

## Deal Destination

November 27, 2018

### R&W INSURANCE FOR INDIA DEALS: FREQUENTLY ASKED QUESTIONS

Financial investors, including private equity investors are currently embracing a second wave of exits from investments in India. The Indian investment market has matured over time, and financial investors are now warming up to providing indemnities to potential acquirers, something that was hitherto unheard of. As these financial investors have been reluctant to carry forward the possibility of payment of these indemnities (due to fund life issues, claw-back provisions being triggered), an important alternative that has emerged is transactional insurance, or more commonly referred to as representations and warranties insurance (R&W insurance).

#### 1. Is R&W insurance available for all transactions?

While R&W insurance is available for most acquisition / investment transactions, insurance companies look at certain sectors / industries (sectors where fines / financial penalties have traditionally been extremely high) with a certain degree of skepticism, and hence R&W insurance may be available at a cost relatively higher than that for other sectors.

#### 2. What are the various insurance policies available for a potential acquisition?

Insurance policies are generally transactional (or R&W insurance) or tax insurance. We would be covering the former in this piece.

#### 3. What is an R&W insurance generally obtained for?

Insurance is generally obtained to cover financial implications arising from the breach of representations and warranties provided by the parties. Tax insurance may also be obtained for covering any withholding obligations.

#### 4. What are the different forms of R&W insurance available?

The different insurance policies available are 'buy-side' and 'sell-side' insurance policies.

- The buyer generally acquires an R&W insurance, generally termed as a 'buy-side policy', in cases where it does not have sufficient comfort from the indemnity provided by the sellers.
- Sellers generally acquire R&W insurance (termed as sell-side policy) to limit the losses to them out of indemnity claims.

Insurance policies are also categorized as (i) recourse based or (ii) non-recourse based. In a buy-side policy which is recourse based, the insurance company may proceed against the seller after payment of the claim in limited cases (fraud, gross negligence, willful misconduct), while in the latter, the insured has no right to proceed against the insured, even if an insurance claim is raised and paid by the insured. In addition, there are situations where the parties may commercially determine the recourse / non-recourse based nature of the insurance being obtained as well. These are covered below.

Insurance policies (if obtained from a foreign insurer) may also vary depending on the governing law of the insurance policy. These are generally US style policies or UK style policies, and there are distinguishing factors between a US style policy and a UK style policy. For instance, US policies generally do not consider data rooms as disclosure, while UK style policies do. Additionally, a UK style policy specifically amends the warranties provided as mutually agreed, as opposed to the US style.

#### 5. When is it beneficial for parties to acquire an R&W insurance policy?

Generally, an R&W insurance is obtained in one of the following situations:

- First, when the party providing the representations and warranties is an individual, or when the financial wherewithal of the corporate entity providing the representations and warranties is under question. The person to whom such representations and warranties are provided would like to have comfort that its right to be compensated in case of breach of any representations and warranties is not frustrated by the inability of the person providing the representations and warranties, and hence prefers to have an R&W insurance.
- Second, private equity investors (PE investors) prefer obtaining an R&W insurance when they are the persons providing the representations and warranties. The rationale for PE investors to seek insurance is to limit their liability, more in terms of time than amount. Most PE investors have limited fund life, and are obligated to report any potential / contingent liabilities, and hence prefer not to have indemnity obligations (backing the representations and warranties) extending beyond a certain time frame. Further, in some cases, if the obligation to indemnify for any breach of representations and warranties triggers after the returns are provided to investors, the funds may be compelled to exercise claw-back rights, which is seldom preferred by PE investors.
- Third, in an economy where distressed buy-outs are becoming common due to the large gamut of assets available at attractive valuations, an R&W insurance provides acquirers comfort on the strength of the financial backing to the representations and warranties.

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- Finally, the other reasons why R&W insurance is preferred by parties are the 'softer aspects'. In bidding situations, potential acquirers look at R&W insurance to 'sweeten the deal' for the vendors, making their bids attractive to the vendors. Further, the comfort of procuring a R&W insurance also reduces substantial time on the negotiation of documents since indemnities are not required to be negotiated, which are generally heavily negotiated clauses. In addition, the representations and warranties being backed by an R&W insurance, rather than indemnities provided by counterparties also does not impact relationship between parties where prolonged litigations between the parties to the transaction could sour relations between them.

#### **6. What is the cost of an R&W insurance policy? When are the parties expected to pay the premium?**

The premium on an R&W insurance policy generally ranges between 1 – 2.5% of the insurance coverage sought. However, the premium may vary depending on the circumstances, the sector of the target company and the extent of coverage being insured.

The payment of premium can be discussed and negotiated with the insurer. However, the insurance policy does not kick-in until the premium is paid. Parties may elect to pay the premium upon closing, i.e. on the day the transaction is actually consummated, and the policy is effective from such date. On the other hand, the parties may also pay the premium prior to closing, and in such cases, if the transaction is not consummated, a bulk of the premium is refunded to the parties. The insurer may require certain confirmations upon closing if the insurance is obtained prior.

The parties may also be required to pay certain amounts upfront prior to the underwriting process being initiated by the insurer, which amount is forfeited in case the policy is not bound ultimately. If the policy is bound, such amounts are generally subsumed in the insurance premium.

#### **7. Are there any financial obligations of the parties, even if an R&W insurance has been obtained?**

Yes.

- Apart from the cost of acquiring the R&W insurance, R&W insurance policies are obligated to make payments under the insurance policies only once a specified amount, termed as 'retention amount' has been borne by the parties. 'Retention amounts' are generally a specified percentage of the enterprise value of the target.

For instance, if the retention amount in an R&W insurance for USD 100 million is USD 5 million, the insurance company shall offer coverage of USD 100 million to the parties only once a loss of USD 5 million has been borne by the parties to the transaction.

This loss, being the retention amount can be borne by the indemnified party or the indemnifying party, as may be commercially agreed between them.

- R&W insurance policies generally have certain exclusions, and any loss arising from such excluded items are not covered under the insurance policies. Generally, exclusions are of two kinds – standard exclusions and deal specific exclusions.

- Standard exclusions are insurer specific, and generally any loss arising from issues such as data security or privacy breach, anti-bribery and corruption, inadequate stamping, secondary tax transactions, transfer pricing issues, and loss of deferred tax assets are standard exclusions. In case of sell-side R&W insurance policies, fraud by the sellers are also standard exclusions.

It may be pertinent to note that standard exclusions vary depending on the nature of the business of the target. For instance, if the target is engaged in data management, it is unlikely that data security would be a standard exclusion.

- Deal specific exclusions are generally determined based on the specific contours of the transaction. The deal specific exclusions are also dependent on the level of diligence undertaken by the acquirer / investor. If any item has not been adequately diligence and the acquirer / investor are relying on the warranties of the vendor/ company, such items may be excluded. Further, specific indemnities are also generally excluded.
- One important exclusion, which is a standard as well as a deal specific exclusion, is disclosed items. If any issue has been raised during the diligence or identified under the transaction documents, any loss arising from such issue would not be covered under the R&W insurance policy

#### **8. When can one approach the insurer for an R&W insurance? How much time should one factor in for the policy to bind from the time the insurers are approached? Does the insurer conduct a diligence before issuing the R&W insurance?**

Parties can approach the insurer for underwriting at any time, even post the execution of the transaction documents.

One should factor in about 3-4 weeks to obtain an R&W insurance policy from an insurer from the time they provide the insurer access to all documents. The process entails a few procedural aspects, including execution of relevant documents and payment of a fees, which is generally subsumed into the final premium. However, one should always check with the broker on the timeline, since it may vary depending on the complexity of the transaction, number of target companies involved and the extent of diligence undertaken.

The insurer conducts a limited diligence. However, the insurer's diligence is only meant to have a clear understanding of the diligence undertaken by the acquirer, and is not an independent diligence which may substitute the diligence undertaken by the acquirer. For the purpose, the insurer may, in addition to the transaction documents and disclosure letters, require all diligence reports (except the acquirer's diligence report if the policy being obtained is a buy-side insurance policy), diligence materials, data room, Q&A logs to all be provided to the insurer.

#### **9. Are there any restrictions on who can obtain an R&W insurance?**

There are generally no restrictions on who can obtain an R&W insurance. However, if the proposed insured under the policy is a resident, a non-resident insurance company cannot underwrite such risks under the laws prescribed by the Indian insurance sector regulator, the Insurance Regulatory and Development Authority of India, and an Indian insurer would have to be considered for underwriting such policy.

#### **10. What is the relevance of the indemnity clause under the transaction documents, where the indemnified risk is covered by way of an R&W insurance?**

Even though the liability from breach of a representation / warranty may be covered by the R&W insurance generally, the indemnity provision is crucial from multiple aspects.

- First, the indemnity provisions would need to clarify who would bear the loss till the retention amount, or in case the loss arises from items excluded from the coverage under the R&W policy.
- Second, the indemnity provisions would in most cases, provide for an amount below which claims cannot be made by the parties under the indemnity provisions, i.e. the de-minimus. The de-minimus is generally taken into account by the insurers when determining whether to exclude certain items, depending on the potential monetary implication any particular item may have.
- Third, the process for raising and defending any indemnity claim is crucial, and the insurer may require the process to be a fair and reasonable one to ensure it has adequate protection to enable the claim to be appropriately defended.
- Fourth, there may be cases where the parties commercially agree to have a recourse-based insurance policy, i.e. the person making the warranties would be liable to indemnify the counterparty in case the R&W insurance does not make payments under the claim. In such cases, the indemnity provisions provide for such eventuality.
- Finally, the indemnity commercially agreed between the parties may cover a higher amount / longer time frame than what is provided under the R&W insurance. In such cases, the indemnity provisions are crucial to decide the limitations in terms of amount / time for which the indemnifying party may be liable.

#### 11. What happens if a claim is raised under the R&W insurance?

In case a claim is raised under an R&W insurance policy, the insurance company engages a legal counsel to ensure that the loss claimed is not excluded under the R&W policy, as a deal exclusion item, standard exclusion or a disclosed item. Further in case of sell-side policies, any loss incurred as a result of fraud is also excluded. Once the insurance company satisfies itself of the above, the claim is processed.

*As the Indian market matures further and R&W insurance becomes a common product in the market, it is expected that R&W insurance products would be tailored further to be in tune with the Indian market and deal contours.*

— **Abhinav Harlalka, Simone Reis & Nishchal Joshipura**

You can direct your queries or comments to the authors

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