



Complex deals during COVID - by Chris Graham

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The impact of COVID-19 has brought increased market volatility to the real estate sector as investors seek to divine the short-term impact of restricted openings and potential long-term impact of increased online shopping and working from home, as well as other changes in behavior.

This volatility is expected to drive real estate M&A activity higher, with speed of execution and the ability to close a deal quickly becoming major points of focus for sellers when reviewing competing bids.

Navigating the risks in complex property deals, however, can pose a significant barrier to speed. The myriad risks can include lease agreement flaws, construction defects, environmental exposures, tax claims, title deficiencies, local zoning and permitting missteps, and more. Such concerns have often caused a deal to fall apart when neither party could agree on how the risk would be shared.

Only recently, M&A participants in the real estate industry have started turning to a tool well known in other industries to address these fears and successfully conclude transactions: Representations and Warranties insurance (RWI). This form of insurance provides coverage for a buyer if there is a breach of or inaccuracy in the representations and warranties a seller makes in the acquisition agreement. Using RWI to backstop the risks can help otherwise hesitant buyers get more comfortable in closing a deal, while also allowing the seller to minimize its indemnification obligations (or get rid of them altogether).

M&A law firm partners have for years recognized RWI to be a valuable tool for allocating risk and maximizing value for both the buyer and the seller in the corporate M&A market. By contrast, acquirers of real estate assets only started using the product a few years ago, usually in the context of acquisitions of REITs. Now, acquirers of complex portfolios of non-REIT property assets are also turning to the product to help mitigate risk and make their bids more attractive to sellers by lowering or removing seller indemnification requirements, while still giving themselves recourse if any reps are breached.

In REIT transactions, RWI gained traction as a way to mitigate the buyers' primary fear of losing the favorable tax status of the REIT—a potentially catastrophic loss. The fact that many frequent acquirers have made RWI a standard part of their process for bid submissions, shows that they and their counsel see the value and are confident that sophisticated insurer partners are able to understand and underwrite the risk without affecting the deal timeline.

In non-REIT property transactions, acquisitions are usually structured as asset deals with sellers unwilling to offer representations and warranties as broad as those usually seen in non-property acquisitions. Furthermore, indemnification escrows backing up those limited representations are generally smaller and shorter in duration, if any indemnification/recourse exists at all. These limitations mean that buyers of real property assets have been left to take on risks that non-property M&A buyers have always been able to mitigate by obtaining fulsome reps backed by a seller escrow, an RWI policy or a combination of the two. There are the obvious exposures that exist in real estate transactions of almost any size, including liens and zoning issues, title matters, tax matters, and condition of property concerns. Once you get into larger, more complex transactions, however, the potential for exposure is compounded by, among other things, the existence of multiple assets with numerous tenants, varying lease terms, complex rent rolls and varying environmental exposures and compliance regimes.

As recently as two years ago, buyers were often wary of taking on those risks without a fulsome set of reps or an adequate indemnification escrow from the seller. Now, buyers are increasingly seeing the value in backstopping their risk with an RWI policy. Concurrently, sellers are seeing the value in being willing to negotiate more expansive representations and warranties, without having to take on additional risk, because more buyers will be willing to come to the table with bigger offers.

Given the short but promising history of RWI in the real estate sector, M&A law firm partners and other players in the market should recognize that the experience of insurers with RWI can vary greatly. It is important when selecting the right partner to inquire about their experience in underwriting property deals and their record of paying claims. More experienced insurers often have staff with deep legal expertise in M&A work, generally, and working on real estate deals, specifically, and can therefore work with greater confidence, creativity and speed, especially when non-standard terms or low attachment points come into play. These nuances can prove decisive when evaluating competing offers.

As awareness of this tool increases and the market starts to recover from the impact of COVID-19, usage of RWI should continue to grow until it becomes as common in complex property acquisitions as it is in the broader M&A space.

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