RWI policies typically exclude coverage for breaches of covenants. Insurers therefore may try to insert exclusions to eliminate coverage for certain types of deal-related shareholder lawsuits.

Materiality Scrapes

Due to the more prevalent use of MAE qualifiers in reps in public company deals compared to private company deals, insurers may be more reluctant to offer materiality scrapes in public company RWI policies. Insurers might fear that by including many MAE modifiers in reps, sellers would be inclined to include more and broader reps on the theory that "none of it matters unless it rises to the level of an MAE." This concern may be exacerbated by the use of an MAE threshold for a bring-down condition for two reasons, namely that it may increase the willingness of sellers to give reps that have small inaccuracies, and it may lead to more deals with rep breaches, thus increasing the risk of liability for insurers.[5] If public company sellers did broaden the scope of reps because of the inclusion of more MAE modifiers, then scraping materiality from an enhanced set of reps (which has become common in private company deals) might subject RWI insurers to higher risks compared to the private company deal market. On the other hand, if an RWI insurer does not scrape away the MAE standard, insurance coverage has far less value to public company buyers, at least with respect to MAE-qualified reps.

This concern may be overstated. Sellers typically do not want to risk allowing known breaches of reps to exist at signing, whether the reps are qualified by a simple "material" standard or by an MAE standard, and therefore there is usually adequate disclosure of known or potential issues in the disclosure schedules. Buyers also prefer and therefore negotiate for fewer MAE qualifications in the reps themselves, to encourage sellers to disclose more as exceptions to reps in disclosure schedules. Buyers seeking an RWI policy can also do more due diligence on reps that are MAE-qualified to provide further comfort to the insurer beyond the disclosure schedule itself.

If the combination of due diligence and disclosure schedules is not sufficiently thorough, insurers may insist on per-claim materiality standards for specific reps. Even in this case, however, insurers should scrape below the MAE, meaning that buyers should be able to obtain meaningful protection by buying insurance. Insurers who do not provide a full scrape of MAE might provide a synthetic materiality threshold (for example, they may provide insurance against a breach of a rep in excess of a certain loss threshold, effectively adjusting the retention for a claim based on a breach of that rep). These per-claim materiality constructs are frequently tied to a specific dollar threshold, and often include both aggregation language and a tipping concept (meaning recovery from the first dollar once the threshold is exceeded). Such constructs should not, however, impede a buyer from recovering on a claim of any real significance.

Deal Size and Retention

Extending RWI to public company deals raises the issue of whether the larger deal size, and correspondingly larger retention, may make insurance less useful. As noted above, retentions in RWI are

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typically around 0.5% to 1% of deal size (sometimes less for larger deals).

The relative size of public and private company deals should not prevent parties from seeking RWI in public company deals. As an initial matter, very large private company deals do get RWI coverage. Marsh, a leading broker, has noted that deals in excess of $10 billion have been insured in recent years.[6] Furthermore, on larger deals, insurers have sometimes been willing to reduce the size of the retention as a percentage of the transaction. Even if insurers are not willing to reduce percentage retentions on larger deals, a larger acquiror should be able to absorb the loss from a higher deductible and could still benefit from the protection given by the insurance.

At times, the largest public company deals may exceed the maximum amount of coverage typically available in the RWI market (unless purchasers would be willing to purchase less coverage than the usual 10% of the value of the transaction). The maximum amount of coverage available currently is generally believed by practitioners to be approximately $1.5 billion of insurance coverage, corresponding to a deal value of approximately $15 billion. However, the exclusion of the largest end of the public deal market should not be an obstacle for many public company deals. Most public company deals are not mega-deals. According to the data provider Capital IQ, only 1.5% of all deals involving publicly traded U.S. target companies in the last three years have had a deal value above $10 billion. In addition, if RWI is extended to public company deals, it is possible that over time the size of insurable deals will grow, as it has with private company deals, or that insurers will raise the current maximum insurance coverage, if the RWI product is otherwise working in the public company deal market.

Confidentiality and Timing

Obtaining RWI necessarily may increase the chance of a leak, because it increases the number of people who know about the deal. This is a concern in any deal, but obviously a bigger danger in public company deals, where protecting against leaks is necessary to prevent a run-up in the stock price and to avoid damage to the company if the negotiations fail. It is possible that issues concerning the timing and speed of a public company deal may make RWI impractical in certain types of public company deals. However, not all public company deals move at breakneck speed, and it is feasible in many public company deals to undertake the RWI placement process prior to signing.

Alternatively, if RWI cannot be bound pre-signing, it should be possible in some cases to place and bind coverage after signing. This removes the danger of a leak and also removes one set of tasks from an already hectic pre-signing schedule (which is often compressed in public company deals because of concern about leaks).

There are some disadvantages and impediments to placing insurance post-signing. For example, when signing transaction documents, the buyer does not know exactly what insurance it will be able to buy, and for how much. Binding after signing also means that the parties are without coverage for pre-signing breaches learned about after signing and before the policy is bound (however, breaches that both occur and are discovered post-signing but pre-closing are generally excluded as interim breaches, even if the policy is bound at signing). The more time that elapses after signing, the more the buyer is likely to learn about the seller, reducing the value of insurance against unknown risks.

These downsides to binding after signing (if

necessary) may be mitigated by moving very quickly after signing and preparing and planning as much as possible (including getting quotes and selecting a primary insurer) in advance of signing. Moreover, in a public company deal, waiting to bind insurance until after signing does not present the same lost opportunity costs as might exist in a private company deal context, such as a buyer's loss of the chance to obtain indemnification from a seller. In a public company deal context, indemnification is not a lost opportunity. Even if a buyer receives an insurance quote higher than it expected, it can still decide whether to buy RWI or to self-insure (meaning not get RWI, which is the norm in public company deals currently).

The Road Ahead

We believe that RWI has strong potential in public company deals or other situations that share some public company characteristics. Commentators are right to note the unique elements of public company deals that would present possible challenges, or that would require changing the current RWI model. But while these differences mean that public company RWI will necessarily look different from private company RWI, none of them should, in our view, bar the use of RWI in public company deals in the appropriate circumstances. Public company M&A deals remain the next frontier in the RWI domain.

ENDNOTES:

[1]*See* 2019 ABA Private Target Mergers & Acquisitions Deal Points Study, at 116, *available at* americanbar.org (login required).

[2] In 2019, there were 59 SPAC IPOs, which raised $13.6 billion. By comparison, in 2012, there were only 10 SPAC IPOs, which raised only $521 million. Bloomberg Law, *Analysis: SPACs—Back & On Track to Challenge Traditional IPOs* (Feb. 11, 2020), https://news.bloomberglaw.com/bloomberg-law-analysis/analysis-spacs-back-on-track-to-challenge-traditional-ipos. This year, there have already been almost twice as many SPAC IPOs as there were last year, raising over $40 billion. *SPACInsider*, https://spacinsider.com/stats (accessed Sept. 22, 2020).

[3]*See* Aon, Representations and Warranties Insurance Claim Study (2020), at 7, *available at* aon.com. (Because there is a lag between policies being issued and claims being placed, more recent policy years do not yet have a full claim history.)

[4]*Id.* at 8.

[5]*See* above, *The Public Option: Obstacles and Potential Solutions.*

[6]*See* Marsh, Transactional Risk Insurance 2019: Year in Review (2020), at 7, *available at* marsh.com.

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