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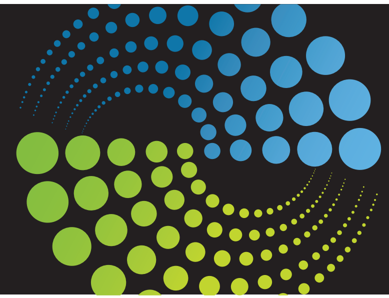
M&A Tax Talk

Representation and warranty insurance



The robust and competitive M&A market has led to an increase in representation and warranty insurance (RWI) policies, which has transformed the M&A process.

What is representation and warranty insurance?

RWI is a type of insurance policy that can be purchased in connection with an acquisition. While RWI has been around for more than 20 years, RWI policies have become increasingly popular due to the "hot" M&A market and decreased policy costs, including decreases to both the policy premium and retention (i.e., deductible). The decrease in cost is likely attributable to the fact that previously, only a handful of insurers offered RWI, whereas today more than 20 insurers offer RWI policies. RWI protects a buyer against a breach of representation and warranties included in the acquisition agreement. RWI does not protect a buyer against any other breach in the acquisition agreement, such as a breach of seller covenants. Further, RWI does not protect a buyer against any "known" issues, such as exposures identified during the diligence process. Lastly, insurance companies often have a list of standard tax-related items that they will not insure for, such as net operating losses, tax reserves, transfer taxes, and accrued but unpaid taxes on the balance sheet.

RWI does not provide coverage as broad as a seller escrow of the same amount, so it is not a perfect replacement; however, in the current M&A market, it may be the only option for a buyer in a competitive bid process. Further, while the coverage is not as broad, a buyer may be able to obtain more coverage and for a longer period when compared to a standard seller escrow.

In order to obtain a RWI policy, a buyer must conduct diligence on the target. The insurer will generally require access to the diligence report and may request a call with the buyer and diligence team to understand the procedures performed and any issues identified in diligence to confirm satisfactory diligence was performed.

Why is it important to know about?

RWI is beneficial for both buyers and sellers. From a seller standpoint, RWI can facilitate a "clean" exit with limited (or no) escrow. From a buyer's perspective, RWI can be a distinguishing factor in a competitive bid process by providing a faster bid process and a short (or no) escrow.

Historically, insurers preferred that both the seller and buyer had some responsibility for the policy and required an allocation of the retention/deductible among the seller and buyer. However, insurers have adapted to the current M&A market of auctions and competitive processes and now may allow buyers to obtain RWI policies for "no-indemnity deals." It is not uncommon for no-indemnity deals to have slightly higher premium and retention amounts. RWI can also be attractive when collection from the seller is expected to be difficult (e.g., numerous sellers, sellers in foreign jurisdictions) or if a significant portion of management will remain with the business. According to American International Group (AIG), approximately one in five AIG RWI global policies received a claim notification, with deals ranging in size from $500 million to $1 billion having the largest claim frequency. The statistics for claim frequency show that frequency remains the highest for the largest, most complex M&A transactions. In terms of RWI claims by breach type, tax claims were the second most frequent (representing 18 percent of RWI claims), with financial statement claims being the first[1].

[1] AIG, *Taxing times for M&A Insurance*, https://www.aig.com/content/dam/aig/america-canada/us/documents/insights/aig-manda-claimsintelligence-2019-r-and-w.pdf

Tax implications

The Internal Revenue Service ("IRS") has not issued formal guidance on the tax treatment of RWI policies. Thus, it is unclear whether the costs associated with a RWI policy (e.g., premiums, brokerage fees) should be capitalized, and if capitalized, whether the policyholder can recover the costs through amortization. Although the tax treatment of the costs associated with a RWI policy is not clear under the Treasury Regulations, the LB&I Process Unit covering Transaction Costs, last updated by the IRS in July 2018, noted that "the costs of representation and warranty insurance, or directors' and officers' insurance required by the terms of the transaction agreement does not facilitate the transaction, but may be capitalized as a cost to create the insurance contract (an intangible)." As the tax treatment of the costs associated with a RWI policy is based on the particular facts and circumstances underlying the transaction (e.g., prior existence of RWI; stock acquisition versus asset acquisition), we suggest consulting with a tax adviser to determine the appropriate tax treatment.

Similar to the costs associated with a RWI policy, the IRS has not issued formal guidance on the tax treatment of RWI insurance proceeds. Although insurance proceeds are generally includible into income and subject to tax, there may be instances where the proceeds are treated as a purchase price adjustment, first reducing tax basis in the property acquired, resulting in such proceeds being taxable to the extent they exceed tax basis. The tax treatment of insurance proceeds is based on the particular facts and circumstances underlying the transaction, and therefore we suggest consulting with a tax adviser to determine the appropriate tax treatment.

Further, depending on the insured loss, a corresponding tax deduction may not be available. For example, if the insured loss resulted in additional federal income tax, no deduction would be available, as federal income taxes are not deductible. However, if the insured loss resulted in additional sales tax, a corresponding federal income tax deduction would be available.

It should be noted that the tax treatment of RWI proceeds differs from the treatment of indemnity claim payments provided for in an acquisition agreement. In general, indemnity claim payments are not taxable to the recipient, as they are treated as an adjustment to the purchase price in accordance with the acquisition agreement. Accordingly, the receipt of RWI proceeds may be less favorable from a tax standpoint than the receipt of an indemnity payment.

Conclusion

Although RWI is not a solution for every transaction, RWI policies have become increasingly popular in today's robust M&A market, as the policies can be favorable for both buyers and sellers and may be the only protection for a buyer in a no-indemnity transaction.

Want to learn more?
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