

RWI in Merger and Acquisition Transaction

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A merger and acquisition (**M&A**) transaction is often viewed as a long and daunting process as representations, warranties and indemnity clauses are often the most extensively negotiated clauses in a definitive agreement. This is not surprising as representations, warranties and indemnity clauses serves as a risk allocation mechanism in an M&A transaction. Lawyers are often engaged to conduct due diligence on a target before any definitive agreement is executed, and such due diligence also serves as the reference point for representations and warranties to be included in the definitive agreement.

A representation is a statement or assertion of past or present fact which induces a party to enter into the M&A transaction, while a warranty is an assurance that the representation is true and will continue to be true for a certain period of time depending on the terms of the agreement. Indemnity, on the other hand, is a promise to compensate by the seller in the event the buyer suffers losses as a result of false representation or warranty and it is common for the indemnity to be backed by a certain percentage of the acquisition price which will be placed in escrow.

In recent years, there has been an increase in the purchase of representations and warranties insurance (**RWI**), particularly in higher value M&A transactions and sale vide tenders.

The RWI protects against financial losses arising from a breach of representations or warranties in a transaction agreement. This essentially shifts the risk of losses from the seller to the insurer without affecting the buyer's recourse for compensation. For an M&A transaction with escrow or holdback arrangement, RWI allows for reduction or elimination of such escrow or holdback arrangement, allowing the seller to maximise gains at the closing of the transaction.

RWI can be taken up by the seller (*sell-side policy*) or the buyer (*buy-side policy*). In a buy-side policy, the buyer claims for any losses arising from the breach from the insurers, while in a sell-side policy, the buyer claims for any losses from the seller who can then claim reimbursement from the insurers.

Although RWI insures against representations and warranties given by the seller, buy-side policy represents most of the RWI in the market. This is unsurprising as such policy allows for:

- (a) a more attractive offer compared to non-RWI covered offer, particularly in a sale by tender, as the buyer can rely on RWI thereby reducing the need for extensive indemnities from the seller; and

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- (b) greater assurance on compensation for breach of representations and warranties since compensation is paid by the insurer. RWI may potentially provide for a greater compensation depending on the terms of RWI and financial position of the seller.

As the name suggests, RWI only covers losses arising from representations and warranties and does not extend to other fundamental terms of the definitive agreement, such as payment obligation and post-closing consideration adjustment. Parties keen to take up a RWI should scrutinise the terms and conditions of the RWI policy as they often include a range of coverage exclusions and limitations, such as:

- 1) Limit on Quantum of Compensation
The common limit of compensation is usually approximately 10% of the deal value.
- 2) Exclusion for breach
RWI policy typically excludes all losses attributable to breach of representations and warranties which the buyer has actual knowledge or ought to have known.
- 3) Tax
Most RWI policies exclude significant losses arising from tax liabilities such as any error in the accrued tax for the period prior to closing of transaction, losses arising from transfer pricing issues and accuracy of taxes accrued on balance sheet.

In addition to the coverage exclusions and limitations, parties should also consider the economic viability of RWI. Notwithstanding the significant reduction in RWI premium and retention amount attributable to the increase in popularity of RWI, the RWI premium and retention amount is approximately 2%-3% of the coverage limit and 1%-1.5% of the deal value, respectively.

RWI is a good facilitator to an M&A transaction but it should not be used as a blanket alternative to the traditional seller's representatives, warranties and indemnities. The gap between the coverage of RWI and the buyer's expectation will still need to be complemented by the seller's representatives, warranties and indemnities.

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