Reps and Warranties Coverage: A Growing Force in M&A Transactions

Hartford Chapter

May 24, 2017
Reps/Warranties Insurance – Our Agenda

• The History & Evolution of the Product
• The Risk Covered
• Distinguishing Factors
• The Marketplace
• The Claims Process
Speakers

Panelists
Brian H. Mukherjee, Esq.
Counsel, Goodwin Procter LLP

Michael Walder, Esq.
Director, Nationwide Insurance

Moderator
Craig A. Allen, FCAS,
Senior Consultant, Commonwealth Research Group, Inc.
M&A Transactions – the "Deal" Documents

• The Structure of the Document
• Representations
  » Purpose
  » Scope
  » Qualifiers: Materiality/Knowledge
• Indemnity Agreements
  » Survival Periods
  » Thresholds, Caps and Escrows
• **Contrast with General Indemnification Provisions**
  
  – Separate and Distinct
  
  – Assuming the indemnification of directors and officers
    
    • By-laws
    
    • Articles of Incorporation
    
    • Stand alone indemnity agreements
  
  – Distinguished from D&O Insurance/Tail Coverage
Rep with a Knowledge Qualifier:
Survival Periods & Caps
Common Representations

- Title to Shares
- Capitalization and Authority
- Financial Statements
- Compliance with Laws
- Labor and Employment
- Employee Benefit Plans
- Intellectual Property
- Taxes
- Customers and Suppliers
- Litigation
- Real and Personal Property
- Environmental Matters
- Contracts
- Insurance
Roadblocks and Risks in the Deal

• Eliminate and Reduce Potential Risks
  – Disclosure
  – Legal/Judicial Interpretation
  – On-Off Contingencies

• Allocate Financial Risk
Strategically Using Reps/Warranties Insurance

• Buyer versus Seller
• Escrow issues
• Survival Periods
What Motivates the Procurement of Reps/Warranties Insurance?

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<tr>
<th>Why Buyers Request Coverage:</th>
<th>Why Sellers Request Coverage:</th>
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<tr>
<td>• Enhance amount or duration of indemnity</td>
<td>• Distribute Sale Proceeds</td>
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<td>• Distinguish Bid in an Auction</td>
<td>• Increase Purchase Price</td>
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<td>• Ameliorate Collection Concerns</td>
<td>• Supplement Disclosure</td>
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<td>• Protect Key Relationships</td>
<td>• Protect Passive Sellers</td>
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<td>• Protect the Deal</td>
<td>• Expedite Sale</td>
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<td>• Assure Purchase Price</td>
<td>• Reduce Contingent Liabilities</td>
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R&W Scenario: Reducing an Escrow

- **Scenario:** The target company in a pending transaction, Company X, is a manufacturing company owned by a family with several third and fourth generation family members holding all of the equity and significant management control of the Company.

- **Challenge:** Buyer of Company X requires an indemnity for breaches of all representations and warranties and an escrow to backstop the indemnity from the sellers. However, due to divergent interests among the family members and the desire to realize the sale proceeds soon after the sale, the sellers are not willing to place a significant amount of the sale proceeds in escrow.
R&W Scenario One: Reducing an Escrow

- **Solution:** The transaction is structured with a minimal escrow that survives for one year. An R&W Policy is issued to the buyer, which provides a limit in excess of the escrow that covers breaches of any representations for a period of six years. For the buyer, this insurance solution provides (i) an indemnity which meets their requirements in terms of indemnity amount and survival, and (ii) a single source of recovery instead of pursuing multiple sellers. For the sellers, this solution allows them to have a minimal escrow as their sole post-transaction obligation which can be distributed soon after the sale.
R&W Scenario Two: Securing an Indemnity

- **Scenario:** Due to recent liquidity concerns and in an effort to strengthen its balance sheet, a financial institution is selling off one of its non-core businesses.

- **Challenge:** The potential purchaser is demanding an escrow for any breaches of Representations and Warranties due to the fact it does not believe there is a high likelihood that the seller will remain solvent and therefore be able to perform its indemnity obligations under the Purchase and Sale Agreement. However, the seller is unwilling to provide an escrow.
R&W Scenario Two: Securing an Indemnity

• **Solution:** The seller provides an indemnity for any breaches of its Representations and Warranties and also purchases an R&W Policy for the benefit of the buyer which will indemnify the buyer in the event (i) there is a breach of a R&W, and (ii) the seller is financially insolvent.
R&W Scenario Three: Facilitating an Investment

- **Scenario:** The target company in a pending joint venture arrangement, Company X, produces a wide range of custom electronic devices for clients in the medical field. The shareholders of Company X have received a letter of intent from a long-time business partner to enter into a joint venture agreement whereby they would purchase a 20% interest in Company X.

- **Challenge:** The 20% investor requires a standard indemnification for potential breaches of representations and warranties. However, due to the nature of the transaction, whereby the investor and existing owner will jointly own and manage the company going forward, they would like to avoid any potential disruption of their relationship and operations in the event of a dispute regarding possible breaches of representations and warranties.
R&W Scenario Three: Facilitating an Investment

• **Solution:** An R&W Policy is issued covering the investor for damages it incurs as a result of breaches of any of the original owner’s representations. This insurance solution provides the desired protection to the investor and alleviates the likelihood of a strain on the relationship with their joint venture partner had the investors required a traditional indemnity.
Buying Reps/Warranties Insurance

• Phase I
  – Application
  – Confidentiality

• Phase II
  – Due Diligence
  – Underwriting Fee

• Phase III
  – Negotiating the Policy
  – Premium Considerations
The Claims Process

• What Constitutes a Claim?
• What is Covered?
• Coverage Issues?
Claims Scenarios

• Patent Infringement
  – Seller-side policy responds to claim brought by buyer for breach of the IP R&W s resulting from a third party claim of patent infringement

• Accounts Receivable
  – Seller-side policy responds to a claim brought by buyer for breach of the financial statements R&W s in connection with the target’s issuance of over $1 million of gift certificates which had not been recorded in the financial statements

• Material Adverse Change
  – Buyer-side policy responds to a claim brought by the buyer against the seller and the R&W insurance policy for alleged breaches of the R&W regarding operation of the business in the ordinary course and no MAE between the date of the interim financial statements and the closing, among others
Concluding Thoughts

• Established in the Marketplace
• Avoids Coverage Gap
• Buyers and Sellers Benefit
• Defensive and Offensive Use
• Increasingly Popular