



DELIVERING STRATEGIC SOLUTIONS ACCA'S 2000 ANNUAL MEETING

Representation & Warranty Insurance

Issue

M&A transactions generally require the seller to indemnify the buyer for breaches of the representations and warranties that are made in the purchase and sale agreement. Depending on the parties involved and the nature of the representations and warranties, the seller may be required to escrow a material percentage of the indemnification requirement. This requires the seller to maintain substantial illiquid capital following an exit. If the seller is a private equity investor, it may limit their Ability to wind down partnerships formed for investment purposes, and may further limit their ability to return funds to investors.

From the buyer's perspective, an uninsured indemnity provides only limited comfort, as there is no guarantee that they will be able to collect losses if a breach occurs. In many acquisitions, the representations and warranties do not survive after closing because there is no one left to provide indemnity.

Solution

To address these obligations, a risk transfer insurance policy was developed which can reduce or replace the indemnification and escrow requirements created by the seller's representations and warranties section of a purchase and sale agreement. The policy will pay excess of a retention, which is often the basket aggregate outlined in the purchase and sale agreement.

Frequently Asked Questions

How long does it take to get a quote?

It depends on the complexity of the deal, but an indication should be made within a week. A firm quote is available 10 days after the initial indication.

Is a draft policy available?

Each policy is manuscripted and requires a confidentiality agreement; however, the attached coverage summary provides a comprehensive coverage review.

What does it cost?

The premium will depend on the risk of the transaction; however, as a general rule, the premiums have been ranging from 4% to 10% of the policy limit.

What is a typical retention?

The retention is determined by the underwriter and the insured; however, 10% to 15% of the policy limit is common. Most transactions utilize the basket aggregate as the retention.

Can the underwriter subrogate against the purchaser or their advisers?

The short answer is "yes." However, the underwriter can subrogate against the purchaser only for misrepresentations of factual issues. In addition, the underwriters use their own attorneys for due diligence, so it is difficult for the underwriters to claim that they relied solely on the analysis of the purchaser's adviser. This makes it difficult to subrogate in the absence of intentional misrepresentations.

Case Studies

Study I

Issue — A private fund is exiting their final investment of their third fund. However, the buyer is requiring a \$5,000,000 escrow for three years to secure the seller's Representations and warranties. If the private equity firm is required to escrow \$5,000,000, they will be unable to distribute proceeds to their limited partners (impacting the fund's internal rate of return).

Solution — An insurance policy can be written to replace the seller's obligation. The policy has a \$1,750,000 limit of liability excess of a \$250,000

Solution — An insurance policy can be written to replace the seller's obligation. The policy has a \$4,750,000 limit of liability excess of a \$250,000 retention. In the event of a loss, the policy pays directly to the buyer, allowing the private equity fund to distribute substantially all proceeds to their limited partners without fear of future claims.

Study II

Issue — A manufacturer is making a strategic acquisition to expand its geographic penetration. The target company is 100% owned by the founder who has run the company for 20 years.

The seller has negotiated a very attractive price and completed substantial due diligence. However, the seller is being paid primarily with the buyer's stock and is not willing to have the representations and warranties survive closing.

The acquisition is critical to the buyer's strategy, but as a public company they are afraid that a loss arising from an unindemnified representation or warranty could lead to a suit from their shareholders.

Solution — The buyer purchases a Representation and Warranty Insurance policy to provide protection for a breach of the representations and warranties. The insured elects to purchase a \$10,000,000 limit of liability excess of a \$500,000 deductible with a three-year policy period for a one-time premium of \$550,000.

Information Required for Indications

- *Copy of the purchase and sale agreement with attachments (draft or final)*
- *Financials of the buyer and seller*
- *Copy of the due diligence information requested and received*
- *Transaction summary, including: purpose, limits, parties involved, advisers and timing*

The Underwriting Process

Day One — Submission received.

Day Two — Sent to appropriate underwriters and their counsel.

Day Four — Conference call with underwriters and client to discuss interest and timing.

Day Seven — Initial indication from underwriters and their counsel. Includes pricing parameters and required deposit premium. If the underwriters do not quote within the range, the premium is returned. If the client does not purchase the product, the deposit premium is kept by the underwriters to pay counsel.

Day Seventeen — Final notes are received with a draft policy.

Policy Summary

Note: Policies are manuscripted to respond to specific risks. The policy summary below is a review of a specimen policy.

Coverage: The underwriters will indemnify the Insured for Loss in excess of the Retained Amount due solely and directly to a breach of the Representation & Warranties.

Key Definitions

Breach of Representation and Warranty - (1) An untrue, false or materially inaccurate statement or material fact, or (2) an omission of a material fact necessary to make a material statement in the Representations and Warranties not false.

Loss - Manuscripted.

Insured - Manuscripted. May be the buyer or seller.

Retained Amount - Serves as a deductible.

Exclusions -

- Failure of any party to the Merger Agreement to perform any obligation thereunder, except for a Breach of a Representation and Warranty;
- Failure of Insured to perform any covenant made by Insured in this Indemnity, or by falsity or inaccuracy of any representation or warranty by Insured in this Indemnity as of the date made;
- Events, facts or circumstances of which the Insured had actual knowledge on or prior to the Inception Date or events, facts or circumstances identified in the Operative Documents and schedules and exhibits thereto;
- Any amendment, agreement, waiver, consent, change, modification, supplement, instrument or similar device of the Operative Documents unless such changes have been consented to by Underwriters;
- Change in law;
- Any events or circumstances which occur after the inception date;
- Particular exclusions may be added to address risk specific issues.

General Terms & Conditions

Policy Period: Up to six years

Cancellation: Not cancelable

Subrogation: Underwriters reserve the right to subrogate against any party to the transaction

Contests: Underwriters have the ability to request the Insured contest an alleged Breach of the Representation and Warranties

Arbitration: Binding arbitration by the American Arbitration Association. Arbitration shall take place in New York, NY, unless otherwise agreed

Other Insurance: This insurance is excess of all other insurance under which the Insured may be entitled to collect

Representation & Warranties Insurance Proposal Transaction Summary

Please provide appropriate documentation for a Phase I underwriting review, including: copy of the purchase and sale agreement (draft or final), due diligence request list and financials.

Applicant Information

1. Name of Company:

2. Role in Transaction (i.e., Buyer, Seller):

3. Contact/Title: _____

4. Address: _____

5. Telephone: _____

Fax: _____

6. State of Incorporation: _____

7. Description of Operations: _____

8. Does the Company have publicly traded debt or equity? _____

9. Does the Company have independently rated debt obligations? If yes, please provide rating information.

Transaction Information:

1. Transaction summary including the parties involved, their roles and the insurance coverage desired. _____

Additional Information:

1. Expected Basket Aggregate: _____

2. Desired Retention: _____

3. Will policy be excess of an escrow or indemnity obligation? If yes, please provide details. _____

4. Is the policy intended to replace or reduce escrow or indemnity obligations? If yes, please provide details.

Description of Other Party to the Transaction:

Legal Counsel:

Buyer:

Seller:

Other:

Financial Advisers (Please list the firm and their role in the process):

Other Information

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