BB&T Capital Markets

Allocating M&A Post-Closing Risks

Solutions today include both escrow and insurance

In merger and acquisition negotiations, deal participants have traditionally allocated post-closing risks using tri-party escrows. While escrow agreements continue to play an important role in M&A transactions, a growing number of participants are buying insurance to address seller breaches of representations and warranties as well as other post-closing risks.

Until less than a decade ago, the predominant method of allocating risks between deal participants was through the use of an escrow. Under such an arrangement, the buyer funds an escrow account with a portion of the sale proceeds. Those funds are only released to the seller after a pre-stipulated length of time, once it has been determined the seller is in compliance with all representations made at closing. Escrows can also be utilized to facilitate purchase price adjustments, milestone payments pegged to post-closing revenue targets, management retention or environmental remediation. To address multiple needs, a typical escrow can have various sub accounts set up under one agreement.

Emergence of transactional insurance

In recent years, several types of transactional insurance have emerged to complement M&A risk allocation via escrow agreement. In addition to representations and warranties ("reps and warranties") coverage, these include tax opinion/tax liability and contingent liability insurance policies.

Reps and warranties policies allow deal participants to pay an insurance premium to allocate the risk of an unknown breach of representations and warranties in the purchase agreement. Common breaches relate to the truth and accuracy of financial statements, compliance with laws, material contracts and employment issues. In contrast, tax indemnity and contingent liability policies cover risks known at the time coverage is bound – for example, the risk of a loss due to ongoing litigation.

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Private equity sellers were initially responsible for driving the use of transactional insurance, but over time strategic buyers have come to view purchasing coverage as a way of making their bids more attractive to sellers in an increasingly competitive M&A market.

Growing demand for reps and warranties coverage

Reps and warranties is the most common type of transactional insurance used to allocate M&A deal risk. A leading insurance carrier providing such coverage reports that its annual reps and warranties submission count – the number of quote requests it received – rose more than twelvefold from 2012 to 2018.[1]

An increasingly common rationale driving purchase of the coverage today is the desire to protect relationships with executives, rollover shareholders and customers.

Consider, for instance, a buyer that purchases 80% of a company but agrees to allow the seller's owner to retain a 20% interest and remain CEO. In that situation, what happens if the seller's financial statements turn out to be inaccurate, leading to breach of a purchase-agreement representation and a loss for the buyer? Without any indemnity structure in place, the buyer would be put in a position of needing to sue its own high-ranking employee – the former owner/current CEO ultimately responsible for the breach – to recoup the losses. On the other hand, with reps and warranties coverage in place, the buyer can look to the insurance company issuing the policy to recoup those losses.

Indeed, reps and warranties coverage offers the general advantage of allowing a buyer to pursue a claim against an insurer – typically a financially stable company with a claims-paying reputation to uphold – rather than a counterparty.

Just a few years ago, there were only five underwriters offering reps and warranties policies, and companies in a number of industries – such as energy, financial services and health care – were considered uninsurable for the coverage. Now, however, there are more than 20 underwriters offering such transactional insurance. Also, with growing competition among insurers, the coverage has become available across most industries.

Many M&A participants purchase insurance to protect relationships with executives, rollover shareholders and customers.

Reps and warranties insurance basics

Coverage: Protects against financial losses (including defense costs) from breaches of representations and warranties. It is not insurance against business risk, i.e., a bad deal.

Premium: One-time payment of between 2.5% and 3.5% of primary policy limits (i.e., between $250,000 and $350,000 per $10 million of indemnity protection).

Policy limits: Typically 10% to 25% of enterprise value, depending on the insured's risk appetite.

Policy period: Typically six years for fundamental and tax, and three years for general.

Retention: Typically 1% to 2% of enterprise value, dropping down to a minimum level (e.g., 0.5%) upon release of seller's escrow, if any; retention is aggregate and thus eroded by each claim.

[1] AIG Americas R&W

Fashioning the best risk allocation strategy

With the emergence of transactional insurance – and with escrow agreements still a valid tool – M&A participants have more choices today for allocating post-closing risks. Here are factors to evaluate when establishing a strategy for any particular deal:

- **Type of risks:** Common risks such as a breach of a purchase agreement's representations and warranties can be mitigated through either insurance or escrow. Risks excluded from insurance policy coverage, such as a pending lawsuit, historical environmental issues or a disputed tax liability, can always be ring-fenced by an escrow structure and can sometimes be transferred to an insurance policy.
- **Negotiating leverage:** Sellers typically require buyers to use reps and warranties insurance for post-closing recourse so that sellers can walk away from the deal at closing with the maximum proceeds. In many cases, buyers still prefer a significant seller escrow, but there are also buyers now that seek reps and warranties insurance for its own benefits.
- **Timing of risk identification:** The reps and warranties insurance underwriting process typically takes two to three weeks from submission to binding, although it can be completed faster if necessary. Escrows, on the other hand, can be established in a matter of days.
- **Deal size:** Reps and warranties insurance fits best in mid-market deals involving around $20 million to $3 billion in enterprise value. For smaller transactions, the cost of an insurance policy might be prohibitive. However, deal size is less likely to impact whether an escrow solution is available.

Often the best solution is to combine a traditional escrow agreement with insurance. Since the seller's indemnity is typically capped at a much lower amount by using reps and warranties coverage, the seller is often willing to pay for all or a portion of the coverage.

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BB&T offers both traditional escrow services and – through its McGriff, Seibels & Williams insurance brokerage firm – brokerage services for transactional insurance. Contact the following representatives to learn more:

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