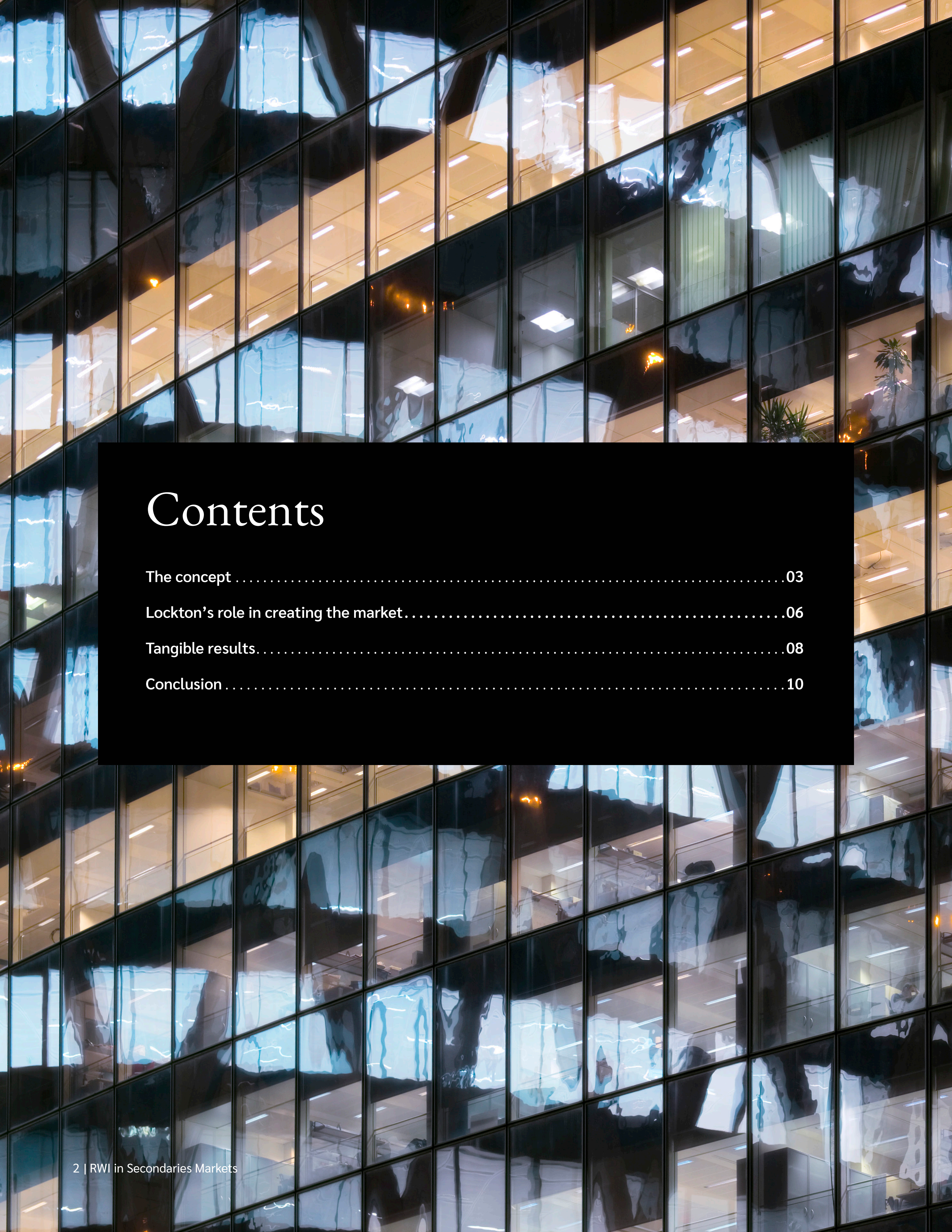
Representations & Warranties Insurance (RWI) in Secondaries Markets

February 2023



Contents

The concept

Representations and warranties insurance (RWI) has made an indelible mark on the traditional mergers and acquisitions landscape over the last two decades. While its applications vary, two fundamental principles have driven the growth of the RWI market from a handful of deals per annum circa 2008 to upward of 4,500 deals in 2021:

1. The desire of sellers to exit closed transactions with little to no escrow obligation or held-back deal consideration for post-close indemnities
2. The desire of buyers to efficiently close deals with both adequate indemnity protection and minimal political capital (or actual capital) spent negotiating indemnities with sellers

As we discovered a few years ago, these same fundamental imperatives — more cash at closing for sellers and efficient indemnity protections for buyers — have historically applied in the secondaries market, particularly the general partner (GP)-led portion of the market, with the same importance and impact on process as in buyouts.

Recognizing this, it has not taken long for the RWI market to:

- Modify traditional RWI coverage to meet the needs of the secondaries community in providing this same efficient indemnity package.
- Amend the traditional RWI placement process to the contours of the typical secondaries transaction structure and diligence process.
- Continually evolve alongside the maturing coverage and process concerns of GPs, lead investors, counsel and the investment banking community as RWI becomes increasingly ubiquitous in the secondaries space.

Since 2019, Lockton brokers have worked on upward of 70 secondaries transactions and spearheaded the development of RWI in the secondaries market. This includes not just GP-led single-asset or full fund recap transactions but also GP stakes deals, limited partner (LP) transfers, VC fund GP-led and strip sales and multiple hybrid transactions. We have earned a 50%+ market share in this space and placed coverage on 15-20% of the GP-led net asset value (NAV) that traded across 2021 and 2022.

The Lockton team continues to modify the product and process in conjunction with our RWI underwriting community to:

1. Meet the needs of the clients, counsel and bankers with whom we interact daily; and
2. Lead the market in results and innovation.

This document provides a high-level depiction of our approach to handling insurance placements around secondaries transactions of any sort and explains why Lockton is uniquely positioned to assist you in your next secondaries transaction of any shape or size.

Lockton’s role in creating the market

Traditional RWI placements have, for many years, held to a very simple procedural norm: the carrier conducts its underwriting via access to and auditing of the diligence performed by a buyer in a transaction. The seller is insulated from the placemat by and large, and the underwriting can be performed without the seller knowing or caring to know about the process or result.

When presented with an opportunity to place RWI to eliminate a selling limited partner’s indemnity/holdback obligation, it quickly became apparent that this tried-and-true approach would need to be modified for the secondaries space. Lead investors have historically had little appetite to invest the time or money required to perform full change of control diligence. However, it also became apparent that the contours of secondaries deals would allow underwriters to modify their traditional approach to manage this very different risk. What makes a secondaries RWI placement different?

- Underwriters’ alignment with GPs based upon GPs’ ongoing financial interest in the continuation vehicle
- Typically knowledge-qualified Representations and Warranties (RWI) around the operations of the portfolio company(ies)
- GPs’ willingness to aid in the process from the “sell side” given the light lead investor diligence and the aforementioned knowledge qualification of the R&W

As underwriters developed comfort and familiarity with these dynamics and a presumably lighter risk profile than they underwrite on buyouts, it became clear that the RWI market would support a placement in the secondaries space that featured less operational diligence, a faster timeline given the lighter lift, and less premium expense.

Once we achieved proof of concept on this baseline level of coverage, expense and procedure, we had the momentum to explore coverage for additional risks unique to the secondaries space, including excluded obligations (whether defined in the applicable transaction document or on a synthetic basis included in the policy), effectively connected income (ECI) tax risk, fund wind-downs and hybrid transactions (for example, a minority sale in the portfolio company preceding a secondaries sale/syndication, with all documentation mirroring the buyout-style language in the underlying minority deal).

With each successful RWI placement on more traditional secondaries deals (for GPs, lead investors and underwriters), appetite has grown to explore new coverages that can make the secondaries investment negotiation even more efficient for principals. The iterations of coverage mix have been limitless, including coverage for:

- Solely new money investors, including the lead investor plus any syndicate investors sourced between signing and closing or the entirety of a contribution vehicle (including GP contributions and rolling LPs)
- Excluded obligations
- Staggered closings across the breadth of a syndication with multiple lead investors
- Cost-effective coverage on an excess basis and for a higher percentage of NAV for solely “true fundamentals” or “true fundamentals” plus excluded obligations

The traditional insurance market is often viewed as monolithic and not necessarily synonymous with innovation. However, the speed at which we have mobilized and evolved to make the secondaries community aware of our capabilities, and to meet shifting risk transfer requests has proven to be an exception.

Tangible results

Lockton and several underwriters have made efforts to craft a workable insurance option in the secondaries market. Here are a few examples of our successes, using both standard processes and more creative approaches.

Traditional GP-led fund restructure

- A GP sought to extend the life of a portfolio of more than a half-dozen legacy assets through a continuation vehicle with an NAV greater than $1 billion.
- The GP proposed the use of R&W, as an alternative to the traditional holdback structure for indemnification of breaches of R&W and excluded obligations, to a crowded field of potential lead investors bidding for the asset.
- The Lockton team structured an insurance solution with the GP in advance of the auction process and assisted the GP in describing the breadth, expense and process associated with the RWI process to the lead investor candidates, and ultimately worked with the lead investor who won the bid.
- The policy was placed, covering the entire continuation vehicle (including the GP to the extent of its new money contribution, rolling LPs and all new investors).
- Coverage was provided up to 10% of the NAV, with additional coverage provided up to a higher level of NAV for just "true fundamentals."
- Anti-sandbagging exclusions and "no claims" certifications were bifurcated among the top several new money investors, insulating each from an exclusion based on the knowledge of another.

Hybrid GP-led process

- Lockton was approached by an investor leading the funding for 60% of the NAV of a large portfolio company.
- Prior to the secondaries process, a third-party sponsor had already signed a minority deal to acquire 40% of the portfolio company; closing of the minority deal was conditioned upon closing of the continuation vehicle.
- Full buyout-style reps were provided to minority investor in its agreement. The selling sponsor and lead investor agreed to use essentially the same negotiated agreement as the basis for the continuation vehicle transaction.
- While using the same agreement created efficiencies for the deal timeline, the lead investor did not perform the same level of diligence to support the accuracy of the R&W provided in that document, nor did the minority investor share its diligence with the lead investor. This created a gap between the traditional "knowledge-qualified operational R&W" approach in most secondaries deals and the usual support required by RWI underwriters to cover full buyout-style R&W.
- The Lockton team crafted a hybrid solution, whereby certain R&W would be covered on a non-knowledge-qualified basis, supported by more limited diligence than typically provided. The remainder of the granular operational reps at the portfolio company would be synthetically knowledge-qualified for purposes of the policy, more in line with the R&W provided in more traditional secondaries transaction agreements.

Conclusion

It is not an overstatement to say that the Lockton team built the current marketplace for RWI on secondaries and continues to innovate with advances in coverage, structuring and deal type.

Given our understanding of secondaries transactions, our intimate knowledge of the RWI market — both in the secondaries space and beyond — and our market share, premium deployment and relationships with underwriters in this space, no team has more expertise or leverage to obtain the best, fastest and most successful result in placing RWI coverage on a secondaries transaction. Our reputation with bankers, lawyers and investors hopefully speaks for itself at this stage, and we are always available to assist.

For more information on the secondaries market, please contact Secondaries Team:

Matthew Heinz
Partner and Co-Practice Leader | Transaction Liability | Lockton Companies
mheinz@lockton.com | Mobile 917.582.7990

Gaurav Sud
Partner and Co-Practice Leader | Transaction Liability | Lockton Companies
gaurav.sud@lockton.com | Mobile 917.287.7800

Emily Rosen
Vice President | Transaction Liability | Lockton Companies
erosen@lockton.com | Mobile 310.210.6071

UNCOMMONLY INDEPENDENT

C | 2195048-0223