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Representations and Warranties Insurance in Complex Real Estate Transactions: Emerging Tool to Mitigate Risk and Close Deals

Evaluating When Insurance is Appropriate, Negotiating Coverage and Exclusions

THURSDAY, FEBRUARY 25, 2016

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Representations & Warranties Insurance
Real Estate Transactions

Why Purchase a Real Estate R&W Policy

- Representations & Warranties Insurance covers loss incurred as a result of the inaccuracy or breach of reps and warranties or crystallization of exposures covered under an indemnity (such as a tax or other specific indemnity).

- Transactional Insurance products can address road-blocks to completion of a transaction by:

  - Eliminating or reducing perceived or identified exposures that prevent completion of the transaction,

  - Addressing disagreements on the allocation of financial risk for the perceived or identified exposures.

- Can be used to enhance, supplement or replace some or all of a sellers indemnification obligation.

Buyer v. Seller Policy

- Buyer Policy: First party indemnity policy structure – covers loss resulting from breaches discovered during the policy term

  - Can extend survival periods beyond acquisition agreement (can be tailored to meet needs of parties out to as long as 6 years)

  - Can increase indemnification above seller indemnification cap

  - Distinguish a bid in an auction

- Seller Policy: Liability policy structure – covers claims made against the sellers alleging breach of representations and warranties

  - Generally follows caps and survival periods in acquisition agreements (to maximum of 6 years)

  - Protect Sellers and expedite distribution of sale proceeds

Types of Transactions for Real Estate R&W Policy

- **Types of Transactions**
  - Asset sale of Real Property
  - Stock sale of entity which owns real property
  - REIT Transactions
  - Portfolio Asset Transactions

Example

An institutional buyer entered into an agreement to purchase a recently completed and almost fully leased regional shopping mall for $150 million. A $75 million non-recourse fully amortizing life insurance company loan was made available to the buyer. The mall is located along a river and preserved wetlands in a state with a sophisticated set of state and local township permitting rules regarding environmental impact (state NEPA rules), water quality (surface waters and wetlands), zoning (zoning by special permit), and air quality (indirect source rules). The seller was a developer and merchant builder who built properties for sale but planned to liquidate its existing portfolio properties over the next few years. The buyer was a governmental pension fund with deep experience in owning and operating real estate through select qualified fund managers. Real estate represented slightly more than 10% of its investment portfolio.

R&W Insurance – Basics

- All representations and warranties generally are included in coverage including tax matters and environmental.

- Pricing
  - Generally 2% to 4% of the limit of liability – (i.e. $200,000 to $400,000 per $10 million of indemnity protection)

- Policy period
  - Typically matches survival period in acquisition agreement (up to 6 years) or extends survival period up to 6 years

- Retention
  - Minimum 1% to 2% of the transaction value
  - Typically drops down as escrow is released to a minimal retention level of between .5% and 1% of purchase price)

- Underwriting Considerations
  - Items not covered: forward looking statements and projections, covenants (can be considered in some situations), known or disclosed items (may be addressed via a separate contingency policy), asbestos
  - Due diligence

Underwriting Process

- Broker

- Account Clearance/Execution of Non-Disclosure Agreements

- Provision of Underwriting Submission
  - Required information includes: draft purchase agreement, draft disclosures, financials of target

- Non-binding Indication within 2 - 3 days
  - No cost to obtain conceptual proposal

- Payment of Underwriting Fee
  - Fees range from $10K - $30K (depending on nature and complexity of risk).

- Underwriting Process: 5 – 10 days
  - High level review of diligence process (if Buyer Side) or disclosure process (if Seller Side)
  - Access to legal, financial tax and other DD reports (if Buyer Side)
  - Underwriting calls with Proposed Insured's deal team and advisors

- Policy Negotiations
  - Concurrent with underwriting process
  - Impact on transaction agreement terms
  - Representations Letter

R&W Policy Negotiations

- Typically, the policy is conformed with the terms and conditions set out in the underlying transaction agreement.

- Policies are negotiable

- Key Terms
    - Claims made coverage (when Breach is discovered)
    - Survival Period, Policy Period
    - Limit of Liability
    - Retention (dropping over time)
    - Representations Letter

Key R&W Policy Terms

- **Definitions**
    - Covered R&W
    - Covered Loss (damages, taxes, covered costs/legal costs)
- **Exclusions**
    - Known existing Breach
    - Projections or estimates
    - Purchase price adjustments
    - Physical condition of property
    - Title defects
    - Non-monetary relief
- **Miscellaneous Terms**
    - Mandatory ADR
    - Inadvertent Policy breach
    - Loss payee

Claims Process

- **Claims Process**
    - Notice of Breach ASAP
    - Prior consent of Insurer to settle or incur costs
    - Insured's duty to pursue other recoveries
    - Insured's duty to cooperate/mitigate loss
    - Insured selects counsel
    - Defense cost advancement
    - Subrogation rights
    - Subsequent recoveries/offsetting benefits

Current Trends

- Auction Process
  - Buyer's distinguish a bid an auction
  - Sellers seeking quotes pre-biding and including R&W insurance as sole remedy in draft agreements
- Lender driven
- REIT Transactions
- Brokers - M&A teams
- Law firms have pre-negotiated forms

Thank You

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