

M&A Series – 1

A Growing Trend: Representations & Warranties Insurance on Cross-Border Deals

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The use of representation and warranty insurance, also known as M&A insurance and warranty and indemnity insurance [“**R&W Insurance**”], has grown in recent years to the stage where it has now become a standard feature of the cross-border M&A landscape. Estimates suggest that in the United States, the product was used in around 50% of the private acquisitions last year. Also, statistics pertaining to the year of 2019 indicate that the R&W Insurance was purchased in 49% of large deals having a value more than 100 million Euros in the European market. As is seen, R&W Insurance is frequently being used in M&A transactions and, in many respects, is now a mainstream.

Despite the low number of established practices in Turkey, this trend is expected to gain popularity as many more cross-border deals involving Turkey develop in the market. We expect that as the product further matures in Turkey, the M&A market and deal advisers will continue to adapt their processes and become increasingly sophisticated users of the product.

What is a R&W Insurance?

R&W Insurance is in general described as an alternative remedy for the parties to the potential deal in connection with M&A transactions. It is used primarily to protect the insured party from financial losses incurred in case of breach of representations and warranties contained in an acquisition agreement. The insurance can be used both in share deals and asset deals. For the determination of the major function of R&W Insurance, it is important to define the term of “*representation and warranty*” set forth in the acquisition agreements.

Accordingly, a “*representation*” is defined as the statement of fact associated with the company as well as its business, assets, liabilities, and financial position, whereas a “*warranty*” refers to a contractual promise that an assertion of fact is true, supported by an implied promise of indemnity if the assertion is false. Having said that, in Turkish legal system as well as in some other continental European legal systems, like Germany and Switzerland, the term representation and the term warranty have similar meanings and lead to same remedies unless otherwise is agreed in the agreement. Regardless of how transaction is structured and what is the type of business of the target company, the parties rely on the function of representations and warranties disclosed in the acquisition agreements. By providing representations and warranties in the agreement, the seller assumes the risk relating to the matters covered thereunder and promises to indemnify the buyer in case of a breach. So, representations and warranties allow the parties to allocate the risk of liability with respect to various matters associated with the target company.

Conversely, the R&W Insurance reallocates the risk from the insured party [either buyer or seller] to the insurer by replacing or supplementing indemnity provisions in acquisition agreements. R&W Insurance thus is a useful alternative to the traditional methods of risk allocation, the most common being indemnifications backing representations and warranties, which are in turn supported by an escrow account or a purchase price retention arrangement where a portion of purchase price is deposited.

Sell-side Policy vs. Buy-side Policy: What is the Difference?

R&W Insurance policy can be obtained in favor of either the buyer or the seller. Each policy is tailored to meet the specific needs of transaction.

In sell-side policies, the seller is a policy holder and insuring his/her liability against the injured third party. In this type, the buyer would make an indemnity claim against the seller directly in case of breach of representation and warranties and the seller would then compensate that claim and file a claim with the insurer for any insurable loss. Alternatively, sell-side policy can be designated as a third-party liability insurance where seller’s policy will indemnify third party injured buyer against the loss and damages that s/he will suffer as a result of breach of representations and warranties. In third-party liability insurance policies, the commencement of claim procedure going along with the resort of seller to the insurer for the compensation of third-party beneficiary buyer. However, this type of policy does not provide protection in case of

the willful misrepresentations and fraudulent behavior of the seller while giving the representations and warranties in the acquisition agreement.

On the other hand, in buy-side policies, the buyer, as the insured party, will directly resort the insurance company for the losses and damages arising from the seller's breach of representations and warranties. This type of the R&W Insurance policies currently constitutes the vast majority. Their key difference from sell-side policies is that they provide the fraud coverage which is not available in sell-side policies. That is to say, if the seller commits a fraud or misrepresents the fact during contract negotiations, then the policy would still pay out.

General Policy Terms

Coverage: Coverage limits in deals are generally upwards of 10% of the purchase price. In addition, larger coverage can be arranged on a case-by-case basis.

Retention: Policies usually include a retention amount is about 1% to 3% of the purchase price. Retention is referred basically an amount of money an insured person becomes responsible for. In other words, insurer will become liable only for the claims exceeding the retention amount.

Policy Period: The duration of coverage differs between a buy-side policy and sell-side policy. While a sell-side policy matches the indemnity survival periods in the underlying acquisition agreement, a buy-side policy can be issued longer, even for the breaches that become apparent after these survival periods have lapsed. Policy periods will last 12 [twelve] months to 7 [seven] years. In tax related representations and warranties, the policy period is often set as the respective statute of limitation, which is 5 [five] years in Turkey.

Premium: Premiums would often range from 1% to 2% of overall transaction value in recent years as the insurance industry has become more familiar with the product and competition has increased between the insurers. However, as the risk factors significantly increases in Covid-19 outbreak, the premiums become higher, and exclusions broader.

Policy Exclusions: What is not covered under the policy?

In cross-border transactions, circumstances are easily changeable depending on the law system, or government regime of the target country. Therefore, the exclusions in cross-border transactions must be carefully negotiated and worded in the insurance policies.

Generally, R&W Insurance policies provide a blanket coverage. At the same time, exclusions are carved out for several items, including (1) breaches that were known to certain individuals, (2) fines and penalties, (3) purchase price adjustments and forward-looking statements, (4) profit milestones, (5) revenue projections, and (6) breaches of certain "fundamental" representations and warranties [*i.e.*, that buyer would not conclude the deal were it known that a fundamental representation and warranty was untrue].

A typical R&W Insurance policy will also exclude liabilities specific to the policyholder's [seller or buyer] particular situation, such as outstanding litigation or other known potential risks discovered during due diligence. It is once again important to note that as opposed to sell-side policies, buy-side policies can include coverage for seller's fraud.

Furthermore, insurance companies are also keen to add deal-specific exclusions to the policies to exclude issues that do not constitute an insurable interest of the policyholder [*e.g.*, product warranty and bodily injury]. Ultimately, the deal-specific exclusions are either (i) a product of issues discovered during the due diligence [*e.g.*, sales and use tax liability], or (ii) as a result of failing to diligence or insufficiently diligence a material aspect of the target.

Motivations of the Parties in Obtaining R&W Insurance Policy

Parties may have various motivations in purchasing a R&W Insurance policy, and those motivations may differ in each transaction depending on the specifics of the deal. Typical motivations of the parties can be listed as follows:

1. The structure of providing parties with effective remedies and to shift the risk of compensating indemnities and financial loss to the third parties may give certainty to the success and growth of M&As in emerging markets.
2. R&W Insurance is used as an effective tool for facilitating the negotiations and closing stages of complicated transactions.

3. R&W Insurance gives an opportunity to the seller to have a clean exit from the target company and to retain good relationship with the buyer if the seller stays in the company, for instance, as a key employee following the closing.
4. Buyers use R&W Insurance to compensate for lower indemnification caps and shorter survival periods and to make their bid more competitive in auctions.
5. R&W Insurance policies can meet with the expectations of the parties and cover their loss and damages under the policy coverage. Especially in distressed M&As where the target has financial difficulties and seller is not willing to provide sufficient remedies in the event of breach of representations and warranties, R&W Insurance will provide an alternative remedy for the protection of the policyholder's financial position.
6. R&W Insurance helps buyer a clear understanding of target company's business and feeling safe after the post-closing stage of the deal.
7. The seller could have paid the entire purchase price without depositing it to an escrow account or in another retention and could be safe for the further claims of buyer in the future.

In a nutshell, having implemented the use of R&W Insurance will thus strengthen the parties' position over the course of negotiations as well as in the post-closing stage of the deal.

R&W Insurance under Turkish Law

The R&W Insurance is relatively new to the Turkish market, and the number of M&A projects involving the insurance is still quite low.

There are multiple reasons for that. The most prominent one is the lack of regulations. Turkish legislation does not explicitly regulate any legal framework for the instrument, and there is no existing local insurer directly offering the R&W Insurance in the Turkish insurance market. Therefore, parties need to obtain the insurance policy from foreign insurance companies. Second, premium amounts are relatively high in Turkey given that there is no competition in the market. As no local insurer can issue the policy, there are only few foreign insurers interested in the market, and foreign insurers tend to request higher premium amounts in Turkey due to instability in the economy and regional security issues. For these reasons, the warranty insurance is not effectively recognized in Turkey yet.

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