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What R&W Insurance Access Means For Small-Cap M&A

By **Caroline Thee and Ewelina Mikocewicz** (January 26, 2024, 6:01 PM EST)

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Historically, buyers operating in the small and midsize enterprise, or SME, space could not obtain representations and warranties insurance with satisfactory scope of coverage on economically reasonable terms.

However, the slowdown in mergers and acquisitions caused in part by the historically high interest rates of 2023 has increased insurer appetite for underwriting SME deals.

This article investigates the cause of this change in appetite, and outlines considerations for SME buyers looking to add R&W insurance to their repertoire of available tools.

2023 was not a banner year for M&A. Private buyers — particularly private equity sponsors — faced numerous headwinds to closing transactions, with the most significant being the increased cost of capital due to historically high interest rates, and uncertain macroeconomic conditions affecting debt and equity investors' appetites for M&A.

With the Federal Reserve currently waffling on whether interest rate cuts will occur in March, the 2023 conditions may continue well into 2024.

One silver lining arising from relatively poor M&A market has been the expansion of the R&W insurance industry into transactions below approximately $50 million in enterprise value — referred to in this article as small-cap or SME deals. Such deals are generally less affected by the higher costs of capital, and thus serve as a good source of deal volume for R&W insurance providers in this current market.

R&W insurance can offer added protection and reassurance to both parties involved in corporate transactions. But historically, R&W insurance was not widely used in small-cap deals.

This was due to several factors, including cost-effectiveness, lack of awareness among buyers and lack of capacity of underwriters to take on transactions of that size. However, many of the historic barriers to entry no longer exist.

The M&A slowdown came at an inopportune time for R&W insurance providers, as the insurance marketplace scaled to underwrite greater capacity just as the availability of deals tanked. Almost overnight, the supply/demand curve for R&W insurance flipped — resulting in a sharp decrease in premiums charged to buy the product, and an expanded appetite for transactions that were not historically underwritten.

One of the beneficiaries of this change has been SME buyers. Only two years ago, there was a reluctance to underwrite these deals at all. Today, insurers are providing tailored and cost-effective R&W policies for transactions as small as $5 million in enterprise value.

R&W insurance for smaller companies provides the same benefits for buyers in SME deals as it does in the mid-to-large-cap space, including:

- Providing a means to reduce or eliminate the need for escrows and to limit sellers' indemnification obligations;
- Giving a buyer a sense of comfort that there is a reliable pool of funds to seek recovery from in the event of a claim;
- Pushing sellers to give more fulsome representations and to accept more buyer-friendly provisions; and
- Providing a means for buyers to stand out and provide more attractive offers during the letter of intent stage.

For example, SRS Acquiom Inc.'s 2023 M&A Deal Terms Study found that 56% of deals with R&W insurance in 2022 had an escrow between 0% and 0.5% of the transaction value, while 53% of deals where no R&W insurance was identified in such data had an escrow between 5% to 10% of the transaction value.[1]

Similarly, 50% of deals with R&W insurance in 2022 were structured as a full "walk away" transaction — with no seller representations surviving post-closing, outside of customary carveouts — compared to the 12% of deals where R&W insurance was not identified in the data provided.[2]

Whether R&W insurance is providing a means to reduce escrow amounts or to push buyers to accept a no-seller indemnity transaction, the benefits to sellers are clear. In the small-cap space, sellers are often founders looking for an exit, or to set up an exit strategy, and the ability to significantly reduce, if not eliminate, indemnification obligations is incredibly attractive.

The primary barriers to widespread adoption of the product in the SME space are cost and additional diligence obligations required by buyers to satisfy underwriting needs. Greater adoption of the product shows that buyers increasingly see the cost/benefit analysis favoring the purchase of R&W insurance.

Concerning diligence obligations, underwriters are answering the call by adapting their processes to address the reality that buyers of small-cap companies have different due diligence focus points than buyers of large-cap companies.

Some underwriters have taken the need to offer a streamlined underwriting process to heart by offering more R&W insurance products that are limited in scope, or are driven by software-as-a-service platforms to make the product acquisition process as painless as possible for potential buyers.

Whether R&W insurance makes sense on a particular deal rests on various factors. Even in the SME space, size matters. The size of the deal dictates insurance premiums — or, more specifically, the limit of liability under the insurance policy.

Still, some insurers have internal policies dictating the minimum premium they will accept on any given transaction. A $1 million deal may be insurable, but the insurance cost may be unacceptably high for the buyer.

Aside from price, a buyer should make sure the need is there. As previously noted, R&W insurance best serves the parties when there is a gap between the seller's and buyer's respective needs.

Either the seller is reluctant to escrow funds, or the buyer needs to keep the seller engaged post-closing, such that making indemnity claims against the seller is an unappealing option. But many small-cap deals do not have such a gap.

For example, a strategic acquirer looking at a $5 million asset purchase who has no need for the target's current leadership and has negotiated for itself a holdback structure, rather than third-party escrow, is a poor fit for R&W insurance, given the following: (1) the cost of insurance will be relatively high; (2) the need for post-closing seller cooperation is low; and (3) the holdback structure ensures the capital will be there to resolve a claim.

In contrast, a private equity buyer considering a $20 million stock purchase with 20% management rollover equity should strongly consider R&W insurance as the gaps between the parties that make R&W insurance so appealing in the first place still exist — and the cost of insurance, and the scope of coverage, are much more appealing today than they used to be.

Ultimately, the growth of R&W insurance in the small-cap space is a welcome and valuable tool in the SME M&A landscape. The rapid growth and flexibility of underwriters in adapting to the needs of SME buyers demonstrate how immensely beneficial it can be for the transaction process and the outcome.

Buyers in SME transactions should consider adding R&W insurance to their repertoire of available tools to help win deals, facilitate faster closings and ultimately support higher returns on investment.

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[1] 2023 M&A Deal Terms Study, SRS Acquiom Inc., 78-79.

[2] 2023 M&A Deal Terms Study, SRS Acquiom Inc., 53.
