R&W INSURANCE: A VALUABLE CATALYST FOR REAL ESTATE TRANSACTIONS

The representations and warranties insurance ("R&W insurance") is an increasingly universal feature in M&A deals. As real estate transactions have become more complex, with properties being traded in share deals and selling entities operating as institutional corporate vehicles, R&W insurance can help facilitating these transactions. Indeed, what makes R&W insurance so attractive for the private equity and M&A arena applies equally to the real estate industry.

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WHAT ARE WE TALKING ABOUT?

R&W insurance is a tripartite transaction between seller, purchaser and an insurance company in which the insurer protects either the buyer or the seller from financial losses resulting from a breach of the R&Ws provided for in the sale and purchase agreement. These R&Ws are made about certain material facts of the asset in order to induce the other party to enter the transaction and in most cases are one the basis for the price agreed in the transfer document.

There are two types of R&W insurance:

- A buy-side insurance policy, in which the purchaser is the insured, offers first-party coverage. The purchaser files a claim directly with the insurance company, which basically "steps into the shoes" of the seller and indemnifies the purchaser in case a breach of the seller's R&Ws is identified post-closing.
- A sell-side policy, in which the seller is the insured and provides third-party coverage. If the seller files a claim for a breach of the R&Ws with the insurance company, then either gets reimbursed by the insurer for payment of claims or the insurer will pay the purchaser directly for those suffered losses.

In our experience, the buy-side policy offers more transparency to both seller and purchaser during the process and facilitates the introduction of this tool into the deal.

WHY IS THIS SO BENEFICIAL TO COMPLETE TRANSACTIONS?

It is critical that in a seller-friendly market where the demand is so competitive and sellers offer little or no indemnity for losses, this tool has become increasingly utilized as an alternative purchaser's protection at a reasonable cost. As a consequence, R&W insurance is used by purchasers as a way to remain competitive and attractive in a bidding process assuming this transaction cost.

As a selling entity, R&W insurance is something you should consider introducing at the outset of the sale process to materially shorten negotiations. One of the main advantages for a seller is that the R&W insurance simplifies the liquidation process or the end of the operations after closing, since there would not be outstanding potential liabilities to be transferred to the shareholders/equity fund members.

WHEN MIGHT YOU NEED R&W INSURANCE?

Because R&W insurance shifts the risk of unknown breaches of R&Ws in a transaction to an insurance company, for obvious reasons it reduces the stakes on both the purchaser and the seller in negotiating the transaction documents.

Parties are typically driven to structure deals in which R&Ws are secured by indemnification provisions with –in some cases- escrow accounts or some other forms of security used as guarantees. The R&W insurance eliminates the need for these workaround measures, which can hold up the negotiations of a transaction. Parties can take ages negotiating the wording of a specific representation or warranty or the size of the indemnity provision when the protection may not be needed basically because the unknown risk is significantly low. R&W insurance can replace all these measures ensuring that a breach of that R&W will be protected, without the need for long negotiating sessions.

This tool is also valuable in certain transactions where due diligence could not provide the purchaser with important information on the asset, or the seller has not compiled such information, albeit in both cases the cost provided by the insurance policy will be higher.

WHAT IS KEY FOR A SUCCESSFUL R&W INSURANCE?

Adding in R&W insurance to the transaction will have timing implications, as typically insurers' underwriting process takes time, and the underwriting process itself may raise issues that could impact the terms of the final R&W insurance. So the analysis and decision-making process to put this tool in place should be adopted at the beginning of the transaction and involves the insurance company from day one.

The R&W insurance generally will not cover any known liabilities or contingencies identified during the due diligence process. Instead, it will only cover unintentional and unknown breaches. Therefore, the interaction between both purchaser and insurance teams (lawyers and real estate advisors) during the underwriting process is of essence to share available information and disclose the work conducted during due diligence.

CONCLUSION: A STRATEGIC TOOL FOR THE FUTURE

Our experience with R&W insurance in property transactions in the last years is positive. In some cases it allowed us to simplify the sale processes and in some others led our clients to complete the deal successfully by reducing heavy negotiation rounds at a reasonable cost. And our prediction is that this will smoothly penetrate a more complex and sophisticated real estate market in Spain in the next years. ◆