Floyd Advisory

Best Practices to Maximize Value from Representations and Warranties Insurance Policies

Insights from Forensic Accounting & Finance Experts

The use of Representations and Warranties Insurance ("RWI") in mergers and acquisitions has been on the rise in recent years – with leading insurer, Aon, reporting an increase of more than five-fold in both number of policies underwritten and award limits on those policies over a recent five-year stretch[1] – and for good reason. RWI policies protect and benefit both buyers and sellers in multiple ways in mid-size as well as large transactions. These benefits include acting as a bid enhancement and speeding up the close process, minimizing the escrow needs and locking in purchase price amounts for distributions to funds or shareholders earlier for a seller, and protecting buyers against collectability risks of indemnity provisions. Assuming you are already aware of the value that RWI can add to your current or prospective deal, the question then becomes: how do you optimize your policy? If a breach occurs and you are considering submitting a claim, what can you do to keep the interaction with the insurance company efficient and meaningful to your bottom line? There are steps you can take, especially prior to closing the deal, to help ensure that you benefit appropriately from your insurance policy, if the need arises.

Below is a list of items, and insights on each, that prospective RWI holders and their advisors should consider when contemplating the use of a RWI policy.

1. Make Sure Value Drivers are Documented, Not Just ROI Tables
   - Document the Drivers of Purchase Price (and Align Your Claim Basis)
2. Don't Get Caught in a Policy Coverage Abyss
   - Understand the Claims that the RWI Policy Does – and Doesn't – Cover
3. Don't Let Your Due Diligence Report Be Your Worst Enemy
   - Be Hypersensitive to Disclosures and Prior Knowledge
4. Imagine Your Worst Case Scenarios… and Get Them in Writing!
   - Document Hypotheticals
5. For One-Time Damages Claims, K.I.S.S! ("Keep It Simple, Stupid!")
   - Maintain Sufficient Support to Keep One-Time Damages Claims Simple
6. A Bit of Finesse Will Help Clean the Mess of Business Valuation Damages
   - Use a Nuanced Approach for Business Valuation Damages
7. Take a Walk In an Arbitrator's Shoes Before Presenting Your Claim
   - Assess the Quality of the Claims

"…determining ways to document the underlying value drivers of the deal in anticipation of a possible RWI claim can also help secure and improve investor returns."

Areas to Address Upfront When Considering RWI

Understanding both the importance of the RWI provisions and your deal valuation process and taking the appropriate measures upfront can help for a smoother experience if claims ultimately arise.

1 Notably, Wachtell, Lipton, Rosen & Katz recently published "Representations and Warranties Insurance in Public M&A Deals," citing Aon's growth from 131 RWI deals with $5.6 billion of policy limits in 2014 to 795 RWI deals with $28.6 billion of policy limits in 2019. (https://www.wlrk.com/webdocs/wlrknew/AttorneyPubs/WLRK.27026.20.pdf)

1. Make Sure Value Drivers are Documented, Not Just ROI Tables

Valuation models are a complex treasure trove of information. They often contain key or proprietary assumptions from the buyer that help inform the decision to ultimately buy or pass on a deal. The secret sauce that goes into a valuation model directly contributes to the investor returns required to compete and differentiate among investment managers and thus such models are often held close to the chest. While this practice is common and undoubtedly rational, determining ways to document the underlying value drivers of the deal in anticipation of a possible RWI claim can also help secure and improve investor returns.

First – how is the deal priced? Often, buyers use cash flow metrics (EBIT, EBITDA) to develop purchase price multiples with which to compare to other transactions in the market. There can be a range of acceptable deal multiples or one specific target multiple under consideration. In some transactions, a deal multiple is contractually agreed upon as part of the negotiated terms. In others, the purchase price is determined by other factors, rendering the purchase multiple a secondary consequence. Documenting these considerations is an important way to decrease the variables used in potential damage calculations related to breaches under RWI policies. Alternatively, if the buyer's documentation (or lack thereof) leaves open the possibility that the deal was predicated on a range of acceptable multiples, then one could argue that the damage to the buyer is limited to the low end of the purchase multiple range.

"The stronger the support for the valuation narrative that you can produce to the insurer, the more you can demonstrate the strength of your claim and minimize vulnerabilities to counterarguments."

Understanding that a transaction negotiation is dynamic, the buyer may be more focused on the targeted return on investment rather than strictly the pure purchase multiple. This could easily make sense, as there are various levers to be pulled to help manage the impact of purchase multiples at different levels. An important question in damage considerations then becomes: is there a range of acceptable returns, or is the deal contingent on a more binary minimum target return threshold? Similar to the multiple scenario, the facts weigh differently when considering a damage calculation for a deal that was targeting a specific minimum rate of return on investment versus a deal that could have succeeded with a range of returns. The existence of a potential range or the lack of clearly documented terms and requirements will certainly be factors considered by forensic accountants and insurance companies when calculating these damages.

Additionally, there are other sources of damages to contemplate. Take the considerations of a strategic buyer, for instance, where the buyer expects to realize synergies across business units. While a purchase price can equate to a competitive market multiple off of TTM EBITDA, the buyer may have also anticipated consolidating operations, decreasing overhead, and increasing profit margins. Thus, a breach of representation or warranty could very well cause damages at more than the purchase price multiple calculation, which again emphasizes the importance of documenting valuation models, strategic forecasts, and other deal considerations.

In addition to valuation models, there are other documentation items that can play a role in preemptively creating a robust set of RWI documentation. These may include:

- Board minutes or other internal presentations which may provide insight into the key considerations or valuation criteria for the subject transaction (what was/were the target multiple(s), how was/were the target multiple(s) determined, were there other important metrics driving the negotiation, such as return on investment, etc.);
- Internal evidence showing prior consummated deals at similar multiples or prior deals using similar valuation considerations during negotiation; and/or
- Presentations or notes with lenders presenting similar parameters or factors.

The stronger the support for the valuation narrative that you can produce to the insurer, the more you can demonstrate the strength of your claim and minimize vulnerabilities to counterarguments.

As a final note on the pricing of a deal, it would behoove a buyer to consider materiality, both within the valuation and contract context. The contract may not provide an explicit quantification or definition of materiality. Thus, unless your contract includes a comprehensive materiality scrape for breaches and damages (e.g., eliminating any materiality consideration such that an issue of *any* quantity would be considered a breach), documenting or defining issues as material to the valuation process will add additional support and clarity to the damage calculation, should the need arise.

2. Don't Get Caught in a Policy Coverage Abyss

While ensuring a claim aligns with the prepared documentation on the drivers of purchase price is completely in your control, what about consistency with the RWI policy itself? Are there certain areas to consider regarding the policy that are perhaps more critical to the valuation or execution of a deal than others? Obviously, each part of the policy has its purpose, but being especially dialed in to specific sections of the contract will contribute to a successful transaction.

From the outset, it is important to consider the potential overlap and difference in coverage between the working capital purchase price adjustment mechanism ("PPAM") within the transaction documents and a RWI claim within the policy. The PPAM is used to bridge the gap between the estimated closing working capital (at the time of signing) and the actual working capital (at the time of closing). Often these balance sheet items, such as cash, receivables, inventory, payables, etc., are hard to accurately predict at the level of precision needed for such a large transaction, so the PPAM provides opportunity for the parties to adjust the closing payment amount to make up for this difference. However, there are directly competing incentives for the buyer and the seller for the PPAM. The buyer benefits by keeping the provisions general and broad (reflecting a general desire to protect against any last minute financial gamesmanship by the seller), whereas the seller benefits by keeping the provisions strict and defined (reflecting the desire to lock in the sale price and limit uncertainty of cash flows). As it relates to RWI, the policy terms may exclude any losses that could have been recovered under the jurisdiction of the PPAM. However, if these losses were directly caused by a qualified breach, then the RWI policy may supersede the PPAM. Proactively addressing these items in a clear and concise manner will allow you to avoid confusion, misunderstandings, or costly mistakes.

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Implied in the previous discussion is a rule worth repeating explicitly: Understand the RWI language! RWI policies are drafted in conjunction with the purchase and sale documents, potentially adding an iterative effect to the negotiations. They use similar key words but also contain their own definitions and jargon. The policy will endeavor to limit the scope of coverage, including specifically identified exclusions of known or existing liabilities. It is critical to understand not only the key terms of the policy (i.e. coverage limit, retention amount, premium) but also the more subtle concepts (e.g. scope, claim submission rules, interaction with the transaction documents, etc.). The vastly different timeline for submitting a claim between the PPAM (one to two months after close) and the RWI policy (one to three years after close) requires a solid understanding of both to properly address any post-acquisition issues in the right venue.

3. Don't Let Your Due Diligence Report Be Your Worst Enemy

Every transaction will involve a significant amount of due diligence, a key component of which is the Quality of Earnings report ("QoE"). As part of the QoE, the target company's EBITDA is calculated and normalized to adjust for one-time or extraordinary expenses. These reports, along with the company's financial statements, should be combed through in great detail to garner a better understanding of the especially sensitive areas, such as historical practices for accounting estimates. Furthermore, after becoming familiar with these documents, it is important to know what you still do not know.

- Are asset reserve estimates general or specific? If specific, to what degree of granularity?
- Does the reserve policy logically align with the business, or is it lacking relevant considerations?
- If the target company deals with regulatory agencies, do you or your consultants have the necessary relevant expertise to assess compliance levels?

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Asking the right questions during diligence may bring issues to light during the negotiation process, and it is preferable to address items of concern head on rather than after the fact. Additionally, it is imperative that diligence efforts be updated from its original timeframe to as close to closing as possible. If information was available but not considered in the pre-deal period, including information that arose between signing and closing, policies may exclude claims on the basis of prior knowledge by covered persons (based on the specific policy limitations).

Remember, the ultimate goal is to not have to submit a RWI claim at all, so do the work to mitigate the probability of going down that path in the first place. Underwriters of RWI policies are intending to provide coverage for the "unknown" – but that does not allow for buyers to be willfully ignorant of facts that should have been considered pre-closing.

4. Imagine Your Worst Case Scenarios… and Get Them in Writing!

Identifying sensitive assumptions and documenting the various potential "what if" scenarios can be a valuable tool to set the rules in advance when negotiating and agreeing to policy terms. Leaving policy terms general until a need arises is a sure way to slow down the claim process and allow significant room for misunderstandings or differing interpretations between the parties. On the contrary, contemplating potential breach scenarios and including examples or hypotheticals in the documentation will force both parties to have a dialogue on these sensitive issues. Ideally, following this communication there will be a seamless meeting of the minds; however, if this is not the case, then the upshot is that you have just uncovered some critical issues that need to be addressed before signing on the dotted line.

For example, in a carve-out or spin-out scenario, the target company may have reported certain G&A costs on an estimated or allocated basis in its historical financials. What if actual costs exceed those estimates? Will the policy cover those overruns, which may lead to a less profitable company than what had been anticipated and modeled? If not, how does the policy differentiate between legitimate breaches to representations on the accuracy of financial information and specific situations such as the hypothetical discussed above? Using examples or addressing hypotheticals proactively helps avoid a policy scope dispute later on!

There may be other situations where a specific process, or even historical financial data, are not available to which the sellers can make representations. This may be a case where a TTM EBITDA was not deployed as a driver of value, or an earn-out is used in deal valuation. These scenarios add a layer of complexity to the RWI claims process, necessitating greater contemplation as to what representations sellers are making and how RWI could apply.

Finally, be sure to carefully consider who on the seller side is making representations and warranties during the diligence process, and ensure they are also the ones making the representations and warranties for purposes of finalizing the agreement.

In essence: the use of a RWI policy does not preclude the need for strong, thorough representations and warranties from sellers.

Preparing for Claims

Up to this point, you have prepared for your transaction, taking care to proactively consider the RWI policy and prepare as best you can for any post-transaction issues. In an ideal world, your transaction will go off without a hitch, but in reality, a breach may be more common than you would expect. The percent of RWI policies with claims submitted against has been holding steady at around 20% in recent years, according to insurance giant AIG.[2] Once both an alleged breach and a causal link to damages have materialized, and there are no relevant exclusions under the contract, it is necessary to quantify and classify potential damages for your transaction. As alluded to above, there are two main types of claims for which to prepare: one-time damages and business valuation damages.

5. For One-Time Damages Claims, K.I.S.S! ("Keep It Simple, Stupid!")

One-time damages are often easily recognizable. Undisclosed liabilities or other "oldco" costs you incur may neatly fall into this category. Other damages may include costs to remediate a breach such as consultants or committing additional unplanned capital expenditures. These types of damages often come well-packaged with engagement letters, line-item invoices, and other primary documentation that both forensic accountants and insurance companies greatly appreciate. Another segment of one-time damages deals with accounting estimates.

2 "With global claims frequency holding steady at one-in-five policies, it is clear the product is responding and that it has reached maturity as a deal facilitator." (https://www.aig.com/content/dam/aig/america-canada/us/documents/business/management-liability/aig-manda-2020-r-and-w.pdf)

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"One-time damages are often easily recognizable. Undisclosed liabilities or other 'oldco' costs you incur may neatly fall into this category. Other damages may include costs to remediate a breach such as consultants or committing additional unplanned capital expenditures."

These types of damages are, by definition, less concrete than the explicit costs to remediate a breach, but this does not imply that these losses are any less real. Items such as inventory or reserve accounts, for example, could have significant financial impacts if the values are misstated. The judgmental nature of these damages requires special attention to collecting and preserving the relevant documentation needed to prove a claim. If your one-time loss includes accounting estimates, make sure that it is within the jurisdiction of the RWI (as opposed to the PPAM), and pay particular attention to supporting a tight narrative.

6. A Bit of Finesse Will Help Clean the Mess of Business Valuation Damages

Business valuation damages are the other segment of potential damages to recover from RWI. These damages are recurring in nature, resulting in a permanent decrease to the value of the business, or said another way, an overpayment for the target company at the transaction date. Often, this can take the form of a calculation showing the impact to EBITDA (or other metric) applied to the purchase price multiple. However, as mentioned above, the resulting damages may be a bit more complex when factoring in negative impacts to synergies, etc.

Do note, the various types of damages are not mutually exclusive. There could be legitimate one-time damage claims that accompany a business valuation damage claim. An example of this could be a breach in regulatory representations that required the company to hire expert consultants to help remediate the issue (one-time damages), and, as part of their recommendations, the company added multiple new full-time employees to maintain compliance going forward (recurring / business valuation damages).

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7. Take a Walk In an Arbitrator's Shoes Before Presenting Your Claim

Assessing the quality of the claim(s) is an important final piece to consider when preparing to file RWI claims. The truth is that only a fraction of claims end in payouts by the insurers. Based on a recent RWI claims study published by Aon, only 26% of the resolved claims resulted in a payout, while 39% resulted in settlements within the retention (i.e. no payout), 26% became inactive over time, and 9% were denied coverage.[3] Thus, it is a helpful step, especially in a situation with multiple claims being submitted, to assess the relative strengths and weaknesses individually for each claim. Taking this one step further, the various claims can be given a ranked weighting based on overall quality or probability of success, and a resulting expected damage outcome can be calculated. Having this probability-adjusted damage number is highly recommended to not only help frame your initial expectations of potential outcomes, but also to give valuable insight when it comes time for settlement negotiations.

Conclusion

It is clear that being proactive, even prior to the consummation of the transaction, is key to maximizing the value of a RWI policy. Being organized, asking the right questions, understanding the nuances of the RWI policy, and having your documentation in order will set you up for the least painful outcome, should an unfortunate breach and subsequent damages occur.

Furthermore, in the event of such a breach and damage event, knowing the different types of damage claims, being able to quantify the damages, and assessing the quality of each claim all play an important part in the process. Taking these steps will protect shareholder returns by optimizing the speed and value available with RWI.

3 Aon's study included more than 340 claims made against its policies within North America since 2013. 54% of these claims remain active. Payments made to clients total more than $350 million, with a total loss related to these payments of more than $525 million. The delta between loss and payments is absorbed by policy retentions. (https://img.response.aonunited.com/Web/AonUnited/%7B64ae979e-1fbb-41f7-826b-d05e449b9d16%7D_Aon_2020_North_American_R_W_Claim_Study.pdf)

Floyd Advisory helps parties manage complex issues that come with engaging in a transaction process, starting with pre-deal risk mitigation efforts – helping to review accounting practices, crafting language in purchase and sale agreements related to the post-closing adjustments, assembling accounting records, reviewing and preparing for RWI policies – and through to any post-transaction dispute processes, either with the seller or insurance provider, as needed. Our professionals have served in all roles within transaction service advisory work and can team with you as you approach the completion of the transaction and work with you through and beyond the closing process. We have the experience necessary to ensure RWI claims are prepared in a manner best suited to a successful outcome. Select practice leadership and their experiences are summarized below.

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WILLIAM SHEA, CPA, is a Partner at Floyd Advisory. He has an extensive range of experience covering accounting, advisory and investigation services, including post-acquisition and earn-out disputes, royalty audits and other specially-prepared calculation disputes, restatements, forensic accounting, valuation assignments, and special investigations. Mr. Shea has worked with many top corporate law practices, private equity firms and their portfolio companies on M&A-related matters, including pre-deal consulting work designed to mitigate risk, as well as post-acquisition disputes, including purchase price disputes, as the accounting expert on numerous arbitration proceedings. He has also served as an expert witness in United States District Court, state courts and in front of arbitration panels.

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ABOUT Floyd Advisory

Floyd Advisory is a consulting firm providing financial and accounting expertise in areas of SEC reporting, transaction advisory, investigations and compliance, litigation services, as well as business strategy and valuation.

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