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REAL ESTATE TRANSACTIONS

Representations And Warranty Insurance


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Representation and warranty insurance (or RWI) is a tool increasingly used to facilitate mergers and acquisitions transactions. This insurance product benefits sellers by reducing exposure to post-closing liabilities and providing greater certainty of distributable proceeds, and it appeals to buyers by providing a creditworthy party to support any significant warranty liability. RWI has not typically been used in real estate acquisitions, where buyers tend to rely on third-party reports, governmental searches and other due diligence, as well as title insurance and estoppels, to protect themselves from infirmities in the acquired asset. Given the relative sparseness of representations and warranties in real estate transactions as compared to corporate acquisitions, insurers have not historically offered the pricing to make RWI attractive to buyers of real estate. However, RWI insurance has become more common in recent years in real estate transactions in Europe (in particular in the United Kingdom) and in U.S. real estate transactions structured as entity-level acquisitions.

Benefits of RWI

Representation and warranty insurance first entered the marketplace around 1998 and has surged in popularity in the last three to four years as the market has developed[1]. Its prevalence is changing the way sellers and buyers in M&A transactions think about the post-closing liabilities associated with the acquisition/disposition of a company. In the typical M&A purchase agreement, as in the typical real estate purchase agreement, the seller makes certain factual representations about the acquisition target and agrees to indemnify the buyer for inaccuracies in those representations. Given the potential for significant liability, the substance of these representations and the limitations on the indemnity can be hotly contested. RWI can facilitate negotiations by replacing or supplementing the seller's indemnity while still ensuring that the buyer remains protected from financial loss resulting from a breach of the representations and warranties, for example, it may provide protection that exceeds the contractual cap on the seller's indemnity, or for a survival period that exceeds that of the seller's indemnity[2]. RWI also offers buyers who are willing to rely on and pay for such insurance an opportunity to distinguish their bid in a competitive situation. In transactions where an escrow is expected to be established out of the purchase price in order to secure an indemnification obligation, the use of RWI allows the seller to reduce the escrow and distribute funds to investors more quickly.

How It Works

The following example illustrates how RWI typically works within the structure of an M&A purchase agreement[3]. In the example, the M&A agreement provides for a "basket" of $2 million (*i.e.*, the monetary threshold under which buyer absorbs any loss on account of warranty breaches without a remedy against the seller). The RWI policy would similarly have a retention (*i.e.*, a deductible), providing that the insurance company will only pay out for aggregate losses on account of warranty breaches over $4 million[4]. The difference between the basket and the policy deductible would be the seller's limit of exposure[5].The insurer can take comfort in the fact that both the buyer and the seller still have "skin in the game." Because the buyer and the seller each cover part of the retention, the buyer is incentivized to thoroughly conduct its due diligence, and the seller will actively negotiate its representations and warranties and also take care in disclosing the exceptions to the warranties in the disclosure schedules.

Transactional Risk Insurance

Currently, private equity firms are the most common users of transactional risk

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insurance, a category of insurance products used in mergers and acquisitions and other types of transactions to protect the deal participants from the risk of unanticipated financial losses. Transactional risk insurance includes the subcategories of RWI, tax liability insurance and other contingent risk insurance. Tax liability insurance protects the insured against the liability of paying additional taxes, fines or penalties, typically relating to an identified specific contingent tax issue or treatment. Similarly, contingent risk insurance protects against known exposures in other areas, including litigation, environmental and employment matters. In statistics reported by a leading insurance broker in 2015, policies placed for private equity buyers comprised 71 percent of total policies placed in the United States, with corporate policies comprising the remaining 29 percent[6].

Buyer-Side Policies

Both buyer-side and seller-side policies are offered by RWI carriers, though the overwhelming majority of RWI policies being issued are buyer-side policies. Under a buyer-side policy, the buyer is the insured and the insurance company pays the buyer directly for any losses arising out of breaches of the seller's or the target company's representations and warranties. Conversely, under a seller-side policy, the seller is the insured and the insurance company reimburses the seller for warranty losses for which the seller is required to indemnify the buyer under the purchase agreement. Buyer-side policies are generally viewed to have better coverage because they do not include an exclusion for losses resulting from seller's fraud, whereas, not surprisingly, seller-side policies do. In addition, proceeding against the insurer directly under a buyer-side policy can be preferable in certain situations where there are difficulties associated with a claim against the seller. For example, in a buyout transaction where the existing management rolls over its equity and continues to run the company, it can be awkward and damaging to the ongoing relationship for a buyer to press claims for misrepresentations based on information provided by (or neglected to be provided by) the company's current management team. Another scenario where a buyer-side policy may be preferable is where there is a high risk of seller insolvency.

In a buyer-side policy, the question of who pays for the policy is routinely negotiated along with the other economic terms of the transaction, and is largely dependent on whether the sale is being negotiated in the context of a competitive auction. The premium is typically 3-4% of the limit on liability, although pricing has been increasing. The retention, or deductible, is typically 1-3 percent of the transaction value. The policy amount (or insurer's liability cap) would customarily be calculated as 8.5-10 percent of the purchase price (to replicate a typical cap on liability in an M&A transaction, but can be increased to provide additional coverage). Insurers typically do not offer coverage for less than $3 million, which means that parties to smaller transactions are unlikely to avail themselves of RWI, given that they would typically not expect to insure much more than 10 precent of the purchase price.

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The Process

Brokers and insurance companies are sophisticated and are often staffed by former M&A attorneys able to work on aggressive timeframes. The entire process of issuing an RWI policy, from start to finish, can be completed in under two weeks—with two to three business days to receive quotes and seven to ten days for the underwriting process. The process begins with engaging a broker early on and having the broker and potential insurers execute non-disclosure agreements. Within two to three business days, insurers can provide quotes (at no cost) upon reviewing certain key documents including a confidential information memorandum (or other background information about the target), financial statements and a draft purchase agreement. To proceed, the parties would select an insurer and pay an underwriting fee of $20,000-40,000. Following receipt of the fee, the insurer will commence a seven-to-ten day underwriting process and negotiation on the policy terms. During that time, the underwriters will evaluate the transaction based on their high-level review of the due diligence process, more comprehensive access to additional documents and telephone conferences with the transaction team and their advisors. Common issues in negotiations include defining the scope of losses excluded from coverage, the policy period, the amount and structure of the self-insured retention and the inclusion of certain "enhancements," such as a materiality "scrape" (*i.e.*, reading materiality provisions out of the representations and warranties for indemnification purposes) and coverage for consequential damages.

In the case of buyer-side policies, sellers should take special care to confirm that the insurer agrees to a waiver of subrogation. Insurers typically will do so, except for instances of the seller's fraud. Subrogation would otherwise give the insurer the right to step into the buyer's shoes in pursuing the seller for its losses, thus nullifying any benefit to the seller of the RWI policy.

Each policy is negotiated and tailored to the specific transaction. However, as a general matter, the following items are usually excluded from coverage: (1) forward looking statements and projections, (2) covenants (*i.e.*, agreements to perform or refrain from performing an action, as opposed to representations regarding a set of facts), (3) items known by or disclosed to the insured at the time of the policy inception (though these may be addressed via a separate contingency policy) and (4) losses arising from breaches or representations between signing and closing which are known by the buyer at closing. The definition of "knowledge," as it relates to the exclusion of known breaches, can be negotiated with insurers, and the insured party should seek to limit the definition of knowledge to only the actual knowledge of a control group composed of the internal deal team. While environmental representations are not part of the exclusions going in, as a practical matter coverage for environmental matters is often whittled away during the underwriting process and, other than in the case of targets presenting a remote risk of environmental issues, environmental warranties may effectively be excluded by the time the policy is issued. Rather than rely on the limited coverage in an RWI policy, parties often purchase separate pollution legal liability policies to protect against environmental risks.

Real Estate Transactions

Now that RWI has become commonplace in M&A transactions, the question is whether real estate transactions will follow suit. For more complex transactions, where traditional due diligence may fall short or be impractical, or where an entity rather than an asset is being acquired, the answer may be yes.

In traditional real estate transactions involving a single property or small portfolio of properties, most issues can be uncovered by a title search (which is also typically insured through title insurance), a physical inspection of the property, review of leases and other material contracts and other types of due diligence. Furthermore, in real estate transactions, the property is usually sold "as-is," without any representations made as to the physical or environmental condition of the property or its financial performance. In these cases, the buyer is more likely to rely on its own due diligence and a title insurance policy for protection than to turn to an RWI policy. As a caveat, the value of such due diligence is in some cases tied to the quality of the disclosures provided by the seller. For example, while the purchaser of an office building or shopping center would likely review all of the leases provided by the seller and attempt to confirm its review with tenant estoppels, it would likely not receive estoppels from all tenants and would then have to rely solely on the lease documents provided by the seller. To protect against shoddy disclosures by the seller, the buyer may request representations that complete and accurate copies of all leases, management agreements and like contracts have been provided. This is the type of representation which cannot fully be confirmed by due diligence and which could be covered by RWI. Sellers may also be willing to give representations not typically offered in a real estate transaction—for example, to deal with a known condition peculiar to a particular property—if the presence of RWI allows it to limit its liability to the difference between its deductible and the policy's retention.

For transactions involving large portfolios of property or the sale of real estate through a transfer of entity shares, RWI may prove useful. In the case of portfolio deals, both parties may struggle to make or verify factual statements about a large number of properties, with a resulting greater likelihood of an unknown liability emerging[7]. Transactions where there is a sale of interests in a REIT or other entity may also benefit from insurance that covers entity-level representations or tax representations. These representations are substantially more extensive than in the case of a property sale in view of the potential liabilities of the entity being acquired (such representations may relate to, among other things, title to the acquired interests, the capitalization of the entity being acquired, financial statements, indebtedness, undisclosed liabilities, taxes, contracts to which the target is a party and employee, labor and employee benefit representations), and this broader range of representations increases the likelihood of a breach. In the case of the purchase of REIT shares, RWI coverage can also include the seller's representations as to the REIT status of the target.

Conclusion

RWI can be expensive and the cost will not be warranted in every transaction, whether M&A or real estate. As with purchasing any type of insurance, the parties must weigh the known cost of the insurance premium against the likelihood of suffering a loss and collecting against the contractual indemnitor. With the potential to tap into a new market, and recognizing that in order to increase the use of RWI by buyers and sellers of real estate the self-insured retention needs to be closer to traditional basket levels in real estate transactions, insurers are pushing to reduce pricing and self-insured retentions in real estate transactions.

1. Howard B. Epstein & Theodore A. Keyes, Representations and Warranty Insurance Comes of Age, N.Y.L.J. (March 31, 2016)

2. Note that the policy coverage period for RWI is typically three years for general representations and up to six years for fundamental representations and tax representations—which exceeds the typical survival period of the seller's indemnity.

3. While the RWI structure we describe in this example is more common, buyer can also obtain a "public company" style policy where the seller has no escrow/indemnity obligations. These policies tend to be more expensive and the "enhancements" discussed below may not all be available.

4. Buyers and sellers typically split the retention 50-50, as in this example.

5. Note that losses over the policy's coverage limit may also be seller's responsibility depending on the terms of the transaction and whether there is a cap on seller's potential liability.

6. Marsh & McLennan, Marsh Insights: Midyear Transactional Risk Report 2015, https://www.marsh.com/us/insights/research/transactional-risk-2015.html.

7. George J. Kroculick and Meredith Carpenter, Should You Consider Representations & Warranties Insurance in Your Real Estate Deal?, https://www.icsc.org/newsletters/article/should-you-consider-representations-warranties-insurance-in-your-real-estat.