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Representations and Warranties Insurance: Enhancing Returns on M&A Transactions in Israel

Buyers and sellers in the US and Europe have been using RWI to create value for a number of years — the time has arrived for parties in Israel to do the same.

OVERVIEW

Buyers and sellers that use representations and warranties insurance (RWI) recognize the unique benefits it can bring to a transaction. These include bridging the gap in negotiations, increasing deal efficiency, providing a genuine source of recourse for the buyer, and the ability for the seller to have limited liability after closing for breaches of reps and warranties, without the need to hold funds in escrow (i.e. the much coveted "clean exit"). RWI is estimated to be used on over 50% of all M&A transactions in the US, and a significantly higher percentage on transactions involving a financial sponsor.

However, for those involved in M&A transactions in Israel, the question has been: *When will RWI make its way to the "Start-up Nation?"*

Over the past 12 months, this has been answered with a significant increase in the use of RWI on Israeli deals, both by US investors acquiring assets in Israel and by Israeli buyers acquiring assets domestically and internationally. Insurer appetite for RWI in Israel is growing as the US, UK, and European insurance markets gain familiarity with Israeli transactions, noting their similarity in form and style with US M&A.

This article sets out the key characteristics of RWI in Israel, including details of the coverage, pricing, and process; how it compares to the process in the US; and the future of M&A insurance in Israel in 2022 and beyond.

GROWTH IN M&A HEIGHTENS AWARENESS OF RWI

Most Israeli M&A activity consists of local companies being acquired by buyers from the US, UK, Europe, and Asia. The structure of these transactions follows international standards, with the closest comparison being to the US as Israeli acquisition agreements generally follow their form and style. The disclosure process mirrors that of the US, and Israeli due diligence reports and transaction documents are almost always in English. In addition, Israel's corporate and securities laws are similar to those in the US, and Israeli courts often look to Delaware as a source of influence for new case law.

Recent years have seen a continued increase in the use of RWI on US transactions, making the extension to Israel both logical and expected. According to Barak Platt and Ezra Gross, partners at Yigal Arnon & Co: "As it becomes more popular and insurance companies get more comfortable with Israel, the use of such policies in M&A transactions is expected to continue to grow."

Israel's evolution from the "Start-up Nation" to the "Scale-up Nation" has led to consistent growth in mega-acquisitions and increased investment from multinational technology companies and US financial sponsors. These buyers have been using RWI on transactions across the globe and are now seeking to do so in Israel.

In addition, Israeli sellers (be they founders, management, or institutional investors) are now more aware of RWI's benefits and increasingly raise this option at the outset of their sale processes, providing them with both greater control and insight into available RWI terms. As is common on European transactions, for no cost or commitment, sellers can instigate the RWI process, engage a broker to review the transaction documents, and request terms from insurers. At the appropriate time, the terms are "flipped" to the buyer, who will put the policy in place.

Marsh has been at the forefront of RWI growth in Israel. Over the past 18 months, we have used our global experience and local market knowledge to develop awareness of the value RWI adds to an M&A deal, and have worked with global insurers to educate them on regional nuances. Marsh has advised on more Israeli transactions in 2021 than any year previously. We expect this trend to continue, and for RWI to become an established part of the M&A process.

According to Ashok Chandrasekhar, partner at Goldfarb Seligman & Co: "Having represented buyers, sellers, and insurers in numerous deals where RWI was put in place, I can attest to its effectiveness as a tool to bridge negotiating gaps and enable parties to find common ground on the contours of appropriate liability. We have seen insurance fit seamlessly into deal structures in fields as varied as large portfolio sales, tech acquisitions, and regulated industries. I anticipate that RWI will play an important and growing role in the Israeli M&A scene."

SIMILARITIES AND DIFFERENCES IN US AND ISRAELI RWI

An RWI policy on an Israeli transaction will look and feel similar to a US policy, with the fundamental purpose being to cover against financial loss that may arise from a breach of a representation or warranty in an acquisition agreement. Coverage and process are "US style," including no general disclosure of the data room or diligence reports, and loss calculated on an indemnity basis. Most policies are governed by Delaware or New York state law, notwithstanding that the acquisition agreement may itself be governed by Israeli law. For US investors, this should provide the comfort of a familiar process and the confidence to pursue RWI on transactions where the target or underlying business sits in Israel.

JOSHUA BEGNER
SENIOR VICE PRESIDENT

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When is RWI best used in Israel?

Given the extensive range of limits that can be purchased for any deal, and the available insurer capacity and appetite for Israeli deals, RWI can be used on transactions with an enterprise value as low as USD10 million or in excess of USD2 billion. Insurer appetite is strongest for cross-border transactions, in particular where the buyer or seller is backed by a financial sponsor. In addition, many are becoming increasingly comfortable insuring earlier stage technology companies where there is a sensible valuation methodology.

Does RWI in Israel have the same benefits as in the US?

For buyers and sellers of Israeli companies, the benefits of using RWI closely align with its use on US transactions, including the ability for sellers to obtain a clean exit and for buyers to have a genuine source of recourse. In addition, RWI can act as a bid enhancement tool, giving a buyer the ability to obtain:

(i) enhanced survival periods; typically seven years for fundamental reps, tax reps, and the pre-closing tax indemnity, and three years for general business reps; and

(ii) coverage limits that are higher than would typically be obtained under an acquisition agreement; typically, RWI limits range from 10% to 30% of enterprise value, but the limit could be as high as 100% of enterprise value for some or all of the reps and warranties.

There are also nuances when considering the benefits of RWI in Israel. In the US and Europe, the market practice is for sellers to limit their liability for any breaches of reps and warranties to USD1.00, making the RWI policy the only form of recourse for buyers. However, this construct is not yet market standard in Israel. We have seen a variety of liability structures on deals in Israel over the past 12 months, including sellers remaining liable up to the deductible applicable under the policy, and sellers remaining liable for certain items where such items have been deemed excluded under the policy.

In time, as investments in Israel grow – particularly from financial sponsors – and RWI becomes an established part of the M&A process, it appears likely that the USD1.00 cap structure will become more prevalent. Furthermore, a USD1.00 cap structure would suit the profile of buyers and sellers involved in Israeli transactions as sellers often include founders and management who will remain with the business post-closing, and financial sponsors that will want to limit post-closing indemnification liabilities. Using a USD1.00 cap structure can provide sellers with the peace of mind that they will not be subject to claims for breach of reps and warranties post-closing. Similarly, for US buyers that are unlikely to bring a claim against founders and management that continue to be instrumental in the running of the target business post-closing, a USD1.00 cap structure would incentivize management to engage with the disclosure and transaction processes.

How does Israel RWI coverage compare to US policies?

Like in the US, an RWI policy generally covers "loss" from claims made by the buyer for any breach of the representations and warranties made by the seller. An RWI policy can be structured to cover only certain specific reps or warranties; however, coverage is generally afforded on a blanket basis for all reps and warranties to the extent they are "market standard" and have been the subject of buyer due diligence. As with US policies, the definition of "loss" in the policy should match the extent of the indemnity negotiated in the acquisition agreement.

For Israeli technology transactions, insurers place significant focus on the diligence findings in respect of the target groups' intellectual property ownership and data privacy compliance. As a starting point, insurers typically will cover these warranties subject to underwriting and review of diligence. Typically, the intellectual property reps and warranties are covered, and data privacy is predominantly only excluded where historical compliance issues are identified in the diligence.

What kinds of exclusions will an RWI policy typically contain?

RWI policies generally include certain market standard exclusions. For example, RWI does not cover known issues, such as those discovered during the due diligence or described in the disclosure schedules. In addition, policies typically will not cover purchase price adjustment provisions contained in the acquisition agreement, pension underfunding, and certain environmental liabilities. Other exclusions, to the extent included, will depend on the buyers' diligence findings.

How do costs and deductibles compare to a US

RWI policy?
The cost of an Israeli RWI policy is based on factors such as the nature of the risk, the location of the primary operations of the target business, and the relative size of the deductible. For an Israeli deal, RWI pricing typically sits between US and European pricing. We have seen it range from 2% to 5% of the coverage limit under the policy; in contrast, pricing on pure US policies are now as high as 5.5% of the coverage limit.

Historically in the US and Europe, market practice was that the buyer paid the policy premium. However, increasingly, this cost is being shared between buyer and seller in recognition of the mutual benefits the policy provides. We have seen a similar trend for Israeli deals – the question of who pays the premium will often come down to commercial bargaining strength.

The deductibles on Israeli RWI policies match the US and typically sit at 1% (or 1% dropping to 0.5% after 12 months) of transaction value. However, deductibles can vary and lower ones will be available for asset heavy transactions, for example, real estate deals. Insurers also provide higher deductible options, whose impact is to reduce the risk exposure for the insurer and lower the policy cost.

Will the RWI process delay my transaction timetable?
In recent years, the RWI insurance market has responded to concerns about the amount of time necessary to place a policy. RWI brokers and insurers understand the need to keep pace with the deal timetable, and using RWI can, in fact, speed it up. Key to this is an experienced broker who understands the competing time pressures for the transaction principals. This is particularly important on Israeli transactions, where RWI is still less familiar.

As in the US, typically within 72 hours of being instructed and provided with the relevant information, a broker should be in a position to present a report summarising the available terms. A broker can work with the buyer's deal team to analyse the terms provided and identify an insurer that meets the buyer's needs. Once an insurer has been appointed, they should be in a position to underwrite the transaction and put the policy in place within one to two weeks from receipt of buyer diligence reports. Insurers do <u>not</u> undertake their own diligence, but will review the buyer diligence reports on a <u>non-reliance basis</u> and raise follow-up questions. Insurers will typically engage local counsel in Israel to help review the reports.

Is it straightforward to make a claim?
In recent years, a large number of RWI claims have been made globally in the US and Europe, resulting in significant payments by insurers. In 2019, Marsh saw multiple insurance payments in excess of USD20 million, and payments made on 84% of closed claims.

The broker on a transaction should remain the buyer's advocate throughout the policy's lifecycle. In the event of a claim, the broker should work with the buyer's legal counsel and guide them through the process to help position them for success in making a claim. The experience and market positioning of the broker's claim team is fundamental and should be a key consideration when appointing a broker.

Where are insurers that underwrite Israeli deals based?
The pool of insurers underwriting Israeli deals is growing, with most based in the US or UK, where appetite is strongest. It is important that the broker on the deal is able to access any insurer globally, maximising the potential for competitive terms.

An increasing number of insurers are "discovering" Israel, as they come to understand that doing a transaction there is akin to doing one in the US in form, style, and risk profile.

Lorraine Lloyd-Thomas, an underwriter at Beazley with significant experience underwriting Israeli RWI, notes: "From mid-2020 onwards, and particularly in 2021, we have seen an exponential rise in RWI submissions on Israeli transactions, of which we have insured a significant proportion; there is now real momentum. The US style nature of the SPA and disclosure process fits neatly into our wider RWI book, and I have been genuinely impressed by the quality of many of the targets that have been brought to market."

CONTINGENT LIABILITY INSURANCE IN ISRAEL

RWI covers unknown breaches of reps and

warranties; however, it will not cover "known risks" that have been identified in respect of the target business. Such risks can be addressed separately in a contingent liability policy, which insures known, identified, specific risks. Historically, it was confined primarily to insuring identified tax risks, but now can cover areas including intellectual property, pensions and regulatory issues.

In addition to inbound investors, Israeli buyers acquiring assets outside of the country can now gain the confidence of using a product with which they have greater familiarity

Contingent liability insurance is usually appropriate where parties have identified a technical or legal issue, and can clearly explain why the likelihood of the risk manifesting is low. The policy converts a contingent liability into a known cost (the premium), providing a buyer with a source or recourse in the event the risk crystallizes, and can thereby remove the need to include a specific indemnity provision or escrow mechanic in the acquisition agreement. For such a risk to be insurable, it requires:

(i) of exposure quantified;
(ii) logical reasons as to why the risk is low; and
(iii) supporting documentation and analysis.

The cost of a contingent policy varies depending on the risk. The rate will be fact dependent, but will be a one-off premium, typically falling within the range of 1.5% to 20% of the policy limit.

There has been a significant increase in recent years in the US and Europe in the use of contingent liability insurance and, as with RWI, it is expected that this will increasingly become part of the M&A process in Israel.

WHAT'S NEXT FOR M&A INSURANCE IN ISRAEL?

RWI in Israel had a landmark year in 2021, having been used on a significant number of transactions. We expect the use of RWI will continue to increase and evolve to reflect the characteristics of RWI policies in the US. In addition to inbound investors, Israeli buyers acquiring assets outside of the country can now gain the confidence of using a product with which they have greater familiarity.

According to Mike Rimon, a senior corporate partner at Meitar: "The use of RWI in Israeli M&A has increased significantly, following the trend in the US. It has become very common to use RWI in sales of Israeli businesses to non-Israeli buyers, as well as where Israeli companies acquire businesses from Israeli and non-Israeli PEs. Furthermore, we now see Israeli buyers of non-Israeli businesses relying on RWI. As Israeli M&A activity increases (both on the sell side and buy side), we expect the use of RWI by Israeli buyers and sellers to continue to increase."

The fundamental purpose of RWI and contingent liability insurance is to bridge the gap between buyer and seller, releasing capital and providing each with the peace of mind that comes from protecting themselves from future liabilities. Buyers and sellers in the US have benefited from these solutions for a number of years. The time has arrived for buyers and sellers in Israel to do the same.

ABOUT THE AUTHOR

Joshua Begner is a Senior Vice President in the Private Equity and M&A group at Marsh Specialty (a Marsh McLennan business) and leads Marsh's Israel M&A team. Prior to joining Marsh, Joshua was a senior M&A attorney at Willkie Farr & Gallagher LLP, advising US financial sponsors acquiring technology assets in Europe. Joshua now specializes in structuring insurance solutions for Israeli transactions. Over the past 12 months, he has led a significant number of transactions in Israel, establishing Marsh as the market leading M&A insurance broker, and playing a key role in developing the Israeli RWI market. Joshua's clients include US, Israeli and European financial sponsors and corporates.

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