Representations & Warranties Insurance: The New Frontier in Private Deal Making

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In negotiating private acquisitions, corporate counsel are aware of the importance of the seller's representations and warranties (*"**representations**"*) and the complex interplay between those representations and the negotiated closing conditions and indemnification obligations contained in the acquisition agreement. Inaccurate representations may provide the buyer with adequate basis to terminate an acquisition agreement prior to closing or to seek indemnification from the seller after closing.

Accordingly, the buyer's acquisition lawyer routinely expends a prodigious amount of energy in negotiating robust seller representations and counsels buyer to insist that a portion of the purchase price be held in escrow for a limited period after closing. Simultaneously, the seller's counsel vigorously seeks to limit the scope of the representations, takes measures to better ensure their accuracy, and endeavors to minimize any potential indemnification exposure by utilizing baskets and caps. Experienced acquisition counsel have become comfortable with these concepts and the acquisition agreement provisions that facilitate them.

The recent acceptance of representations & warranties insurance policies (*"**R&W policies**"*) as the new standard in middle market and larger acquisitions has dramatically disrupted these traditional elements of M&A practice, including with regard to the negotiation of representations, indemnities, and escrows. R&W policies are now considered a customary feature of an M&A transaction and it is critical for corporate counsel that operate in the M&A space to become familiar with the coverage provided by R&W policies, the standard terms of R&W policies, the process by which such R&W policies are obtained, and the impact of R&W policies on acquisition negotiations.

Coverage Provided by R&W Policies

Fundamentally, R&W policies provide coverage for losses incurred by the insured that arise from inaccurate representations made in the acquisition agreement. If a seller makes an inaccurate representation that results in a loss to buyer, then the insured can make a claim against the R&W policy for such loss. Importantly, negative purchase price adjustments and other indemnifiable losses under an acquisition agreement are not covered under R&W policies, including losses related to liabilities that are retained by seller, losses based on specific indemnities, losses that are based on breached covenants, and other losses that arise from liabilities that are known at the time that the R&W policy is issued. In addition, the insurance underwriter will attempt to exclude from the R&W policy coverage any potential liabilities that are discovered and that cause concern during the diligence and underwriting process.

R&W policies are popular and becoming standard for middle market and larger transactions because they address a number of concerns of buyers and sellers. They provide each party with greater peace of mind—the seller finds comfort in believing that its post-closing indemnification obligations will be less severe and the buyer feels relief knowing that there will be adequate funds available in the event that it sustains a loss. Sellers are also pleased to have less of their purchase price proceeds tied up in escrow after closing. In situations involving multiple selling shareholders, R&W insurance can virtually eliminate the need for a buyer to pursue multiple shareholders to satisfy indemnity claims (thereby reducing the sting of "joint and several" liability for those shareholders). R&W policies also provide buyers with a formidable tool to make their acquisition offers more attractive to sellers, particularly in a competitive setting.

Standard Terms of R&W Policies

Buy-side or Sell-side

R&W Policies are procured prior to closing and can be written with either the buyer or the seller as the insured under the policy. Buy-side policies (policies written with the buyer as the insured) are more common. With a buy-side policy, the buyer would file the claim directly with the carrier and control the claims process (limiting the seller's involvement in the process). Conversely, with a sell-side policy, the buyer would make an indemnity claim against the seller directly and the seller would then satisfy that claim and file a claim with the insurer for any insurable loss.

Policy Premiums and Fees

As the market for R&W policies has matured, policy pricing has become more attractive. Currently, policy premiums are generally priced at 2.5%-3.5% of the *policy limit*. In addition to the policy premium, the primary carrier would charge additional, non-refundable underwriting fees in the range of $25,000-$40,000 to offset its underwriting expenses.

For example, let's assume that buyer is purchasing a business for $80 *million* and desires to obtain an R&W policy with an $8 *million* policy limit (equal to 10% of the purchase price, essentially serving as a "cap"). The purchase price for the policy would include a premium ranging from $200,000-$280,000 (2.5%-3.5%), plus underwriting fees of $25,000-$40,000. This would amount to total policy costs of $225,000-$320,000, plus taxes and surplus lines fees varying by state.

Based on these pricing economics, it would be unusual for a policy to be issued for less than $3 *million*. Accordingly, while

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R&W policies are becoming standard for mid-to-large size transactions, they are less typical for deals with an enterprise value of less than $20 *million*.

Who pays?

As between the buyer and seller, which is the more appropriate party to pay the policy premiums and fees? This is a subject of negotiation between the buyer and seller. It is often appropriate for the seller to bear at least half of the cost of insurance, since the procurement of the policy more acutely benefits the seller (providing the seller with the ability to "walk away" from its typical indemnity responsibilities). In these instances, the buyer would pay the premium and fees to the insurer directly and reduce from the purchase price paid at closing an amount equal to seller's share of those amounts (as a component of sellers "transaction expenses" under the agreement). Nonetheless, in a competitive situation the buyer may consider covering the full amount of costs and fees. In other circumstances, a crafty buyer might provide that it will cover the full costs of the R&W policy in the non-binding letter of intent (and factor that amount into the purchase price that it offers).

Retentions

Like most insurance policies, R&W policies are issued with a retention (deductible). The general range for policy retentions is between 1.0%-1.5% of the *enterprise value* of the transaction, but that range varies based on the target company's industry. It is common for the buyer and seller to split the retention, with the first half coming from the buyer's basket in the acquisition agreement and the other half coming as an indemnity obligation of seller (which is often held in escrow at closing). Policy retentions are important in that they help ensure that buyers and sellers remain engaged in the diligence process and the negotiation of the representations, notwithstanding the purchase of an R&W policy.

In the $80 *million* transaction example above, a one percent retention would be $800,000. In the event that buyer sustains a $1 *million* indemnifiable loss, the first $400,000 would not be paid to buyer as indemnification (and would be allocated against buyer's basket), the next $400,000 would be indemnifiable, but would be claimed against seller (rather than the insurer under the R&W policy), and the remaining $200,000 (along with any future losses incurred by buyer during the policy term) would be claimed on the policy. Accordingly, even where R&W insurance is contemplated, the careful consideration of representations, indemnification provisions and escrows remain a critical component of the acquisition negotiations.

Policy Term

The term of the R&W policy will be consistent with the survival period of the majority of representations under the acquisition agreement, with such survival period (for non-fundamental representations) typically ranging from one to two years.

Process for Obtaining an R&W Policy

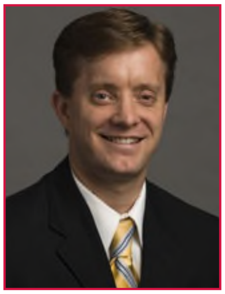
As the market for R&W insurance has matured, the process for obtaining insurance has become more streamlined and efficient. While policies can be procured in as little as two weeks (with the assistance of a skilled broker), it is preferable to begin the process well in advance of closing. In addition to reviewing diligence independently, the underwriter will require that a thorough legal and financial diligence process be conducted and typically requires written third party quality of earnings and legal diligence reports on the target. The diligence process concludes with an underwriting call scheduled with insured's business and legal teams and its third party advisors to review the concerns uncovered in diligence.

Practice Impact and Recommendations

There are a number of actions that corporate counsel can take to better guarantee a smooth and efficient process for procuring R&W insurance:

- Engage an insurance broker that is a predominant player in the R&W policy space—an experienced broker is critical to ensuring a fast and smooth process and obtaining market policy terms.
- Commence the process early in the acquisition process—while the insurance market has become more streamlined, the underwriting process still takes time and typically requires the submission of third party quality of earnings and written legal diligence reports.
- Incorporate the R&W insurance concept into the terms of the acquisition agreement (with thoughtful consideration to the impact of the policy on the purchase price formula, indemnification provisions, basket, cap, and escrow).
- Negotiate market policy terms—ensure that in-house or third party counsel experienced in the negotiation or R&W policy terms reviews the R&W policy to ensure adequate coverage (and minimal exclusions) consistent with market practice and the terms of the acquisition agreement.

While R&W insurance is not appropriate for every acquisition transaction, it is a valuable solution for buyers that desire to structure an attractive bid and for sellers that desire to exit their ownership position with more certainty and peace of mind.



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