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Proskauer Benefits Brief: Rep and Warranty Insurance and Executive Compensation and Employees Benefits

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In this episode of The Proskauer Benefits Brief, David Teigman, partner in the Employee Benefits and Executive Compensation Group, Simon Sharpe, partner and member of our Private Equity and Mergers & Acquisitions groups and Nick LaSpina, senior counsel in the Employee Benefits and Executive Compensation Group discuss rep and warranty insurance (RWI) in the mergers and acquisitions context. They also focus on certain aspects of this insurance product as it relates to executive compensation and employee benefits matters. For the last 10 years, we have only seen the use of this insurance product proliferate, so be sure to tune in as these issues will continue to be highly relevant in any transactional practice.

David Teigman: Hello and welcome to The Proskauer Benefits Brief: Legal Insight on Employee Benefits and Executive Compensation. I'm David Teigman, Partner in the Employee Benefits and Executive Compensation Group at Proskauer and with me today are my colleagues, Simon Sharpe, a Partner and a member of our Private Equity and Mergers & Acquisitions group, and Nick LaSpina, who is a Senior Counsel in our Employee Benefits and Executive Compensation Group. Welcome to you both.

Simon Sharpe: Good to be here.

Nick LaSpina: Good to be here, as well.

David Teigman: Today, I wanted to talk about rep and warranty insurance (or RWI for short) in the mergers and acquisitions context and then focus on certain aspects of this insurance product as it relates to executive compensation and employee benefits matters in a transaction. Simon, if you wouldn't mind, could you give us a brief overview of rep and warranty insurance?

Simon Sharpe: Sure. As I'm sure most folks in our audience are aware, a purchase agreement for an M&A transaction includes a number of representations made by the seller regarding the target and its business. These representations cover matters such as compliance with law, financial statements, IP, taxes and, of course, executive compensation and benefits. Rep and warranty insurance is a type of insurance that provides coverage for breaches of these representations. In simple terms, it's an insurance product that provides recourse for a buyer for losses or liabilities that may arise post-closing in connection with a breach of representation.

Rep and warranty insurance is a substitute for the traditional indemnification structure that used to be pervasive in M&A deals. In a deal without rep and warranty insurance, a seller's representations would survive the closing and a portion of the purchase price, typically in the range of 10-15%, would be set aside in an escrow account for anywhere from 1 to 2 years. That escrow would be used to fund and provide security for the seller's obligation to indemnify the buyer for breaches of those reps. In a deal with RWI, there is generally no indemnification for rep breaches — an insurer effectively steps into the seller's shoes as the party that backstops those reps.

David Teigman: How long has this product been around, and why did it come around?

Simon Sharpe: I started seeing the product being used about a decade ago, although I would not say it was common at the time. Its early adopters were buyers who wanted a leg up in competitive auction situations involving the sale of portfolio companies from private equity funds – for example, if a bidder went to a PE seller and said "I may be offering the same purchase price as someone else, but my bid is better because I will deliver 100% at closing rather than 85% upfront and 15% in 2 years", that bidder is at a significant competitive advantage. From the seller's perspective (1) RWI minimizes the risk that indemnification claims chip away at the purchase price, and (2) even if the full purchase price is ultimately received, receiving all of it at closing improves the fund's internal rate of return, or IRR, which takes into account the time value of money and is the primary yardstick by which funds measure their performance. Using RWI also leaves less for the parties to negotiate in the purchase agreement, which is attractive to sellers from a speed and deal execution perspective.

Over the last decade, the market for RWI has grown significantly and matured, to the point where the product has become fairly pervasive in M&A deals – buyers, both private equity and strategic, have become very comfortable with obtaining it, just as sellers, both private equity and strategic, have come to expect it, especially in competitive situations. It’s broadly used across sectors and types of private company deals, including cross-border transactions, continuation fund transactions, and smaller deals.

David Teigman: I see the appeal from the sell side — what are some of the advantages from the buy side?

Simon Sharpe: Indemnification provisions are designed to allocate risks and liabilities between the buyer and the seller, but they can be difficult and time-consuming to negotiate, and often result in post-closing disputes. RWI can provide more comfort to a buyer that it will have a creditworthy counterparty to efficiently make a claim against, for example, in distressed M&A or where there is a large group of sellers. From a claims perspective, RWI can be helpful in preserving key relationships, for example, by eliminating the need to pursue claims against management sellers who continue to work for the buyer post-closing. One of the main advantages from the buy side is in terms of scope of protection – purchase agreements in deals with RWI deals tend to have a more robust set of representations; since sellers do not have to stand behind them with a contractual indemnity post-closing, they should more readily agree to providing reps that are broader than what they would otherwise agree to.

David Teigman: That all makes sense. How are these policies typically structured and how much do they cost?

Simon Sharpe: The policy will have a retention amount, or deductible, which is the amount of losses that the buyer must bear before the insurance kicks in. The retention amount can vary depending on the transaction size and the policy terms, but it’s usually around 0.5% to 1% of the enterprise value of the target business. A bigger deal will have a lower retention as a percentage of the target’s enterprise value. The policy will also have limits on the amount of coverage. The coverage limit will depend on the buyer’s risk tolerance, pricing and overall deal size – as a percentage of the enterprise value of the target business, a normal range for the coverage limit of liability would be anywhere from 5% to 15%. So, for example, on a $100 mm transaction, a normal amount of coverage might be $5 to $15 million.

These days, the cost is around 3.5% of the limit of liability (which is inclusive of underwriting fees and broker fees). Although, the cost of the coverage varies based on market forces — pre-pandemic I was used to seeing policies price just under 3% of the limit of liability; at the height of the deal activity in late 2021, I saw pricing approach 6%. Pricing has come down a lot since the height of the market – these days there is much more competition among carriers to underwrite deals. The terms of the policies are also becoming more buyer favorable.

David Teigman: Thank you, Simon. That's all very helpful background and context. Nick, if we can transition to focus on executive compensation and employee benefits matters in the context of rep and warranty insurance that would be great. To that end, what is one of the first things an executive compensation professional will need to focus on related to rep and warranty insurance in an M&A transaction?

Nick LaSpina: I'm glad you started with that question, Dave. As with any transactional issues, you really need to understand the big picture to help ensure you'll be providing practical and actionable advice. In this case, as an executive compensation transactional attorney, you should confirm upfront whether the transaction will be a rep and warranty insurance deal or not. Buyers are generally incentivized in a rep and warranty insurance deal to obtain very robust, specific representations from sellers on executive compensation, benefits, and even labor issues to maximize the availability of insurance coverage. In turn, insurance providers will expect to see that detailed diligence on the specific issues addressed by the representations has been completed by specialists who are well-versed in those issues. If a provider is not satisfied with the diligence performed on an issue, the provider will look to exclude that issue from coverage under its policy.

David Teigman: That's helpful context, Nick. Interestingly, one of the most significant liability issues that could be present in a transaction from an executive compensation and benefits perspective is the presence of defined benefit pensions, including multiemployer plans. But, the rep and warranty insurance policy will almost always exclude these types of liabilities (in particular, any underfunding liabilities) upfront as part of the so-called standard policy exclusions. Nick, so if these types of liabilities are likely to be excluded from the insurance policy, what types of liabilities would the rep and warranty insurance cover?

Nick LaSpina: Well, theoretically, almost any other liability related to executive compensation and benefits could be covered by rep and warranty insurance, as long as it does not relate to liabilities that are already known at the time of a deal. These liabilities could relate to equity awards, 401(k) plans, employment agreements, worker classification issues, specific state and local law issues, etc. However, in recent years, there has been more resistance from insurers regarding coverage for “wage and hour”-type claims without a significant amount of specialized labor diligence being conducted, largely due to the difficulty of assessing compliance on those issues through documentary diligence and the potential for those types of claims to turn into class actions.

David Teigman: What’s the trick to helping make sure coverage on these types of issues is maximized in a rep and warranty insurance policy?

Nick LaSpina: Although it is often counterintuitive to buyers, the most important item is to conduct a robust diligence process. There is sometimes a misconception among buyers that the existence of rep and warranty insurance means that the buyer can save costs on diligence – but that is not ultimately the point of a rep and warranty policy. As Simon described, the real benefit is certainty for sellers (who in a traditional deal would often have a portion of their proceeds tied up in an indemnity escrow or would need to live with the possibility of a buyer seeking indemnification for breaches of pre-closing representations years down the line), and a streamlined indemnification process for buyers (who may otherwise be in the position of suing a counterparty to a sale transaction that the buyer may have – or want – a continuing relationship with). Typically, the insurer and its counsel will want to see a diligence memo that covers employee benefits and executive compensation issues.

David Teigman: That makes sense, Nick. That is, the insurer will get some level of comfort on the various liabilities that could relate to employee benefits and executive compensation if Buyer’s counsel has done a detailed review and analysis of the various documents and potentially even done a diligence call with the seller’s management, including those individuals with knowledge of the company’s benefit plans and HR-related issues. So, is this the only step in hopefully limiting exclusions with the insurer?

Nick LaSpina: No, there is another important step. Most likely, the insurer is going to request a call with Buyer's counsel to discuss Buyer's counsel's findings in the diligence process as well as to assess the adequacy of the diligence process generally.

David Teigman: What do you mean by a discussion related to the diligence process generally?

Nick LaSpina: It's a good question, Dave, and something that is often overlooked. Early on in any diligence process, certain judgment calls need to be made. For example, if only a limited number of employees of a target company are outside the United States, a buyer may decide not to engage non-U.S. counsel to diligence employee benefits and executive compensation issues outside of the United States, and to rely on only internal or business-level review. At the very least, the rep and warranty insurer will want to know what sort of diligence process was undertaken for legal issues that relate to any non-U.S. operations of a target. And, if the answer is that limited diligence was done outside of the U.S., then the insurer is likely to ask follow-up questions on those issues or require formal diligence to be conducted (unless the buyer is simply willing to agree to exclusions on these items in the policy). This issue can arise in a myriad of areas, and in our experience, are most likely to come up where a specific legal expert was not engaged – for example, the non-U.S. legal issues I just mentioned or state specific issues (California labor compliance is a good example). At its core, this is really just a balancing act for any potential buyer, who must weigh the costs of incremental diligence against the potential benefits of broader insurance coverage (and the ultimate risk of any material breaches of the seller's representations).

David Teigman: Thank you, Nick. That's all very helpful and those are important points for any Buyer to be aware of. Simon, from the perspective of leading teams of transactional lawyers, is there any specific advice you can offer to specialists and in particular executive compensation attorneys when a transaction will have a rep and warranty insurance policy?

Simon Sharpe: Yes, succinctly said, rep and warranty insurance can be a valuable tool for managing risk in M&A transactions, but it's not a substitute for proper diligence. In fact, as part of the underwriting process, the specialist teams, including executive compensation attorneys, need to get the insurer comfortable that they have adequately diligenced the relevant risks and gotten comfortable with the accuracy of the representations on the basis of their diligence. The underwriters expect to see that the advisors' DD process was driven by expertise and conscientiousness. Specialists should never tell underwriters on an underwriting call anything along the lines of "we're comfortable because we are receiving a representation from the sellers on that point" – that's a big red flag for underwriters and will lead to a policy exclusion.

David Teigman: Simon and Nick, thank you so much for this informative discussion about rep and warranty insurance generally and specifically in the context of employee benefits and executive compensation issues. For the last 10 years, we have only seen the use of this insurance product proliferate and its usage is unlikely to decrease, so these issues will continue to be highly relevant in any transactional practice. Thank you also to our listeners for joining us on The Proskauer Benefits Brief today. Stay tuned for more insights on employee benefits and executive compensation, and be sure to follow us on Apple Podcasts, Google Podcasts and Spotify.

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