Representations and Warranties Insurance: Go On, Take the Money and Run

By Adam Adkin and Jeff Woodcox, Attorneys at Tonkon Torp LLP

Adam is an associate in Tonkon Torp's Business Department. He works closely with business owners and their key employees in the purchase and sale of businesses. Adam has assisted clients at every stage of their business life cycle, including corporate formation, corporate governance compliance, raising capital through private placements of debt and equity securities, and structuring ownership transitions.

Jeff is a partner in Tonkon Torp's Business Department. He focuses his practice on mergers and acquisitions, corporate finance, securities regulation, and corporate governance. He is experienced in advising clients on the acquisition and disposition of businesses and assets, securities compliance, and raising capital through private placements of equity and debt.

No seller in a mergers and acquisitions (M&A) transaction wants to wait for the release of its money from escrow while the buyer takes the business for a spin. And no buyer wants to discover post-closing issues. These competing objectives regarding post-closing risk allocation often create tension in the M&A process. Even with the risk-allocating tools available to lawyers to balance these competing objectives—including materiality and knowledge qualifiers, escrow holdbacks, survival periods, baskets, and caps, to name a few—sellers and buyers can still find themselves unable to reach agreement. For the right deal, representations and warranties insurance (R&W insurance) can bridge the gap.

What is R&W Insurance?

R&W insurance insures a buyer (or, more rarely, a seller) against losses resulting from a seller's breach of its representations or warranties in the purchase agreement. Instead of making claims against the seller and pursuing losses against an escrow holdback or the seller directly, the buyer seeks compensation by filing a claim with the insurer.

R&W insurance is becoming increasingly common as a tool used by both strategic and private equity buyers to distinguish their bids in an M&A auction. Additionally, sellers are weaving R&W insurance policies into the fabric of a deal early on to set expectations for how indemnification claims will be handled. Although insurance brokers can assist parties who are interested in obtaining an R&W insurance policy, the best starting place for parties who are considering R&W insurance is likely their current insurers.

Benefits of R&W Insurance

R&W insurance provides a number of benefits in M&A transactions.

R&W insurance can save time and alleviate frustration.

Although an insurer will expect the seller and the buyer to thoroughly negotiate the representations and warranties in the purchase agreement, the R&W insurance can go a long way in resolving many of the more challenging concerns each party may have regarding the scope of the representations and warranties.

A seller may also be more amenable to providing certain representations and warranties if the R&W insurance policy will provide the sole or even primary source of recovery for breaches of those representations and warranties.

R&W insurance can put more of the purchase price in the seller's pocket at closing.

Because R&W insurance provides the buyer with an alternative source for recovering losses it suffers from the seller's breach of its representations and warranties, the seller can negotiate for shorter survival periods and smaller holdbacks and caps. As a result, the seller gets more funds at closing and has greater certainty it will get to keep those funds after closing.

R&W insurance can minimize the concerns of how liability is allocated among multiple sellers.

Buyers often require sellers to be jointly and severally liable for losses that arise from breaches of the sellers' representations and warranties. This requirement can be contentious for sellers who do not want to bear the responsibility for their fellow sellers' share of liabilities. R&W insurance can reduce that tension by diverting claims to the R&W insurance policy. Additionally, because passive investors typically have little or no knowledge about the accuracy of the representations and warranties in the purchase agreement, they may resist sharing in any losses arising from breaches of those representations and warranties. Passive investors are, however, more likely to accept sharing the cost of R&W Insurance as a cost of the transaction.

R&W insurance offers greater certainty to the buyer of collecting losses.

Buyers often don't have great appetite for tracking down a seller to make claims for breaches of representations and warranties, which is why buyers press hard for a robust holdback escrow. An R&W insurance policy may provide greater coverage for claims than a seller would be willing to commit to an escrow holdback, and may provide coverage for longer than a seller would be willing to escrow a portion of the purchase price.

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R&W insurance can also prove useful in transactions with a distressed seller, such as a seller that is in bankruptcy or otherwise unable or unwilling to agree to indemnify the buyer.

In those cases, an R&W insurance policy can provide the buyer with a source of recovery that otherwise would be unavailable.

R&W insurance can help preserve post-closing relationships.

If the buyer and the seller will have an ongoing relationship following the sale, such as when a selling party rolls over part of its ownership into the buyer or the buyer retains one or more sellers as employees following the sale, the independent source of recovery offered by R&W insurance can reduce the likelihood that post-closing claims will sour the continuing relationship.

Drawbacks and Limitations of R&W Insurance

While offering many benefits, R&W insurance is not right for all transactions and won't solve all post-closing risk allocation issues.

Like all insurance, R&W insurance exchanges uncertainty for a fixed cost.

Generally, the premium for an R&W insurance policy ranges from 2% to 4% of the policy's limit. Although the seller rarely bears the cost of obtaining the R&W insurance directly,[1] the premium for R&W insurance is ultimately a transaction cost. Accordingly, a seller who perceives little risk of post-closing claims is unlikely to see the value in reducing the purchase price that the buyer otherwise would be willing to pay by the cost of the R&W insurance premium. The cost of obtaining an R&W insurance policy may make it a poor fit for transactions with a value of less than $20 million, and many insurers are not willing to provide R&W insurance for transactions with a value of less than $50 million.

R&W insurance policies generally provide for a retention of between 1% and 3% of the value of the transaction.

Similar to a deductible, the retention is the amount of losses that the insured must incur before the insurer will pay claims under the policy. Depending on the size of the retention and who pays for the R&W insurance policy, the buyer and the seller may struggle to agree on whether the seller should share responsibility for any portion of the retention.

Acquiring R&W insurance brings a third-party into the deal that has the potential to disrupt deal flow.

The insurer will make its own assessment of the risks and impose requirements on the parties and the purchase agreement that, depending on the posture of the negotiations, could derail the negotiations or delay closing.

R&W insurance won't cover all claims.

Generally, R&W insurance does not provide coverage for breaches of representations or warranties that are known when the transaction closes. Additionally, R&W insurance generally does not provide coverage for breaches of covenants or other indemnification obligations that may be negotiated in the purchase agreement. Accordingly, the buyer may require a holdback escrow or reserve the right to pursue claims against the seller regardless of an R&W insurance policy.

Conclusion

For the right deal, R&W insurance can facilitate negotiations and resolve roadblocks that otherwise might have prevented the parties from reaching an agreement. Nonetheless, it is not a silver bullet for all negotiation hang-ups. The sooner the concept of R&W insurance is introduced in a deal, the more likely it will serve the parties in reaching a successful agreement. ◆

Footnote

1. M&A Market Trends Subcommittee, Mergers & Acquisitions Committee of the American Bar Association's Business Law Section, *Private Target M&A Deal Points Study* 106 (December 22, 2017).