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Closing the Deal: Using Transactional Risk Insurance

Transactional Risk Insurance

What Are We Talking About?

- Representations & Warranties Insurance
- Contingent Liability Insurance
  - Covers identified “one-off” potential exposures (e.g. successor liability; regulatory risk)
- Tax Liability Insurance
  - Known tax risk or uncertain tax position

Representations & Warranties Insurance (“RWI”)

Introduction

- RWI provides coverage for financial losses resulting from breaches/inaccuracies of a seller's or target company's representations and warranties in an acquisition agreement
- Generally will cover all representations in a purchase agreement and a pre-closing tax indemnity
- **But** a few important exclusions

Benefits for Sellers

Clean Exit	RWI allows sellers to minimize or eliminate post-closing indemnification obligations, facilitating a smoother exit.
Appeals to Buyers	Sellers with RWI attract more buyers by reducing risk and offering greater post-closing security.
Protects Minority Shareholders	Passive shareholders benefit from reduced exposure to potential indemnification claims.
Escrow-Free Proceeds	Sellers can collect full proceeds up front without tying up funds in escrow.
Avoid Contingent Liabilities	RWI reduces the risk of post-closing contingent liabilities and legal proceedings.
Streamlined Negotiations	It minimizes contentious negotiation over representations and indemnification provisions, leading to smoother deal-making.

Benefits for Buyers

Enhance Bid	RWI strengthens a buyer's bid in auction settings by reducing the need for seller indemnity.
Streamline Negotiations	Focus on main deal terms, reducing time spent haggling over indemnity provisions.
Increased Indemnity	Buyers can secure higher indemnity amounts and longer survival periods than sellers typically offer.
Reduced Litigation Risks	Minimizes the risk of post-closing litigation or credit issues.
Future Resale/Financing	Eases future resale or financing by reassuring potential investors and lenders.
Broader Representations	Buyers often gain broader representations under the policy than sellers would agree to.
Extended Survival	Provides extended survival periods, typically 3 years for general reps and 6 years for fundamental reps.

RWI Basics

- **Term**
  - 3 years for General Representations
  - 6 years for Fundamental Representations + Pre-Closing Tax Indemnity
- **Limit**
  - Risk appetite
- **Retention**
  - Based on enterprise value
  - Current market start around .5% of enterprise value
  - Dropdown feature
- **Price**
  - Soft market
  - Lowest the U.S. market has experienced

RWI Process & Timing

- Day 1: Engage Broker
- Day 3-6: Insurance Quotes
- Day 6: Select Insurer
- Day 6-12: Underwriting/Policy Negotiation
- Day 12: Bind Coverage

Key Definitions

Actual Knowledge	▪ Actual conscious awareness or knowledge that a fact, event or condition is a Breach ▪ No constructive or imputed knowledge ▪ Burden of proof
Breach	▪ Any breach of, or inaccuracy in the representations and warranties ▪ Materiality scrape
Loss	▪ Costs ▪ Limitations from deal document ▪ Punitive or exemplary damages, fines or penalties ▪ Materiality scrape

Dealing with Exclusions

- **Standard Exclusions**
  - Actual Knowledge of a Breach (e.g., items disclosed on disclosure schedules or "known" by the Buyer's deal team)
  - Asbestos/Polychlorinated Biphenyls
  - Pension underfunding and withdrawal liability
  - Specific indemnities
  - Specific tax liabilities or assets (e.g., transfer taxes, net operating losses)
  - Interim breaches
  - Operations in Russia, Ukraine, Belarus
  - COVID-19-related representations
- **Deal Specific/Industry Specific**

Interim Breach

- What is covered during the interim period?
  - Breaches that occur prior to signing and that become known after signing
  - Breaches that occur between signing and closing that are discovered after closing
- Note: Insurers will generally provide this partial “interim period” covered for four months with no additional premium.
  - If a buyer wants to extend this partial “interim period” coverage beyond four months, an additional monthly premium is required and generally can be extended for an additional eight months

Dealing with Exclusions

- Exclusions & Specific Indemnities
  - Policy generally doesn’t cover “known” matters
  - Beware of the overbroad exclusion: insurer may seek to broadly exclude the subject matters of any known issues or specific indemnities (work to narrow)
  - Buyer may wish to negotiate specific indemnities for deal-specific exclusions in the policy, but often those won’t be known until after underwriting (always include concept in term sheets or early drafts)

Obtaining RWI Post Signing

- Sometimes, clients obtain RWI in the period between signing and closing
- Several potential problems:
  - General non-RWI risks of signing and then doing due diligence
  - Potential inability to get RWI at all (perhaps a low or non-existent risk in today's market)
  - Potential for higher than anticipated RWI pricing
  - Potential for unexpected exclusions
  - Inability to negotiate for special indemnity from Seller for RWI exclusions
  - Potential lack of coverage for matters arising between the signing of the acquisition agreement and the signing of the RWI binder
  - Insurer's potential increased leverage in policy negotiations

Market Trends and Claims Landscape

Market Trends

Soft market: Premiums and retentions are at historic lows, and many insurers offer $0 retention for fundamental representations.

Expanded capabilities: GP-led secondaries, minority investments, distressed transactions, take privates, etc.

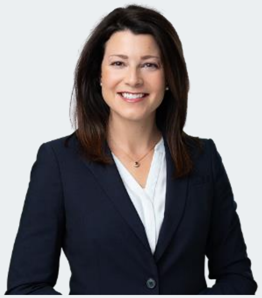
Trends in Coverage: The market has shifted toward underwriting specific risks, reducing the frequency of blanket exclusion for industry like technology or healthcare.

RWI – Recent Claims Data*

- Claim Types
  - Compliance with laws
  - Financial statements
  - Undisclosed liabilities
  - Tax
  - Material contracts
- Loss
  - Dollar-for-dollar v. multiple of EBITDA
- Timing
  - Within 12 months of closing

* Source: Aon, 2024 *Transaction Solutions Global Claims Study*

Presenters



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Jennifer H. Thiem is a partner in the firm's Charleston office, focusing on complex commercial litigation and insurance risk management counseling. She represents clients in state and federal courts, handling cases involving fraud, breach of contract, and real estate disputes. Jennifer also advises commercial policyholders on coverage under various policies, including transactional risk insurance such as representations and warranties insurance. She works closely with deal counsel on the placement of representations and warranties insurance and assists clients with post-closing claims.

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