

ACC ONLINE EDUCATION

Representation and Warranty Insurance in Real Estate Transactions

November 30, 2022

Agenda

- 1. General Overview of RWI Policies**
- 2. Role of RWI in Real Estate Transactions**
- 3. RWI Timing and Process**
- 4. Negotiation of Policies**
- 5. Impact of RWI on Transaction Documents**

General Overview

What is Representation and Warranty Insurance?

Representation and Warranty Insurance (RWI)

Insurance that is designed to provide coverage for unknown breaches of representations and warranties in a Purchase Agreement.

Key Structural Considerations:

Buy vs. Sell-Side Policy

Will the RWI policy be structured as a Sell-Side Policy (insuring the Seller for its indemnification exposure) or Buy-Side Policy (insuring the Buyer for liabilities arising from Seller rep breaches)?

Walk-Away Deal?

Will the RWI policy be supplemental to Seller indemnification packages (e.g., excess coverage), or serve as the Buyer's sole recourse for rep breaches?

Role of RWI in Corporate RE Transactions

Indemnification Expectations in Traditional vs Corporate RE Transactions

Traditional RE Transactions

Lighter indemnification packages on reps (6-12 months survival; 1-3% cap on liability) because Buyers are able to rely on alternative sources of protection from liabilities, such as:

- Physical investigations of assets and third-party reports (PZR, Environmental Reports, PCRs, etc.);
- Estoppels from key parties (key tenants, ground lessors, lenders); and
- Title Policies to address ownership of fee interests and liabilities that run with land.

Corporate RE Transactions

Robust indemnification packages on reps (survival up to 6 years and caps of 100% of price for fundamental reps) to address additional potential liabilities that cannot be addressed by other means, such as:

- Corporate liabilities that do not appear on title reports (e.g., entity-level debt, tax, litigation and employment liabilities);
- Capitalization of target entities and ownership of transferred equity interests; and
- Due Authorization, Execution and other Fundamental concerns that are not addressed by title policies.

RWI in Corporate RE Transactions

Why Structure RE Transactions as Corporate Transactions?

Portfolio Deals

Ease of transferring a large number of properties in a single transaction through a corporate structure

Tax Issues

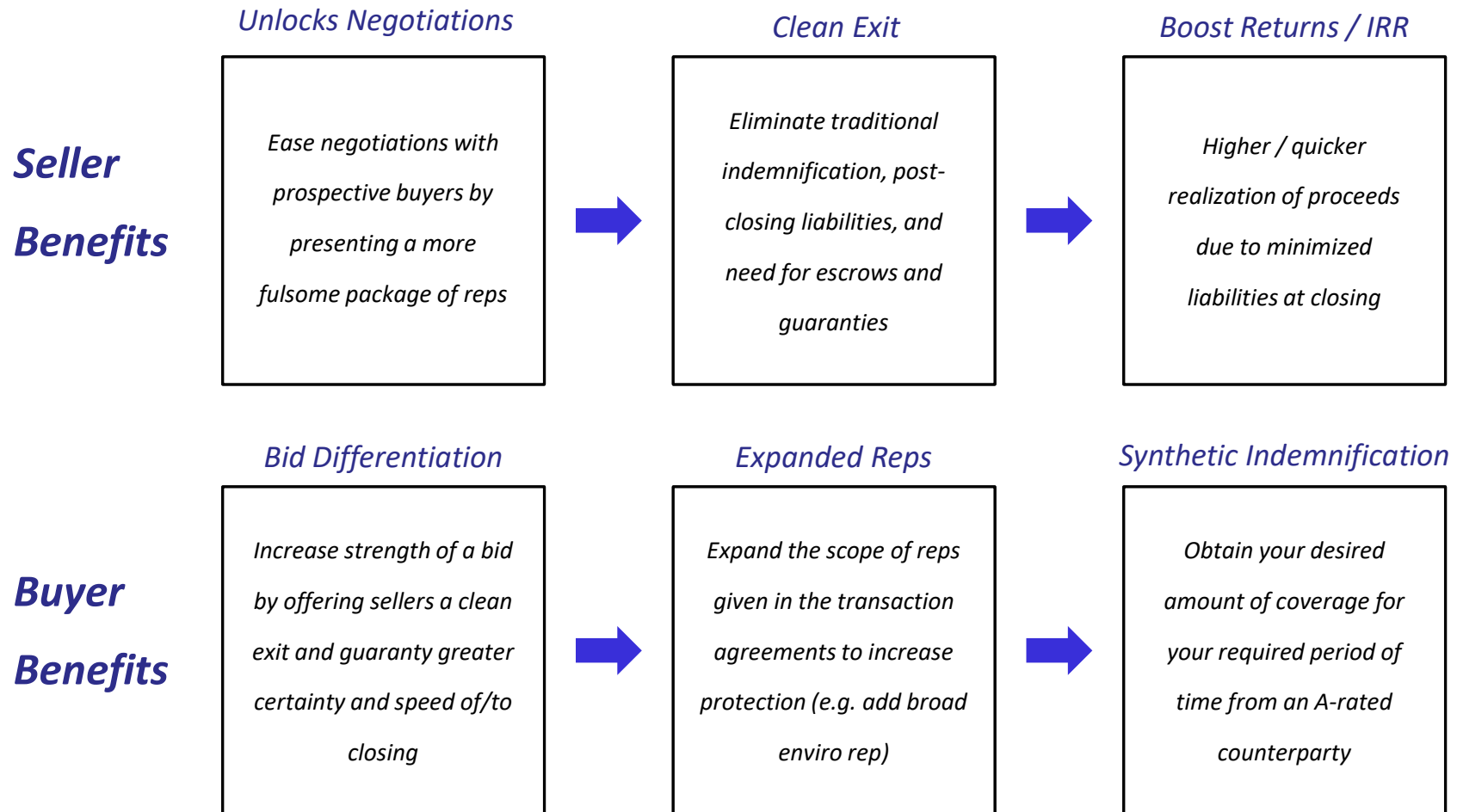
Tax concerns may require a corporate structure (e.g., avoiding transfer tax or exiting through sales of REIT shares)

Partial Equity Sales

Recapping equity or partial interest transactions must be structured as corporate transactions

Additional Benefits of RWI

How RWI can Benefit Both Buyers and Sellers



Selecting RWI Policies

Key Policy Terms

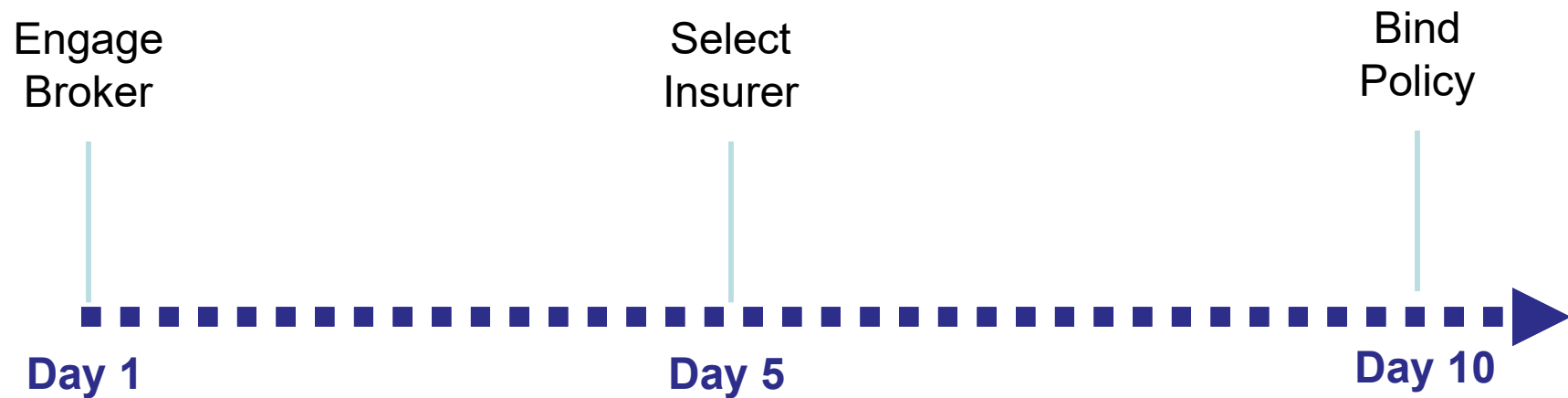
The primary terms that your deal team will consider in comparing quotes are:

- ❑ **Policy Limit** – 1-3% of Purchase Price for an RE asset transaction and 5-10% of Purchase Price (but up to 100% for fundamental reps in a Fundamental Policy) for a Corporate RE transaction
- ❑ **Retention (deductible)** – 10-25bps of Purchase Price (which may drop down after a period of time)
- ❑ **Premium** – One-time payment of 2-3% of Policy Limit (10% deposit due when Policy is bound, remainder due at closing)
- ❑ **Broker Fee** – Typically either a percentage of the Policy Limit (50-75bps) or a commission percentage of the Premium (15-20%) (due when Policy is bound)
- ❑ **Underwriting Charge** – \$15-50K fee paid to Insurer (non-refundable, and due prior to commencing underwriting process)
- ❑ **Coverage** – Which reps are covered (e.g., entity/property, fundamental, tax reps)
- ❑ **Policy Period** – Typically 2-3 years for entity/property reps, 6-7 years for tax and fundamental
- ❑ **Deal-Specific Exclusions** – Asbestos, underfunded pension plans, identified recognized environmental conditions, etc.

RWI Process and Timing

Key Steps in Obtaining RWI Coverage

Sample Timeline for RWI Process



Initial Diligence / Obtaining Quotes

- Identify Key Risks, Potential Exclusions and Insurance Structures
- Obtain general indication of pricing

Negotiate Policy / Underwriting Process

- Share Diligence Materials; Diligence Questionnaire; Underwriting Call
- Review and Negotiate Key Terms

Underwriting and Diligence Process

How the RWI Process Impacts Diligence

Information Sharing

Provide Insurer with: (i) PSA drafts; (ii) all third-party reports (tile report, survey, zoning, phase I, PCRs, engineering, seismic, lease audits, law firm abstracts/memos, etc.) and (iii) access to data room.

Underwriting Call

- Insurer will provide a Diligence Questionnaire to discuss on an underwriting call;
- Failure to demonstrate sufficient knowledge and diligence into issues on the call can result in reps being excluded from coverage;
- In order to avoid this result:
 - Review questionnaire in advance with specialists and deal team to have a plan for who will answer each question;
 - Avoid stating that you are “relying on the reps” for comfort on any issues;
 - Provide as much detail as possible when responding—this is as much about giving the insurer comfort that you’ve run a customary and appropriate process as it is about the actual results of the diligence.

Negotiating the Policy

What Isn't Covered By the Policy?

Exclusions

One of the largest areas of focus in negotiating a policy is the scope of what's excluded from coverage. Liabilities are typically excluded if they fall into one of the following categories:

General exclusions in every RWI policy:

- Forward-looking statements, and contingent Claims based on Future Events, covenant breaches
- Matters Known to the Deal Team prior to Binding the Policy (or executory period breaches Known to the Deal Team prior to Signing)
- Purchase Price Adjustments and Collection of Receivables
- Unfunded or Underfunded Benefit Plan Liabilities

- Asbestos or polychlorinated biphenyls; identified RECs
- Punitive Damages and Equitable and other Non-Monetary Relief

Transaction-specific exclusions subject to underwriting:

- Liabilities that are not Adequately Diligenced
- Off-Market Reps

Negotiating the Policy

Key Terms

Approach Towards Negotiation

Unlike standard insurance policies, RWI Policies are negotiable. Attorneys should make many of the same comments to an RWI Policy that they would make to the indemnification provisions of a purchase agreement, including:

Knowledge Definition

Policies will exclude breaches that are “known” to the Buyer. To address this, define “Knowledge” as actual conscious knowledge—without duty of inquiry—of a limited number of individuals in the Buyer’s deal team

Losses Definition

Define “Losses” to include all damages that would be recoverable at law for a breach, disregarding any survival periods, claim thresholds, caps, deductibles or other limits on liability under the purchase agreement

Materiality Scrape

Insurers will typically agree to include a “materiality scrape”, which provides that all materiality-qualifiers will be ignored for purposes of determining (a) whether a breach has occurred, or (b) the amount of Losses resulting from a breach

Policy Timing

Determining When to Bind the Policy

Binding at Signing*

- ❖ Obtain coverage for pre-signing rep breaches that the Buyer discovers during the executory period;
- ❖ Avoid risk of RWI coverage not being available on satisfactory terms prior to Closing

Binding at Closing

- ❖ Avoid paying deposit on Premium until you know that the deal will close
- ❖ Save time during negotiation of Purchase Agreement by shifting workload of the RWI process into the executory period
- ❖ Note that if the Policy is not bound at Signing, then the Purchase Agreement will need to address allocation of risk between Buyer and Seller for what happens if the Policy is not available on satisfactory terms at Closing

*For purchase agreements with a due diligence period, the RWI Policy is typically bound when the Buyer's deposit becomes non-refundable.

Purchase Agreement Considerations

Provisions that are Needed When RWI is Bound at Closing

Who Bears the Risk?

- ❖ **Closing Condition**: Buyers will typically push for the issuance of the RWI Insurance Policy to be a condition to Closing. However, in a competitive process Sellers may not be willing to agree to an RWI condition to Closing, shifting the risk of policy availability onto the Buyer.
- ❖ **Efforts Covenant**: If the Seller agrees to an RWI condition to Closing, then the Purchase Agreement should include a covenant requiring the Buyer and Seller to cooperate and use commercially reasonable efforts to obtain the policy prior to Closing.
- ❖ **Policy Definition**: For an RWI condition to be effective, the parties will need to define the RWI Policy terms (scope of coverage, cost, retainer, survival, exclusions, etc.) that need to be met in order for the condition to be satisfied.

Purchase Agreement Considerations

Impact of RWI on Representations

Scope of Reps

Given the lack of post-closing indemnification, the Buyer will expect broader reps than what Sellers customarily provide in non-RWI deals. However, broader reps still create the following issues for the Seller:

- (1) Deal certainty, in terms of need to satisfy the rep bring-down condition at Closing;
- (2) Scheduling burden, in terms of expanded disclosure obligations; and
- (3) Risk of fraud claims, since the Seller is not released by Buyer from fraud claims, and the Insurer's subrogation waiver will not apply to Fraud claims.

Fraud Definition

The Seller should define "Fraud" narrowly to include only intentional fraud, based on the actual knowledge of limited individuals on Seller's deal team.

Materiality Qualifiers

Given the synthetic materiality scrape in the RWI policy, Buyers should agree to more liberal use of materiality qualifiers to get Sellers comfortable with broader reps.

Purchase Agreement Considerations

How to Define Fraud

Sample Fraud Definition

“Fraud” means, with respect to Seller, a claim for Delaware common law fraud with a specific intent to deceive based on a representation of Seller contained in Article [X]; provided, that at the time such representation was made (i) such representation was materially inaccurate, (ii) a Seller Knowledge Party had actual knowledge (and not imputed or constructive knowledge), without any duty of inquiry or investigation, of the material inaccuracy of such representation, (iii) such Seller Knowledge Party had the specific intent to deceive Buyer, (iv) Buyer acted in reliance on such inaccurate representation, and (v) Buyer suffered Losses as a result of such material inaccuracy. For the avoidance of doubt, “Fraud” does not include any claim for equitable fraud, promissory fraud, unfair dealings fraud, or any torts (including a claim for fraud) based on negligence or recklessness.

- ❖ **Relationship to RWI Policy:** The Fraud definition in the RWI Policy is typically linked to the definition in the Purchase Agreement, so it’s important to get the right definition when negotiating with the Buyer. Insurers will require Fraud to be carved out of any provisions limiting (i) the Seller’s liability, (ii) survival period of the reps, and (iii) buyer’s right of recourse in the event of a breach of rep or warranty.

Purchase Agreement Considerations

Additional Provisions to Limit Seller Liability

Walk-Away Deals

In addition to omitting a Seller indemnity from the Purchase Agreement, a Seller that is expecting a “public-style” walk-away deal (i.e., no surviving liability of any kind) will need to add additional waivers and releases to the Purchase Agreement to limit sources of post-closing liability.

- ❖ **Push-Out Election**: The Purchase Agreement should prohibit the Target Company from making a “push-out election” under Section 6226 of the IRC following the Closing. Insurers will accept this only if appropriate tax diligence is undertaken.
- ❖ **Waiver of PSA Claims**: The Purchase Agreement should explicitly state that reps do not survive Closing, and include a waiver by Buyer of any breach claims (for both reps and pre-closing covenants) under the Purchase Agreement (or any other closing deliverables) following closing.
- ❖ **Release of Pre-Closing Claims**: The Target Company and its subsidiaries should release the Seller (and its affiliates, shareholders, employees, etc.) from any pre-closing claims.
- ❖ **Title Affidavits**: Any title affidavits customarily delivered by Sellers should instead be delivered by the Target Companies, if at all.

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Q&A