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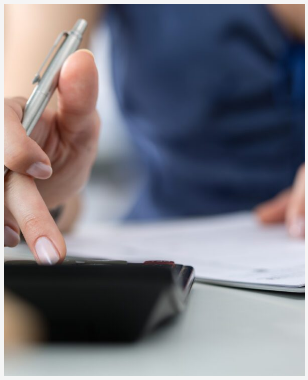
Representations and warranties insurance – An increasingly important tool for Canadian dealmakers



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In 2020, representations and warranties insurance (RWI) continued to play an increasingly significant role in the Canadian private M&A market. RWI is an insurance policy, usually obtained by a buyer, that replaces all or most of the traditional seller indemnification obligations for losses that arise due to breaches of, or inaccuracies in, seller representations and warranties. As a result, depending upon the structure of the transaction and the policy, a seller is able to significantly reduce or even eliminate its post-closing indemnification obligations. At the same time, a buyer is able to retain the indemnification protection that it would normally seek to have in a traditional M&A deal. RWI is commonplace in the United States and its presence in the Canadian market has been rapidly expanding over the last few years. In this article, we explore the state of the Canadian RWI market in 2020, including the impacts of COVID-19.

RWI use in Canada continues to grow

Use of RWI in Canada has become an increasingly common tool for Canadian dealmakers, a trend that seems to be continuing despite the COVID-19 pandemic. Though RWI is still not as prevalent in Canada as it is in the United States, a bidder in a competitive process in Canada, such as an auction, should expect that a seller is likely to propose RWI in lieu of traditional indemnification provisions. A bidder in search of a competitive advantage should be prepared to either offer or accept RWI in its bid in order to remain competitive. While historically RWI transactions often had a nexus to the United States or to private equity funds or financial investors, recently there has been a proliferation of RWI-supported transactions in Canadian domestic transactions that have included strategic acquirors.

More RWI professionals dedicated to the Canadian market

In 2020, we saw a maturing of the RWI market in Canada. An increased number of RWI insurance brokers and underwriters now have professionals or teams dedicated to the Canadian market. In the case of the largest global insurance brokers and RWI underwriters, many now have teams on the ground in Canada. This increased presence, along with the growing popularity of RWI, has led to greater coverage availability and competition. The result has been increased access to RWI in Canada, and an underwriting process that has become smoother and more efficient, resulting in increasingly standardized RWI policies and greater deal certainty.

Deemed agreement changes have increased

Despite heightened competition amongst RWI underwriters, more scrutiny has been given recently to the contents of the representations and warranties in transaction agreements, including an increase in deemed changes to certain representations and warranties. For example, for the purposes of the RWI policy, underwriters may deem certain words be “read in” to the RWI policy to the extent the underwriters believe such words are standard or typical in such representations and warranties. This might include deeming the words “in writing” to be added after a “receipt of notice” provision or the deemed addition of “knowledge” where the representation or warranty would typically be qualified by knowledge. It is typical for underwriters to raise these concerns early in the underwriting process, which results in fewer surprises for the policy holder when the deal is executed and the policy bound.

Deal-specific exclusions still often arise in the RWI underwriting process, but there are generally fewer exclusions agreed upon at the term sheet stage. These exclusions are typically proposed only after the underwriting call has occurred and the insurer has received more detailed information about the target business and the diligence completed by the buyer.

More seller indemnity coverage remains common in Canada

Consistent with the Canadian M&A market generally, which has traditionally offered more buyer-friendly indemnification terms than the U.S. M&A market, the terms of Canadian RWI deals have not yet converged with those in the United States. It remains common to see Canadian sellers offer indemnification coverage for fundamental representations and tax liabilities beyond the RWI policy limit. In addition, although less common, special indemnities for matters subject to deal-specific exclusions under the RWI policy can be seen. In contrast, it is more common in U.S. transactions for there to be no indemnity protection above the RWI coverage limits.

Effect of COVID-19

While the COVID-19 pandemic slowed the Canadian M&A market in the second quarter of 2020, RWI insurers nevertheless remained ready to underwrite transactions. As M&A activity increased during the remainder of 2020, Canadian underwriters became as busy as ever. Initially, underwriting resulted in broad COVID-19 related exclusions from RWI coverage, but as RWI underwriters became more comfortable with COVID-19 risk and the impacts of COVID-19 on M&A targets, the underwriting approach to COVID-19 coverage became more flexible. While RWI policies will generally contain a COVID-19 related policy exclusion, underwriters have recently been taking a more nuanced and bespoke approach that limits the COVID-19 policy exclusions to areas of heightened underwriting risk for the specific target business.

Although they are prepared to focus the scope of the exclusion, Canadian underwriters have shown heightened concern over COVID-19 related risk during the interim period between the signing of an agreement and closing the transaction. In these circumstances, underwriters may insist that any limitations on the breadth of a COVID-19 exclusion apply as of the signing date and that a broader COVID-19 exclusion apply as of the closing of the transaction. Sometimes an underwriter will agree that if the effects of COVID-19 on the business during the interim period appear to be minimal, a more limited COVID-19 exclusion can be restored as of the closing.

In addition, policyholders should continue to expect longer and more in-depth bring-down due diligence calls prior to closing as underwriters look to confirm the effect of COVID-19 on the target business during the interim period between signing and closing. If an RWI policy for a transaction signed before the onset of the COVID-19 pandemic in the jurisdiction does not contain a specific COVID-19 exclusion, policyholders should be prepared for the underwriter to take advantage of an opportunity to add a COVID-19 related exclusion to the RWI policy. This is most likely to occur where the COVID-19 risk is deemed material and the insurer is of the view it has leverage because the insured may require an independent waiver or consent (for example, in relation to an amendment to the transaction agreement or an extension of the outside date).

Conclusion

RWI continues to be a significant and growing aspect of the Canadian M&A marketplace and COVID-19 has not changed its utility or importance to deal-making. Canadian dealmakers should be informed about the product and prepared to deploy it as a tool in their transactions to remain competitive in an M&A process.