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The Continued Rise of Representations and Warranties Insurance: 2024 Forecast

By Jessica Rivero, Jae Lynn Huckaba, Syed Ahmad
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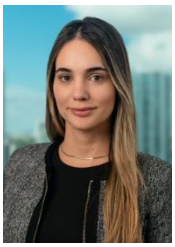

It is no secret that merger and acquisition ("M&A") activity has caused whiplash in recent years. In the two short years between 2021 and 2023, global deal values were cut in half—from a whopping $5 trillion to $2.5 trillion.[1] However, middle market deals have proven resilient in this challenging economic and geopolitical environment and are expected to rise in 2024.[2] This article discusses trends in representations and warranties ("R&W") provisions in M&A transactions, including those that may spark disputes and litigation, as well as the role of R&W insurance policies in reallocating risks associated with transactions and limiting litigation expenses, particularly in middle market deals.

M&A TRENDS AND COMMON PROVISIONS

Approximately one-third of M&A deal disputes in North America arise out of an alleged breach of a seller's R&W.[3] R&W provisions commonly include materiality and knowledge qualifiers and are frequently subject to survival periods, each of which often favor the seller by limiting the scope of disclosures and, therefore, reducing the risk of a buyer's claim for breach.

Material Adverse Effect ("MAE") provisions are pervasive in M&A transactions. In 2023, only 5 percent of private target M&A deals went without an MAE clause or chose not to define its meaning.[4] In this context, MAE clauses are frequently heavily negotiated and are intended to allow buyers to terminate a transaction should certain agreed-upon events occur.[5] Typically, MAE definitions contain forward-looking language and carveouts for particular events, such as war, changes in law, or pandemics.[6] However, MAE provisions have been historically difficult to prove and, therefore, often work to the benefit of the seller.[7]

Materiality scrape clauses, however, have seen a sharp increase in the last two decades, from being identified in approximately 15 percent of deals in 2005[8] to 82 percent of deals in 2022 (including in 64 percent of deals to determine breach).[9] Materiality scrape provisions are included in the indemnification section of a transaction document to remove materiality qualifiers for the purposes of determining breach, damages, or both, thus opening the door for buyers to successfully assert a claim for breach.

Materiality scrapes also appear in R&W insurance policies. Notably, a New York court recently found that a materially scrape in the R&W insurance policy at issue was ambiguous and decided that the representation, for the purpose of insurance, required only an adverse effect instead of a materiality showing.[10] The court reasoned that if it applied the materiality scrape as it was drafted in the R&W

insurance policy, then the scrape would remove the entire "Material Adverse Effect" phrase, which creates an ambiguity, and ambiguities are typically resolved against the drafter.[11]
Knowledge qualifiers are also widespread. Generally, "knowledge" definitions are constructive.[12] But companies should carefully draft such definitions, as knowledge qualifiers may lead to ambiguity if not properly defined, resulting in the need to determine what constitutes knowledge and who must possess the same.

The survival period of a seller's R&W is also commonly identified. In 2023, general survival clauses were identified in 93 percent of deals that did not procure R&W insurance and in 67 percent of those that did.[13] While 67 percent is a decline from 2019 (where 79 percent of deals with R&W insurance contained a general survival of a seller's R&W), it is an increase from 2020, 2021, and 2022, where deals with R&W insurance contained a general survival of a seller's R&W at the rate of 64 percent, 64 percent, and 50 percent, respectively.[14] Since 2018, the median survival period has been fifteen months.[15] Companies should note, however, that there are typically carveouts for certain R&W that are assigned longer survival periods, such as taxes and capitalization.[16] R&W relating to taxes and capitalization account for two of the three most common claims relating to breaches of R&W.[17] In 2022, taxes and capitalization R&W accounted for 45 percent and 9 percent of such claims, respectively.[18]

R&W INSURANCE COVERAGE SOLUTIONS

Given the above, it is not surprising the use of R&W insurance has increased over the years, as these insurance policies respond to cover loss resulting from a breach of representation or warranty. A party making a representation or warranty commits a breach if a representation or warranty proves to be inaccurate. Where R&W insurance is available, the non-breaching party may seek to recover its losses from the R&W insurer instead of seeking recovery from an established escrow account or directly from the seller under the transaction agreement. R&W insurance is often preferred over escrow accounts because the escrow funds cannot be used by either party during the period specified in the transaction agreement. R&W insurance frees up the capital that would otherwise be tied up in the escrow account. Plus, if R&W insurance negates the need for an escrow account, or lessens the amount needed, the seller may receive all of the purchase price, or more of it, at closing. Some deals may still require the seller to indemnify for claims within the R&W insurance retention and fund an escrow account in that amount, but that amount is necessarily smaller than if there was no R&W insurance.

To recover under an R&W policy, the non-breaching party usually must establish a breach of a covered representation or warranty and a loss resulting from such breach. Policyholders should be aware, however, that the definition of "breach" under the policy may carve out certain representations and warranties. In other words, the policyholder should not assume that breach of a certain representation or warranty is covered just because the representation or warranty is included in the transaction agreement. Some representations and warranties may be explicitly excluded from the policy's definition of breach or otherwise carved out. Under these circumstances, the R&W policy will not cover any losses resulting from an inaccuracy in the excluded representation or warranty. Accordingly, companies should advocate for coverage of specific representations and warranties, especially those that often lead to disputes. Compared to other kinds of policies, the terms of the R&W policy are typically more negotiable.

The negotiation and purchase of R&W policies can be an integral part of the due diligence process. While generally an important part of M&A transactions, due diligence becomes integral to obtaining an R&W insurance policy. R&W insurers will seek to mitigate the risk they acquire by ensuring that the buyer has completed an appropriate amount of due diligence. Such due diligence frequently includes an in-depth

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legal, tax, and accounting review, including memorandums addressing “red flags” or potential issues on the aforementioned topics. Underwriters review such information along with the corresponding data room to understand the depth and accuracy of the due diligence conducted. In fact, insurers may access the data room and request copies of any diligence reports that may impact the underwriting of the R&W policy.

Both buyers and sellers can procure R&W insurance. One key difference between buyer-side and seller-side policies is that under a buyer-side policy, the buyer makes the claim against the insurer for the losses incurred because of the seller’s breach. In contrast, under a seller policy, the seller pays the buyer for the seller’s breach of a covered representation, and then the seller may make a claim against the insurer for reimbursement.

While both buyers and sellers can procure R&W insurance, buyer-side policies are more common. Buyer-side policies typically offer broader coverage than seller-side policies. For example, a buyer-side policy usually covers seller fraud, while a seller-side policy will often exclude coverage for fraud. Buyer-side policies can also extend the survival period for the representations and warranties, meaning the buyer has more time to determine whether a breach occurred. For this reason, survival clauses are more prevalent in deals not involving R&W insurance. In other words, because a R&W policy has its own survival clause, the insurance may eliminate the need for a survival clause in the transaction agreement. Importantly, R&W insurance—regardless of which party purchases the policy—allows both parties to potentially avoid post-closing disputes and related expenses, including the costs of arbitration and litigation.

TAKEAWAYS

Recent M&A trends and the forecasts for the upcoming year highlight the importance of mitigating the risks and costs associated with disputes arising from transactions. As deals increase in value and frequency, companies may become more susceptible to potential losses. R&W insurance, in particular, is an important tool for mitigating losses that arise from inaccurate representations and warranties made by the seller or target company during the transaction. The R&W insurance market has continued to evolve, and like transaction agreements, insurance policies require negotiations and careful review of specific policy language, as coverage disputes often arise. As a result, companies should consult counsel with comprehensive expertise and experience in M&A deals, as well as competent coverage counsel to limit losses and maximize insurance recovery where losses occur

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Notes

1) Brian Levy, *The M&A starting bell has rung. Are you ready?*, PWC (Jan. 23, 2024). ↥
2) *Capstone Partners & IMAP Survey Finds Middle Market M&A Outperforms Broader Market Despite Global Deal Flow Decline*, CAPSTONE PARTNERS (Jan. 30, 2024). ↥
3) Berkeley Research Group, *M&A Disputes Report 2022: Global Economic Headwinds Impact M&A Market and Drive Disputes* (2022), 23. ↥
4) American Bar Association Business Law Section Mergers & Acquisitions Committee, *2023 Private Target M&A Deal Points Study (US Deals)* (2023). ↥
5) Stephen M. Kotran, *Material Adverse Change Provisions: Mergers and Acquisitions*, Practical Law Practice Note 9-386-4019. ↥
6) SRS Acquiom, *2023 M&A Deal Terms Study* (2023), 29–30. ↥
7) *Id*. ↥
8) Daniel Avery, *2021 Trends in Private Target M&A: The 'Materiality Scrape,'* BLOOMBERG LAW (June 2022). ↥
9) SRS Acquiom, *2023 M&A Deal Terms Study* (2023), 56. ↥
10) Novolex Holdings, LLC v. Illinois Union Ins. Co., No. 655514/2019 (N.Y. Sup. Ct. Jan. 18, 2024). ↥
11) *Id.* ↥
12) SRS Acquiom, *2023 M&A Deal Terms Study* (2023), 32. ↥
13) SRS Acquiom, *2023 M&A Deal Terms: Three Trends to Watch* (2023), 2. ↥
14) SRS Acquiom, *2023 M&A Deal Terms Study* (2023), 53. ↥
15) *Id*. at 59. ↥
16) *Id*. at 60. ↥
17) SRS Acquiom, *2022 M&A Claims Insights Report* (2022), 14. ↥
18) *Id*. ↥

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