Deal Insurance: Representation & Warranty Insurance in Mergers & Acquisitions

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This draft has benefited from comments received at workshops at Duke Law School, Fordham Law School, the University of Michigan Law School, Vanderbilt Law School, the American Law and Economics Association 2019 Meeting, and at the 2018 National Business Law Scholars Conference. Thanks to Tom Baker, Albert Choi, John Coyle, John de Figueiredo, Jennifer Hill, Vera Korzun, John Pfaff, Peter Molk, Jim Ryans, Daniel Schwarcz, and Peter Siegelman for comments and conversations on earlier drafts. Thanks also to the professionals who completed the survey and offered insights in conversations and interviews. For superlative research assistance, thanks to Isabella Abelite, Nadav Ben Zur, Julian Constain, Sophia Dauria, Aaron Drew, Vanessa Fazzino, Kaitlyn Laurie, Andrew McAllister, Samantha Ragonesi, and Sacha Urbach, all FLS 2020. The viewpoints and any errors expressed herein are mine alone.

Abstract

Efficient contracting depends upon imposing risk on the party with superior access to information. Yet the parties in mergers and acquisitions transactions now commonly use Representation and Warranty Insurance ("RWI") to shift this risk to a third-party insurer. Because liability and trust go together, RWI would seem to give rise to a credible commitment problem between the transacting parties, and it raises adverse selection and moral hazard problems for the insurer. This paper examines the emergence of RWI, focusing on three interrelated questions. First, how does RWI affect transactions? Second, why do transacting parties use RWI? And third, why do insurers sell RWI? The paper follows a two-fold empirical methodology. It develops data both by surveying RWI market participants—insurers, brokers, lawyers, and private equity managers—and also by analyzing a sample of over 500 acquisition agreements, approximately half of which involved RWI. Analysis of this data reveals a broad transfer of mispricing risk from buyers and sellers to insurers. RWI allows sellers to minimize risk at exit and allows buyers to control risk aversion in selecting investments. At the same time, RWI threatens to disrupt the contracting process by introducing problems of credible commitment, moral hazard, and adverse selection. Insurers' ability to respond to these problems through shifts in the deal market and the underwriting cycle may determine whether RWI ultimately facilitates or impedes mergers and acquisitions.

Keywords: mergers, acquisitions, contract, insurance, representations, warranties, private equity, indemnification, escrow, adverse selection, moral hazard, credible commitment, M&A, deal, rep & warranty, transaction insurance

JEL Classifications: K22, K12

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DEAL INSURANCE:

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Sean J. Griffith*

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INTRODUCTION

Mergers and acquisitions contracting begins with an information problem.[1] In order to value the assets for sale, buyers need to know details concerning operations, revenues and expenditures, customer and employee relationships, and a wide array of contingent liabilities. Inaccurate or incomplete information on any of these points could result in mispricing the assets. Sellers, who presently own and operate the assets, have access to this information. But much of it is costly to produce—buried within the organization, diffusely held by agents, or dependent

[1] *See* Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239, 267–93 (1984) (discussing contractual responses to "the failure of the costless information assumption"). *Accord* Albert Choi & George Triantis, *Strategic Vagueness in Contract Design: The Case of Corporate Acquisitions*, 119 YALE L. J. 848, 856 ("The challenge of contract design is largely the management of information problems.").

upon expert intermediaries—and costly to verify. This information problem threatens to inhibit transactions or lead to severe discounts in price.[2]

The contractual solution to this problem centers on the representations and warranties. Although technically distinct—representations are statements of fact; warranties are promises that a stated fact is true[3]—the distinction collapses in practice because the two are simultaneously offered and collectively referred to as "reps."[4] The reps address the information problem at the heart of M&A contracting by allocating the burden of information production, refining the scope of information required, and enhancing the credibility of information provided.

Consider an example recently in the news.[5] In the wake of allegations of sexual misconduct involving such prominent executives as Harvey Weinstein, Les Moonves, and others, buyers have begun to ask sellers for a rep that "no allegations of sexual harassment have been made to the Company against any individual in his or her capacity as an employee of the Company."[6] The seller might flatly refuse this request, leaving the risk of latent misconduct wholly on the buyer. But this reaction may cause the buyer to reduce the purchase price on account of the risk or even to abandon the transaction altogether. A more likely response, therefore, is for the seller to agree to the rep after qualifying its scope—narrowing it to the knowledge of specific individuals, a confined period of time, and the conduct of a limited set of employees.[7] These qualifiers limit the scope of the seller's inquiry and, thereby, contain the cost of producing the information. Having agreed to offer the rep, the seller will review its HR records and, if any allegations do appear, provide the information to the buyer on a separate

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[2] Choi & Triantis, *Strategic Vagueness*, 119 YALE L.J. at 860 ("Bearing in mind the risk of adverse selection with regard to this [information asymmetry], the buyer might decline to contract or demand a significant discount on the price.").

[3] The legal distinction is that representations, as mere statements, cannot give rise to liability without justifiable reliance, while warranties, as contracts, can. CBS, Inc. v. Ziff-Davis Publishing Co., 75 N.Y.2d 496 (1990) (holding that purchaser who been informed of a misrepresentation prior to closing lacked reliance and therefore could not recover for the misrepresentation but could recover for the contractual warranty).

[4] The section of the contract containing the representations and warranties typically begins with a pre-amble stating that "the Company represents and warrants" with no distinction between the two. *See* John C. Coates IV, *M&A Contracts: Purposes, Types, Regulation, and Patterns of Practice*, in RESEARCH HANDBOOK ON MERGERS & ACQUISITIONS 38–39, n.36 (Claire A. Hill & Steven Davidoff Solomon, eds., 2016) ("M&A contracts do not typically distinguish between them, but include them together without identification."). *See also* Glenn West, *Reps and Warranties Redux—A New English Case, An Old Debate Regarding a Distinction With or Without a Difference*, Weil Insights, Weil's Global Private Equity Watch, August 2, 2016, https://goo.gl/WW9oJ4. For the sake of brevity, this article will follow standard practice and refer to representations and warranties together as "reps." Also for the sake of brevity, it will refer to mergers and acquisitions as "M&A."

[5] Nabila Ahmed, *Wall Street Is Adding a New 'Weinstein Clause' Before Making Deals*, BLOOMBERG (Deals) (Aug. 1, 2018), https://www.bloomberg.com/news/articles/2018-08-01/-weinstein-clause-creeps-into-deals-as-wary-buyers-seek-cover; Matt Levine, Opinion, The Weinstein Clause, BLOOMBERG (Aug. 2, 2018).

[6] Agreement and Plan of Merger by and among Forest City Realty Trust, Inc., Antlia Holdings LLLC, and Antlia Merger Sub Inc., dated as of July 30, 2018, §5.08(n).

[7] This appears to be what happened to the rep quoted above. It ultimately appeared in the merger agreement as follows: "[t]o the Knowledge of the Company, in the last five (5) years, no allegations of sexual harassment have been made to the Company against any individual in his or her capacity as an employee of the Company … at a level of Senior Vice President or above." *Id. See also infra* note 70 and accompanying text (discussing knowledge qualifiers generally).

disclosure schedule.[8] Armed with this information, the buyer can more accurately assess the risk and, ultimately, price the deal.

In this way, transacting parties negotiate reps to compel disclosure. Reps do not appear in acquisition agreements because they are, strictly speaking, true. Nor do reps create liability risk merely to entitle one side to extra proceeds post-closing. Rather, reps impose liability risk on the party with better access to information in order to induce efficient disclosure.[9] The liability risk generated by the reps is the engine driving the exchange of information in the deal, motivating its production and ensuring its credibility, thus improving price accuracy.

The fact that transacting parties now commonly avoid liability for misinformation by shifting the risk to an insurer thus comes as an affront to the standard account of M&A contracting. Instead of allocating the cost of misinformation among themselves, transacting parties increasingly transfer it, more or less entirely, to a third-party insurer. Representations and Warranty Insurance ("RWI"), an insurance product that covers losses from breached reps, is the vehicle for this outsourcing of risk. RWI may be used as a supplement or, increasingly, a substitute for seller liability. Already widespread in private acquisitions—estimates suggest that it was used in 30%–50% of private deals in 2017.[10] Moreover, the use of RWI continues to grow. Coverage is now available from more than twenty insurers, with new entrants coming into the market each year, insuring deals from $50 million to over $1 billion in size.[11]

The substitution, in whole or in part, of third-party insurance for seller liability under the contract raises a host of challenging questions. How, for example, can it enhance efficiency to allocate risk to a third-party insurer that plainly has less access to relevant information than the seller? Instead, the transacting parties' superior access to information suggests adverse selection, which threatens the accuracy of risk-pooling and the stability coverage.[12] Likewise, how does the presence of insurance impact M&A contracting? RWI invokes the specter of moral hazard—the tendency of insured parties to reduce precautions—suggesting less careful reps, a less

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[8] *See generally* Matthew Jennejohn, *The Architecture of Contract Innovation*, 59 B.C. L. REV. 71, 85 (2018) (noting that disclosure schedules "are an expansion of the representations and warranties and may also be over one hundred pages").

[9] Following canonical economic theory, the parties allocate this burden to the one that can produce the relevant information most efficiently—ordinarily, the seller. *See, e.g.*, Ronald Coase, *The Problem of Social Cost*, 3 J. L. & ECON. 1, 16 (1960) (noting that in a positive transaction cost environment, "the costs of reaching the same [efficient] result by altering and combining rights through the market may be so great that this optimal arrangement of rights, and the greater value of production which it would bring, may never be achieved"); RICHARD POSNER, THE ECONOMIC ANALYSIS OF LAW, 101–06 (4th ed. 1992) ("In general, if not in every particular case, the owner will have access at lower cost than the buyer to information about the characteristics of his property and can therefore avoid mistakes about these characteristics more cheaply than prospective buyers can.").

[10] Deals are "public" or "private" depending upon whether the target company or assets in the acquisition is publicly traded or privately held. *See infra* Part I.A. On the widespread use of RWI in private acquisitions, see *infra* note 99 and accompanying text.

[11] *See, e.g.*, Goodwin Procter, LLP, M&A Trends—Representations and Warranties Insurance (Mar. 22, 2018) (noting that "[t]he number of insurers jumped from a handful to over 20 today"). On the insurance and deal size, see *infra* Part II.A.

[12] Michael Rothschild & Joseph Stiglitz, *Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information*, 90 Q. J. ECON. 629 (1976) (modeling adverse selection in insurance markets). *See also infra* Part II.B., discussing distortions introduced by the possibility of adverse selection in RWI.

comprehensive diligence process, and greater risk embedded in the deal.[13] Similarly, if sellers are no longer liable for inaccurate or incomplete disclosures, how can buyers have the same degree of trust in the information they receive?

Fundamentally, insofar as the imposition of liability through reps is the key to resolving the information problem at the heart of M&A contracting, RWI would seem to inhibit efficient contracting by creating a credible commitment problem. The introduction of RWI thus suggests greater potential for misinformation in M&A, leading to increased mispricing risk, which might induce buyers to discount or abandon otherwise wealth-enhancing transactions. RWI, in other words, threatens to recreate the very problem that the reps were designed to solve.

But, if RWI creates these problems, why do transacting parties buy it? And why do insurers sell it? Conventional explanations for the purchase of insurance do not fit RWI. Insurance is a tool that allows risk averse parties to minimize risk by spreading it.[14] But the parties to most M&A transactions are corporations or investment funds, neither of which is risk averse and both of which have access to more or less the same risk-spreading technologies as insurance companies.[15] Considering that insurance companies charge a premium for taking on risk and that this premium necessarily exceeds the present value of losses insured, why would an otherwise risk-neutral corporation seek to transfer risk to an insurance company?[16] The purchase of RWI is even more puzzling once one sees the credible commitment and moral hazard problems introduced by the insurance. Yet transacting parties purchase RWI at steadily increasing rates. And insurers continue to sell the product in spite of these risks.

Although these puzzles go directly to the heart of M&A contracting, RWI is entirely absent from the scholarly literature. This paper aims to fill that gap, offering the first account of RWI and its role in M&A. It does so by focusing on three interrelated questions: First, how does RWI affect M&A contracting? Second, why do transacting parties use RWI? And third, given the risks of adverse selection and moral hazard embedded in these policies, why do insurers sell RWI?

Finding data to address these questions is a challenge. RWI policies are not publicly available. Transacting parties are generally under no obligation to disclose the purchase of RWI in SEC filings or to their investors.[17] Nor are RWI policies publicly filed with state insurance

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[13] Steve Shavell, *On Moral Hazard and Insurance*, 93 Q.J. ECON 541 (1979) ("Moral hazard refers here to the tendency of insurance protection to alter an individual's motive to prevent loss."). *See also* Tom Baker, *On the Genealogy of Moral Hazard,* 75 TEX. L. REV. 237 (1996).

[14] *See* ROBERT COOTER & THOMAS ULEN, LAW & ECONOMICS 178 (6th ed. 2012) ("Insurance spreads risk among policy holders. In general, spreading risk more broadly reduces the amount that anyone must bear.").

[15] That is, the creation of reserves and diversification. *See infra* text accompanying note 189.

[16] The insurance premium must incorporate not only the present value of expected losses but also the insurance company's costs and profit margin. *See* Karl Borch, ECONOMICS OF INSURANCE 13–15 (Knut K. Aase & Agnar Sandmo eds., 1990) (explaining that insurance premiums equal the sum of expected claims plus administrative expenses plus a reward to the insurer for bearing the risk).

[17] Many transacting parties in private acquisitions are not SEC registered companies and therefore are generally not required to make SEC filings at all. *See infra* Part I.A.

regulators.[18] The details of these policies—their limits, retentions, premiums, and claims activity—are available in no publicly accessible database. The opacity of this market calls for alternative methods of collecting data. Accordingly, this paper follows a two pronged empirical methodology—one qualitative, one quantitative.[19]

First, the paper employs qualitative methods to gather essential information on how RWI is used in practice and how industry professionals and transacting parties understand its role.[20] I began compiling this information by collecting the literature, attending industry conferences, and interviewing market participants, but the centerpiece of my qualitative empirical methodology was a survey of market participants—including insurers, brokers, lawyers, and private equity buyers. The survey consisted of approximately thirty five questions, some of which were brief and factual (inquiring, for example, into typical limits, premiums, and deductibles) while others were open-ended, seeking lengthy comments or opinions (asking, for example, why respondents have used RWI or how RWI has affected the transaction process).[21] In the summer of 2018, I distributed the survey through my own contacts and through the mailing list of a leading industry conference, and I encouraged those receiving the survey not only to complete it themselves but also to forward the link to colleagues or acquaintances that might have a perspective on the relevant issues.[22] Ultimately, the survey was completed by ninety two respondents with experience in RWI.[23] Those completing the survey identified themselves in the following roles:

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[18] On the regulatory structure of insurance, see Robert H. Jerry II & Steven E. Roberts, Regulating the Business of Insurance: Federalism in an Age of Difficult Risk, 41 Wake Forest L. Rev. 835 (2006) (describing and critiquing the state-based regulatory structure of insurance law).

[19] Qualitative empirical methods can shed light into areas where quantitative data is absent. Such methods were pioneered in legal scholarship by Lisa Bernstein and Robert Ellickson, among others. *See* ROBERT C. ELLICKSON, ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES (Harvard Univ. Press 1991) (using field interviews to demonstrate how California farmers settle conflicts through norms, rather than law); Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115 (1992) (using interviews and participant observation to describe the extralegal ordering in the diamond industry). *See also* TOM BAKER & SEAN J. GRIFFITH, ENSURING CORPORATE MISCONDUCT (Univ. of Chicago Press 2010) (using interviews to study D&O insurance); MITU GULATI & ROBERT E. SCOTT, THE THREE AND A HALF MINUTE TRANSACTION: BOILERPLATE AND THE LIMITS OF CONTRACT DESIGN (Univ. of Chicago Press 2013) (using interviews to understand the meaning of contract boilerplate).

[20] *See generally* John Coyle, *Interpreting Forum Selection Clauses*, 104 IOWA L. REV. (forthcoming 2018) (surveying lawyers to shed light on how they understand and use boilerplate forum selection terms); Tess Wilkinson-Ryan & David A. Hoffman, *The Common Sense of Contract Formation*, 67 STAN. L. REV. 1269 (2015) (surveying consumer attitudes toward contract formation); Omri Ben-Shahar & Lior Jacob Strahilevitz, *Interpreting Contracts Via Surveys and Experiments*, 92 N.Y.U. L. REV. 1753 (2017) (advocating solving disputes over interpretations of contracts by surveying consumers' interpretations of the relevant provision).

[21] The exact number of questions a respondent received depended upon the respondent's role in the industry and their level of experience with RWI.

[22] In other words, I followed "snowball" sampling techniques. *See* Leo A. Goodman, *Snowball Sampling*, 32 ANNALS MATH. STAT. 148 (1961) (defining snowball sampling techniques). *See also* Tom Baker & Sean J. Griffith, *The Missing Monitor in Corporate Governance: The Directors' & Officers' Liability Insurer*, 95 GEO. L.J. 1795, 1798, n.12 (2007) (describing and applying snowball sampling techniques).

[23] The survey was completed by 121 respondents, but the threshold question: "Have you ever encountered RWI in any professional capacity?" was answered in the affirmative by only ninety-two respondents. Respondents answering this question in the negative were dropped from the survey without being asked any further questions. Sean J. Griffith, *RWI Survey*, Results Collected June – Sept 2018 (unpublished survey results, on file with author) [hereinafter *RWI Survey*].

three private equity managers,[24] sixteen lawyers advising on M&A transactions in which RWI had been involved ("deal lawyers"),[25] twenty-nine insurers providing RWI coverage,[26] thirty-two RWI brokers,[27] one accountant advising on RWI matters, and eight lawyers advising on RWI claims ("claims lawyers").[28]

This was not a random sample. The goal of this part of the research, however, was not to provide definitive answers but rather to shed light upon an otherwise opaque market by soliciting a broad range of perspectives and reporting shared understandings and, when they arose, areas of disagreement. In this, I was helped by the fact that RWI remains a narrow specialty field. Most of the participants know each other, either through business dealings or through the two main professional conferences on the subject. As a result, I soon found that the people I met were referring me to others I already knew. I spoke with as many of these people as I could, took extensive interview notes, and sent all of them the survey.[29] These efforts form the basis of my qualitative research.

In addition, I also followed a more traditional quantitative empirical methodology to study the impact of RWI on acquisition agreements. In this part of the research, I assembled a dataset of over 500 acquisition agreements, approximately half of which had used RWI in the transaction and half of which did not.[30] I then hand-coded various provisions in the agreements in order to compare differences between contracts with and without RWI with the goal of learning how RWI affects M&A transactions.

Analysis of this data reveals a broad transfer of mispricing risk from buyers and sellers to insurers. RWI allows sellers to minimize risk at exit and allows buyers to mitigate risk aversion in selecting investments. Yet RWI threatens to introduce frictions into the contracting process of which the breadth of coverage is both a cause and an effect. In turn, the insurer manages the risk of adverse selection and moral hazard by free-riding on the buyer's incentive to price accurately and also through the threat of exclusions. The result is a delicate balance that may not weather shifts in either the deal market or the underwriting cycle.

From this Introduction, the paper proceeds as follows. Part I provides an overview of M&A contracting, focusing on responses to the central information problem and distinguishing

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[24] The private equity ("PE") respondents characterized themselves as always or nearly always on the buy side of transactions involving RWI. *RWI Survey*, PE #1, PE #2 (both saying they had done ten or more M&A transactions over the last three years, and both said they had used RWI in 4–6 such transactions). *Id.*

[25] The deal lawyers ("DL") in the sample reported spending an average of sixty four percent of their time on M&A. RWI Survey, DL #1–15 (unpublished survey results, on file with author). Most (71%) reported being involved in more than ten transactions over the past three years, and (57%) having used RWI in more than ten transactions over the past three years. *Id.*

[26] The insurer respondents ("I") underwrite an average of 211 primary RWI policies annually (median 50). RWI Survey, I #1–30. They underwrite an average of 135 excess policies annually (median 40). *Id.*

[27] The broker respondents ("B") place an average of 186 RWI policies annually (median 75). RWI Survey, B #1–31.

[28] As a group the claims lawyer respondents ("CL") spent an average of sixty seven percent of their practice on insurance coverage/ claims issues and devoted an average of fifty eight percent of their insurance practice on RWI. RWI Survey, CL #1–8.

[29] Ultimately, the survey was supplemented by [14] interviews with market participants.

[30] Transactions involving RWI often contain a reference to RWI in the acquisition agreement. *See infra* Part III.

between public and private deals. Part II introduces RWI, describing typical coverages, claims, and patterns of use. In addition, Part II outlines distortions to the M&A contracting process that may be introduced by insurance. Part III addresses the first of this paper's three central questions—how RWI affects M&A contracting—by analyzing how insured and uninsured transactions differ on key terms. Part IV uses survey data to address the second major question—why transacting parties purchase RWI—against the background literature on corporate insurance. Part V addresses the third question—how insurers are able to sell RWI in light of its risks—focusing on insurers' strategies for managing adverse selection and containing moral hazard. The paper then closes with a brief summary and conclusion.

I. Information Problems in M&A

The information problem at the heart of most buy-sell transactions is not that the parties have no incentive to share information. Because they recognize that uninformed buyers will assume the worst about the underlying asset and discount their bids accordingly, sellers have strong incentives to disclose.[31] Rather, the crux of the problem is that trustworthy information is expensive. Information relevant to valuation is often diffused through agents across the organization, making it costly to produce.[32] Moreover, experts may be needed to produce some kinds of specialized information, adding additional costs. Accountants, for example, may be brought in to produce financial information, and lawyers and other consultants may be brought in to assess contingent liabilities.

Verification increases information costs. Buyers will want to confirm that seller disclosures reflect actual fact. Their concern is not necessarily that they are being intentionally misled—legal rules place the risk of fraud firmly on sellers.[33] Rather, because incorrect or incomplete information is harmful regardless of the seller's intent, buyers will want to protect against unintentional errors and omissions as well. Buyers will therefore ask sellers to demonstrate not only what they know but also how they know it, thereby adding a layer of cost. Here again agency problems compound costs as does the need for independent experts to verify information produced by the seller.[34]

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[31] Sellers will disclose even unfavorable information in order to avoid worst-case-scenario discounting. *See, e.g.*, Sanford Grossman, *The Informational Role of Warranties and Private Disclosure about Product Quality*, 24 J.L. & ECON. 461, 479 (1981). Grossman illustrates with the example of an apple seller. Apples are sold in boxes, and the seller cannot lie (because fraud is illegal) but can offer as much or as little information as she likes about how many apples are in the box. If the seller says nothing, a rational buyer will conclude that there are no apples in the box. If she says that there are at least 6 apples in the box, the buyer will conclude that there are six and only six apples in the box. This logic leads the seller to say exactly how many apples are in each box because she will want to say at least that that amount (to maximize her per apple revenue) and (because she cannot lie) no more. Id. at 465–66. *See also*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, ECONOMIC STRUCTURE OF CORPORATE LAW (Harvard Univ. Press 1996) (applying this insight to securities law).

[32] To produce this information, the seller's top managers will need to inquire of departmental managers who will need to inquire of line managers who will need to inquire of employees in the field and so on. Such inquiries create the additional risk of leaks, compromising the confidentiality of negotiations.

[33] *See, e.g.*, § 224.7. Deceptive Business Practices., Model Penal Code § 224.7; Restatement (Third) of Torts: Liab. for Econ. Harm § 9 TD No 2 (2014); Restatement (Second) of Contracts § 162 (1981).

[34] Because agents' interests are not always aligned with those of their principals, sell-side executives negotiating the transaction will need to verify information provided by their agents. For instance, it may serve an employee's

The reps respond to these information problems. In M&A contracting, however, the reps respond differently depending upon whether the acquisition target is public or privately held. This Part therefore begins by highlighting relevant differences in public and private deals. It then proceeds to an overview of how reps address information problems in M&A.

A. Public and Private Deals

There are significant differences in M&A contracting depending upon whether the target company is publicly traded or privately held. Two such differences are worth noting here. First, there is a lesser degree of information asymmetry in public deals as a result of the regular disclosure of information required of publicly traded companies. Second, private deals very often involve private equity funds on either the buy side or the sell side of the transaction, often both.

The key difference between publicly traded and privately held companies is the amount of publicly available business and financial information as to each. SEC rules require public companies to file audited financial statements every year and to file unaudited financial statements every quarter.[35] Annual reports also contain extensive discussion of business results, operations, identification of subsidiaries and affiliates as well as disclosure of the revenues contributed by major products or departments, a description of property owned, and information on management.[36] In addition, public companies are under an obligation to periodically report on important changes to their business, such as the entrance into important contracts, merger and acquisition activity, the issuance of securities, changes in officers and directors, and amendment of bylaws.[37] Securities laws also require reporting companies to take steps to verify public disclosures, requiring that financial statements be audited by outside experts and certified by corporate officers.[38] Securities law also imposes significant liability risk on public companies and their agents from inaccurate or incomplete information.[39] This wealth of information is closely followed by investment analysts, and incorporated into the market price of public company shares.

By contrast, much less information is available about private companies. Although privately held companies may be very large in terms of assets, revenues, and even the number of shareholders, they are not required by securities laws to disclose the information required of

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interests—in receiving a bonus or avoiding termination—to inflate sales numbers. Anticipating this, managers will not trust everything their agents tell them but rather will seek to confirm much of what they are told. The verification costs outside the organization are thus replicated within the organization.

[35] SEC rules also public companies to implement record-keeping and internal control procedures to guarantee the accuracy of financial statements. Additionally, public company CEOs and CFOs must personally certify financial statements filed with the SEC. Sarbanes-Oxley Act, 15 U.S.C. §§ 7241(a)(5) (2012).

[36] Form 10K.

[37] Form 8K.

[38] Sarbanes-Oxley Act, 15 U.S.C. §§ 7241(a)(5), 7262(b) (2012).

[39] Securities Act of 1933, 15 U.S.C. § 77k(a); Securities Act of 1934, 15 U.S.C. §78t(b); 17 C.F.R. § 240.10b-5.

public companies.[40] Because information is costly, private companies typically produce far less of it than public companies and rarely, if ever, disclose it publicly.[41]

The vast differences in the amount and quality of information available directly affect deal dynamics in public versus private acquisitions. Public company due diligence is largely done through a review of information available in SEC filings. Similarly, because there is less need for public companies to call forth unknown sources of risk, the reps are less extensive than in private deals. Perhaps the greatest difference, however, is that in public company deals there is no indemnity, and the reps do not survive the closing.[42] Breaches of reps in public company deals thus only matter if they are discovered prior to the closing and are sufficiently large to enable the buyer at least to threaten not to close. Public company deals provide no remedy at all for breaches discovered after the closing.[43] The basic justification for this structure is the availability of information concerning the seller and thus the absence of the information asymmetry that is fundamental to private company deals.

A second distinction between public and private deals is the role played by private equity funds. Although private equity funds can be involved in public company deals—specifically, in take-private transactions—they are almost always involved in private deals. Private equity funds finance the private deal market.

Private equity funds buy and sell controlling stakes in businesses.[44] Private equity firms, such as Bain Capital or Blackstone, organize individual funds to raise capital from investors. Private equity investors are typically other investment funds, such as pension and hedge funds, corporations, or wealthy individuals.[45] Funds are organized as limited partnerships, with the investors serving as limited partners and the private equity firm, or partners from that firm, serving as the general partner. The limited partners provide 98–99% of a fund's equity capital, with the remaining 1–2% provided by the general partner.[46] Nevertheless, the general partner has exclusive managerial control over the fund. Limited partners do not vote or exercise any meaningful control over the life of the fund. Investment returns are shared between limited and general partners at an 80% and 20% ratio, but only if gains exceed an 8% "hurdle rate," below which all investment returns are paid to the limited partners.[47] Above the hurdle rate, limited partners receive 80%, and general partners receive 20% as their carried interest (or "carry"). In addition, the general partner receives an annual 2% "management fee," initially calculated as a

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[40] Uber, for examples, is valued at more than $120 billion yet is "privately held" by an assortment of accredited investors, private equity and venture capital funds, and public company investors. Liz Hoffman, Greg Bensinger & Maureen Farrell, *Uber Proposals Value Company at $120 Billion in a Possible IPO*, WALL ST. J., Oct. 16, 2018.

[41] Disclosing information publicly destroys its value and therefore any incentive to produce it.

[42] Coates, *supra* note 4, at XX.

[43] Unless there is fraud. *See supra* notes 33 and 39.

[44] Elisabeth de Fontenay, *The Myth of the Ideal Investor*, 41 SEATTLE U. L. REV. 425, 442 (2018) ("[P]rivate equity funds hold controlling stakes in mature businesses, giving them clear incentives to exert effort to maximize corporate value.").

[45] Investors in private equity must be either "accredited investors" or "qualified buyers." Under the SEC's "Accredited Investor" definition—basically an annual income of at least $200,000 and a net worth of at least $1 million. Qualified buyers must either have $1 million under management or meet a $2 million net worth threshold.

[46] Jarrod Shobe, *Misaligned Interests in Private Equity*, 2016 BYU L. REV. 1452 (2016).

[47] Brian Cheffins & John Armour. *The Eclipse of Private Equity*, 33 DEL. J. CORP. L. 1 (2008).

percentage of committed capital but later as a percentage of invested capital.[48] The management fee is paid over the life of the fund, irrespective of performance.

Acquisitions financed by private equity are highly leveraged. Typically, funds contribute 30–40% of deal price as equity and finance the rest with debt.[49] Private equity funds have a short to intermediate time-horizon for their acquisitions. Funds lock up investor capital during the life of the fund, typically ten years, after which they must return it to investors. Returning investor capital, of course, means selling the portfolio companies acquired during the life of the fund. Because not all acquisitions take place at the inception of the fund, this may mean a significantly shorter time-horizon for some portfolio companies. The industry average is less than six years.[50]

This structure of private equity shapes incentives in the market for private companies. Private equity funds have incentives to sell companies at or above the 8% hurdle rate. Below the hurdle rate, private equity managers may prefer to keep funds invested so that they continue to earn their 2% management fee, rather than liquidating the losing investment and returning funds to investors.[51] Above the hurdle rate, funds will seek to maximize gains in the sale but, other things being equal, may prefer to sell quickly in order to avoid the limits on the fund's life. Whether a portfolio company investment beats the 8% hurdle rate is thus central in determining the disposition of the asset.

B. Contractual Solutions

Acquisition agreements respond to information problems principally through the reps.[52] Reps address information problems in three ways.[53] First, they allocate the burden of producing information. Second, they define the scope of information required. And third, they create credibility mechanisms to mitigate verification costs. This is no small task. The reps account for more words and, by some estimates, more time and attention than any other part of the contract.[54]

1. Allocating the Burden of Production

[48] Timothy Spangler, *Deconstructing Management Fees in Alternative Funds*, FORBES (Aug. 19, 2014). *Accord* David T. Robinson & Berk A. Sensoy, *Do Private Equity Managers Earn Their Fees? Compensation, Ownership, and Cash Flow Performance*, 26 REV. FIN. STUD. 2760, 2764 (2013) (estimating that this this shift occurs in about one third of funds).

[49] Steven M. Davidoff, *The Failure of Private Equity*, 82 S. CAL. L. REV. 481, 488–89 (2009).

[50] De Fontenay, *supra* note 44 at 443 (reporting an industry average portfolio company holding period of 5.5 years).

[51] Klaas P. Baks & Lawrence M. Benveniste, Alignment of Interest in the Private Equity Industry (July 2010).

[52] Other provisions that respond to information problems include the indemnity and the termination provisions, but insofar as these provisions are triggered by breached reps, the reps may be seen as the key provision. *See infra* notes 85-89 and accompanying text.

[53] This list is derived from Gilson's seminal account. *See* Gilson, *supra* note 1 at 271–87 (summarizing how representations and warranties: (1) facilitate the transfer of information to the buyer, (2) facilitate the production of previously nonexistent information, (3) place limits on "what information to look for and how hard to try," and (4) address verification costs).

[54] Coates, *M&A Contracts*, *supra* note 4, at 40 (tbl 2.1) (studying word counts in public merger agreements); JAMES C. FREUND, ANATOMY OF A MERGER: STRATEGIES AND TECHNIQUES FOR NEGOTIATING CORPORATE ACQUISITIONS 229 (L.J. Press 1970) (estimating that "lawyers spend more time negotiating 'Representations and Warranties of the Seller' than any other single article in the typical acquisition agreement").

Reps allocate the burden of information production by transferring the risk of inaccurate or incomplete information from one party to the other. At the outset of the transaction process, the buyer bears the burden of inaccurate or incomplete information insofar as any such misinformation may lead to a mispricing of the assets for sale. The reps transfer this risk to the seller through statements that create adverse consequences to the seller—cancellation risk or liability risk—if they are false.[55] The threat of these consequences induces the seller to invest in producing trustworthy information.

Most of the information produced through the reps is not contained in the acquisition agreement itself, but rather is produced on a supplemental disclosure schedule that formally qualifies statements made in the reps.[56] Thus, in spite of a contractual rep stating, for example, that there is no pending or threatened litigation, the disclosure schedule may in fact list many such cases, all of which become formal exceptions to the statement made in the rep.[57] In this way, statements made in the reps are true only insofar as they are not contradicted by the disclosure schedules.[58]

The information sought through the reps divides roughly into two types. Basic information as to the seller's organizational status and legal capacity to carry out the transaction is provided through a set of "fundamental" reps.[59] More specific information concerning the assets for sale is sought through the "general" reps—for example, reps concerning the seller's financial statements, material contracts, and pending or threatened litigation. Sellers may offer reps—such as the "full disclosure" rep[60] and the "no undisclosed liabilities" rep[61]—attesting to the comprehensiveness of their disclosures. But even without these reps, sellers have a strong

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[55] Although the buyer also makes basic reps—for example, as to the validity of its organization and its authority to enter the transaction—the seller's reps are typically far more extensive. *See, e.g.*, Coates, *supra* note 4, at XX. (demonstrating, from a data set of public company acquisitions, that the seller reps are much more extensive, in terms of word count, than buyer reps). However, when the deal consideration is stock of the buyer, the buyer may be asked to make reps as robust as the seller's, so called "mirror reps," because in accepting stock consideration, the seller essentially becomes the owner of the buyer's business just as the buyer becomes the owner of the seller's business.

[56] Often this occurs in the preamble to the reps, stating that "Except as set forth in the Disclosure Schedule, the Company represents and warrants to Buyer as follows…." Stock Purchase Agreement, dated as of Jan. 30, 2018, by and among Lifetouch Inc. and Shutterfly, Inc., at 17.

[57] Why not just disclosure this information in the agreement itself? One possible answer is brevity. The disclosure schedules may be much longer than the acquisition agreement itself. *See* Jennejohn, *supra* note 8, at 85 (making this point). Incorporating this information into the agreement itself would make it unwieldy. A second answer is regulatory. The SEC requires the public disclosure of acquisition agreements under certain circumstances. It does not require the public disclosure of disclosure schedules. Parties may therefore use disclosure schedules to avoid publicly disclosing the potentially sensitive information that appears there.

[58] *See* Coates, *supra* note 4, at 50 (describing how, through the disclosure schedules, the reps trigger the release of "extensive information that the buyer can use in planning for integration as well as to firm up pricing").

[59] These include representations as to the capitalization, organization, and due authority of the seller, as well as ownership of the relevant assets. Coates, *supra* note 4, at 41 ("'Fundamental' representations consist of those needed to insure the buyer obtains the basic legal package entitling it to control over the assets it expects . . .").

[60] The full disclosure rep expressly states that seller disclosures are complete and do not contain any material omission. The full disclosure rep may also be referred to as the "10b-5" rep because it frequently tracks the language of Rule 10b-5. Securities Act of 1934, 15 U.S.C. §78t(b); 17 C.F.R. § 240.10b-5.

[61] Sellers also frequently provide a "no undisclosed liabilities" rep, certifying that no such liabilities have arisen, at least since the date of the last financial statements.

incentive to disclose fully because any contradictory information omitted from the disclosure schedule fails to qualify the rep and, when subsequently discovered, puts the seller in breach.

A breached rep can create two remedies: cancellation of the transaction or damages. When discovered prior to closing, a breach may entitle the buyer to cancel the transaction if, as is often the case, the agreement makes accuracy of the reps a condition to close.[62] Breaches discovered prior to closing may also entitle the buyer to damages.[63] When a breach is discovered after closing, cancellation is no longer possible, but damages may be.[64]

Most contracting parties opt out of common law damages remedies in favor of an indemnification provision in the acquisition agreement.[65] In order to create a right to post-closing damages, the indemnification provision provides a "survival" period for the reps, often twelve to eighteen months, during which damages may be sought according to the terms of the indemnification provision.[66] These remedies are the foundation of the transfer of risk to the seller. By exposing the seller to the risk of cancellation and damages, the reps give the seller a strong incentive to produce all relevant information

2. Defining the Scope of Production

Although they may accept the burden of information production, sellers are likely unwilling to shoulder it at any and all cost.[67] A second key function of the reps is thus to define the scope of information required in order to contain information costs. Although these savings redound directly to the seller, avoiding wasteful information costs is an objective shared by both parties since any such costs reduce the joint gains available for division between them.[68] Acquisition agreements therefore contain qualifiers that limit the scope of the reps. These qualifiers narrow the risk of breach and thereby decrease the seller's burden of inquiry.

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[62] This condition works in conjunction with the "bring down" covenant to allow buyers to cancel transactions at no cost for breaches discovered at any time prior to closing. The "bring down" covenant effectively makes the reps speak a second time, at the closing date, in addition to the signing date. In such an agreement, breaches may occur if subsequently discovered information demonstrates the falsity of a rep at the time of either signing or closing.

[63] *See CBS Inc. v. Ziff-Davis Pub. Co*., 75 N.Y.2d 496, 503–04 (1990) (allowing damages for breach of warranty prior to closing).

[64] For example, misrepresentations, if material, may lead to either to rescission, restitution, or damages depending upon whether the seller's intent was innocent, negligent, or fraudulent. Restatement (2nd) Contracts, §164. Restatement (2nd) Torts, §538. Breaches of warranty give rise to damages without regard to intent. *See, e.g.*, *Nunn v. Chem. Waste Mgmt, Inc.*, 856 F2d 1464, 1470 (10th Cir. 1988).

[65] See, e.g., Lifetouch-Shutterfly Agreement, supra note 56 ("Each of Buyer and Seller acknowledge and agree that… with respect to any breach of any representation, warranty, covenant or agreement by the other party hereto… shall be pursuant to the provisions set forth in this Article IX"). *See infra* notes 85-90 and accompanying text for further discussion of indemnification provisions.

[66] Unlike the bring-down covenant, the survival provision does not have the effect of making the representations and warranties speak again. Contradictory information still must invalidate a representation or warranty *when made*—either at signing or, in connection with the bring-down, at closing. The survival provision merely extends the period when evidence of a pre-existing contradiction can be discovered and remedied.

[67] A "flat" or unqualified rep may be breached by any contradictory information, regardless of its origin or its significance. A breach could be caused by literally anything known by anyone. But having to disclose what every last person in the firm knows about every little thing may impose greater search costs than the seller can bear and may result in more information than the buyer needs.

[68] Gilson, *supra* note 1, at 270.

Qualifiers that speak to knowledge and materiality are among the most common.[69] Knowledge qualifiers narrow the seller's inquiry to a subset of agents within the organization.[70] Similarly, materiality qualifiers narrow the seller's inquiry to a threshold level of significance.[71] Materiality can be defined relative to the target's business as a whole, as when the defined-term Material Adverse Effect ("MAE") is invoked to qualify a rep,[72] or relative only to the subject matter of a particular rep.[73] Qualifying reps relative to the business as a whole creates less scope for breach. Accordingly, reps are more often MAE-qualified in public than in private deals, reflecting the decreased risk of misinformation associated with public companies.[74]

In private deals, meanwhile, it is not unusual for the indemnity provision to contain a "materiality scrape" eliminating materiality for purposes of the indemnity.[75] Materiality scrapes can be partial or full. A partial scrape eliminates materiality in calculating loss, not in determining whether a breach has occurred.[76] A full scrape, by contrast, eliminates materiality

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[69] There are others. Reps may be given specific date limitations or dollar thresholds. Moreover, qualifiers may be unique to particular reps. For example, the No Undisclosed Liability rep may be qualified by reference to Generally Accepted Accounting Principles ("GAAP"). GAAP requires reporting of a balance sheet liability for loss contingencies only if the impact can be reasonably estimated and it is probable that a loss has occurred, else a note to the financial statements is required disclosing a contingent liability if it is at least reasonably possible that a loss has occurred. Therefore, qualifying a no undisclosed liability rep by GAAP effectively means that loss contingencies whose probability of occurrence are remote are excluded from the rep and thus need not be disclosed. *See, e.g.*, Agreement and Plan of Merger between Darden Restaurants, Inc. and Cheddar's Restaurant Holding Corp., dated March 27, 2017 [hereinafter Darden-Cheddar's] at § 2.6(b) ("The Company does not have any material liability that would be required to be set forth or reserved against in financial statements prepared in accordance with GAAP . . . .").

[70] Knowledge qualifiers name *who* within an organization must be in possession of the relevant information and define those individuals' knowledge as actual or constructive. Constructive knowledge imputes some amount of inquiry to the named individuals, often "due inquiry of their direct reports," attributing to them what they would have known if they had so inquired, regardless of whether they in fact did. Specific reps will then be qualified by incorporation of this general definition, thereby serving to limit the amount of inquiry necessary under the rep.

[71] Materiality qualifiers define *what* information is relevant to a particular rep.

[72] *See, e.g.*, Darden-Cheddar's, at § 2.1 ("The Company is duly qualified to transact business and is in good standing in each jurisdiction in which its ownership of property or assets or the conduct of its business as currently conducted requires it to qualify, except where the failure to so qualify would not, either individually or in the aggregate, reasonably be expected to have a Material Adverse Effect."). The definition of Material Adverse Effect is heavily negotiated because, in addition to qualifying reps, it is also made a condition to close, potentially triggering a walk away right for the buyer. *See generally* Adam B. Badawi & Elisabeth de Fontenay, *Is There a First-Drafter Advantage in M&A*, working paper at 18–19 (describing the importance of the MAE as a condition to close) (on file with author).

[73] For example, a tax rep might state that a company has filed all material returns and that its returns are accurate in all material respects. *See, e.g.*, Darden-Cheddar's, at § 2.8(a) ("The Company … has timely filed … all material Tax Returns…, and all such Tax Returns are true, complete and correct in all material respects."). Under this formulation, in order to constitute breach, tax inaccuracies need not harm business operations as a whole. Rather, they need only be inaccurate in some meaningful way on a particular return.

[74] *See supra* notes 35-39 and accompanying text.

[75] *See, e.g.*, *id.*, at § 5.2(a) (providing indemnification for losses from breached reps, "disregarding any qualifications as to Material Adverse Effect, materiality or phrases of like import contained in such representations and warranties").

[76] The original, partial, form of the materiality scrape seems to have entered acquisition agreements in order to solve the so-called "double materiality" problem in which sellers benefited from arguing not only that an inaccuracy had to be material to constitute breach but that losses from the breach had to be material in order to count towards damages. In response, buyers answered that sellers already had protection—in the form of baskets and mini-baskets,

for both purposes. As a result, in agreements with a full scrape, any inaccuracy, large or small, will be counted as a breach, materiality notwithstanding. Materiality scrapes are not used in public deals because public deals generally lack an indemnity provision.[77]

Agreements with a full scrape beg a question: Why include the word "materiality" at all? The answer lies in the attempt to separate disclosure standards from liability standards. Scraping materiality as a liability standard leaves it in place as a principle of disclosure. Insofar as sellers disclose to the reps, they need disclose only material matters. Thus, while omission of the materiality concept would maximize both the seller's liability and its disclosure burden, a full scrape maintains maximum liability but limits the burden of disclosure. Why a seller might want to assume this liability burden and whether it is ever really possible to separate disclosure from liability are questions explored below. Suffice it to say, for now, that the answer to both questions may be related to the transfer of liability risk under an RWI policy.[78]

3. Enhancing Credibility

Buyers may hesitate to lift their discounts until they have confirmed the accuracy of information provided by sellers. M&A contracting provides two basic verification mechanisms: due diligence and indemnification. These operate as complements, not substitutes. Together they enhance the credibility of seller disclosures, thereby enabling the buyers to increase their bids.

In due diligence, the seller provides access to documents and perhaps also to key facilities and personnel.[79] The process is arduous and costly, consuming the time of employees and top level executives inside the company as well as lawyers, accountants, and other outside experts.[80] Parties may therefore seek to use the imposition of legal liability, through the indemnification provision, to limit the scope of diligence.[81] More indemnification may imply less need for due diligence.

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discussed *infra* note 88 and accompanying text—against insignificant losses being claimed against the indemnity. As a result, they argued that materiality should be scraped from the reps for purpose of determining loss. *See generally* John LeClaire, et al., *Scraping By*, MERGERS & ACQUISITIONS: THE DEALMAKER'S JOURNAL (July 2008); Tyler B. Dempsey, *Seller Beware: Potential Pitfalls and Unintended Consequences of the 'Materiality Scrape,'* A.B.A., BUS. L. SEC.: PRAC. RESOURCES.

[77] *See supra*, note 42 and accompanying text.

[78] For further discussion of this point, see *infra* note 173 and accompanying text.

[79] Documents are typically deposited into a virtual or physical "data room," containing for example sales data and other financial information, along with copies of material contracts and summaries of important litigation.

[80] *See* Jeffrey Manns & Robert Anderson IV, *The Merger Agreement Myth*, 98 CORNELL L. REV. 1143, 1184 (2013) ("[d]iligence is expensive and may not be the best way to uncover information already in the possession of the target.").

[81] In the words of then-Vice Chancellor Strine:

> Due diligence is expensive, and parties to contracts in the mergers and acquisitions arena often negotiate for contractual representations that minimize a buyer's need to verify every minute aspect of a seller's business. ... By obtaining the representations it did, [the buyer] placed the risk that [the company's] financial statements were false and that [the company] was operating in an illegal manner on [the seller]. Its need then, as a practical business matter, to independently verify those things was lessened because it had the assurance of legal recourse against [the seller] in the event the representations turned out to be false.

The converse, however, is not true. More due diligence does not imply less need for indemnification.[82] Legal liability is the engine driving the diligence process. Due diligence, like the disclosures it seeks to verify, depends upon information provided by the seller. Without the threat of legal liability in the background, confirmatory evidence offered in connection with the diligence process would be as dubious as the information it supposedly confirms.[83] Legal liability breaks this cycle of doubt and, in doing so, forms the ultimate basis of the seller's credibility.[84]

Indemnification provisions in M&A contracts essentially operate as a form of insurance.[85] The seller undertakes to insure the buyer for breaches of reps,[86] and like other forms of insurance, the seller's indemnity has a limit of liability (the "cap")[87] as well as a deductible or retention amount (the "basket").[88] Caps and baskets, like limits and retentions, allow for the sharing of risk. The higher the indemnity cap and the lower the basket, the greater the seller's risk. The lower the indemnity cap and the higher the basket, the greater the buyer's risk. Finally, like most insurance policies, the seller's indemnity has an effective term of coverage—the survival period.[89] Through these terms of the indemnity, the seller agrees to insure the reps within a specified range of liability and for a specified period of time.

Indemnification provisions also specify how the parties will manage claims, providing procedures for claiming and contesting breach.[90] Escrow accounts, into which sellers may

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Cobalt Operating, LLC v. James Crystal Enterprises, LLC, No. Civ. A. 714-VCS, 2007 WL 2142926, at *28 (Del. Ch. July 20, 2007) (holding that plaintiff's failure to uncover fraud during due diligence was not unreasonable and plaintiff satisfied its burden as a fraud plaintiff to show justifiable reliance).

[82] *See generally* Manns & Anderson, *Merger Agreement*, at 1184-85 ("representations and warranties that have teeth … serve as a means of signaling information, which eliminates the need for costly investigations of quality (e.g., due diligence). The signaling function only works, however, when a cost is imposed on the maker of the warranty when the warranty is untrue.").

[83] Due diligence can only check the consistency of the seller's representations against other evidence provided by the seller.

[84] *See* Thomas C. Schelling, *An Essay on Bargaining*, 46 AM. ECON. REV. 281, 299 (1956) ("the right to be sued is the power to accept a commitment.").

[85] Albert Choi & George Triantis, *The Effect of Bargaining Power on Contract Design*, 98 VA. L. REV. 1665, 1693 (2012) ("[R]epresentations and warranties allocate risks and might be thought of as insurance products within acquisition agreements.").

[86] Coates, *Allocating Risk through Contract*, at 10 ("it is the combination of representations with explicit indemnification clauses that that is typically the principal way in which both misevaluation and value-shifting risks are allocated"). Although most private company acquisitions involve an indemnification provision, public company acquisitions typically do not. *See supra* Part I.A.

[87] The cap is often tied to the escrow amount.

[88] Baskets appear in two basic types, either as "first dollar baskets," in which losses must exceed the basket amount in order to be payable but, once this amount is exceeded, are fully payable from the first dollar of loss, and "deductible baskets," which operate like ordinary insurance deductibles in compensating only loss in excess of the threshold amount. There may also be "mini-baskets," which require each loss to meet a minimum amount before it can be counted towards the larger basket amount.

[89] *See generally* PLC ("The survival period of a seller's indemnification obligations usually mirrors the survival period of the representations and warranties.").

[90] The indemnification provision specifies the general contents of the notice—a reasonably detailed description of the issue and identification the representations and warranties upon which the claim is based—and requires sellers to respond within a specified period of time. The provision may also mandate a period of negotiation before litigation can formally commence.

deposit a portion of the deal price to fund claims of breach,[91] may also be referenced in the indemnification provision.[92] Indemnification claims against escrow accounts are handled by escrow agents, typically banks, empowered to release funds only when instructed jointly by the parties or, in the case of disputed indemnity claims, when provided with a court order.[93] Escrow arrangements thus provide credit-backing, but claims administration ultimately depends upon either agreement or litigation.

II. Insurance Against Misinformation: RWI

RWI is an insurance policy to cover losses from breached reps. RWI evolved out of tax-liability policies sold in the London market in the 1980s.[94] RWI coverage soon expanded internationally, but it took much longer to become widespread in the United States.[95] Although some form of RWI coverage has been available in the U.S. since the 1990s, due to the arduous weeks- or months-long diligence process insisted upon by insurers, early policy forms were seen to inhibit, rather than facilitate transactions.[96] As a result, RWI was not often used.

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[91] Escrow accounts serve as a kind of hostage arrangement until the indemnity's survival period ends. Leaving hostages is a recognized device to enhance credibility and thereby support exchange. Oliver E. Williamson, *Credible Commitments: Using Hostages to Support Exchange,* 73 AM. ECON. REV. 519, 537 (1983) (demonstrating that "the use of hostages to support exchange is widespread and economically important"). *See also* Gilson, *supra* note 1, at 282 (citing Williamson and noting that "the hostage metaphor rings especially true because the seller's promise to indemnify the buyer is frequently backed by… retention of a portion of the consideration as a fund to assure the seller's performance of its indemnification obligation").

[92] *See, e.g.*, Darden-Cheddar's, *supra* note 69, at § 5.6 (stating procedures for making claims against escrow and for distribution of escrowed funds at the end of the survival period).

[93] These terms typically appear in a separate escrow agreement between the transacting parties and the escrow agent. *See, e.g.*, Escrow Agreement between Vecima Networks, Inc., Concurrent Computer Corp., and Suntrust Bank, dated Dec. 15, 2017, filed as Exh. 2.1 to the 8-K of Concurrent Computer Corp., dated Dec. 15, 2017, § 3.3(a) and (b) (providing for the release of escrow funds on the basis of either joint written consent of the seller and buyer or a final judicial decision).

[94] The RWI policies that emerged in the 1990s evolved out of tax policies sold by Lloyd's of London in connection with leasing transactions in the 1980s. *See* Rosen & Blitz, at 2.

[95] A form of RWI, known as "Warranty and Indemnity Insurance" or "WII," is widespread across deal-markets from Europe to Australia. However, WII policies typically provide a much narrower form of coverage than RWI. This is partly a result of the idiosyncrasies of foreign deal markets, in which all information in the data room is deemed to qualify the reps in the acquisition agreement. There is, in other words, no need to separately qualify reps by information summarized on a separate disclosure schedule. Moreover, WII providers may insurer a narrower set of reps than those that are operative in the deal, covering only the reps that appear on a separate "warranty spreadsheet," without regard to the terms as they actually appear in the acquisition agreement. These practices are not followed in the US market. Instead, providers of WII have begun to enhance their policies to provide "US-style" coverage. *See* HOWDEN INSURANCE GROUP, HOWDEN M&A ANNUAL REVIEW MERGERS AND ACQUISITION 2017 INSIGHTS 7 (2017).

[96] For example, an industry publication describing the earlier form of RWI notes that: "Insurance companies would underwrite by redoing diligence. That is an arduous underwriting process that would take weeks and would be very intrusive to the transaction." Insurance & Risk Management Knowledge Alliance, Transaction Insurance – It's Gaining Momentum (2015). *Accord* Rosen & Blitz ("Originally, insurers would typically undertake a lengthy and independent diligence review of the target company with respect to the representations and warranties to be covered by a given policy. This process could take months in total … and was typically intrusive to the in-process transaction.").

Since 2013, however, use of RWI in the U.S. deal market has exploded.[97] Respondents to my survey unanimously reported a vast expansion of RWI coverage in recent years.[98] Deal lawyer respondents estimated using RWI in fifty percent of their transactions in 2017.[99]

Although now common in private deals, RWI remains rare in public deals.[100] Respondents report that RWI is most often used when private company targets are purchased by private equity buyers (72%) and occasionally when private company targets are bought by public company buyers (21%).[101] Respondents report that RWI is rare when public company targets are taken private and even more so when public companies buy other public companies.[102] However, it is important to remember that private deals are not necessarily small deals. RWI coverage is available for transaction sizes from $50 million to over $1 billion.[103]

A partial explanation for the expansion of RWI in the U.S. is that insurers learned to underwrite the product faster, largely by free-riding upon the underlying due diligence of the parties themselves rather than undertaking an extensive due diligence effort of their own.[104] Once underwriting was expedited, the product could be sold within the tight time-frame of deals. Whether and how the product responds to the interests of the transacting parties is a subject explored at length below.[105]

A. Basic Terms of Coverage

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[97] Rosen & Blitz; Lockton.

[98] Asked whether underwriting volume of RWI policies has increased, decreased, or stayed the same since last year, respondents unanimously reported that it has increased. RWI Survey, question 57.

[99] *Id.*, question 30.

[100] *See, e.g.,* Omri Even-Tov & James Ryans, *Representations and Warranties Insurance and Valuation Uncertainty in Mergers and Acquisitions*, Jan. 2019, at 11-12 (working paper on file with author) (analyzing proprietary sample of 1,690 RWI policies issued worldwide between 2011 and 2016 consisting exclusively of non-public targets) [hereinafter Even-Tov & Ryans, *Valuation Uncertainty*].

[101] This is consistent with my sample of publicly filed acquisition agreements referencing RWI, the vast majority of which (85%) involved public buyers and private sellers. Private buyers of private sellers would not have shown up in the sample because private companies are not required to publicly file acquisition agreements. *See supra* Part I.A.

[102] Forty-nine respondents reported that, on average, of their RWI deals, 4% involved public companies being taken private, and 2% involved public to public deals. The medians reported for these transaction types were 1% and 0%, respectively. RWI Survey, questions 40, 62, 106.

[103] Respondents reported the use of RWI across transaction sizes, but it appears to be slightly more common at lower transaction values. *Id.* Asked to associate RWI use with deal size, respondents replied that 31% of the transactions in which RWI was used had a deal value of less than $100 million, 25% had a deal value of $100 million to $250 million, 19% had a deal value of $250 million to $500 million, 19% had a deal value of $500 million to $1 billion, and 6% had a deal value above $1 billion. *Id.*, questions 35, 65. These estimates are roughly consistent with AIG's estimate of its RWI policy distribution. *See* AIG, M&A INSURANCE COMES OF AGE 3 (2017) (estimating policy distribution across deal sizes: 45% deals under $100 million, 26% deals between $100 million and $250 million, 14% deals between $250 million and $500 million, 9% deals between $500 million and $1 billion, and 7% deals over $1 billion.).

[104] *See* Insurance & Risk Management Knowledge Alliance, Transaction Insurance – It's Gaining Momentum (2015) (stating that "insurance companies have realized that they don't need to redo the diligence. What they do now is review the diligence that was done. . . . What was a multi-week, if not a multi-month process has been reduced to . . . two weeks, and is frequently done over a weekend."). For further detail on the insurers' diligence efforts, see *infra* Part V.B.

[105] *See infra* Part III.

RWI, like other forms of insurance, transfers risk from the buyer of the insurance, the policy-holder, to an insurance carrier. Early RWI policies, offered "a bridge to get the deal done" when transacting parties could not agree on an indemnity amount.[106] If buyers wanted a higher indemnity than sellers were willing to offer, they might purchase an RWI policy to bridge the gap.[107] In such cases, RWI coverage could be viewed as a compliment to the seller's indemnity. Recently, however, coverage has broadened such that RWI now frequently substitutes for the seller's indemnity.[108] Survey respondents reported that roughly one third of recent RWI policies were written to cover deals in which there was no seller indemnity.[109] Moreover, when indemnities do appear in deals in which RWI is present, they are likely to be significantly smaller than the traditional 10% seller indemnity. When a seller indemnity was present alongside an RWI policy, respondents estimated it at 3% of deal value on average, with a median estimate of 1%.[110]

RWI policies can be underwritten to cover either sellers or buyers. The original policy form covered sellers' indemnification obligations ("sell-side" policies) but was subsequently adapted to cover buyers directly ("buy-side" policies). Buy-side policies now predominate, constituting over ninety percent of all RWI policies sold for the past several years.[111] This does not necessarily mean that the buyer pays for the policy. RWI is a transaction cost, allocated between the buyer and seller like any other cost or benefit in the transaction.[112] Likewise, the predominance of buy-side policies should not be taken to mean that it is always buyers who shop for and obtain coverage. Sellers may arrange for insurance to cover the buyer upon consummation of the underlying acquisition—an arrangement referred to as the "seller-to-buyer flip" or "stapled insurance."[113] In any case, insurance brokers are typically involved in placing RWI coverage.

Like other forms of insurance, RWI has limits, retentions, and premiums. Survey respondents confirmed the statistics commonly reported in the industry literature: Typical limits

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[106] RWI Interview, Broker, Apr. 18, 2018.

[107] If, for example, the buyer demands a $20 million indemnity but the seller is only willing to offer an indemnity up to $10 million, the parties may buy-side RWI to bridge the $10 million gap. The efficiency of RWI for this purpose, as opposed to other forms of finance, remains an open question. *See supra* Parts III.D. and V.A.4. (discussing the Alternative Finance hypothesis).

[108] Chapman, et al., Representations and Warranties Insurance in M&A Transactions, Harvard Law School Forum on Corporate Governance and Financial Regulation, Dec. 11, 2017 (discussing the evolution of RWI policies).

[109] Respondents reported that an average of 63% (median 70%) of recent policies covered transactions that also included a seller indemnity. RWI Survey, question 15.

[110] RWI Survey, questions 16 and 73. *See also infra* Tbl. 1 (comparing indemnities in acquisition agreements with and without RWI).

[111] Lockton, at 7 (showing 90% buy-side in 2014, 95% in 2015, 99% in 2016, and 95% in 2017. *Accord* Gallagher & Co, July 2017 Study, at 2 ("Today, over 90% of these insurance policies are purchased by the buyer, even if the seller funds part or all of the insurance purchase."). Survey respondents confirmed the overwhelming predominance of buy-side policies, with the majority of estimating that buy side policies dominate sell side policies at a rate of 95% to 5% or 99% to 1%. RWI Survey, question 84.

[112] *See, e.g.*, Lifetouch-Shutterfly Agreement, supra note 56, at 10 (allocating to the seller "one-half of the R&W Insurance Premium"). *See also* IRMKA interview, at 2 ("[F]requently when the product is used, the buyer and seller will split the cost.").

[113] IRMKA interview, at 2 (noting the "seller flip"); Rosen & Blitz, at 5 (describing the design of a "Stapled Insurance Package"). *See also* Willis Towers Watson, "Stapling" Warranty & Indemnity Insurance.

are 10% of deal value.[114] Typical premiums are 3% of limits.[115] And typical deductibles are approximately 1% of deal value.[116] Limits anchor around 10%, one insurer remarked, because the purpose was "to replace the seller escrow that used to predominate 5 to 10 years ago."[117]

RWI policies track the liability and indemnity provisions in the underlying acquisition agreement. "Breach," in a standard policy form is defined as "any breach of, or inaccuracy in, the representations and warranties set forth in . . . the Acquisition Agreement."[118] "Loss" likewise refers back to amounts to which policyholders are entitled "[p]ursuant to the terms of the Acquisition Agreement…."[119] *Known* liabilities are excluded from coverage, whether known prior to negotiations or uncovered during the diligence process.[120] Insurers may also add exclusions if they are uncomfortable with the level of disclosure or the quality of diligence around a suspected area of risk.[121] Historically, policies also had a package of standard exclusions,[122] but these have largely been negotiated away as coverage has broadened in the current market.[123]

The broadening of RWI coverage can be seen in the elimination of the exclusion of losses relating to diminution-in-value or multiplied damages (hereinafter "DIV/ multiplied damages"). DIV/ multiplied damages measure losses not by the amount of loss caused by the breach itself but by the effect of the loss on the value attributed to the target business at the time of the acquisition.[124] For example, if the buyer paid a 12X multiple of earnings before interest, taxes,

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[114] Mean and median limits were 9.75% and 10%, respectively. Mean and median premiums were 3.04% and 3%, respectively. In comments, respondents reported that factors influencing limits purchased include: industry and level of regulation within the industry, audited financials, international operations. Insurers in their comments noted that "10% of deal value is the general rule," but also noting that "some RWI insurers are unwilling to write policies with limits below $5 million" which may result in very small (less than $50 million) deals purchasing more than the typical limit amount.

[115] Commenting on factors influencing the premium, respondents listed industry, size, and the number of carriers willing to offer a quote. One deal lawyer respondent included "the extent of due diligence in the deal," RWI Survey, DL #14 but another deal lawyer commented that the range is "typically 3–4%" and that the "market is pretty stable on this." RWI Survey, DL #8. A buyer confirmed this, commenting that premium tends to be "a pretty standard rate with not much variability." RWI Survey, PE #2.

[116] The mean and median deductibles reported were 1.5% and 1% of deal value respectively. RWI Survey, question 13. In comments, respondents reported that the market standard for deductibles is 1%, dropping to 0.5% 12 months after closing. *Id.* Respondents reported that some deals, especially larger deals, may have deductibles below 1%. *Id.*

[117] RWI Survey, I #21.

[118] AIG Specimen Policy at 1.

[119] AIG Specimen Policy at 2.

[120] Standard policies provide no liability for "any Breach of which any of the Deal Team Members had actual knowledge prior to inception. . . ." AIG Specimen Policy at 3.

[121] *See* Part V.B.

[122] *See, e.g.*, AIG Specimen Policy, at 3 (excluding DIV/ multiplied damages, asbestos liabilities, and unfunded benefit plans).

[123] *See, e.g.*, HOWDEN M&A INSIGHTS 2017, *supra* note 95, at 7 (discussing "policy enhancements" including broader definition of loss and other enhancements).

[124] See, e.g., Michael Gill & Frank Mascari, Confusion Reigns: Applying the Multiplied Damages Exception in Representations and Warranties Insurance Policies, Bloomberg BNA, Jan. 25, 2016. Agreements may expressly include or exclude DIV/ multiplied damages, often in the indemnity provision or in the definition of loss. *See, e.g.*, Agreement and Plan of Merger among Eastside Distilling, Inc. and Craft Canning LLC, dated Jan. 11, 2019

depreciations, and amortization ("EBITDA") for a target company and an undisclosed liability had the effect of reducing EBITDA by $10 million, the buyer might claim $120 million of loss under a DIV/ multiplied damages theory as opposed to $10 million of direct loss. DIV/ multiplied damages may be seen as a type of consequential damages.[125] The consequence of the breach is the mispricing of the acquisition. DIV/ multiplied damages can thus be thought of as mispricing damages.

Although DIV/ multiplied damages had formerly been excluded from coverage under RWI policies, the market has now settled on a practice of "following silence with silence."[126] If the underlying acquisition agreement does not expressly exclude DIV/ multiplied damages, neither will the RWI policy. In this situation, insurers will at least entertain the possibility of providing coverage for DIV/ multiplied damages should they arise.[127] At the same time, according to market participants, insurers are unwilling to contractually commit to covering DIV/ multiplied damages by expressly including them in either the acquisition agreement or the policy, but if on the other hand, DIV/ multiplied damages are expressly excluded in the acquisition agreement, they will be uncovered under the policy because coverage tracks the definition of loss in the underlying acquisition agreement. In other words, the market has settled on an uneasy state where DIV/ multiplied damages are *implicitly* covered.

Insurers may have been willing to broaden coverage to include DIV/ multiplied damages because the additional risk seemed small. Historically, claims under RWI policies have been neither frequent nor severe. Deal lawyers report claim frequency under RWI policies as roughly equal to claim frequency under a seller indemnity.[128] AIG, a leading underwriter of RWI, reports receiving a notice of claim on approximately 20% of its policies, escalating slightly with transaction size.[129] Aon, a leading broker of RWI, reports relatively flat claim frequency, around 15%, for policy years 2013–2015.[130]

(defining "losses" to include "without limitation, incidental, consequential, special or indirect damages (including loss of revenue, diminution of value or any damages based on any type of multiple)").

[125] See Glenn D. West, Sara G. Duran, *Reassessing the "Consequences" of Consequential Damage Waivers in Acquisition Agreements*, 63 BUS. LAW. 777, 779 (2008) (noting that "many deal professionals and their counsel believe that all lost profits are consequential damages and vice versa" but arguing that diminution in value and multiplied damages are conceptually distinct from consequential damages). *See also* Glenn D. West, *Consequential Damages Redux: An Updated Study of the Ubiquitous and Problematic "Excluded Losses" Provision in Private Company Acquisition Agreements*, 70 BUS. LAW. 971 (2015) (updating prior study). The definition of loss may also expressly include or exclude consequential damages. *See, e.g.*, BPSGreenland, Inc.-Bauer Hockey, Inc., Asset Purchase Agreement, dated 2014, at §6.5(b) (expressly providing for "consequential, incidental, special and indirect damages" for indemnified parties).

[126] *See, e.g.*, RWI Interview, Broker, Sept. 25, 2018 ("Going silent on DIV in the merger agreement means opting in to DIV damages in the insurance policy.").

[127] Insurers offer coverage for DIV/ multiplied damages through silence rather than expressly including the damages measure because "insurers don't want any implication that they're obligated to pay multiplied or DIV damages, they simply want to provide the Insured with the opportunity to present their case for multiplied damages when appropriate." E-mail correspondence between Author and RWI Broker, dated Aug. 1, 2018.

[128] RWI Survey, question 49.

[129] AIG, CLAIMS INTELLIGENCE SERIES: TAXING TIMES FOR M&A INSURANCE (2019) at 3, available at https://www.aig.com/content/dam/aig/america-canada/us/documents/business/management-liability/aig-manda-claimsintelligence-2019-w-and-i.pdf (reporting claim frequency of 18% for deals under $100 million and 23% for deals over $1 billion). By contrast, survey respondents generally estimated claims frequency to be more common at

When claims do come in under RWI policies, respondents reported that they are most likely to arise under the financial statement rep.[131] Other commonly named sources of RWI claims include the tax rep,[132] the compliance with law rep,[133] and reps relating to labor and employment matters.[134] These reports are consistent with industry studies.[135]

Claim severity—losses claimed against RWI policies—also appears to be low overall.[136] Survey respondents confirmed this, noting that claims rarely exceed ten percent of policy limits.[137] Several respondents commented that settlements rarely exceed the deductible.[138] Asked to report on the largest claim they had seen paid under an RWI policy in the last five years, many participants answered approximately $20M. One answered over $100 million. Several said $0.[139]

Finally, the term of coverage under RWI policies may exceed the survival period of a seller's indemnity. RWI policies may cover breaches of the general reps for as long as three years (compared to 12 to 18 months under a seller's indemnity) and fundamental reps for twice

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lower transaction sizes. Respondents (39) reporting: 27% less than $100M, 34% $100–250M, 21% $250–500M, 11% $500M–$1B, 7% over $1B. RWI Survey, question 87.

[130] Aon data shows claim frequency at 14.6% for RWI policies underwritten in 2013, 17.6% for 2014 policies, and 13% for 2015 policies. Rosen, Blitz, at 7.

[131] 72% (13/18) of respondents named the financial statement rep as the leading source of RWI claims. RWI Survey question 90 (asking respondents to name the top five sources of RWI claims). The next leading source of claims, the tax rep, was named by two respondents. No other source was named more than once. *Id.*

[132] *Id.* 28% (5/18) of respondents named the tax rep as the second leading source of RWI claims. The same number of respondents named the financial statements rep as the second leading source of RWI claims. The litigation rep and other third-party claims were named three times as the second leading source of RWI claims.

[133] *Id.* The compliance with the law rep was twice cited as the second leading source of RWI claims. Overall, it was named six times as one of the top five leading sources of RWI claims.

[134] *Id.* Reps relating to labor and employment were cited six times as one of the top five sources of RWI claims.

[135] AIG, TAXING TIMES, *supra* note 129, at 5 (reporting 19% of claims arise as a result of the financial statement reps, 18% arise from the tax rep, 15% arise from the compliance with laws rep, and 13% from the material contracts reps). Within the financial statements' reps, AIG reports that claims involving accounting rules breaches are most common (at 26%), followed by claims involving misstatements of accounts receivable (25%), then claims involving undisclosed liabilities (19%), then claims involving misstatements of inventory (17%), and finally claims involving overstatements of cash holdings or profits (13%). AIG, M&A INSURANCE, *supra* note 103. Financial statement claims seem to be the most common source of claims for policies underwritten outside the United States as well. See HOWDEN, M&A INSIGHTS, *supra* note 95, at 10 (noting that 29% of claims in non-US dataset involved financial statement breaches, followed by tax (16%) and undisclosed litigation (16%)). Aon reports the leading sources of claims as the financial statements rep (31%), followed by the IP and tax reps (both at 19%). Rosen, Blitz, at 7. *But see* Lockton study, reporting leading source of claims in its dataset to be claims involving defective equipment (27%).

[136] AIG reports the average claim severity for material claims (losses claimed in excess of $100,000) as follows: 41% claimed losses between $100,000 and $1 million (average claim $360,000), 44% claimed losses from $1 million to $10 million (average claim $4 million), and 15% claimed losses in excess of $10 million (average claim $19 million). AIG, TAXING TIMES, *supra* note 129, at 3. With regard to severity, Aon reported in 2017: "[o]f 145 claims since 1999, 73 remain open and are early in the claims process, 25 were resolved within the applicable retention, 17 have been inactive/ dormant, 16 resulted in loss payment and just 4 were ultimately denied by the insurer." Rosen, Blitz.

[137] Respondents (25) reporting: 44% under 10% limits, 20% within 10-35% of limits, 16% 35-70% of limits, 4% 70-90% limits, 16% over 90% of limits. RWI Survey, question 88.

[138] *See, e.g.*, RWI Survey, B #20 ("I have not seen a claim breach the retention."); *id.,* B#10 ("Most claims settle within the retention."); *id.,* B#9 ("All are settled below retention.").

[139] RWI Survey, question 89.

as long, often six years.[140] However, the relevance of this difference may be exaggerated because most claims for breach arise after the buyer's first audit of the acquired company, typically within twelve to eighteen months.[141] Survey respondents confirmed that vast majority of claims come in within the first eighteen months of closing.[142]

B. Potential Distortions

Insurance introduces several potential distortions to the M&A contracting process. Two of these problems, adverse selection and moral hazard, are paradigmatic problems of insurance with potential applications to RWI. A third, the recreation of the credible commitment problem, is specific to the M&A contracting process. This section briefly introduces each.

Adverse selection is created by information asymmetry: consumers have information about risk that underwriters lack and use this information in deciding whether and how much insurance to buy.[143] For insurers, adverse selection implies that risk pools contain higher than average risks and, consequently, that policies priced to the average risk are underpriced. For consumers, adverse selection implies that low and average risk policy-holders subsidize higher risk policy-holders and thus overpay.[144] Once consumers learn this, low and average risk policy-holders exit insurance markets, leading risk pools to be composed of steadily worse risks and, eventually, to collapse.[145]

RWI poses a clear threat of adverse selection. The transacting parties likely understand the riskiness of their deal better than the insurer, and they may use this information to their advantage in deciding whether to purchase RWI. Recall that RWI is not purchased in every deal. In spite of the growth of the market, participants estimate that the insurance was involved in less than half of private deals last year.[146] Parties may self-insure for less risky deals and purchase RWI only for deals of above-average risk. Moreover, the availability of RWI allows buyers to entertain high risk deals that they might not otherwise consider, simply buying insurance for the riskiest transactions.[147]

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[140] Lockton report. See also supra note 59 and accompanying text (distinguishing between general and fundamental reps).

[141] AIG, TAXING TIMES, *supra* note 129, at 4 (showing that 74% of RWI claims are noticed within 18 months).

[142] Respondents (38) reporting: 17% first noticed 0–6 months from inception, 20% 6–12 months, 18% 12–18 months, 4% 18–24 months, and 1% 24 months or longer. RWI Survey, question 86.

[143] Peter Siegelman, *Adverse Selection in Insurance Markets: An Exaggerated Threat*, 113 YALE L. J. 1223 (2004) ("The phrase 'adverse selection' was originally coined by insurers to describe the process by which insureds utilize private knowledge of their own riskiness when deciding to buy or forgo insurance.").

[144] Michael Rothschild & Joseph Stiglitz, *Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information*, 90 Q. J. ECON. 629 (1976) (modeling adverse selection in a market of "Strongs" and "Frails").

[145] *See, e.g.*, Roberta Romano, *What Went Wrong with Directors' and Officers' Liability Insurance?*, 14 DEL. J. CORP. L. 1, 27–28 (1989) (explaining the collapse of the D&O market in the mid-1980s as a result of adverse selection).

[146] *See supra* note 99 and accompanying text.

[147] Seen in this light, adverse selection in RWI operates as a kind of *ex ante* moral hazard. The availability of insurance and the lesser inability of insurers to distinguish risk leads transacting parties to consider riskier transactions and to insure transactions with a higher degree of inherent risk.

Moral hazard, like adverse selection, can lead to the accumulation of risk in insurance pools and, hence, the destabilization of insurance markets. But, unlike adverse selection, moral hazard does not arise from the inherent riskiness of prospective insureds, but from actions taken by insureds.[148] More specifically, moral hazard is the tendency of insurance to increase loss by reducing the insured's incentive to prevent it.[149] In the context of RWI, where losses are generated by misinformation, moral hazard may explain the transacting parties' reduced enthusiasm for due diligence. And indeed, survey respondents reported that in their experience, RWI often leads to greater laxity in the diligence process.[150]

Neither moral hazard nor adverse selection occurs in every insurance market. For example, adverse selection does not occur in the absence of private information about risk or when relatively few consumers possess the requisite private information, nor does it occur when the insurer has superior information or predictive power.[151] Likewise, moral hazard may be less concerning when the underlying activity contains its own incentives to take care.[152] The extent to which adverse selection and moral hazard affect RWI and the mechanisms available to insurers to address these threats are discussed in greater detail below.[153] Insofar as they persist, however, they may lead to inadequate loss reserves and unreliable due diligence.

More generally, RWI threatens to distort the M&A contracting process by undermining the transacting parties' ability to make credible commitments. As discussed above, legal liability for misinformation is the basis of the seller's credibility.[154] A seller who can be sued for disclosing false information or for failing to disclose relevant information is a seller who can be believed, hence the indemnification provisions common in private M&A. But RWI transfers a seller's liability for misinformation, in whole or in part, to a third-party insurer. In no-indemnity deals, for example, this transfer of risk is more or less complete. Although it is still the seller that provides the buyer with the information, it is the insurer that bears the risk. Having transferred liability for misinformation to an insurer, sellers are unlikely to exert the same degree of care in the information they produce. Errors and omissions are therefore more likely.

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[148] Alma Cohen & Peter Siegelman, *Testing for Adverse Selection in Insurance Markets*, 77 J. RISK & INS. 39 (2010) ("Unlike adverse selection, which has to do with 'hidden information,' moral hazard has to do with 'hidden action.'").

[149] *See supra* note 13 and accompanying text. Moral hazard may also refer to policyholders' actions after a loss occurs, sometimes referred to as ex post moral hazard. *See, e.g.*, Georges Dion & Pierre St-Michel, Worker's Compensation and Moral Hazard, 73 REV. ECON & STAT. 236 (1991) (discussing ex post moral hazard in connection with workers' compensation insurance).

[150] *See, e.g.*, RWI Survey, PE #2 ("I believe Sellers are less discerning on disclosure schedules [due to RWI]."); *id.*, I #23 (noting "less due diligence [is] being completed" under RWI policies and that RWI "speeds up due diligence"). *Accord id.*, DL #2 (noting "less negotiation regarding rep and warranty scope" with RWI); B19 ("the reps are slightly less aggressively negotiated when there is RWI"); *id.*, B #1 (stating that RWI "shortens negotiation of reps"); *id.*, B #14 (observing that "much less time is spent negotiating reps" but also noting that "buyers and sellers are still thorough in the diligence and disclosure process"). More generally, the "streamlining" of the acquisition process noted above may suggest lax diligence. *See infra* note 178 and accompanying text.

[151] Cohen & Siegelman, at (ms 18–25).

[152] For example, the threat that careless driving poses to the life and limb of the driver may limit the scope of moral hazard in the context of automobile insurance. *See* Baker, *Genealogy of Moral Hazard, supra* note 13.

[153] *See infra* Part V.

[154] *See supra* note 84 and accompanying text.

Understanding that sellers are no longer motivated by the threat of legal liability, rational buyers will discount seller disclosures to reflect this lack of credibility. In this way, RWI effectively reintroduces the credible commitment problem into M&A contracting.

These insurance-induced distortions impose frictions on efficient contracting. Ultimately, they suggest above-average risk accumulation in RWI policies, a less reliable exchange of information, and less seller credibility. If either the insurers or the transacting parties do not introduce mechanisms to contain these threats, the predictable result is greater discounting and broken transactions, the very problem that the reps were designed to solve.

III. How Does RWI Affect M&A Contracting

Survey participants overwhelmingly asserted that RWI changes the nature of the underlying transaction.[155] If they are right, these changes ought to manifest themselves in the acquisition agreement. The question thus becomes how acquisition agreements in deals with RWI differ from acquisition agreements in deals without it. This Part reports the results of an empirical study into that question. Its findings support the proposition that RWI has evolved into a broad-based coverage, under which the insurer agrees to bear considerably greater risk than the typical seller under the typical indemnity.

In order to analyze the effect of RWI on M&A contracting empirically, I conducted a comparative study of acquisition agreements. I assembled a database of acquisition agreements by searching the Westlaw Practical Law database for acquisition agreements making reference to RWI,[156] supplementing the results by repeating the same searches on Intelligize,[157] an online platform that facilitates searches of the exhibits to SEC filings.[158] Combining these searches yielded 271 acquisition agreements through year-end 2018 making reference to RWI in the underlying transaction.[159] Although the Westlaw and Intelligize databases go back to 2010 and 2008 respectively, acquisitions making reference to RWI began to appear only as of 2012 and to appear with regularity only as of 2015. The number of acquisition agreements making reference to RWI then began to increase dramatically. The incidence of acquisition agreements making reference to RWI is summarized in Figure 1 below.

[155] Eighty-nine percent of all respondents. See RWI Survey, questions 11, 38, and 74.

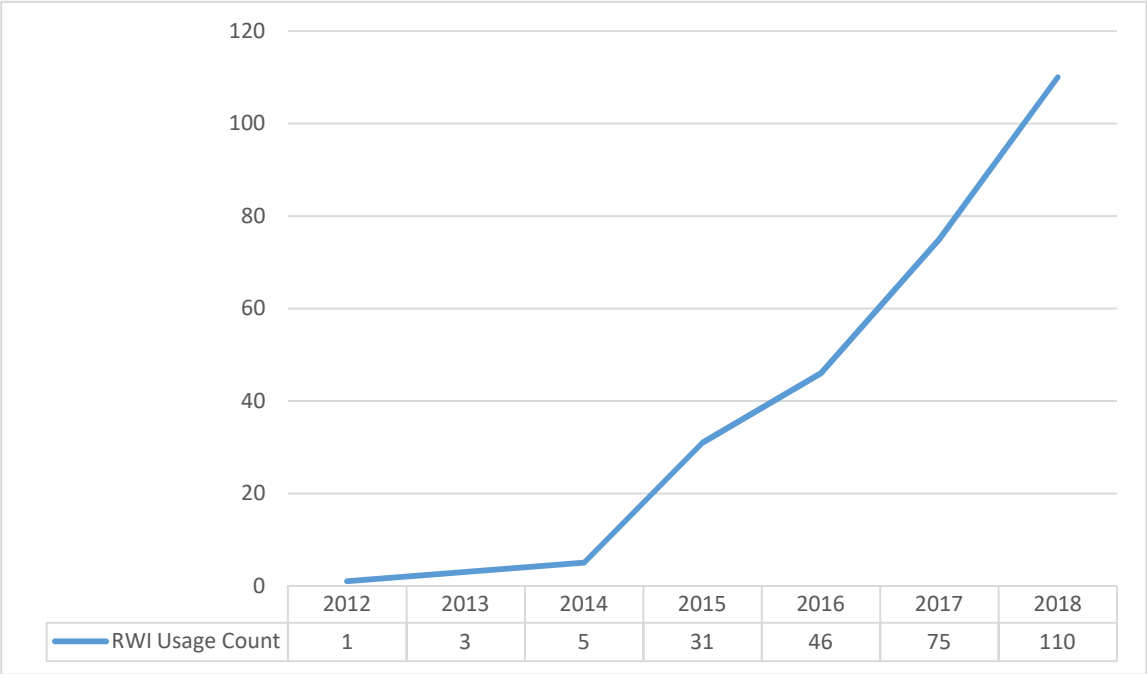
[156] The principal Westlaw database includes "all publicly filed acquisition agreements entered into after January 1, 2010, with a signing value of at least $25 million involving the acquisition of (i) all or substantially all of the assets of private US companies, (ii) at least a majority of the outstanding stock of private US companies or (iii) business units of US companies." Westlaw, Private Acquisition Agreements Database.

[157] The Intelligize database contains publicly filed acquisition agreements in excess of $1 million, from 2008 to the present.

[158] I searched under various formulations of the phrase. For example: "Rep & Warranty Insurance," "RW Insurance," "R&W Insurance," "RWI," and others.

[159] The reference to RWI in the acquisition agreement often appeared as a covenant or a condition to closing or as part of a provision describing how the parties would divide transaction costs.

Figure 1: Acquisition Agreements Making Reference to RWI



The acquisition agreements in this sample involved private targets or privately held assets (99% of the sample) and public company acquirors (83% of the sample).[160] This result reflects, in part, the regulatory environment. Public companies must file material contracts as exhibits to their SEC filings. Acquisition agreements, when they are of a sufficient size relative to the public company, are material contracts. Private companies, however, have no such filing or disclosure obligations. Because both the Westlaw and Intelligize databases are based on SEC filings, the only way for an acquisition agreement to find its way into my dataset was through the involvement of a public company, either as the buyer or the seller. My data set therefore is likely missing deals between purely private parties (funds and founders, for example, or sales from one private equity fund to another) as well as those where the acquisition is not material to the public company. Nevertheless, in my data set, the public company is was overwhelmingly the buyer, confirming the notion that RWI is principally a product for acquisitions of private companies.

Next, in order to construct a set of agreements for comparison purposes, I ran another search for private acquisition agreements in the Westlaw Practical Law database, this time excluding phrases referencing RWI, then further narrowing these results to deals signed on or after January 2015, the time period when RWI had begun to appear with regularity in the prior search. This yielded over 1,000 results, from which I randomly selected 274 agreements. After confirming the absence of any reference to RWI, I saved these agreements as my comparison set. The result of this process is a dataset of 544 acquisition agreements, from 2012 through 2018 (predominantly 2015-2018), 270 of which contain some reference to RWI (hereinafter "insured

[160] My sample contained only three insured deals involving public company targets, all of which were take-private transactions, in which a public company is purchased by a private company or a private fund of investors.

deals") and 274 of which do not (hereinafter "uninsured deals"). The average deal size among the insured deals was $407 million compared to $562 million for uninsured deals.

I then hand coded the acquisition agreements in the dataset for specific features of the reps and the indemnity provisions. I recorded the number of words in the reps and the number of words in the acquisition agreement overall. I coded for materiality scrapes and the presence of materiality qualifiers in the No Undisclosed Liability rep.[161] I coded the type of knowledge qualifier used in each agreement, actual or constructive, and recorded the presence of knowledge qualifiers in a standard set of reps—litigation, IP, financial statement, real property, tax, employee benefits, and material contracts.[162] With regard to the indemnity provisions, for example, I recorded the indemnity cap, basket amount and type, survival period, and escrow amount. I coded the definition of loss for whether or not it included DIV/ multiplied damages. I also collected information concerning the buyer and seller, the deal value, industry, signing and closing dates, the law firms involved in the transaction, any alternative dispute resolution provisions, type of acquisition, and the presence or absence of debt financing.

Table 1: Indemnification and Escrows[163]

	RWI Deals	Non-RWI Deals
Indemnification Present	83%	82%
Mean Indemnity Amount (% of deal value)	9%	10%
Median Indemnity Amount (% of deal value)	1%	10%
Indemnification Survival (months, average)	16	16
N	*223*	*224*
Escrow Present (% of deals with indemnification)	78%	46%
Mean Escrow Amount (% of deal value)	2%	9%
Median Escrow Amount (% of deal value)	1%	6%
Escrow Survival (months, average)	17	17
N	*175*	*102*

As summarized in Table 1, above, the basic statistics concerning indemnity size and escrow amounts differ meaningfully between insured and uninsured deals. Although a seller's indemnity was similarly present in both groups (83% and 82%, respectively), the mean and median seller's indemnity for insured deals was 9% and 1%, respectively, versus 10% for uninsured deals. In other words, fully half of the reported indemnities for insured deals were 1%

[161] *See supra* note 70 and accompanying text (discussing knowledge qualifiers).
[162] I selected these reps specifically because they are standard reps present in most acquisitions.
[163] Indemnity amounts calculated in Table 1 exclude no indemnity deals as well as deals where the indemnification amount includes amounts based upon equity valuations or purchase price adjustments because such values were unavailable and the total indemnity amount therefore could not be calculated. There were 38 insured deals with no indemnity, and 44 uninsured deals with no indemnity.

or less of deal value. Recall that retentions in RWI deals are typically set at 1% of deal value.[164] This means that most RWI deals in my sample preserved a seller's indemnity only large enough to cover the retention.[165] Apart from the retention, in other words, most insured deals are zero indemnity deals. Uninsured deals, by contrast, have a fairly consistent seller's indemnity of approximately 10%.

Escrow accounts tell a similar story. Escrows were surprisingly common among insured deals—in 78% of deals, compared to 46% of uninsured deals. However, the amounts escrowed differed meaningfully. The mean and median escrow amounts for insured deals were 2% and 1% respectively versus 9% and 6% for uninsured deals. That escrows are more common but substantially lower in insured versus uninsured deals may indicate that sellers are often expected to escrow an amount related to their retention obligation under the RWI policy.

Table 2: Baskets[166]

	RWI Deals %	Non-RWI Deals %
Basket Present (% of deals with indemnity)	80	84
Mean Basket (% deal value)	0.7	0.9
Median Basket (% deal value)	0.5	0.8
N	*179*	*189*

Evidence from baskets suggests further risk-shifting from seller to buyer in insured deals. As described in Table 2, above, baskets are equally common in insured versus uninsured deals where indemnification is present (81% versus 85% of deals). However, the mean and median basket size as a percentage of deal value differs. In insured deals, the median basket is 0.5% of deal value. This suggests that in insured deals baskets, like indemnities and escrows, relate back to the standard 1% retention in RWI policies. Sellers offer indemnities and escrows only large enough to cover the retention, and buyers agree, through the basket, to split the retention amount.

I sought evidence of moral hazard by comparing the length of the reps in insured versus uninsured deals. Because moral hazard suggests less effort in due diligence, I hypothesized that insured deals would have shorter reps than uninsured deals. However, there was no meaningful difference between insured and uninsured deals with respect to the number of words in the reps. The acquisition agreements in insured deals tended to be longer on average than uninsured deals: 45,000 words compared to 41,000 words. But the percentage of words in the reps was essentially the same: 24%, on average, in insured deals compared to 22% in uninsured deals. Thus, if moral hazard is present in RWI Deals, it is not manifest in the word-count of the reps.

[164] *See supra* note 116 and accompanying text.
[165] Indemnities of 1% or less consisted of 52% of the insured deals in my sample.
[166] Table 2 excludes no indemnity deals (because deals without indemnification do not have baskets) as well as deals where the indemnification amount includes amounts based upon equity valuations or purchase price adjustments because such values were unavailable and the total indemnity therefore could not be calculated.

Nor was there strong evidence of moral hazard in my review of knowledge qualifiers. Both insured (77%) and uninsured (79%) deals in my sample tended to use a form of constructive knowledge as the basis of the knowledge qualifier. Moreover, the frequency with which a knowledge qualifier appeared in the set of reps that I analyzed was also similar (71% insured deals versus 66% uninsured deals).[167] The absence of a meaningful difference between the two sets of deals with respect to knowledge is ultimately unsurprising, given that policies use and define knowledge differently from the underlying acquisition agreement.[168]

To compare the use of materiality qualifiers, I focused on the No Undisclosed Liabilities rep, a term present in most acquisition agreements.[169] There are two common ways to qualify the No Undisclosed Liabilities rep: either with a basic materiality qualifier or by importing the concept of materiality from the accounting standards.[170] The No Undisclosed Liability can be qualified in either or both ways. However, it was slightly more common—24% versus 16%—for RWI Deals to be qualified in *neither* way. A less qualified rep has a greater potential for breach, suggesting that insurers accept greater risk in RWI policies than the transacting parties typically allocate among themselves.

Table 3: Materiality Scrape

	RWI Deals	Non-RWI Deals
Some Scrape Present	191 (78%)	165 (63%)
Full Scrape (% of scrapes present)	52%	45%
Loss Only (% of scrapes present)	30%	43%
Breach Only (% of scrapes present)	18%	12%
N	*244*	*262*

A materiality scrape may have a more profound effect than any single materiality qualifier on the potential for breach since a scrape has the effect of removing the materiality qualifier wherever it appears in the agreement.[171] Materiality scrapes are more common in RWI Deals than in Non-RWI Deals. As summarized in Table 3, above, 78% of RWI Deals contain some form of materiality scrape, compared to 63% of Non-RWI Deals. Slightly more than half (52%) of RWI Deals that contained scrapes contained "full scrapes"—scrapes for purposes of

[167] These reps included the litigation, IP, financial statement, real property, tax, employee benefits, and material contracts reps. Knowledge qualifiers appeared at slightly different rates for each reps. For example, knowledge qualifiers appeared in roughly 94% of litigation reps for both insured and uninsured deals, but they appeared in 89% of IP reps for insured deals compared to 76% of uninsured deals. Meanwhile, they appeared in financial statement reps in 22% of insured deals, but in 28% of uninsured deals.
[168] *See infra* note 311 and accompanying text.
[169] It was present in 100% of insured deals and in 83%of uninsured deals.
[170] *See supra* note 69.
[171] *See supra* notes 75-77 and accompanying text.

both loss and breach—while slightly less than half of Non-RWI Deals with scrapes (45%) contained full scrapes.[172]

A full scrape means that any inaccuracy in the reps—"foot faults," in the words of one broker—will amount to a breach.[173] The only question is how much will be owed in damages. Sellers appear to be more willing to accept liability for foot faults when an insurer is paying the bill. Insurers are, no doubt, aware of this, and may treat the full scrape as an *ex ante* waiver of the right to contest the materiality of breach. This may make business sense from the insurer's perspective—contesting whether a material breach has occurred might make RWI coverage seem illusory and therefore difficult to sell. But it also demonstrates a way in which the breadth of RWI coverage exceeds the bounds of what sellers are typically willing to offer under an indemnity. The full materiality scrape is a means of transferring greater risk to the insurer than the seller might typically bear.

Table 4: Damages Provisions

	RWI Deals	Non-RWI Deals
Silent on Diminution in Value (DIV) Damages	87%	71%
DIV Expressly Excluded	10%	19%
DIV Expressly Included	4%	10%
Silent on Multiplied Damages	87%	82%
Multiplied Damages Expressly Excluded	13%	16%
Multiplied Damages Expressly Included	0%	1%
Silent on Consequential Damages	65%	40%
Consequential Damages Expressly Excluded	30%	50%
Consequential Damages Expressly Included	5%	10%
N	*214*	*233*

Finally, I analyzed contractual attempts to limit or expand the scope of covered losses by including or excluding various measures of damages. Principal among these are DIV/ multiplied damages which, as discussed above, amount to a commitment to make the buyer whole for any mispricing resulting from a breach. As shown in Table 4, acquisition agreements in RWI Deals are more likely to be silent on DIV damages than Non-RWI Deals (87% versus 71%). Moreover, Non-RWI Deals are almost twice as likely as RWI Deals to expressly exclude DIV

[172] These results are consistent with studies by a SRS Acquiom on their database of private deals. *See* SRS ACQUIOM, BUY-SIDE REPRESENTATIONS AND WARRANTIES INSURANCE DEAL TERMS STUDY 23 (2018) (finding that in 2015–2017, 95% of deals with Buy-Side RWI contain a materiality scrape, compared to 85% of deals without, and that of deals with scrapes, 54% of deals with RWI contain double scrapes, compared to 30% of non-RWI deals). See also SRS ACQUIOM, 2019 M&A DEAL TERMS STUDY (2019) (finding that of all 2018 deals containing a scrape, 47% contained a full scrape while 37% scraped only damages and 16% scraped only breach).
[173] RWI Interview, Broker, Sept. 25, 2018.

damages (19% versus 10%).[174] This is consistent with the report of market participants that insurers are willing to "follow silence with silence" on DIV/ multiplied damages. Because insurance coverage tracks the underlying acquisition agreement, eliminating the express exclusion of DIV/ multiplied damages means they are at least potentially covered. Insurers will not have a clear contractual basis for refusing them and must instead contend with the merits of the policy-holder's argument that such damages ought to be covered. In contrast, in Non-RWI Deals, where there is no insurance benefit for remaining silent on such damages, the transacting parties are more likely to exclude them. The analysis of DIV damages in acquisition agreements thus demonstrates another way in which RWI coverage is broader than the protection buyers often receive under a seller's indemnity.

Interestingly, a substantial number of insured deals expressly exclude consequential damages yet are silent on DIV/ multiplied damages.[175] This is notable because there is at least some basis for treating DIV/ multiplied damages as a form of consequential damages.[176] But if this is the case, then expressly excluding consequential damages might also operate to exclude DIV/ multiplied damages when the agreement is otherwise silent. "Following silence with silence," in other words, might not work if the underlying agreement excludes consequential damages. The market participants to whom I floated this argument generally doubted it and stated that, in their experience, the argument has not been used by insurers to avoid claims. But it is worth considering that these conversations took place in a soft market, in which insurers are eager to sell policies and therefore sensitive about taking coverage positions that might undermine their ability to do so.[177] It is possible that, when the market hardens, at least some insurers will take the position that DIV/multiplied damages are also swept into a broadly worded exclusion of consequential damages.

Summarizing the principal findings of this Part: In insured deals, indemnities tend to be either non-existent or limited to the standard retention amount under RWI policies—that is, 1% of deal value. By contrast, uninsured deals offer a substantially larger indemnity, approaching 10% of deal value. The retention amount is often escrowed in insured deals, but it is also often split between the buyer and the seller by means of a basket, meaning the seller retains liability for only 0.5% of deal value. Furthermore, deals with insurance are more likely than uninsured deals to include a full materiality scrape and to remain silent on DIV damages, thereby increasing the risk of liability.

These findings suggest that RWI transfers greater liability risk to the insurer than the typical seller would be willing to bear. There is a sense in which this transfer of risk may serve to facilitate transactions, consistent with the suggestion of some respondents that RWI makes

[174] That there was no difference in the frequency of "multiplied" versus "DIV" damages suggests that transacting parties view these terms as accomplishing essentially the same ends. Any difference may just reflect that one phrasing (DIV) is more commonly used.
[175] RWI Deals are more likely to be silent on consequential damages than Non-RWI Deals (65% versus 40%). Moreover, RWI Deals are three times more likely to expressly exclude consequential damages than they are to expressly exclude DIV/ multiplied damages (30% versus 10%).
[176] *See supra* note 125 and accompanying text.
[177] *See infra* Part V.D. (discussing the underwriting cycle of "hard" and "soft" markets in insurance).

acquisition contracting more streamlined.[178] However, insofar as the seller no longer bears significant transaction risk, RWI creates a credible commitment problem. The seller is no longer trustworthy because it no longer stands behind its reps, the ordinary result of which is that the buyer walks away or severely discounts its price.

The scrape and implicit inclusion of DIV damages address the credible commitment problem. Through these commitments, the insurer promises to make the buyer whole from any losses caused by an untrustworthy seller. While this redounds to the benefit, most obviously, of buyers, it also benefits the seller by mitigating the discount the buyer would otherwise insist upon. The breadth of coverage in RWI Deals, in other words, is designed to respond to the commitment problem created by using RWI as a substitute for the seller's indemnity.

IV. Why Do Parties Purchase RWI?

Still, the purchase of RWI presents a puzzle. Transacting parties are fully capable of allocating the risk of misinformation through the reps. Indeed, as noted above, the reps are a form of insurance within the acquisition agreement.[179] What advantage is there for transacting parties in insuring the risk of misinformation through a third-party insurer instead of allocating it among themselves?

Commonly touted advantages of RWI include, from the seller's perspective, limited post-closing exposure, expedited exit, and less contentious transaction negotiations and, from the buyer's perspective, supplemental liability protection, greater collection security, and the protection of ongoing business relationships.[180] But each of these supposed benefits of RWI could be created by the transacting parties themselves, without the need for an intermediary insurance company. Liability risk can be reduced for either the seller or the buyer by varying the size of the seller's indemnity. Collection security can be enhanced by increasing funds held in escrow, and exit can be expedited by minimizing funds in escrow. That these choices frequently offset reflects the fundamental reality of allocating costs and benefits through negotiation.

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[178] RWI Survey, DL #15 (noting "more streamlined negotiation of acquisition agreement"); *id.*, DL #9 (noting "standardization of certain terms in the agreement … which may streamline some of the underlying negotiations between buyer and seller"); DL #2 (noting "more streamlined agreements and negotiations"); *id.*, I #22 (noting that presence of RWI "smoothes negotiation of terms between buyer and seller attorneys for matters that are not material from an economic standpoint"); B #17 (noting "smoother negotiations of the purchase agreement"). There was, however, one dissenting view. DL #1 (stating that RWI leads to "more robust representations" and "slows deal execution").

[179] *See supra* note 85 and accompanying text.

[180] *See generally* RONALD E. WHITNEY ET AL., PRACTICAL LAW COMPANY, REPRESENTATION & WARRANTY INSURANCE FOR M&A TRANSACTIONS (listing "advantages of R&W Insurance" to include all items listed in text as well as a few others such as "extending the survival period" of certain representations and warranties which also could be accomplished contractually between the parties to the acquisition agreement). *See also* Glenn West, *A New Reason for Private Equity Sellers to Hate Undefined "Fraud Carve-outs"*, Weil Insights, Weil's Global Private Equity Watch, May 16, 2017, https://goo.gl/2MhPmJ ("Private equity sellers require certainty regarding post-closing exposure to claims when distributing the proceeds of a portfolio company sale to their limited partners. … [Often, t]he winning bidder [in an auction] is the buyer who offers complete, 'walk-away,' deal certainty…."

Survey respondents often explained the purchase of RWI as a response to the "seller's market" in M&A.[181] In such a market, sellers resist escrow accounts and indemnification provisions,[182] and RWI provides a means by which sellers can avoid these obligations altogether.[183] Given the competitive market for target companies, RWI may be seen as the best or only alternative for buyers concerned about liability risk.[184] RWI allows buyers to submit no-indemnity bids.[185] The growth of RWI, according to this account, is thus explained by the seller's negotiating power.[186]

But a seller's market in M&A does not mean buyers must purchase RWI. Insurance is not free, and the premiums charged by insurance companies necessarily exceed the actuarial probability of loss.[187] The purchase of RWI by either transacting party only makes sense if the benefits of the insurance exceed its cost. Put slightly differently, if RWI does not increase aggregate transactional gains by more than its cost, it would be more efficient for one side or the other to bear the risk in exchange for a commensurate adjustment to the deal price. The question thus becomes whether RWI is more efficient than self-insurance on either side of the transaction.

The purchase of insurance is often explained by risk aversion. But the parties to M&A transactions are essentially risk neutral.[188] The buyer, as discussed above, is either a corporation or a private equity fund, each of which has access to loss-spreading technologies that mimic those of insurance companies—the creation of reserves and diversification[189]—which ought to

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[181] *See, e.g.*, RWI Survey, DL #7 (emphasizing the "seller's market" in M&A).

[182] For example, deal lawyers frequently emphasized that in the present sellers' market, RWI might be the only liability protection available. *See, e.g.*, DL#14 (explaining RWI as the result of situations in which "the seller is unwilling to provide an indemnity or the buyer wants additional protection"); DL#8 (emphasizing RWI as the "only protection available—i.e., Seller will not provide substantial post-closing protection"); DL#1 (noting simply that RWI is purchased to "accommodate seller").

[183] Asked why their clients purchase RWI, brokers emphasized the minimization of indemnification obligations. RWI Survey, B #3 (emphasizing sellers' desire "to limit their indemnification liability"). *Accord id.*, B #20 (emphasizing that sellers want to "maximize funds at deal close and provide a finite escrow amount instead of variable"); *id.*, B #19 (explaining that sellers "want to avoid an escrow" and prefer a "pure insurance play"); B #15 (noting desire to leave "less money tied up in escrow for [a] shorter period"); *id.*, B #14 (acknowledging "[s]ellers not wanting to leave any material amount of proceeds in escrow").

[184] *Id.*, DL #9 (emphasizing that RWI is bought, "as bidder, to be competitive").

[185] *Id.*, B #3 (noting that RWI is purchased by buyers "because it is required by seller or in order to submit a more seller-friendly bid at auction"); *id.*, B #10 (stating that RWI may give buyers a "better chance to win [an] auction"); *id.*, DL #2 (stating the clients seek coverage "to be competitive in auction processes as a buyer [and] to enhance bids…").

[186] *Id.*, B #19. *Accord id.*, B #1 (stating that RWI is "expected with PE clients; sellers are demanding it; it's becoming the new normal").

[187] In order to cover their costs and provide a return to their shareholders, insurance companies must charge a premium greater than the risk. *See supra* note 16 and accompanying text.

[188] On risk-neutrality and large, sophisticated firms, see generally Victor P. Goldberg, Aversion to Risk Aversion in the New Institutional Economics, 146 J. Instit. & Theoretical Econ. 216 (1990); Victor P. Goldberg, The Devil Made Me Do It: The Corporate Purchase of Insurance, 5 Rev. L & Econ. 541 (2009). For consideration of the possibility that the agents of risk-neutral large firms may be risk-averse, see *infra* Part IV.E.

[189] Corporations spread risk through their shareholder base. Firm-specific risk is idiosyncratic risk, and unlike systemic risk, idiosyncratic risk can be eliminated through diversification. Private equity funds spread risk both through their investment portfolio, which likely contains multiple corporate investments, and through their investor base, who like shareholders, can eliminate idiosyncratic risk through diversification.

render these entities risk neutral.[190] Moreover, because there is very often a private equity fund on the sell side of the transaction as well,[191] the only risk-averse party in corporate acquisitions would seem to be owner-managers without fund backing.[192] But transactions involving unfinanced owner-managers are relatively rare, and deals with such parties on both the buy side and the sell side are exceedingly so.[193] As a result, risk aversion cannot explain RWI as it exists today.

An explanation for the purchase of insurance by risk neutral entities must focus on benefits provided by insurance other than the spreading of risk. This is the focus in the literature on the corporate purchase of insurance, which suggests several possible ways in which insurance might add value to risk neutral purchasers, including loss prevention and loss mitigation advice, claims management expertise, counterparty insistence, and alternative corporate finance.[194] The sections that follow use survey data to examine the applicability of these explanations to the context of RWI, ultimately concluding that another explanation, focusing on the agency relationships in private equity investing, offers the most persuasive explanation for current patterns of coverage.

A. Loss-Prevention and Loss-Mitigation Services

Insurance companies are repeat players in the business of pricing risks and paying losses. This puts them in an excellent position not only to assess the actuarial probability of loss but also to develop techniques for their policy-holders to minimize or prevent loss. Moreover, insurers can insist, as a condition of coverage, that policy-holders adopt these techniques. In this way, risk-management comes bundled with the insurance policy. Companies may therefore purchase insurance in order to benefit from the insurer's loss prevention and mitigation expertise.[195]

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[190] Goldberg, *supra* note 188.

[191] *See supra* note 101 and accompanying text. As a pure risk spreading matter, it would almost certainly be more efficient for a private equity house to self-insure against breach of reps and warranties. This could be accomplished by having the private equity house hold a reserve funds and charge premium (or hold back gain) from individual funds (more effective risk spreading). Or it could be done within individual funds. Or it could be unreserved.

[192] The prospect of undiversified owner-managers is the basis of the "protection of ongoing business relationships." *See supra* note 175 and accompanying for an explanation of the term. Buyers may hesitate to collect from risk-averse owner-managers whom they have brought along to manage the acquired business.

[193] Moreover, even when there are owner-managers on the sell side, as long as there is a corporation or fund on the buy side, self-insurance (with a concomitant adjustment to the purchase price) would seem to be superior to the purchase of insurance.

[194] Mayers and Smith address the corporate insurance puzzle in a series of articles. *See* David Mayers & Clifford W. Smith, Jr., *Corporate Insurance and the Underinvestment Problem*, 54 J. RISK & INS. 45 (1987); David Mayers & Clifford W. Smith, Jr., *On the Corporate Demand for Insurance: Evidence from the Reinsurance Mark*et, 63 J. BUS.. 19 (1990). *See also* Richard MacMinn & James Garven, *On Corporate Insurance*, in HANDBOOK OF INSURANCE 541 (George Dionne ed., 2000) (summarizing prior literature).

[195] Scholars have studied the risk management function in various insurance lines. *See* KENNETH S. ABRAHAM, DISTRIBUTING RISK 57 (Yale Univ. Press 1986) (focusing on environmental risk); Tom Baker & Rick Swedloff, *Regulation by Liability Insurance: From Auto to Lawyers' Professional Liability*, 60 UCLA L. REV. 1412, 1421–22 (2013) (surveying loss prevention across different insurance lines); Omri Ben-Shahar & Kyle D. Logue, *Outsourcing Regulation: How Insurance Reduces Moral Hazard*, 111 MICH. L. REV. 197, 210–12 (2012) (drawing examples of loss mitigation and prevention programs from workers' compensation, automobile, and homeowners' insurance); Haitao Yin, Howard Kunreuther & Matthew White, *Rick-Based Pricing and Risk-Reducing Effort: Does*

The demand for loss prevention and mitigation services, however, is uneven across different lines of insurance.[196] A relevant comparison with RWI is Directors' and Officers' ("D&O") Liability Insurance, a financial line that covers corporations and their managers from the risk of shareholder litigation.[197] Like RWI, D&O insurance has sophisticated corporate buyers and covers complex financial risks. Yet, in prior work with Tom Baker, I found that insurers do not offer loss prevention and mitigation services for D&O policyholders.[198] We explained the absence of loss prevention in D&O largely by reference to information asymmetry. Unlike fire prevention information, which is broadly generalizable, information on how a particular company might minimize the risk of shareholder litigation is idiosyncratic and in the possession of that company alone. It would be costly for an insurer to acquire the information, and the value of the information, if not broadly applicable across the insurer's portfolio, might not enable the insurer to recoup its cost.[199] Moreover, D&O insurers have competitors for loss prevention and mitigation services—namely, in-house counsel and their outside law firm advisors. Insofar as lawyers are already trusted suppliers of corporate governance advice—indeed, many major law firms hold themselves out in precisely this way[200]—loss prevention and mitigation in connection with shareholder litigation may be a difficult business for D&O insurers to break into.[201] As a result, insurers have little or no incentive to invest in loss-prevention or mitigation services for D&O insurance.

RWI presents insurers with similar problems of information asymmetry and idiosyncratic risk. The basis of risk in RWI policies—the accuracy and completeness of the seller's disclosures—is wholly within the control of the transacting parties, specifically the seller. The insurer could invest in acquiring this information through extensive due diligence, but if it did so, it is unclear that the information would have an application beyond the transaction at hand.[202] Moreover, M&A transactions are heavily lawyered, and insofar as there are transactional practices to minimize the risk of incomplete disclosures and post-closing indemnity claims, the obvious suppliers of these techniques would be the M&A lawyers that routinely negotiate similar transactions. RWI insurers seeking to provide loss prevention and mitigation services thus face problems from information asymmetry and competition that parallel those faced by D&O insurers.

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the Private Insurance Market Reduce Environmental Accidents?, 54 J. L. & ECON. 325, 336–37 (2011) (examining loss-prevention in environmental policies).

[196] Baker & Swedloff, *supra* note 195 at 1445 (documenting varying levels of loss prevention and mitigation services, from "none" to "extensive" across different insurance lines).

[197] *See generally* BAKER & GRIFFITH, ENSURING CORPORATE MISCONDUCT, supra note 19 (describing D&O insurance and its role in deterring corporate misconduct).

[198] *Id.*, at 105–127; Tom Baker & Sean J. Griffith, *The Missing Monitor in Corporate Governance*, 95 GEO. L. J. 1795, 1808 (2007) ("D&O insurers do almost nothing to monitor the public corporations they insure, and D&O insurers do not condition the sale of insurance on compliance with loss prevention requirements in any systematic way.").

[199] Page cite. The structure of policies, which limit an insurer's interest in any one risk, and the underwriting cycle, which at least in soft markets, inhibits cost recovery, also work to eliminate the insurer's incentive to invest in acquiring this information. Page cite.

[200] *See, e.g.*, Wachtell, Lipton, Rosen & Katz, "Advice to Boards in 2018" etc.

[201] BAKER & GRIFFITH, ENSURING CORPORATE MISCONDUCT, supra note 19.

[202] It is unclear, in other words, whether there are best practices in M&A contracting beyond basic due diligence that would minimize the risk of a post-closing indemnity claim.

Consistent with this analysis, survey participants reported that insurers do not offer loss-prevention or loss-mitigation services in connection with RWI. Although RWI underwriting generally begins before the acquisition agreement is finalized,[203] insurers often do not typically comment on acquisition agreements.[204] They do not mark-up drafts,[205] and were they to do so, their comments would likely not be taken.[206] Insurers do review provisions, such as the definition of fraud, that may later affect their coverage position.[207] However, their review of these provisions is aimed at determining what risks to cover, not how to prevent loss to the transacting parties.[208] They are looking for exclusions, not trying to help the transacting parties prevent or mitigate loss.[209]

Likewise, the insurer's involvement in due diligence is aimed not at helping buyers avoid loss, but at helping insurers identify issues to exclude from coverage.[210] Insurers do perform due diligence in underwriting RWI policies, but this diligence exercise is secondary to the primary due diligence performed by the transacting parties.[211] Insurers are given data room access and,

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[203] RWI Survey, questions 75 and 109 (32 respondents).

[204] Answering how often insurers comment on the acquisition agreement respondents (40) replied as follows: 3 always, 5 most of the time, 3 about half the time, 24 sometimes, 5 never. *Id.,* questions 45, 77, and 110.

[205] One insurer commented: "while underwriters will sometimes comment on which parts of the draft agreement they do not like or will not insure, they don't typically 'mark-up' written revisions to the agreement." RWI Survey, I #4.

[206] Commenting on the prospect of insurer comments to the acquisition agreement, one deal lawyer remarked "we'd reject them if we ever saw them; they don't get to comment on the docs." *Id.*, DL #8

[207] The definition of fraud in the acquisition agreement may affect the insurer's subrogation rights under the policy. As a result, respondents frequently cited these provisions as a subject of insurer attention. *See, e.g.*, *id.*, I #3 (noting that insurers "typically comment on provisions that would affect the insurer's subrogation rights, such as fraud limitation in the indemnity or release provisions.") *Accord id.*, B #3 ("insurers will insist on a market definition of fraud and that buyer have unimpaired rights (and thus insurer have unimpaired subrogation rights) against seller in the case of fraud").

[208] *See, e.g.*, *id.*, DL # 9 ("[The] insurer doesn't comment on the Agreement. [The] insurer may (in the Policy) propose to synthetically alter the terms of the agreement for purposes of coverage under the policy.") *Accord id.*, B #10 ("Their comments are about how the Policy will deviate from the Acquisition Agreement, for example reading in a materiality or knowledge qualifier, following or not following the definition of Loss.").

[209] *See, e.g.*, *id.*, I #21 ("Insurers may propose exclusions where the agreement contains particularly obnoxious non-market provisions."). *Accord id.*, B #14 ("Insurers typically don't insert themselves in the negotiations of the purchase agreement language itself, and handle any comments they have to reps through the policy language.").

[210] Respondents reported that information uncovered in due diligence is far more likely to lead to exclusions than to any change in the policy premium (79% reporting that diligence is much more likely to lead to exclusions and 21% reporting that it is somewhat more likely to lead to exclusions). *Accord id.*, B #20 (noting that if the buyer's diligence is inadequate "you will have exclusions and unhappy insureds"); *id.*, I #21 ("If buyer did not conduct reasonable dd in really risky areas then those areas might end up being excluded. . . ."); *id.*, I #2("If diligence is not adequate, the insurer will insert applicable exclusions in the policy covering the exposures not properly diligenced.").

[211] *See id.*, I #21 ("Insurers do not re-do the diligence -- the process is really an audit of buyer's dd."); B10 ("Carriers perform a secondary review of buy-side diligence. They need access to the data room and copies of internal and 3rd party diligence reports."). *Accord* Blitz in IRMKA ("[I]nsurance companies have realized that they don't need to redo the diligence. What they do now is review the diligence that was done. Then have one or two conversations with the buyer and the seller. . . . [The] process … can easily be accomplished in two weeks, and is frequently done over a weekend."); Rosen & Blitz ("the insurer's process focuses on conducting secondary diligence of the buyer's primary diligence").

perhaps most importantly, copies of due diligence reports prepared by buyer's counsel.[212] They do not get direct access to the seller.[213] Instead, insurers review previously prepared materials and then ask any follow-up questions on a relatively brief conference call with the deal team.[214] The insurer's due diligence, unlike the buyer's due diligence, is not aimed at uncovering deficiencies in the underlying transaction, but rather at uncovering deficiencies in the buyer's diligence.[215] In doing so, the insurer is looking to protect its own interests by identifying risks to exclude from the policy, not helping the buyer avoid loss or mitigate risk.

It is true, of course, that excluding risks from coverage ex post may have an effect ex ante on the conduct of the transacting parties. Hence, regardless of their motivation, the insurers' review of merger agreements and involvement in diligence may lead buyers to make beneficial changes to the transaction process.[216] But it may also have the opposite effect. For example, one insurer observed that an effect of RWI coverage is that "certain 'uninsurable' reps are more likely to be left out of the agreement so as to allow the RWI policy coverage scope to match the agreement."[217] Leaving reps out of an agreement, however, does not mitigate the buyer's risk. It increases it.[218] Likewise, the fact that the insurer's review of the buyer's due diligence may lead to exclusions from the policy may lead buyers to be *less* thorough in its due diligence exercise in order to avoid uncovering facts that trigger exclusions.[219]

Whatever effect RWI may have on the incentives of the transacting parties, it seems clear that insurers do not provide loss prevention and mitigation services as such. Insurers do not specify improvements to negotiation or transaction processes ex ante and condition coverage on the implementation of those improvements. Furthermore, buying an RWI policy does not seem to lead to the reduction in claims that might be associated with loss prevention services.[220]

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[212] Asked how often insurers request additional information not already in the dataroom, respondents answered as folllows: always (20%), most of the time (33%), half of the time (7%), sometimes (40%), never (0%). RWI Survey, question 81.

[213] Respondents (31) replied: 0% always, 3% most of the time, 0% half the time, 23% sometimes, 74% never). *Id.,* question 82.

[214] Insurers typically ask their questions during a two hour underwriting call devoted to due diligence issues. *See, e.g.*, *id.*, B #9 (noting that in the insurer's due diligence process, "dataroom, dd reports and disclosure schedules are scoured and then a 2hr underwriting call with the deal team to go through findings and other questions"); *id.*, B #15 (noting that insurers "review reports prepared by advisors and ask questions during the [underwriting] call").

[215] The insurer, in the words of one respondent, is "diligencing the diligence done by the buyer." *Id.*, B #14 Other respondents commented that insurers are looking to confirm "robust, independent due diligence on the buy side." *Id.*, B #3. *See also id.*, I #4 ("Key is for the underwriters and their outside counsel to try to become comfortable that the right people (principals, advisors, etc.) performed the right type of diligence and disclosure and negotiation process for the size and type of deal at hand.").

[216] Brokers, for example, noted that they advise their clients to conduct "robust" due diligence to prevent insurers from seeking additional exclusions for omissions in the diligence process. *Id.*, B #3 (describing advice given to clients "to perform robust due diligence including writer reports from third-party advisors for legal, financial, tax and if applicable, environmental (at a minimum)").

[217] *Id.*, I #4

[218] An omitted rep is a rep that does not force any information out of the seller but rather leaves the buyer uninformed about the underlying risk.

[219] This possibility is explored in greater detail at *infra* Part V.B.

[220] Deal lawyers report that claims are about as likely under a seller indemnity as under an RWI policy. *See supra* note 128 and accompanying text.

B. Claims Management Expertise

Because liability insurers repeatedly handle claims, they may develop efficiencies in managing them,[221] either in the form of payment processing or litigation cost management.[222] With regard to payment processing, it is plainly much cheaper to handle auto or homeowner claims through an insurance adjuster than through litigation. And with regard to litigation costs, lines of insurance that cover defense costs often contain terms that allow insurers to choose defense counsel or that restrict the policy-holder's choice to a pre-approved list.[223] These advantages, however, are inapplicable to the context of RWI.

First, with regard to claim processing, RWI payment procedures should be compared to indemnification procedures under the acquisition agreement.[224] Claims administration under an RWI policy largely mirrors indemnification procedures. In RWI claims, the insurer effectively takes the place of the seller-indemnitor.[225] To be paid under an RWI policy, a policy-holder must provide notice, after which the insurer can either pay or dispute the claim. If the insurer disputes payment, the parties litigate, or threaten litigation, until the dispute is resolved with a settlement or court order. Because the claims process is effectively the same under an RWI policy as it is under a seller's indemnity, there is no obvious efficiency derived from an insurer's handling of RWI claims.[226]

Second, the ability of the insurer to control litigation costs is not the same under RWI as it might be under other lines of insurance. Insurers add the greatest value in controlling litigation costs where they defend policy-holders against *third-party claims*, such as tort claimants.[227] But RWI insurers do not defend their policy-holders.[228] Moreover, although there may be third-party claims under an RWI policy—for example, an undisclosed patent infringement claim[229]—the principal litigation exposure is not to third-party claims but rather to *first-party claims* between the buyer and the seller.[230] By stepping into the shoes of the seller in this litigation, the insurer effectively aligns itself with the seller *against* the policy-holder. Policies may but do not always

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[221] Mayers & Smith, *Corporate Demand*, *supra* note 194, at 285 ("Insurance firms develop a comparative advantage in processing claims because of economies of scale and . . . specialization.").

[222] CHARLES SILVER, BASIC ECONOMICS OF THE DEFENSE OF COVERED CLAIMS, IN RESEARCH HANDBOOK ON THE ECONOMICS OF INSURANCE LAW, (Daniel Schwarcz & Peter Siegelman, eds., 2015) (characterizing most insurance policies as some combination of the duty to indemnify and the duty to defend).

[223] KENNETH S. ABRAHAM, THE LIABILITY CENTURY: INSURANCE AND TORT LAW FROM THE PROGRESSIVE ERA TO 9/11 (Harv. Univ. Press 2007) (tracing the evolution of claims management in liability policies).

[224] *See supra* note 90 and accompanying text, describing the procedures for the notification and payment of claims contained in indemnification provisions.

[225] *See supra* Part II.A.

[226] Contrast this, again, with the involvement of an insurance adjuster for auto or homeowners claims. A third-party claims appraiser who values claims, which are typically the basis of quick settlements between policy-holders and the insurer.

[227] See Charles Silver, Basic Economics of the Defense of Covered Claims, in Research Handbook on the Economics of Insurance Law, edited by Daniel Schwarcz, and Peter Siegelman, eds., (Edward Elgar 2015) (distinguishing between "duty to defend" and the "duty to indemnify" and discussing the impact of each on defense costs).

[228] It is indemnity coverage, not duty to defend. AIG Policy Form.

[229] Defense costs for such third-party claims may be covered under the RWI indemnity. Id.

[230] *See* AIG, M&A INSURANCE, *supra* note 103, at 4.

contain a dispute-resolution provision requiring arbitration in such cases, but given the adversarial nature of these proceedings and certain involvement of lawyers on both sides, it is unlikely that RWI significantly reduces the cost of claims.[231]

Consistent with this analysis, survey participants did not identify any advantage of insurers in managing claims. RWI claims are typically settled by direct negotiation with insurers, without formal arbitration, mediation, or adjudication.[232] Lawyers are involved on both sides, and litigation remains in the background. The lawyers argue over the elements of the claim, any defenses to coverage, and the amount of damages.[233] Of these, the biggest differences may be with respect to damages. For example, one claims lawyer noted, "I see a lot of reputable firms/clients making plaintiff-style damage arguments that find no support in case-law or policy."[234] Echoing these comments, an experienced insurer reported:

> Real losses get paid by insurance. The issues come up when [the] Insured claims a breach, then calculates losses very generously (i.e. without backing out expenses, or assuming a customer contract lasts forever, etc.) and then applies a crazy unsupportable EBITDA multiple to that expanded number and then presents that number as their "loss" on a deal, and then demands immediate payment of the whole amount. Obviously no insurer can just write a check based on such a scenario without investigation and loss analysis, which then tends to bring the claim down significantly to be closer to the actual loss incurred.[235]

Asked to estimate what percentage of losses claimed against RWI policies are ultimately paid by insurers, survey respondents with experience in settling claims estimated the amount at 62% of claimed loss.[236] Insofar as settling RWI claims involve lawyers on both sides arguing over liability and damages, the process might not seem to differ substantially from the settlement of uncovered claims or, indeed, from settlement negotiations generally.

Several respondents did insist that insurers may pay claims more easily than seller-indemnitors. However, this observation likely reflects market incentives more than it does

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[231] *See*, e-mail from claims lawyer, dated Dec. 7, 2018. Furthermore, considering that insurers have *less* claim-relevant information than sellers and that sellers have limited incentives to cooperate with insurers in the resolution of claims, information costs may make the resolution of insured claims less efficient than uninsured claims.

[232] RWI Survey, question 53 (reporting that few claims are decided through mediation, arbitration, or adjudication).

[233] *Id.,*CL #3 (noting that the parties "mostly just debate over existence of breach and quantum of consequential loss and calculation of loss."). *Accord* RWI Survey, B #15. (emphasizing "whether the breach is proven and damages are quantified"); DL9 (emphasizing "validity of claim and loss"); *id.,* CL #1 (emphasizing the "strength of facts showing breach and Loss"); CL2 (characterizing the settlement of RWI claims as "litigation risk adjustments"); *id.,* I #21 ("It is just about negotiating to a fair amount of loss to be paid on a claim."); *id.,* CL #6 (emphasizing "coverage issues"); *id.,* I #17 (noting that in settlement negotiations, the parties "dispute … whether a Breach occurred, dispute … calculation of Loss, dispute over Actual Knowledge or other exclusions . . .").

[234] *id.,* CL #1. *Accord id.,* CL #3 (emphasizing "the insured's overstatement of the damages caused by an alleged breach of a representation"); *id.,* CL #2 (emphasizing "over reaching by the policyholders, lack of understanding by policyholder of Loss and claims").

[235] *Id.,* I #21, an experienced insurer (has settled more than ten RWI claims). This respondent estimated that insurers pay fifty percent of claimed loss.

[236] Overall 44 respondents reported experience with RWI claims, of which 44% had settled 10 or more RWI claims; 19% settled 5–9 RWI claims, 25% settled 1–4 RWI claims, and 13% reported having settled zero RWI claims.

claims management efficiencies. If insurers want to sell policies, they must also be seen as willing to pay claims.[237] Especially in the context of RWI, a new product without an established claims history, if insurers were overly resistant to paying claims, the market for the product might disappear.[238] Accordingly, insurers have offered coverage enhancements—most notably, the materiality scrape and DIV/ multiplied damages—to facilitate the payment of claims under RWI policies.[239] Both of these coverage enhancements facilitate claims—no arguments over breach means one less step in processing claims, and the potential inclusion of DIV/ multiplied damages means potentially higher recoveries.

Nevertheless, claims facilitation of this sort is not the same as claims management expertise. Insurers are not offering their skills in processing or defending claims. They are simply waiving defenses and agreeing to pay so that they can sell more policies. In this way, claims facilitation is related to the expansion of RWI coverage.[240] It is not a core element of RWI, but rather a feature of the soft market for coverage.[241] As a result, the relative ease of payment under RWI policies in the present market should not be attributed to the insurer's claims management expertise.

C. Pressure from Creditors and Other Contractual Counterparties

Policy-holders may also buy insurance because contractual counterparties insist upon it.[242] Insurance eliminates the risk faced by creditors and suppliers from a large uninsured loss, such as a major factory burning down, allowing them to lower the cost of credit ex ante.[243] More generally, insurance signals stability.[244] In its absence, counterparties may be unwilling to contract or willing to do so only at significantly higher prices. As a result, companies may purchase insurance in order to facilitate a wide range of business transactions.

But unlike factories and apartment buildings, RWI insures one-time transactions, not ongoing productive assets. Moreover, the liabilities insured by RWI are not, in the absence of insurance, likely to render the buyer insolvent. Losses from a breached rep may mean that the buyer overpaid, but rarely will such liabilities exceed the price paid. The covered risk under an

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[237] *See generally* Tom Baker & Sean J. Griffith, *How the Merits Matter: Directors' and Officers' Insurance and Securities Settlements*, 157 U. PA. L. REV. 755, 797 n.164 (2009) (quoting the head of claims at a D&O insurer stating that "I think it is easier to get money out of an insurance carrier than it is out of an insured. Why? Because it is a third-party's money. We are in the business of paying claims. That is what we do for a living.").

[238] *See, e.g.*, RWI Survey, DL #9 (emphasizing "the expectation is that insurers are going to pay valid claims because the product won't survive if buyers don't have faith in it").

[239] *See, e.g.*, *id.,* DL #7 (emphasizing that RWI has changed the contracting process through the much greater prevalence of "materiality scrapes"); *id.,* B #15 (emphasizing that RWI has induced "silence on consequential/ multiplied damages" in the acquisition agreement so that such forms of damages may be covered); *id.,* B #11 (noting broadening coverage through "silence on multiplied or consequential damages").

[240] *See supra* notes 97-99 and accompanying text.

[241] *See infra* Part V.D.

[242] Goldberg, *Devil*, *supra* note 188, at 546 ("Sellers, tenants, and borrowers are often required to provide proof that they carry adequate insurance.").

[243] MacMinn & Garvin, supra note 194, at 548–50.

[244] Goldberg, 549–550 (arguing that obtaining insurance is a low cost proxy for viability, allowing counterparties to "free ride" on the insurer's risk selection and monitoring efforts).

RWI policy, in other words, is considerably less grave than the risk of a plant burning down. It is therefore unlikely to rise to the attention of most contractual counterparties.

There is, however, one contractual counterparty that may insist on RWI—that is, acquisition creditors of the buyer.[245] For providers of debt capital in the acquisition, RWI-risk may indeed be severe because their loans are based on the expected value of the assets acquired. If the acquired company turns out to be worth substantially less than anticipated, the equity cushion protecting the loan is diminished, thereby increasing their risk. If information about the true (diminished) value of the acquisition is only revealed post-closing, after the loan has been made, it will be too late for the creditor to adjust to this increase in risk—for example, by raising interest rates. As a result, acquisition-creditors might insist on RWI ex ante to protect them against the realization of a risk to which they cannot adjust ex post.

Support for this explanation can be found in the structure of the private M&A market. Debt is widely used in private company deals, and transactions involving private equity buyers are typically highly leveraged. Consistent with this transactional background, survey participants reported the use of third-party financing in over seventy percent of their deals involving RWI.[246] Furthermore, sixty four percent of respondents replied that RWI is "of interest" to banks or other providers of third-party financing.[247]

However, when asked to comment further on the interest of acquisition creditors in RWI, survey respondents reported that creditors do not motivate the purchase of RWI.[248] Instead, creditors are principally interested in securing access to policy proceeds as collateral in the event of default.[249] While this demonstrates some level of creditor interest in RWI,[250] respondents generally reported that lenders do not value the coverage highly enough to insist upon it or to modify the terms of credit in recognition of it.[251] For example, one Deal Lawyer remarked: "The interest is only among certain lenders [or their] counsel, and modest when present; it's focused on obtaining rights in the policy and any policy proceeds, as opposed to consideration as to whether to engage in the deal overall."[252] Another described the lender's interest in RWI as "marginal," something that is "nice to have but [that] doesn't improve [the] economics [of the

[245] *See* Travis Bell, *An Overview of Representations and Warranties Insurance*, SRS Acquiom, Sept. 2016 (claiming that RWI can "facilitate acquisition lending" because funds paid out under buy-side policies can be assigned to lenders, which "can be an important term for acquisition lenders, especially in highly leveraged acquisitions").
[246] Mean: 71%. Median: 75%. RWI Survey, question 96.
[247] This percentage is consistent when isolating the responses of those closest to the financing of the deal—the deal lawyers and the buyers/ sellers—6 of whom said RWI is of interest to banks, 4 of whom said it was not. *Id.,* question 97.
[248] Instead, most respondents named private equity buyers or sellers as the principal driver of RWI coverage. RWI Survey, questions 42 and 108.
[249] *See, e.g.*, RWI Survey, DL #7 ("Lenders often require collateral assignment of RWI."); B1 ("Lenders often want a collateral assignment of the policy"). *Accord id.,* I #21 ("Almost all policies have free Loss Payee endorsements to pay loss directly to lenders."); *id.,* I #10 ("Lenders . . . are often the loss payee on policies").
[250] *Id.,* B #14 ("I don't have knowledge of how this is affecting rates, but most deals now require a collateral assignment of proceeds of the RWI policy to the lenders, indicating that they see value in these policies.").
[251] *See, e.g.*, *id.,* B #9 ("[Creditors] like to know there is another party available for recourse in the case of breaches. Not sure there is a relationship between availability or rates though.").
[252] *Id.,* DL #9

loan]."[253] Brokers surveyed generally agreed: "The lenders do not appear to place significant value on RWI."[254] Another noted that: "No special terms or other consideration are given for RWI, as far as I know."[255]

The survey evidence thus suggests that while creditors are interested in securing access to RWI proceeds as collateral when RWI is present, creditors are not themselves the driving force behind the use of RWI. Market participants report little or no difference in the ease of obtaining credit with or without RWI in the deal. They also report that the terms of credit do not change to reflect the presence or absence of RWI. The dramatic expansion in the use of RWI does not seem to have been driven by acquisition creditors.

D. Alternative Corporate Finance

Insurance may also substitute for other sources of capital, such as debt or equity financing. Using insurance to protect internal cash-flows may thus be efficient when it is less expensive than raising capital externally.[256] Insurance may thus play a regular role in the capital structure of business, depending upon the cost of other sources of capital. It is, in effect, alternative corporate finance.

The importance of insurance as a tool of corporate finance may be enhanced by tax rules.[257] For example, insurance premiums are fully tax deductible while the deductible loss from replacing a destroyed asset may be limited by the asset's book value, creating an incentive to purchase insurance rather than self-insuring for losses relating to depreciable assets.[258] RWI, however, does not provide coverage for a depreciable asset.[259] Instead, RWI is best understood as cash-flow protection insurance, replacing income lost when the cash-flows of an acquired business are lower than anticipated due to a breached rep.[260] Future income is a non-depreciable asset. When it fails to appear, for whatever reason, it is fully deductible in the sense that a reduction in income also reduces tax liability.[261] Hence there is no mismatch in tax treatment between insurance and self-insurance in the context of RWI. As a result, although they may be

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[253] *Id.,* DL #1. *But see id.,* DL #2 (remarking that RWI may make credit "easier to obtain").
[254] *Id.,* B #21.
[255] *Id.,* B #19..
[256] Kenneth A. Froot, David S. Scharfstein & Jeremy C. Stein, *Risk Management: Coordinating Corporate Investment and Financing Policies*, 48 J. FIN. 1629 (1993) (identifying the external cost of capital as a potential explanation for the corporate purchase of insurance).
[257] Mayers & Smith, *Corporate Demand*, *supra* note 194, at 289–91, 294–95; MacMinn & Garven, *supra* note 194, at 559–60 (describing tax rules that favor the acquisition of insurance over the market to self-insuring).
[258] *See* Brian G. M. Main, *Corporate Insurance Purchases and Taxes*, 50 J. RISK & INS. 197, 199 (1983) (noting that "self-insured property damage losses are tax deductible only to the extent of the tax base, or book value, of the destroyed asset. Income from insurance claims, on the other hand, is tax free as long as it is used to repair or replace the destroyed asset . . ." and building, from this example, a theory of the corporate insurance focusing on tax differentials between asset replacement via insurance versus self-insurance).
[259] *See, e.g.*, John Core, *On the Corporate Demand for Directors' and Officers' Insurance*, 64 J. RISK & INS. 63, 68 n.10 (1997) (dismissing tax effects as "second order in magnitude" when the insurance does not cover a depreciable asset).
[260] *See supra* notes 125-126 and accompanying text.
[261] Even in the shortened (average 6 year) time horizons of private equity, losses from reduced future income streams are fully deductible insofar as they reduce the subsequent sale price of the portfolio company, producing a tax deductible loss for the fund.

relevant in other lines of insurance, tax advantages are unlikely to motivate the purchase of RWI.[262]

Still, the corporate finance explanation might apply to RWI insofar as the insurance is cheaper than alternative sources of capital. The alternative to RWI is, of course, self-insurance, funded by an adjustment to the price paid in the acquisition. Because either the seller or the buyer can self-insure, the adjustment to purchase price can be made by either seller or buyer. If the adjustment is made by the seller, it is most evident in the indemnity/ escrow arrangement—that is, the portion of the purchase price set aside to cover breached reps.[263] If the adjustment is made by the buyer, there may be no indemnity/ escrow arrangement, but rather an implicit holding back of some of the purchase price to cover breached reps.

There may be several ways to finance self-insurance on both the buy side and the sell side. For example, rather than consigning sale proceeds to an escrow account, sellers could borrow to fund the escrow account or, what amounts to the same thing, borrow against funds deposited in escrow. Alternatively, private equity sellers could provide a guarantee from the GP or a letter of credit from a bank instead of a traditional escrow account. Or they could buy RWI. The relevant question underlying all of these alternatives, of course, is whether the seller's cost of capital is higher or lower than the insurance premium the seller must pay. Likewise, on the buy side, rather than holding back capital and bidding *less* for targets without an indemnity, buyers could simply *borrow more* and bid the same amount. Or they could buy RWI. Again, the principal consideration would be the relative cost of capital between taking on additional debt (or contributing additional equity) and buying insurance.

The data most relevant to this comparison are not available. Transacting parties publicly disclose neither the cost of their RWI policies nor their marginal cost of capital. Still, it is possible to make some observations from averages and other generally available information. Take, for example, a $100 million acquisition. Taking the typical limits (10% of deal value), typical retention (1% of deal value), typical premium (3% of limits), and typical brokerage commission (18% of premium) all noted above, we arrive at a total cost of $1.35 million for $10 million of coverage.[264] The cost, in other words, is 13.5% of the total coverage, which, as also noted above, is very rarely paid, even in part.[265] How does this compare to other sources of capital? Could a buyer or seller borrow $10 million as a hedge against potential breaches for an interest rate lower than 13.5%? The answer, of course, is very likely yes, especially in the

[262] The tax benefit may be small relative to the load of the insurance premium even for those lines of insurance to which the benefits most apply. *See, e.g.*, Charng Yi Chen & Richard PonArul, *On the Tax Incentive for Corporate Insurance*, 56 J. RISK & INS. 306 (1989) (evaluating the size of the tax benefit over the asset's life, given inflation and the speed of depreciation, and concluding that the tax benefit is small relative to the typical load in insurance contracts and therefore cannot be the sole reason for corporate purchase of insurance).
[263] It may also be reflected in a higher deal price.
[264] Coverage is effectively $9 million because the policy responds only after the retention ($1 million) and only up to the limit ($10 million).
[265] *See supra* notes 128-139 and accompanying text.

historically low interest rate environment that coincided with the explosive growth of RWI policies.[266]

There is an additional reason to doubt that the growth of RWI can be explained by its value as a source of alternative corporate finance. The alternative finance explanation applies to both public and private transactions. If the principal advantage of RWI is that it lowers the cost of capital by providing a cheap source of acquisition finance, then that advantage would seem to be equally attractive in both public and private deals. Yet RWI is used almost exclusively in private deals.[267]

There is no technical obstacle to using RWI in public deals.[268] Although public deals lack survival and indemnification, reps could be made to survive closing exclusively for the purpose of RWI. Alternatively, if the parties were unable or unwilling to negotiate survival, insurers could offer "synthetic warranty" policies, in which the insurer would make warranties directly to the buyer under the insurance contract, effectively disintermediating the seller.[269] Indeed, considering that there is no post-closing remedy for breached reps in public deals, RWI might be especially valuable as a form of contingent consideration in such deals, if indeed it is cheaper than alternative sources of acquisition finance.[270]

That RWI is not used in public deals suggests that the principal purpose of RWI is *not* in fact its use as an alternative source of acquisition finance. If its principal advantage were acquisition finance, there would seem to be a ready and waiting market in public deals. Likewise, although direct comparative data is not publicly available, the average cost of RWI likely exceeds alternative sources of acquisition finance or at least did during the years of the product's flourishing. The alternative finance explanation therefore cannot account for observed patterns in the use of RWI.

E. Divergent Risk Preferences

Each of the previous hypotheses for the purchase of RWI assumed a close alignment of interests between investors and managers. However, these interests may diverge. Fund managers may have reasons to favor RWI that their risk neutral investors do not. This leads to two possibilities. First, if RWI creates a benefit to fund managers that investors do not share, fund managers may use their authority to buy it at the expense of their investors. RWI may, in

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[266] From 2012 through 2018, the time period depicted on Figure 1, supra, the federal funds rate—the interest rate on which much lending activity is based—rose slowly from 0.07% at the beginning of 2012 to 2.4% at the end of 2018. *See* Federal Reserve Bank of New York, Federal Funds Data Historical Search, available at https://apps.newyorkfed.org/markets/autorates/fed-funds-search-page.

[267] *See supra* note 100-102.

[268] Indeed, in other countries, notably Australia, RWI has been used in public deals. AIG, M&A INSURANCE, *supra* note 103. Munich Re reports.

[269] These policies have been used in other related liability contexts, such as tax liability policies. The seller, under such a policy, would provide due diligence to the insurer (as well as the buyer) so that the insurer could assess the risk and price it.

[270] Jeffrey Manns & Robert Anderson IV, *The Merger Agreement Myth*, 98 CORNELL L. REV. 1143, 1185–86 (2013) (discussing contingent consideration mechanisms as a means to "better alight the incentives of both parties" and "enhance the overall efficiency of transactions").

this case, reflect managerial agency costs. Alternatively, fund investors may willingly purchase RWI to protect against managerial risk aversion. RWI may, in this case, reflect efficient contracting.

RWI may be a product of agency costs insofar as it enables managers to show accounting returns (measured by IRR) that exceed real economic returns.[271] On the sell side, RWI may boost IRR by avoiding escrow accounts, which reduce IRR by delaying the return of proceeds.[272] Delay should be of less concern to diversified investors who care principally about real returns. By contrast, because managerial compensation depends in large part on IRR, managers may prefer even inefficient expenditures to support it.[273]

Slightly different incentives apply on the buy side. Given the relatively short time horizon during which they hold portfolio companies—an average of less than six years—overpaying for a portfolio company may threaten to reduce the private equity fund's IRR at exit. Private equity investors are likely to be indifferent because they can spread this risk through diversification.[274] But again, because fund managers are compensated exclusively on IRR, they may favor RWI as a means of protecting it even if the insurance provides no real returns to fund investors.[275] As a result, the use of RWI on either the buy side or the sell side of private equity deals may reflect managerial agency costs.

Another, perhaps more profound, difference in incentives arises from the divergence in risk preferences between private equity managers and private equity investors. Because *investors* can spread portfolio company risk across diversified investment portfolios, they can be assumed to be risk neutral.[276] But because fund *managers* contribute a significant labor component to private equity investments and labor is generally non-diversifiable, private equity managers cannot be regarded as risk neutral.[277] RWI might thus be a function of this difference in risk between fund managers and their investors.

Limited partner agreements already reflect this important divergence between manager and investor risk preferences. The "carry" allocates 20% of the investment gain to fund managers to encourage risk-seeking.[278] At the same time, losses are absorbed almost entirely by

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[271] Under such circumstances, corporate insurance may be a form of earnings management. If managers expect their investors to overlook recurring insurance costs but punish large single period losses, they will tend to buy insurance even if the present value of the premium payments exceeds the present value of the future loss. *See generally* Froot, et al., *supra* note 256, at 1631 (suggesting that risk-hedging may provide private benefits to managers).

[272] Kirk Sanderson, *The Banker's Guide to Reps and Warranties Insurance Economics*, Jan. 2016 (demonstrating impact on IRR from reducing or eliminating the escrow account).

[273] Spreading loss through diversification harms IRR because losses are simply passed along to investors, reducing returns. Self-insurance likewise reduces IRR because losses must be absorbed by the fund, reducing returns.

[274] Private equity investors should therefore favor RWI only when it provides benefits other than risk-spreading that exceed the cost of the premium.

[275] Meanwhile, the private equity firm, although it is likely more diversified than the individual fund and therefore more willing to self-insure, has incentives that mirror those of the fund because its ability to raise future capital depends its funds' IRRs.

[276] *See supra* notes 188-189 and accompanying text.

[277] *See generally* Gilson, *supra* note 1, at 283-84 (noting that "owner-managers will also have an undiversifiable human capital investment in the company they manage").

[278] *See supra* 47 and accompanying text.

the limited partners.[279] Managers continue to earn their two percent management fee irrespective of fund performance.[280] This asymmetrical shifting of risk likely reflects differences in the ability to diversify investment risk between limited partners (who, as investors of capital, can diversify) and general partners (who, as investors of labor, cannot). Because labor invested in underperforming funds cannot be recouped elsewhere, individual managers who are not protected on the downside may abandon the fund in search of richer opportunities.[281]

RWI may serve as an additional hedge against this risk, further insulating private equity managers from non-diversifiable loss. Although they are themselves indifferent to the spreading of portfolio company loss through insurance, limited partner investors may nevertheless be willing to buy RWI to prevent their undiversified managers from becoming risk averse in the selection of investment targets. In this way, RWI may be seen as an efficient term of private equity manager compensation. Through it, fund investors promise to compensate fund managers for losses due to misinformation. In the absence of the insurance product, it is unclear how investors could commit to make managers whole for this type of loss.[282]

Does RWI represent agency costs or an efficient compensation arrangement? Either explanation implies a close association between RWI and private equity. This association is widely acknowledged in the practitioner literature, and it is confirmed by survey participants. RWI is predominantly used in private equity deals, often when private equity is on both sides of the transaction.[283] Moreover, survey respondents overwhelmingly ranked private equity first in driving the use of RWI.[284] As one broker remarked, "the majority of policies are still being purchased by PE buyers (or portfolio companies of PE buyers)."[285]

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[279] Virtually all because the management firm will have invested 1–2% of the fund's equity capital.

[280] *See supra* note 48 and accompanying text.

[281] Fraidin & Foster make this point as follows:

> Because private equity employees expect to share in the incentive compensation of the fund, early poor investments by the private equity fund can have a profoundly negative impact on the fund's ability to retain and hire talented investment professionals…. If it becomes unlikely that the fund will make anything from incentive compensation, employees will realize that they will have to work for the rest of the life of the fund without the opportunity to share in the performance-based pay. As a result, instead of sticking around and helping the fund improve its relative returns, they may search for jobs at other funds. … The same argument applies to being able to hire new talent when the fund is below its hurdle rate. Talented employees are unlikely to join a fund that is already substantially below its hurdle rate and where they are less likely to receive incentive compensation from future successful deals.

Fradin & Foster, JCFL, ms at 33.

[282] This explanation for RWI mirrors the explanation for Side A D&O insurance (managerial risk aversion) as opposed to Side B and C D&O insurance (agency costs). *See* BAKER & GRIFFITH, *supra* note 19.

[283] Respondents (49) reported on average that 19% (median 10%) of RWI Deals involved PE on both buy and sell side. 31% (median 30%) involved PE on sell side only. 47% (median 40%) involved PE on buy side only. 12% (median 10%) reported PE on neither the buy nor the sell side. RWI Survey, questions 41, 63, and 107.

[284] *Id.,* questions 42 and 108.

[285] RWI Survey, B #14.

Private equity fees are notoriously opaque.[286] In addition to the carry and 2% management fee, private equity firms also charge a range of fees directly to the portfolio companies they manage.[287] For example, private equity managers frequently charge transaction fees and monitoring fees directly to portfolio companies.[288] These fees can be significant—transaction fees often amount to between 1–2% of deal value.[289] Because the equity in these companies is 98–99% owned by the funds' limited partners, these charges are almost entirely financed by fund investors in spite of their inability to control or even understand them.[290] RWI is one such portfolio company fee, which investors finance without being able to control.[291] The

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[286] Fees are difficult to anticipate from the limited partnership agreement. *See* Ludovic Phalippou, *Beware of Venturing into Private Equity*, 23 J. ECON. PERSPECTIVES 147, 157 (2009) ("Most fees and costs imposed by private equity buyout firms on their investors are complex and contain a multitude of dimensions. Investors will find it difficult to compare different contracts and to anticipate accurately the magnitude of fees."). It is also difficult to estimate fees from private equity fund prospectuses. *Id.*, at 160–61 ("[D]etails concerning the amount of fees charged in the past are never mentioned. Only 25 percent of the funds report overall past performance net of fees. These funds are typically those with top performance."). *Accord* Yuki Sato, *Opacity in Financial Markets*, 12 REV. FIN. STUD. 3502, 3505 (2014). (articulating model in which financial firms use opacity to exploit less informed agents through asymmetric information and tactics that inhibit learning)

[287] Portfolio company fees can be charged for a range of services.

> [P]ortfolio company fees are taken directly out of the portfolio companies by the private equity firm and so are not directly visible to investors. These include a number of expenses: 1) transaction fees when purchasing and sometimes selling a portfolio company; 2) expenses related to proposed but unconsummated investments; 3) taxes, expenses of accountants, litigation, counsel, and annual meetings; 4) advisory and monitoring fees; and 5) director fees.

Phalippou, *Beware of Venturing into Private Equity*, 23 J. ECON. PERSPECTIVES at 150.

[288] According to a leading study of private equity contracting:

> Aside from management fees and carried interest, the other two components of revenue are transaction fees and monitoring fees. ... When a [buyout] fund buys or sells a company, it effectively charges a transaction fee, similar to the M&A advisory fees charged by investment banks. … In addition to transaction fees, BO funds often charge a monitoring fee to their portfolio companies.

Andrew Metrick & Ayako Yasuda, *The Economics of Private Equity Funds*, 23 REV. FIN. STUD. 2303 (2010).

[289] *Id.*, ("In the purchase of a new portfolio company, [buyout] funds typically charge a transaction fee to that company that is between 1% and 2% of transaction value."). Moreover, evidence suggests that the fixed component of private equity compensation (fees) increases relative to the floating component (the carry) in seller's markets. Robinson & Sensoy, *supra* note 48, at 2761–62 (finding that "during boom periods in private equity, when fund sizes grow, overall pay rises, even as a fraction of fund size. The overall rise is driven by increasing management fees, so in boom periods the composition of compensation shifts toward fixed compensation (fees) and away from variable compensation (carry)").

[290] Metrick & Yasuda, *supra* note 288 ("While this fee is rolled into the purchase price, the GP can still benefit if she owns less than 100% of the company and shares less than 100% of these transaction fees with her LPs. About 85% of [buyout] fund agreements require that GPs share at least some portion of these transaction fees with their LPs . . . .").

[291] There is some evidence that investors accept opaque portfolio company fees because they recognize that excessive portfolio company fees eat into IRR which is the basis of managerial compensation. Phalippou, supra note 286 at 157 ("When asked, some investors say they ignore (voluntarily or involuntarily) such details. The investors who do not ignore them say that if a fund charges too much portfolio company fees, its return is negatively affected, which may upset its current investors; hence, such a fund would raise less money and collect less fees in the future."). Alternatively, it may be agency costs all the way down. *See* Bruce I. Carlin, *Strategic Price Complexity in Retail Financial Markets*, 91 J. FIN. ECON. 278 (2009); Xavier Gabaix & David Laibson, Shrouded Attributes, Consumer Myopia, and Information Suppression in Competitive Markets, 121 Q. J. Econ. 505 (2006); Peter Morris & Ludovic Phalippou, *A New Approach to Regulating Private Equity*, 12 J. OF CORP. L. STUD. 59 (2012).

opacity and lack of investor control over the purchase of RWI may favor the agency cost explanation. However, the inability to control an expense does not necessarily imply that investors do not benefit from it.

In sum, RWI seems to be a product of incentives internal to private equity fund management. As such, it may reflect agency costs or an efficient compensation arrangement to mitigate fund manager risk aversion. Although the cost of RWI is borne by risk neutral investors, they may nevertheless benefit if the insurance increases their investment returns by preventing fund managers from becoming risk averse in the selection of portfolio companies in which to invest.

V. Why Do Insurers Sell RWI?

One character, the insurer, has so far been left out of the story. But it is worth asking why the insurer is willing to sell RWI coverage. A simple answer is that it is profitable. Claims are neither frequent nor severe.[292] Instead, "most claims settle within the retention."[293] Insurers thus would seem to be doing just fine selling policies on which they rarely are made to pay.

But, upon closer analysis, RWI presents a puzzle for the insurer as well. And once again, the cause is a fundamental information problem. The insurer is in a far worse position with respect to information about risk than the insured. True, insurers track claims,[294] and they may, on the basis of claims data, be able to price the average risk.[295] Nevertheless, information relevant to the occurrence of a specific risk—the potential falsity of specific reps—resides not with the insurer but with the insured. This persistent information asymmetry gives rise to problems of adverse selection and moral hazard, problems that cannot be solved by pooling and pricing.[296]

From an insurer's perspective, then, the question becomes how to contain the threat of adverse selection and moral hazard, for if it cannot, it seems impossible to sell RWI profitably over time. These are the questions of this Part. The first section considers responses to the problem of adverse selection, and the second considers responses to moral hazard. Because both of these turn on the reliability of information produced by the transacting parties, the third section considers insurers' tools in responding to misrepresentation and fraud, and the final section considers the role of the underwriting cycle in shaping the insurers' response.

A. Adverse Selection and Unknown Unknowns

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[292] *See supra* notes 128-130 and accompanying text (on frequency) and notes 137-140 and accompanying text (on severity).

[293] RWI Survey, B#10 ("Most claims settle within the retention."). *See also supra* note 138 and accompanying text.

[294] *See supra* AIG, M&A INSURANCE, *supra* note 103; Taxing Times, supra note 129.

[295] One insurer illustrated this point with an analogy to the sale of worker's compensation insurance to contractors during the Iraq war. There was no actuarial data available, at least at the start of the war, on the risk of worker's compensation claims in a war-zone. Yet an insurance company was willing to sell the coverage, but only at a significantly higher price than ordinary policies. The contractor, who simply passed the cost on to the US government, was happy to pay the inflated price, and the insurance company made significant profits on the coverage. The moral of the story: "you don't need a mountain of actuarial data to sell coverage profitably." Insurer interview, dated Oct. 4, 2018.

[296] *See* Rothschild & Stiglitz, *supra* note 12.

Adverse selection can arise when insureds have superior risk-relevant information and use it to their advantage in obtaining insurance.[297] The structure of the RWI market suggests adverse selection. The parties to M&A transactions clearly have better access to information about risk than third party insurers, and not every deal is insured.[298] The dynamics of adverse selection thus predict that RWI is purchased for riskier deals, potentially setting off a cycle of higher premiums, concentrated risk, and the eventual implosion of the risk pool.

Insurers address this threat through risk selection. There are some risks that insurers will not cover.[299] For example, one underwriter noted the risk inherent in technology deals in which the target company is acquired for its proprietary technology rather than its value as an operating company. Insurers view such deals as excessively risky because buyers who value the company for a specific asset may disregard risks associated with the operating company, ultimately leaving them on insurer.[300] Careful risk selection in the underwriting process may thus help insurers contain adverse selection.

The fundamental structure of RWI policies also mitigates the risk of adverse selection. Recall that RWI fundamentally covers only unknown risks.[301] Risks that are known or uncovered during the due diligence process are excluded from coverage, preserving coverage only for "unknown unknowns."[302] It is possible, of course, that transacting parties conceal what they know and that RWI creates incentives to avoid uncovering knowable but presently unknown information. But these problems—fraud and moral hazard—are distinguishable from adverse selection. Putting them momentarily aside leaves the fundamental question of adverse selection: Do the transacting parties have knowledge superior to the insurer concerning the risk to be insured? Given that the risks insured are unknown unknowns—risks that are neither known at the time of contracting nor uncovered in the due diligence process—the obvious answer is: no. By definition, neither the insurer nor the insured knows the unknown.

In this way, RWI policies define coverage so as to exclude the possibility of *pure* adverse selection—that is, adverse selection without any admixture of strategic behavior or fraud—is impossible by definition. The real world, of course, is not pure, and insofar as strategic behavior and fraud are allowed to re-enter the picture, adverse selection reappears. The question thus

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[297] *See supra* Part II.B.

[298] Adverse selection can arise regardless of which transacting party drives coverage. For example, sellers may insist upon RWI rather than an indemnity because they know their deal is especially risky. Or buyers may bid on especially risky deals only with the knowledge that RWI coverage is available, self-insuring for other more benign risks.

[299] Insurers can select risk by refusing to underwrite a policy or by excluding specific types of risk within a policy. The former is a tool for containing adverse selection, while the later, as we shall see, is a tool for containing moral hazard.

[300] Underwriter interview.

[301] *See supra* note 120 and accompanying text.

[302] The division of information into knowns, known (discovered) unknowns, and unknown (undiscovered) unknowns recalls the famous observation of Donald Rumsfeld: "[T]here are known knowns; there are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know. But there are also unknown unknowns – the ones we don't know we don't know." Donald H. Rumsfeld, Sec'y of Def., DoD News Briefing, U.S. Dep't of Def., News Transcript (Feb. 12, 2002).

becomes how well insurers deal with the risk of strategic behavior and fraud. These are the concerns of the next two sections.

B. Mitigating Moral Hazard

Moral hazard occurs when the fact of coverage induces a policy-holder to act carelessly, thereby increasing loss.[303] Moral hazard in RWI operates upon the parties' incentives to produce and exchange information. Having purchased RWI, the parties may search less diligently to uncover all relevant information concerning risk. Moreover, insofar as RWI provides coverage only for risks that remain unknown, the parties may actively avoid uncovering information that, once revealed, will be excluded from coverage. Both of these incentive problems are manifestations of moral hazard.

Insurers generally manage moral hazard through the policy's deductible and limits, terms that effectively allocate loss to the policy-holder, thereby maintaining "skin in the game."[304] In the context of RWI, however, both of these tools have been shrinking. Until recently, retentions under RWI policies had been set at 2% of deal value and were typically split, with the buyer and the seller each bearing 1%.[305] Now retentions are often set at 1% of deal value, sometimes lower.[306] And policies may be structured to allocate the retention entirely to the buyer, leaving no liability at all upon the seller.[307] Meanwhile, as already noted, the seller's indemnity has in many cases vanished altogether.[308] As a result, survey respondents note, "sellers have little to no skin in the game."[309] But this only means that RWI coverage has evolved to move risk from sellers to buyers. And even as deductibles shrink as a percentage matter, they can retain significance as absolute values. For example, at 1% of deal value, the deductible on a $500 million deal is $5 million, enough to motivate at least some serious effort in due diligence.

In addition to policy limits and deductibles, RWI insurers seek to control the risk of moral hazard by supervising the due diligence process. As described above, insurers hire experienced M&A attorneys to review the primary due diligence performed by the transacting parties. They review reports and underlying documents, and ask further questions of the transacting parties during the underwriting call. If this secondary due diligence process reveals additional risks or flaws in the underlying due diligence, then that risk area will lead to

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[303] *See supra* Part II.B.
[304] *See* Baker, *Genealogy of Moral Hazard, supra* note 13, at 282–83.
[305] RWI Survey, I #21. ("Retention amounts used to be around two percent for a number of years. It would be split 50/50 between buyer basket and seller escrow and made a lot of sense for all parties. Unfortunately, with the market expanding the trend has been to reduce the 'skin.'").
[306] *Id.,* I #5 ("There has been market pressure over the past year or two to lower Initial Retentions. The normal rule of thumb is 1% of deal value as the initial retention, but some larger deals are slightly below that."); *id.,* I #4 ("As recently as 2016 or so, RWI deductibles were often in the 2% range. [I]t's currently more typical to see RWI deductibles of 1% for plain vanilla, good sized deals (i.e., deal value north of $50million), but smaller deals and deals in tougher industries still sometimes see RWI deductibles higher than 1%.").
[307] Chapman, et al., Representations and Warranties Insurance in M&A Transactions, Harvard Law School Forum on Corporate Governance and Financial Regulation, Dec. 11, 2017 (describing the "No-Survival" deal and policy structure).
[308] *See supra* notes 108-109 and accompanying text.
[309] RWI Survey, B #14.

exclusions from coverage. The potential for exclusions from coverage, in other words, is the insurers' ultimate means of keeping the transacting parties engaged.

Still, managing moral hazard through exclusions creates contradictory incentives on the part of the transacting parties. To see this, consider that the purpose of due diligence is to uncover risks, making the unknown known, yet RWI covers only unknown risks. Known risk areas are excluded from coverage. If exclusions are also used to police the buyer's care in the due diligence process, the result is a Catch-22: due diligence can result in a loss of coverage either by uncovering risks or by failing to uncover them. A coverage maximizing strategy might therefore be to design the diligence process to appeal to insurers but not necessarily to uncover new information.[310]

The RWI policy is designed to curb such strategic behavior in due diligence, specifically through the definition of knowledge. RWI policies define knowledge by reference to members of the deal team, including lawyers, bankers, and accountants, not merely officers of the target company. For example, the policy form of a major RWI underwriter excludes from coverage losses arising from "any Breach of which any of the Deal Team Members had actual knowledge" prior to commencement of the policy and further instructs that "Deal Team Members" include both those "who (i) supervised, reviewed or conducted any due diligence, analysis or evaluation in connection with the Acquisition Agreement, and/or (ii) supervised, reviewed, prepared or negotiated the Acquisition Agreement."[311] This definition sweeps more broadly than the definition of knowledge in the underlying acquisition agreement, which is typically limited to named representatives of the seller.[312] By excluding losses arising from liabilities known by representatives of the buyer and the seller as well as any professionals that participated in the diligence and drafting process, RWI policies prevent parties from colluding with their representatives to suppress information from insurers.

Furthermore, incentives for strategic behavior in negotiation may be curbed by other means. Just as the incentive to engage in reckless driving introduced by automobile insurance may mitigated by the danger it poses to life and limb of the driver, the risk of mispricing borne by the buyer may induce careful due diligence without regard to RWI.[313] The buyer's interest in accurate information for pricing purposes may drive the diligence process as much or more than the buyer's interest in maintaining insurance coverage. Supervisory due diligence and exclusions are a part of the underwriting process, but both ultimately depend upon the underlying information exchange having a purpose other than insurance—namely pricing.

Nevertheless, there may be limits on the underwriter's ability to free-ride on the pricing incentives of the transacting parties. For example, in some deals, especially multi-bidder auctions, due diligence may come after the deal is priced and, because the parties are no longer

[310] For example, buyers might thoroughly investigate known risks while expending less effort to reveal new ones, which remain covered for only so long as they remain unknown.
[311] AIG Mergers & Acquisitions Insurance Group, Buyer-Side R&W Template.
[312] *See supra* note 70 and accompanying text.
[313] Frank A. Sloan, Tort Liability Versus Other Approaches for Deterring Careless Driving, 14 INT'L REV. L. & ECON. 53, 55 (1994)

able to adjust price to newly discovered risks, reduce the parties incentive to participate actively in due diligence.[314] There is also a more fundamental limitation created by the credible commitment problem described above.[315] Insofar as RWI eliminates seller liability for misinformation, it creates a credibility problem that will either lead buyers to walk away or severely discount pricing. RWI therefore broadened to keep buyers in the deal.[316] But this creates a contradiction. How can an insurer rely upon a buyer's incentives to price the deal right when the buyer is simultaneously relying upon the insurer to provide coverage in case the price is wrong? RWI cannot simultaneously be the cause of and the solution to the underlying information problem.

Relying on due diligence to solve moral hazard is thus imperfect. But due diligence is not the insurer's only weapon against strategic behavior. Insurers are also armed with a set of coverage defenses that may enable them to force transacting to participate faithfully in the diligence process, lest they void coverage. These are the subject of the next section.

C. Coverage Defenses

Ultimately, the insurer's ability accurately to pool risks and control strategic behavior depends upon not being lied to or misled. Insurers mitigate the risk of fraud and misinformation through coverage defenses. Coverage defenses allow insurers to re-impose risk on policy-holders ex post, thereby creating an incentive for them to take care ex ante. In the context of RWI, the principal coverage defenses are the knowledge exclusion, rescission, subrogation, and negotiations around damages.

Standard insurance law allows an insurer to rescind a policy if the policyholder provides false material information without regard to whether the policyholder knew or should have known that the information was false.[317] Insurers might therefore be able to avoid coverage if the buyer provided the insurer with false due diligence information. As applied to RWI, this is somewhat contradictory. False reps and warranties, after all, are the basis of coverage.[318] The false information that triggers the policy, however, is information provided by the seller. Rescission is triggered by false information supplied by the policy-holder. In a typical buy-side policy, this is the buyer, not the seller.

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[314] In an interview with a prominent deal lawyer, the lawyer conceded the potential for moral hazard, but asserted that it does not arise in every deal. The key factor, he suggested, what the timing of pricing—that is, before or after the diligence exercise. When pricing is the culmination of due diligence, as in an exclusive negotiation with a single bidder, the need to get the price right keeps the buyer engaged in the process. However, when pricing occurs prior to the diligence process, as in an auction setting, the lawyer acknowledged that "incentives can get screwy." See RWI Interview, Deal Lawyer, Sept. 28, 2018.

[315] See supra notes 82-84 and accompanying text.

[316] See supra notes 178-179 and accompanying text.

[317] TOM BAKER & KYLE D. LOGUE, INSURANCE LAW AND POLICY: CASES AND MATERIALS (2014).

[318] Consider, for example, a seller who falsely claims no impairment to its material contracts. Provided no deal team member knows the statement is false, this is precisely what the policy is designed to cover. From a policy perspective, rescission of a buy-side policy will not induce the *seller* to take more care in its disclosures, though it may incentivize the buyer to press the seller harder.

Subrogation is the flip-side of recission. Like recission, subrogation is triggered by false information, but unlike recission, subrogation typically creates rights against the seller. RWI policies typically include subrogation rights, in which an insurer may pursue for itself a policy-holder's claim against a third party. In the context of a typical buy-side policy, the insurer would step into the shoes of the buyer to pursue the seller for providing false or misleading information.

Both subrogation and recission shift risk ex post from the insurer to the transacting parties. In the case of recission, risk is shifted to the buyer. In the case of subrogation, it is shifted to the seller. A credible threat that risk may be shifted to them ex post may create ex ante incentives for the parties to take care in producing only truthful information to the insurer.

However, recission and subrogation are rare. Recission is unheard of in RWI.[319] And subrogation is not much more common. The vast majority of respondents (83%) reported never having been involved in a situation in which insurers asserted subrogation rights. Those who had been involved in assertion of subrogation rights reported that subrogation only occurred when there was clear evidence of fraud.[320] Indeed, survey participants reported, the insurer's subrogation rights are expressly waived much more often than they are asserted.[321]

Nevertheless, recission and subrogation may create value for insurers even if they are not litigated (or arbitrated) to an outright denial of coverage. Coverage defenses enhance an insurer's hand at settlement. An insurer that can credibly threaten to exclude, rescind, or subrogate may be able to settle RWI claims at a substantial discount. By agreeing to settle in spite of a potentially applicable defense, the insurer can effectively "cash in the coverage defense."[322] In so doing, a coverage defense can exert considerable force even if it does not lead to a complete avoidance of coverage.

But such tactics may not be widely used in RWI. This can be seen by reference to DIV/ multiplied damages claims which insurers entertain in spite of not having an express contractual obligation to do so. As discussed above, the market has settled on a practice of "following silence with silence" in connection with DIV/ multiplied damages.[323] But not excluding a form of damages plainly does not obligate an insurer to cover them. Moreover, because DIV/ multiplied damages are arguably a form of consequential damages, insurers would seem to have

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[319] Correspondence between author RWI broker, dated Jan. 30, 2018 (on file with author) (stating unequivocally that rescission "Never" happens).

[320] RWI Survey, CL #6 (reporting involvement in a subrogation claim involving "intentional misconduct"); *id.*, I #21 (reporting "clear fraud by seller"); *id.*, CL #3 ("fraud"); *id.*, CL #1 ("fraud or wrongdoing").

[321] More than twice as many respondents (14) reported having been in a situation in which a subrogation waiver was sought than reported being in a situation in which subrogation rights were asserted (6). Asked to comment on circumstances under which subrogation waivers are sought, respondents replied:

> In order to settle a working capital disputes in cases where there is no real likelihood of a fraud claim against the Seller, the Buyer (insured) can ask the insurer to waive its subrogation rights against the seller (only fraud claims are possible by insurer vs. Seller) to give the Seller walkaway peace (and maybe a better settlement for the Buyer). *Id.*, CL #3. *Accord id.*, CL #2 (noting that subrogation waiver is "typically sought" and "typically granted but will be held back if there is any hint of possible bad behavior that needs more exploration").

[322] *See, e.g.*, Baker & Griffith, *How the Merits Matter*, *supra* note 237, at 822 (discussing how D&O insurers "cash in coverage defenses" in negotiating claims payments, effectively forcing policy-holders to share in the risk ex post).

[323] *See supra* note 126 and accompanying text.

a particularly strong case against covering DIV/ multiplied damages when the underlying agreement excludes consequential damages, as it often does.[324] Nevertheless, these arguments are not pressed by insurers in order to avoid coverage. The reason, market participants reported, was that any such attempt to avoid coverage would lead that insurer to be frozen out of the market.[325]

If insurers are willing to pay damages that they may not be legally obligated to pay, it seems unlikely that they are aggressively using coverage defenses to drive down settlement values. This in turn might mean that the threat of *ex post* risk shifting is not fully internalized by transacting parties *ex ante* and that the threat of subrogation and recission therefore do not effectively prevent the parties from providing false information to the insurer. This dynamic is likely influenced by the underwriting cycle, discussed in the next section.

D. The Underwriting Cycle

Insurers' reluctance to use coverage defenses may be explained, in part, by the insurance underwriting cycle. Insurance markets follow a boom and bust cycle as capital enters or exits the market.[326] As capital enters the insurance market, coverage expands and premiums fall, a phenomenon referred to in the industry as a "soft market." As capital exits the market, often in response to a significant loss event, underwriting standards tighten and premiums rise—a "hard market." The process is understood by industry participants as cyclical because each market gives rise, over time, to its antithesis.[327] Profitable underwriting in a hard market attracts new entrants who water down underwriting standards and reduce premiums, eventually giving rise to losses and the exit of underwriting capacity, which allows surviving underwriters to tighten standards and increase premiums and so on. The only question is when the cycle turns.

RWI has been in a soft cycle since it emerged as a widely used form of coverage, around 2015.[328] The soft cycle may explain the reluctance of RWI insurers to use coverage defenses aggressively. An insurer known to pay claims at a slower or lower rate than its competitors may find that it is not solicited by brokers for quotes. Given that there are currently over twenty providers of RWI coverage, it may be particularly easy for brokers to retaliate against insurers that refuse to pay claims. And indeed, the structure of the RWI market around claims would seem to reflect this soft cycle dynamic.

A harder market might correct some of the incentive problems generated by RWI. Insurers might only offer policies when there is a substantial seller indemnity. They might stop offering full materiality scrapes or bring back the policy exclusion for DIV/ multiplied damages. Likewise, a hard market might allow insurers to press coverage defenses *ex post*, thus inducing

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[324] *See supra* note 125 and accompanying text.
[325] Broker interview.
[326] See Neil A. Doherty & James R. Garven, *Insurance Cycles: Interest Rates and the Capacity Constraint Model*, 68 J. BUS. 383 (1995) (explaining the underwriting cycle by reference to interest rates and capital constraints). *See also* Tom Baker, *Medical Malpractice and the Insurance Underwriting Cycle*, 54 DEPAUL L. REV. 393, 369–422 (2005) (exploring the underwriting cycle in connection with medical malpractice insurance).
[327] Sean M. Fitzpatrick, *Fear is the Key: A Behavioral Guide to Underwriting Cycles*, 10 CONN. INS. L. J. 255 (2003).
[328] *See* Figure 1, *supra*.

insureds to take greater care *ex ante*. To the extent that it produces a less expansive form of coverage, a harder market in RWI may mitigate the distortion of incentives by putting more of the parties' skin in the game.

But it is worth wondering whether a hard market in RWI is even possible. RWI coverage might depend upon its breadth.[329] Buyers need coverage for the kind of large mispricing claims that impact whether a fund manager clears the 8% hurdle to the carried interest. Moreover, only broad coverage for DIV damages addresses the credible commitment problem inherent in eliminating seller liability. If coverage were to narrow in a harder market, it is unclear whether transacting parties would find anything of value in RWI. Without the current breadth of coverage, transacting parties might well find self-insurance through a seller indemnity to be efficient after all.

CONCLUSION

RWI currently offers a broad transfer of mispricing risk from buyers and sellers to insurers. As a substitute for standard indemnity and escrow obligations, RWI allows sellers to minimize risk at exit. RWI may also provide value to private equity buyers by preventing managerial risk aversion in the selection of portfolio company investments. At the same time, however, RWI threatens to disrupt the contracting process by introducing a profound credible commitment problem: sellers who do not bear liability cannot be trusted and buyers who cannot trust their sellers will discount or reject what might otherwise be efficiency-enhancing transactions.

The structure of RWI coverage responds to these problems to a degree. In particular, the full scrape and the implicit inclusion of DIV/ multiplied damages responds to the credible commitment problem by promising the buyer that it will be made whole from any losses caused by an untrustworthy seller. Insurers may be willing to undertake these commitments in an expanding market but less so as insurance markets contract. The tightening of coverage terms in a hardening market may cause the transacting parties to rediscover the credible commitment problem at the heart of RWI, which in turn may lead them to abandon the product.

The stability of RWI coverage depends upon a fragile balance of incentives and market forces. Transaction planners, of course, can adjust to a world with or without it. We will thus have to await the next phase of the underwriting cycle before we can begin to predict the long term impact of RWI on M&A contracting.

[329] *See supra* notes 178-179 and accompanying text.

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