REPRESENTATION AND WARRANTY INSURANCE FOR M&A TRANSACTIONS

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Description of Representation and Warranty Insurance (R&W Insurance)

• Policies can be put in place for either a Buyer or Seller

• Buy Side policies provide coverage for indemnification claims for losses resulting from breaches of Seller’s representations and warranties in an acquisition agreement

• Sell Side policies are solely to backstop seller indemnities and reimburse the Seller for indemnification claims to the Buyer

• Current market: 99% Buy Side policies; 1% Sell Side policies
Recent Significant Growth

• One Major R&W Broker Reports:
  o 96% growth in the number of deals from 2014-2017
  o 34% increase in the number of deals from 2016-2017
  o $27.2 billion in limits placed in 2017

• One Major R&W Broker estimates over 34% of private deals with enterprise values between $25 million and $10 billion used R&W insurance, up from 20% in 2016
Advantages to Seller

- Reduces potential liability of Seller by lowering indemnity cap and reduces or eliminates escrow
- Permits immediate realization of greater portion of sale proceeds, and can allow for a clean exit for Sellers
- When multiple Sellers, eliminates disputes over joint and several liability
- Increases likelihood of signed agreement
Advantages to Buyer

- Can increase scope of Indemnity
- Increases duration of Survival Period
- Provides Greater Coverage of Losses
- Protects any Continuing Business Relationship between Buyer and Seller
- Makes Buyer’s bid more attractive in a Competitive Auction
- Increases likelihood of signed agreement
Types of R&W Insurance Policies

- **Sell-Side Policies**
  - Seller purchases policy and is the Insured (Buyer does not interact with Insurer)
  - Backstops the Seller’s Indemnity under Acquisition Agreement
  - Seller Fraud Not Covered
  - Represents only ~1% of R&W Insurance Policies
Buy-Side Policies

• Buyer Purchases Policy and is the Insured
• Policy Limits and Survival Periods can vary from Acquisition Agreement Terms
• Insurer does not Interact with Seller
Certain Key Policy Provisions

• Coverage Limit
  • Sell-Side – Equals Indemnification Cap in Acquisition Agreement
  • Buy-Side – Coverage Limit can be Greater than Indemnification Cap (generally 10% to 20%, but could be higher)
Retentions

- Amount of Covered Losses that are absorbed before R&W Insurance Pays
- Generally ~1% of Purchase Price
- Usually Reduction in Retention After 12 months of Seller escrow is released under the purchase agreement (e.g., retention drops by half at 12 month anniversary of closing date)
Policy Period

- Time Period Policy in Effect
- Begins when Policy is bound (usually at Signing)
- Usually 3 years for General Reps and 6 years for Fundamental Reps and Taxes
Premium/Pricing

- Insurance Premium Typically is 2% to 3% of Coverage Limit
- Insurers often charge a minimum premium (amounts between $100,000 and $300,000 are common)
- Makes R&W Insurance costly for Transactions with Enterprise Value under $20 million
- Premium Subject to Tax (generally 3% to 5% depending on state)
- Diligence Fee – Pass-through cost of outside law firm engaged by Insurer – generally $25,000 to $45,000
- Broker Commission (typically 10% to 20% of premium)
Standard Exclusions

- Breaches of Covenants
- Breaches Known to Insured or its Deal Team
- Purchase Price Adjustments
- Forward Looking Statements, Estimates and Projections
- Fraud by the insured
- Punitive Damages or Multiples of Damages (however, if the agreement is silent with respect to these types of damages, policies are also typically silent)
Standard Exclusions (continued)

- Transfer Pricing
- Hazardous Environmental Conditions
- Product Liability
- Deferred Tax Assets including NOLs
- Pension Plan underfunding and/or withdrawal liability
Obtaining R&W Insurance

- Insurance Company Selection
  - Engage Insurance Broker
  - Obtain Non Binding Indication of Interest Letters (NBILs) Containing Price and Coverage Quotes from Various Insurers
- Information to Get Quotes:
  - Draft Acquisition Agreement
  - Audited Financial Statements (some carriers will accept reviewed financials)
  - Deal Book
  - Anticipated Purchase Price
- Select Insurer
Underwriting Process

- Insurer and its Counsel – high level review of Buyer due diligence process
- Relies on Buyer’s due diligence memos and findings
- Underwriting Call with Buyer’s key deal team members and legal and other third party advisors upon Insurer receipt of third party reports and the latest drafts of the agreement and disclosure schedules
- Insurer will exclude areas without adequate diligence
• Negotiating the R&W Insurance Policy
  • Matching policy terms to Acquisition Agreement
  • Subrogation
  • Exclusions

• Process can Take as Little as one week after Selection of Insurer; timing is largely driven by availability of third party reports and disclosure schedules
Interplay of R&W Insurance with Acquisition Process

• Key R&W Insurance Considerations
  • Most suitable for Deal Size -- $20 million to $2 billion
  • Policy Limits
  • Retention and who pays
  • Certain industry sectors a challenge (hospital systems, for profit education, technology companies with extremely high multiples)
  • Audited Financial Statements
  • Quality of Earnings Report

• Effect on Due Diligence Process
Incorporating R&W Insurance into the Acquisition Agreement

- Supplementing Seller Indemnity
- Replacing Seller Indemnity
- Effect on Negotiation of Representations and Warranties
• Indemnification Provisions
  • Buy-Side Policy
  • Sell-Side Policy

• Typical Indemnification Waterfall
  • Basket and Deductible
  • Escrow (insurer prefers seller having some risk)
  • R&W Insurance
  • Seller (Fundamental Reps and Taxes)
Important Seller Provisions

• Require Buyer Effort to collect R&W insurance
• Buyer must assign right to pursue R&W insurance coverage if requested by Seller
• Prohibit Buyer from terminating or amending policy adversely to Seller
Questions
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