

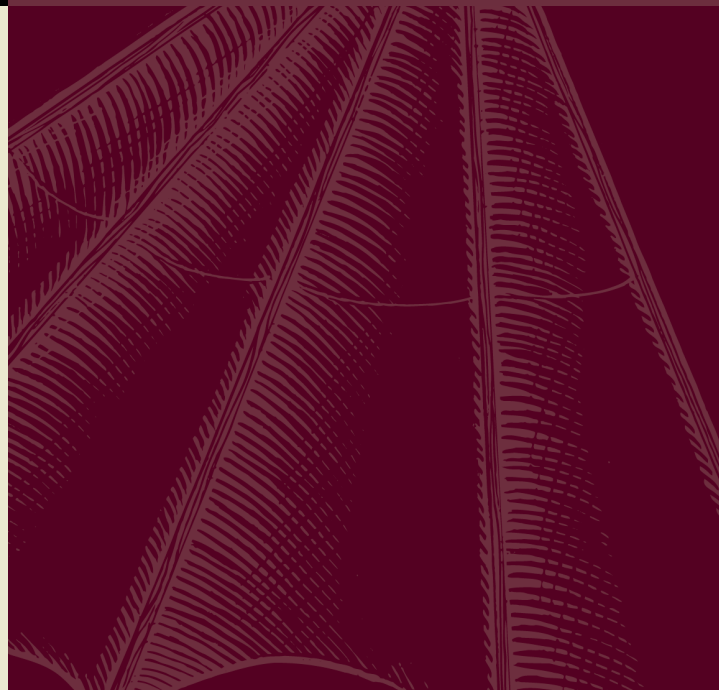
Buying the Business?

Consider Reps & Warranty Insurance

by Jeff Barrett, CIC

Given the complex nature of mergers and acquisitions, Representations (Reps) and Warranty coverage has become an essential tool to manage the risk associated with buying or selling a business.

The past decade has seen a significant increase in the number of customers purchasing Reps and Warranty coverage for mergers and acquisitions. This insurance covers the representations made by the seller to the buyer during the purchase. Examples of such representations may include the salability of the product or services provided by the business, or the financial condition of the seller and their assets. It can cover just a few of the representations or all that are related to a particular transaction.



Who obtains the coverage?

While this coverage can be purchased by either the buyer or the seller of the business, their motivations for obtaining the insurance are quite different. The buyer obtains Reps and Warranty coverage for financial protection (should the representations made by the seller turn out to be unintentionally false or inaccurate). The seller will generally purchase the coverage in an attempt to reduce the escrow amount, ultimately allowing them to collect their funds from the initial sale.

Just as the buyer and seller have their own motivations for purchasing Reps and Warranty coverage, they also have two forms available to secure coverage:

1. A buyer's policy form (which is first-party coverage); and
2. A seller's policy form (which is third-party coverage).

There are advantages to both forms and deciding upon which one to use is dependent upon each unique situation. The buyer's policy form can be advantageous for the buyer in the event of a breach. It will enable them to make a claim directly to the carrier instead of going through the seller to receive damages, making the settlement process much easier for the buyer. On the other hand, the seller's policy form can be less expensive because the carriers give greater credibility to the representations made by the seller since they are taking the initiative to purchase the coverage. As previously stated, the seller usually obtains this coverage in an attempt to reduce the escrow amount, not because they are concerned about the quality of the product or business they are selling. However, when the seller's policy form is used, the buyer is at a disadvantage because the claim must be presented by the seller as opposed to directly from the buyer.

What's it going to cost?

The cost structure of Reps and Warranty programs generally runs from 3 – 6% of the limits requested, and they can have minimum premiums as low as \$100,000. Some factors influencing cost include:

- Length of time needed for the policy.
- Amount of the retention (deductible).
- The strength of the seller's representations.

Additional qualifiers such as financial strength or pollution issues can increase the cost of the policy. Keep in mind, the amount of the retention has a major impact on the overall cost. They can sometimes be set as low as \$250,000, but more often than not they are 1 – 2% of the transaction price. It is important to remember, however, the retention can be somewhat negotiable depending upon the underwriters' comfort level with the transaction.

Signing the dotted line

Several steps in the underwriting process must occur before the policy can be completed:

- After receiving preliminary information regarding the financials, purchase agreement and basic terms and conditions, the carriers will extend a non-bindable indication to the insured.
- If this is accepted, an underwriting fee is then paid for the due diligence the carrier will commence for the final underwriting of the risk. This is a non-refundable fee the carrier charges in order to bring in experts for legal and financial consulting.
- Additional data is usually requested by the carrier at this time.
- A final quote is issued detailing the carrier's terms and conditions, as well as any exclusions to the transaction.

The marketplace has several carriers with significant capacity to provide high limits of liability, including Chartis, CNA and The Hartford. There are also several markets that will offer excess capacity in the event it is needed. Pricing in this coverage line has continued to be rather soft over the last several years, which could account for its current increase in usage.

Protect your purchase

Reps and Warranty coverage has become an essential risk management tool during mergers and acquisitions, especially considering the rise in global transactions and the obstacles that arise. The marketplace is expected to continue to expand, which means this coverage will become an increasingly significant component of such transactions in the near future. If you are (or plan to be) involved in a merger or acquisition, we urge you to find out if this coverage is right for you.

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