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REPRESENTATIONS & WARRANTIES INSURANCE AND WHY BUSINESS ACQUISITION PARTIES SHOULD CONSIDER IT

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At the core of every sale and acquisition of a business is the delicate dance of allocating exposure to potential risk between the buyer and seller. But, what if buyer and seller could agree to place some or a substantial portion of such risk with a willing third-party to facilitate a transaction? That is exactly what the quickly accelerating acceptance of representations and warranties insurance policies ("R&W policies") is accomplishing for the U.S. middle and larger acquisitions market.

In negotiating private acquisitions, 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, play a critical part in risk allocation between the parties. 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.

The buyer's legal counsel routinely expends tremendous energy and effort in crafting and negotiating robust seller representations and advises the buyer to insist that the seller escrow a meaningful portion of the purchase price for a specified period after closing. Simultaneously, the seller's legal counsel vigorously strives to limit the representations' scope, seeks to better ensure their accuracy, and endeavors to minimize any potential indemnification exposure by utilizing baskets and caps. Experienced mergers and acquisitions ("M&A") lawyers are comfortable with these concepts and the acquisition agreement provisions that facilitate them.

R&W policies, however, have dramatically disrupted these traditional elements of M&A practice, including with regard to the negotiation of representations, indemnities, covenants, conditions, and escrows. R&W policies are very quickly becoming a customary feature of M&A transactions, even with target transaction values as low as $10 million, and M&A counsel and their clients need to familiarize themselves with and better understand the coverage afforded by R&W policies, their standard terms, the process by which such policies are obtained, and the impact such policies have on both acquisition bids and negotiations.

Coverage Provided by R&W Policies

Fundamentally, R&W policies provide coverage for losses incurred by the insured that arise from unintentionally inaccurate representations made in the acquisition agreement. If a seller makes an inaccurate representation that results in a loss to the 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 negotiated 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). Because of the reduced risk, sellers may even be willing to provide more "fulsome" representations and warranties, given the reduced risk in receiving most of the enterprise value at closing. Furthermore, both buyers and sellers are spared the awkward dynamics of a buyer desiring to seek indemnity for a loss in a situation where the seller continues to work with or for buyer, whether as an officer, director or in some other capacity. 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 vastly 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 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. Nonetheless, insureds can negotiate for coverage beyond the survival periods set forth in the acquisition agreement, if desired.

When considering the appropriate survival period, the parties should consider statistics with respect to when claims are typically made under R&W policies. AIG published the Global M&A Claims Study 2017, which contained important statistics and data with regard to claims. The AIG study reported that 27 percent of claims were made within six months of the closing of the transaction, 51 percent of claims were made within 12 months of the closing of the transaction, and 76 percent of claims were made within 18 months of the closing of the transaction. This suggests that the typical survival period for non-fundamental representations in negotiated private acquisitions (one to two years) is in line with actual claim experience.

Policy Premiums and Fees

As the market for R&W policies has matured, policy pricing has become more attractive. Currently, policy premiums are more commonly priced at approximately 2.5 percent to 3.5 percent of the *policy limit*. In addition to the policy premium, the primary carrier would charge additional, non-refundable underwriting and diligence fees usually 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 percent of the purchase price, essentially serving as a "cap"). The purchase price for the policy would include a premium likely ranging from $200,000-$280,000 (2.5 percent to 3.5 percent), plus underwriting fees of approximately $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 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, though even that is beginning to be challenged with several transactions with enterprise values of approximately $10 million finding their way into the R&W policy market. Conversely, in larger transactions, those seeking greater protection can sometimes work with multiple insurance providers to stack policies into an "insurance tower" of greater coverage.

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. More often than not, though, buyers and sellers agree to each bear one-half of the cost of insurance. The buyer typically pays the premium and fees to the insurer directly and reduces 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 percent to 1.5 percent 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 and required by the insurer 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. It is also somewhat common for an insured to negotiate a decrease in the retention over time as it remains unused, by implementing one or more step-downs in the retention amount. Still, insurers may insist that the retention be exclusive of any indemnification basket or deductible in the acquisition agreement so that the insured continues to real money at risk before it can recover against the 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 usually be disbursed from the escrow, and the remaining $200,000 (along with any future losses incurred by buyer during the policy term) would be claimed on the policy. It should be noted, however, that breaches related to certain well-recognized "fundamental" representations and warranties (for example, related to Organization, Good Standing, Authority, etc.), that lead to indemnifiable losses will not be subject to the policy limits and may generally still be pursued against the seller, as well as certain other claims for specifically negotiated indemnities that may fall outside the policy limits. 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.

"No Seller Indemnification" Transactions

As described above, R&W insurance providers generally require that the buyer and seller each have "skin in the game" in connection with an indemnifiable event. In the event of any indemnity claim, losses in an amount equal to half of the policy retention is generally borne by buyer (as a "true deductible" basket), while the other half of the policy retention is borne by seller (typically through amounts that are held in escrow during the coverage survival period).

The above liability waterfall helps regulate the terms of the transactions and provides greater certainty that the seller (whose escrow money is at risk) is engaged in ensuring the truth and accuracy of the representations and warranties. With skin in the game, the seller is properly motivated to vigilantly negotiate representations on an arms-length basis (and not "take a dive") by providing representations that are more robust than necessary under market practice. It also helps ensure that customary indemnification limitations are bargained for by the parties. The above construct further promotes engagement by seller on preparation of the disclosure schedules. The seller will be incentivized to ensure that thorough diligence is conducted and that the schedules are accurately prepared.

Nonetheless, there has been an increase in the number of private transactions that are utilizing R&W insurance as the buyer's sole remedy. Similar to public company deals, in this scenario the representations and warranties of seller would not survive closing (for the purpose of an indemnity obligation on the part of seller) and the buyer's recourse for inaccurate representations would be limited solely to the R&W policy, with the buyer bearing the full amount of the policy retention in the event of any claim. It is important to note that in this type of transaction, the seller would not typically provide indemnification for matters that are not traditionally covered under the R&W policy, such as inaccurate fundamental representations and representations that are otherwise excluded from the policy.

These "no seller indemnification" transactions are not as common as the traditional R&W policy construct described above (and are usually only considered for larger deals), but they are beginning to be offered by insurers and utilized by buyers in the most competitive of situations. Given the disadvantages to buyer, including the risk of less than diligent seller engagement in the negotiation of representations and indemnity limitations and in the overall diligence process and the lack of recourse for breaches that are not covered by the policy, buyers and insurers should carefully consider whether or not a "no seller indemnification" package is appropriate for their transaction.

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, and often even before signing with an effort to have the policy bound at signing but only effective upon 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 — 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 more streamlined indemnification process and for sellers that desire to exit their ownership position with more certainty and peace of mind.

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