

PROPERTY &amp; CASUALTY

# Representations and Warranties Insurance (RWI): The Essentials

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Since the 2010 global financial crisis, representations and warranties insurance (RWI) has evolved from a product primarily utilized by certain sophisticated investors, particularly in the private equity industry, into a staple of mergers and acquisitions (M&A) transactions. RWI provides economic protection to parties involved in M&A transactions and advantages over the traditional indemnification method that requires sellers to set aside a portion of their proceeds in an escrow to cover indemnifiable losses by buyers.

It's important to discuss and understand how RWI works, why it has become a customary solution in M&A transactions, policy mechanics and the current RWI market conditions.

## The Purpose of Indemnification in M&A

The fundamental purpose of RWI is to backstop the sellers' indemnification obligations to buyers in M&A transactions. Therefore, the purpose of these seller obligations should first be addressed. Why do sellers in M&A transactions provide representations to buyers and indemnify them for breaches of those representations?

Representations serve several purposes, including providing the buyers with an accurate depiction of the company being acquired (the target). These representations are detailed statements about various key aspects of the target, such as its financial condition, owned assets, liabilities, material contracts, owned or licensed intellectual property and litigation. These representations aim to reduce the buyers'

uncertainty and mitigate the risks associated with the transaction. The disclosure of these details concerning the target allows buyers to make informed decisions about the transaction, assess the value of the target, assess the risks associated with the acquisition and negotiate terms that accurately reflect the business.

## The Role of RWI

RWI acts as a safeguard against the inaccuracy of these representations by providing recourse to the buyers for breaches of these representations, effectively transferring the financial risk from the sellers to insurance carriers.

## Advantages of Using RWI

There are several advantages to using RWI compared to the indemnification escrow paradigm. The principal among these is that RWI allows the sellers to have immediate



access to virtually all proceeds from the sale by eliminating the need to set aside proceeds to protect against future indemnification obligations. Further, insurers face the risk of economic loss from breaches rather than sellers in the event of an indemnification claim.

Additionally, RWI enables the buyers to customize the indemnification terms with receptive insurer(s) rather than reluctant sellers. This flexibility allows buyers to tailor indemnification coverage to suit their specific needs and risk tolerance without requiring sellers to agree to indemnification obligations larger and/or broader than they otherwise would be willing to accept.

Another advantage to deploying RWI is that buyers do not need to seek recourse against sellers, including those with whom they may have a continuing relationship. This is particularly relevant when the buyers retain the sellers' management team post-closing. By securing RWI coverage, buyers can safeguard themselves against potential breaches of representations without needing to adversely impact the sellers financially and/or create internal friction with selling shareholders who continue to work with the target post-closing.

## The Process for Placing Insurance:

The process of obtaining RWI for M&A transactions typically involves the following key steps:

- Broker selection
- Execution of non-disclosure agreements between the buyer and each potential insurer
- Preparation and submission of application materials
- Negotiation of proposed terms and conditions with carrier
- Carrier selection
- Underwriting

- Negotiation of policy terms, conditions and proposed deal-specific exclusions
- Policy binding

The timeline for obtaining RWI can vary depending on the specifics of the transaction, but it typically ranges from less than a week to more than a month. While the overall timeline may be longer, the active part of the process typically takes between 10 to 14 days. It should be noted that placing RWI usually fits within the transaction's overall timeline. It is rare and undesirable for RWI to impact the timing for parties to close a transaction.

Carrier selection plays a vital role in the RWI process, as buyers must identify reputable insurance carriers capable of providing the desired coverage and have good reputations for paying valid claims.

Buyers should engage an insurance broker with experience, established relationships with leading RWI carriers and in-depth knowledge of the RWI market landscape. Working with an experienced insurance broker simplifies the carrier selection process, as brokers can provide critical insights into carrier capabilities, track records and policy offerings. Additionally, experienced brokers assist buyers in navigating the nuances of different policy options to align the selected carrier with the buyer's specific needs and the transaction's risk profile.

Underwriting is a critical phase for insurers. It allows them to understand the transaction details, assess risks and uncover potential liabilities associated with the deal. Underwriters' goals are to evaluate the representations and warranties, understand the financial statements, review due diligence findings and evaluate other relevant information to determine the appropriate coverage terms and pricing. Experienced insurance brokers can also guide buyers through the underwriting process, helping them prepare the necessary documentation, address underwriter inquiries and present the transaction in a favorable light.

Brokers can offer valuable insights into underwriters' preferences, share their knowledge of risk assessment criteria and help develop strategies to enhance the likelihood of securing favorable RWI coverage terms. Ultimately, leveraging an insurance broker's experience can streamline the RWI process, facilitate carrier selection and optimize the underwriting experience for buyers, resulting in a more efficient and successful insurance placement.

## Difficult Industries for Placements

While RWI can be utilized across various industries, placements in sectors with high regulatory scrutiny, complex business models or significant potential liabilities may face challenges in obtaining coverage. For example, industries like healthcare, financial services and oil and gas present unique challenges for RWI underwriters.

RWI coverage in the healthcare industry can be challenging to place because of potential professional liabilities and the complex regulatory environment in which healthcare businesses operate. Additionally, the potential for litigation related to patient care, malpractice and data privacy breaches adds layers of risk that insurers must carefully evaluate. The intricate nature of healthcare transactions that involve numerous stakeholders and specialized assets further complicates underwriting.

Businesses in the financial services industry face similar challenges due to the sector's inherent financial risks and regulatory scrutiny. Financial institutions, including banks, investment firms and insurance companies, deal with complex financial instruments, extensive regulatory frameworks and significant exposure to market volatility. Compared to other industries, the potential for fraud, money laundering and compliance failures is high, making the risk assessment process for RWI policies more demanding for underwriters. Furthermore, the sector's interconnectedness means that a failure in one entity can have cascading effects that amplify the risk for insurers. While not explicitly covered by RWI policies, adverse business performance of the target after closing is commonly believed to increase the likelihood of claims.

The oil and gas industry also presents substantial difficulties for placing RWI. The sector is characterized by its exposure to significant environmental risks and complex regulatory requirements. Environmental liabilities, including potential spills, contamination and the need for extensive remediation efforts, pose considerable challenges. As noted above, the industry's cyclical nature can affect the financial stability of companies, increasing risk for insurers. Additionally, the geopolitical risks associated with oil and gas operations in various regions make the underwriting process even more complex, challenging and risk-laden.

Despite challenges, the RWI market has expanded with new carrier entrants that have broadened market appetites. As a result, transactions in a variety of industries can get placed more than ever before, even in the "hard-to-place" industries discussed above.





## Current Market Conditions

The current market conditions for RWI reflect a dynamic environment influenced by several key factors. First, the number of carriers writing RWI coverage has significantly increased in the last few years. This surge in competition among insurers has led to more diverse policy offerings and greater market capacity. As more carriers enter the space, the terms and pricing of RWI policies, discussed below, have become more competitive, providing buyers with more options and favorable terms and conditions.

While RWI capacity has increased, the market has experienced a decline in M&A activity. Various economic and geopolitical factors, including rising interest rates, inflationary pressures and global uncertainties, have contributed to a slowdown in deal-making. This decline in M&A activity means that insurers have fewer opportunities to underwrite RWI policies and a subsequent abundance of capacity relative to demand.

Carriers have become more innovative and competitive in response to these conditions. As mentioned above, many

are expanding their risk appetite to include more complex and higher-risk transactions, while others have opted to offer coverage options for smaller transactions. All carriers are being compelled to offer improved and broader terms and conditions at lower premiums.

## Typical Pricing, Terms and Conditions

Furthermore, the increased supply of RWI capacity and the decrease in M&A activity have benefited insureds. Currently, pricing typically ranges from 2% to 3% of the policy limit depending on the industry, the transaction size, the specific characteristics relevant to the target company and other inherent risk factors of the deal. By contrast, just a few years ago, premiums were frequently quoted above 4%, reaching 5%-6% in the frenzied M&A market at the end of 2021.

Coverage has simultaneously become broader, with fewer exclusions and lower self-insured retentions (SIR). SIRs are generally quoted between 0.5% and 1.0% of the policy limit. Before 2022, SIRs rarely dipped below 1% for most deals and 0.75% for deals larger than \$500 million.



## Conclusion

RWI is a valuable tool that adds a layer of protection and certainty to M&A transactions. By mitigating risks and facilitating more efficient deal processes, RWI is reshaping how parties approach negotiations and allowing for greater strategic outcomes in the dynamic world of M&A.



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