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Senior Lender Considerations in Respect of Representation and Warranty Insurance in Middle Market Private Equity Transactions

Cari Grieb[*]

This article addresses the benefits to a senior secured lender of representations and warranties insurance ("RWI"), and certain considerations financial institutions should make in documenting a middle market loan transaction when an acquisition financing utilizes RWI.

Critical to a lender's evaluation of an acquisition financing is the allocation of potential liability exposure of the business to be sold. From a lender's perspective, an acquisition arrangement will be ideal if there is a broad indemnity package from the seller to protect against losses incurred post-closing. Traditionally, escrow agreements, purchase price holdbacks or some other form of guaranty have been sources of such protection for buyers and their lenders. But for the past 15 years, an additional method to allocate risk has emerged—representations and warranties insurance ("RWI"). RWI can supplement or backstop an indemnification package or can serve as a buyer's primary source of recovery. This article will address the benefits to a senior secured lender of RWI, and certain considerations financial institutions should make in documenting a middle market loan transaction when an acquisition financing utilizes RWI.

ADVANTAGES OF REPRESENTATION AND WARRANTY INSURANCE IN MIDDLE MARKET ACQUISITIONS

An RWI policy may specify either the seller ("seller-side" policy) or the buyer ("buyer-side" policy) as the insured. The majority of RWI policies underwritten in the United States consist of buy-side policies, since they provide buyers the capability of directly recovering from the insurer without making a claim against a seller. An RWI policy often serves as a backstop (seller-side) or security (buyer-side) for a seller's indemnification obligations for breaches of representations and warranties under an acquisition agreement.

There are four attributes of RWI that make it attractive for both buyers and lenders:

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- it may be used to extend the duration of indemnification coverage for breaches of representations and warranties beyond any time limit set forth in the acquisition agreement;
- it may increase the scope of matters to be indemnified under the acquisition agreement as sellers may be more willing to make representations and warranties in respect of certain matters if their indemnification obligations are limited and coverage is provided by RWI;
- it may increase the amount of loss coverage available to the buyer above the cap(s) provided by the seller in the acquisition agreement or any separate escrow agreement; and
- it can lead to a quicker resolution of acquisition agreement negotiations between anxious, risk-averse buyers and sellers that are trying to limit their indemnity exposure and holdback obligations—especially those private equity sellers that want to be able to close out their funds and fully distribute sales proceeds to investors.

RWI has become a prominent feature in middle market acquisitions since it is most suitable for deals with enterprise values ranging between $20 million and $1 billion. Companies worth over $1 billion may require insurance coverage that is more than most insurance underwriters are willing to take on, and premium costs, professional fees and expenses may be too prohibitive for deals valued at less than $20 million; an underwriting fee alone on average can be as high as $30,000. Of importance, in the last five years, there has been a noticeable surge in the number of RWI policies that have been underwritten for transactions where the purchase price is in the range of $20 million to $100 million.

Three practical reasons why the product has become increasingly popular in middle market private equity transactions include:

(i) the process for obtaining a RWI policy has been streamlined;

(ii) the pricing for policies has decreased drastically over the last five years; and

(iii) there is now a track record of the insurers paying claims.

COMMITMENT PAPER CONSIDERATIONS FOR A SENIOR SECURED LENDER

Most acquisition financing commitment letters have become subject to minimal conditionality, and as a result, quite often buyers and sellers will insist on commitment letters with limited closing conditions. Given this limited conditionality in the commitment letter, lenders need to be satisfied with all aspects of the deal prior to signing because they may not have much flexibility to avoid funding their commitments once the commitment letter and acquisition agreement are signed. And thus, what recourse, if any, the buyer has on a post-closing basis against the seller in the event of the seller's future breach of its representations and warranties, will be of special interest to most lenders during commitment paper negotiations—especially, if the lenders discover any red flags in due diligence prior to the commitment paper signing.

Traditional acquisition agreement indemnification arrangements for buyers may not provide lenders the full protection they need for the duration of any credit facility. While escrow arrangements are still present for many deals, they provide limited protection for both buyers and lenders in that many escrows only last for 12 to 18 months post-closing, with some providing for partial release as time passes; this time period of coverage is much shorter than a typical senior secured credit facility maturity date that commonly ranges from three years to five years. Escrow arrangements, in particular, often do not provide full protection to the buyer, either because the funds in escrow are insufficient to fully cover seller contractual breaches or may require litigation to obtain. Sellers often resist escrows because they tie up funds for extensive periods of time. Separately, absent fraud, taxes, and certain specified representations and warranties, sellers' out-of-pocket indemnification coverage for breaches of most representations and warranties, will almost always be limited to a relatively small percentage of the purchase price; moreover, the time period in which a buyer may be permitted to pursue a claim directly against a seller under an acquisition agreement will often expire prior to the maturity date of any senior credit facility.

In light of the foregoing, RWI has become a useful tool for lenders during commitment paper negotiations, in order to get comfortable with diligence issues and potential acquisition agreement breaches of representations and warranties that may arise after signing; RWI can provide for longer terms of coverage and a much higher amount of coverage than any escrow arrangement or direct seller indemnification package could provide. Under a typical acquisition agreement lender assignment provision, if a lender were to be the successor or assignee of a buyer, such lender would have all of such buyer's rights under such acquisition agreement—such as the right to potentially collect from the sellers or an escrow account for any indemnifiable losses.

SENIOR CREDIT DOCUMENTATION IMPACTED BY REPRESENTATION AND WARRANTY INSURANCE

During commitment paper negotiations, senior lenders will review acquisition agreement documentation to be signed up concurrently with commitment papers. At this time, lenders will be made aware of RWI by (i) receiving a RWI term sheet from the buyer and/or (ii) reviewing various provisions in an acquisition agreement that refer to a RWI policy to be bound on or prior to the closing of the acquisition; more often than not, the delivery of such RWI policy will be a condition precedent to closing an acquisition, and will be referred to in the indemnification section of an acquisition agreement. A lender will be mostly interested in the terms of coverage, the limits on coverage (i.e., limits are often set at 10 percent of enterprise value), the amount of any deductible or retention, any exceptions from coverage and whether the buyer's rights under such policy can be assigned to a lender as additional collateral for the senior secured debt facilities. Common policy exclusions include, but are not limited to:

- Known liabilities and potential liabilities disclosed on acquisition agreement disclosure schedules and known to the buyer as of the closing date.
- Federal Corrupt Practices Act violations; however, coverage may be obtainable if the insured is able to demonstrate a strong compliance and internal controls program.
- Certain tax representations; however the emerging RWI market is becoming more flexible in covering losses and transfer pricing.
- Certain securities law violations in respect of the target's publicly-traded securities.
- Misrepresentations known by the seller (in the case of a seller-side policy) or by the buyer (in the case of a buyer side policy).

Acquisition financing commitment papers describe in detail the amount of any proposed financing, the terms of the financing, and, the conditions that will need to be satisfied before the lenders are required to fund their commitments. And thus, promptly upon being made aware of RWI in an acquisition, senior secured lenders would be well advised to push for certain protections in their commitment papers.

First, a senior lender may inquire if it can be listed as an additional insured or loss payee on the RWI policy itself; this could permit a lender to receive insurance proceeds directly from the insurer, in the event the breach by the seller of any of its acquisition agreement representation and warranties results in losses that are covered by the insurance policy. If this request is rejected, then a senior lender should require, as a condition to funding, that the borrower deliver a collateral assignment of RWI policy.

Often, an insurance broker will have its own form of collateral assignment of RWI policy, and in other circumstances, a lender can prepare its own form.

However, no matter what form is used, the collateral assignment will be held by the senior lenders as collateral security for any and all of the obligations under the definitive financing documentation, and the lenders will be granted the right to receive all insurance proceeds under the RWI policy upon the occurrence of an "event of default" under the applicable loan agreement. Moreover, often upon the occurrence and during the continuance of an event of default, a collateral assignment will bestow upon an administrative agent, on behalf of the lenders, the right to exercise all rights of the buyer under the terms of the RWI policy.

Finally, senior lenders with negotiating leverage against borrowers and private equity sponsors should structure mandatory prepayment term sheet provisions to include the requirement of a mandatory prepayment triggered by a buyer's receipt of RWI proceeds; specifically, commitment papers should include a mandatory prepayment of the senior obligations in the event any loan party or any of its subsidiaries receives, in its capacity as a buyer, any payment in connection with a claim under a RWI policy covering certain losses under an acquisition agreement.

If successful, the lenders will typically exclude certain costs and expenses from any prepayment requirement, such as (i) the payment of (or reimbursement of payments made for) claims and settlements to third persons that are not affiliates of a loan party or subsidiary, or (ii) any out-of-pocket expenses (including out of pocket legal expenses and any taxes) incurred by any loan party or any subsidiary in connection with pursuing payment of the claim or remediating any damages caused by any matter related to such claim under the RWI policy), in excess of a to-be-agreed amount. Often, a borrower will also request a carve-out from the prepayment in the event the proceeds are used to reinvest in similar assets as those affected by a breach by the seller. In the middle market, the indemnification prepayment percentage commonly ranges from 50 percent to 100 percent in deals that include such a prepayment.

FINAL CONSIDERATIONS

RWI can be an effective tool in bridging the gap between a seller's and buyer's indemnifiable risk allocations. It can also lead to a quicker closing of a transaction. But with it, come obligations for the senior lenders to carefully review the terms of the insurance policy, particularly to ensure that lender sensitive risks will be insured, and that the buyer's rights under the policy are assignable to lenders. A sophisticated senior secured lender with negotiating leverage would be best advised to be named an additional insured or lender loss payee on such insurance policy, or in the alternative, to receive a collateral assignment of RWI policy; such lender should also obtain and review copies of all material due diligence reports and requests generated by the buyer during the RWI process. During commitment paper negotiations, a senior lender should carefully strive to negotiate a mandatory prepayment from any proceeds received under such policy, subject to certain carve outs.

However, as no two transactions are identical, there is no perfect playbook for lenders when RWI is utilized on a given transaction. Instead, lenders and their counsel should be prepared to focus on the RWI terms of coverage and related loan documentation that will impact them the most—especially as RWI shows no signs of leaving the middle market any time soon.