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INSIGHT: In-Depth Insights on Representations and Warranties Insurance—Market and Coverage Trends and a Look Ahead

BY JOE CASTELLUCCIO AND WILLIAM KUCERA

Transactional liability insurance—often in the form of representations and warranties insurance (RWI)—has evolved from a niche product into a common element in mergers and acquisitions practice. This evolution has accelerated in recent years and while this type of insurance product is well known to many M&A practitioners, use of transactional liability insurance continues to expand across geographies, asset classes, and industries.

As part of this rapid evolution, a few key trends have emerged and a few important observations about the current state of the market are worth noting, especially for companies that intend to use RWI.

Looking forward, changes in economic or market conditions may test these trends. As advisors that work regularly with RWI insurers, we take a look at a few areas of the market that are likely to be impacted by these shifts in conditions and trends.

Insurance markets–and insurance coverage–have evolved and become more sophisticated In short, there are more markets with more insurers willing to write transactional liability insurance policies than ever before. While there are market norms that have evolved and some standardization in policies and coverage, many insurers have the flexibility and expertise to step outside of those standard terms to problem-solve in deal contexts or modify coverage to address specific transaction issues on a case-by-case basis. In particular, underwriters and brokers with broad experience and the right platform can add value to the insured parties in a transaction. While premiums will often increase to reflect elevated or novel risks, transactions that are truly uninsurable have become relatively rare in the market.

Risk sharing among buyer, seller and insurer has shifted In general, transactional liability insurance policies have fewer exclusions and broader coverage than just a few years ago. In addition, more insurers are willing to underwrite deals in which there is minimal or no initial recourse against the sellers before the insurance policy can be invoked. One reason for this is that insurers are generally better at identifying potentially uninsurable risks early in the underwriting process. Candidly, market forces are also at play in this risk shifting—as the number of insurers in the market has increased, so too has competition and pressures on insurers to assume more of the risk in these transactions.

Look beyond the underwriting process While evaluating the underwriting processes of insurers is a key component of choosing a transactional liability insurance provider, it is not the only factor to consider. Market diligence—often with the assistance of a knowledgeable broker—on an insurer's claims history and experience is another key consideration for choosing an insurance provider. This is especially true because claims are often made in the context of unfulfilled expectations related to the acquired business and/or contentious post-closing disputes.

Looking forward The expansion and adoption of transactional liability insurance has coincided with strong M&A and equity markets in the past 5+ years. As valuations continue to rise and business synergies are achieved, there has not been a volume of claims that have significantly tested underwriting practices (although several market studies have pointed to an uptick in claims during the past 12 months). Of course, throughout this period there have been episodic claims for large amounts that have tested individual insurers, including some claims that continue to be litigated.

While it is not clear what effects a sustained downturn in stock markets or a significant economic disruption will have on the transactional liability insurance market, it is reasonable to expect that these types of events will lead to a sharp increase in both the volume of and size of claims under transactional liability insurance policies.

In addition, studies and anecdotal evidence suggest that certain types of representations—for example, representations regarding the financial statements—are more likely to be the basis for claims. A downturn in the business cycle may also lead to increased numbers of

RWI claims in other areas covered by representations, such as litigation (and the basis therefor).

Finally, the performance of RWI insurers in the face of increased claims—and the claims experiences of the insureds—could impact the increased adoption of RWI. At the same time, it seems unlikely that RWI will lose its place as a key component of risk allocation in M&A transactions.

Joe Castelluccio is a partner in Mayer Brown LLP's Corporate & Securities practice in New York. He helps clients balance risks and opportunities in global mergers and acquisitions with a combination of legal acumen and business experience. He focuses his practice on complex, cross-border M&A, joint ventures, equity transactions and other corporate matters. Joe also regularly represents underwriters in issuing transactional insurance in connection with M&A deals.

William Kucera is Co-Chair of Mayer Brown's M&A practice in the Americas and a partner in Mayer Brown's Chicago office. He concentrates his practice on mergers and acquisitions, including public and private mergers, tender and exchange offers, joint ventures, and venture capital and other private equity investments. Bill also leads Mayer Brown's practice representing underwriters in issuing representation and warranty insurance and other types of transactional insurance in connection with M&A deals.