

WHAT IS REPRESENTATIONS & WARRANTIES COVERAGE?

WHAT IS REPRESENTATIONS & WARRANTIES, AND WHAT DOES IT COVER?

Protects against adverse financial consequences arising from the warranties and indemnities made/given by a seller to a buyer in the Sale and Purchase Agreement (SPA) governing the acquisition of a company

WHO PURCHASES THIS INSURANCE?

SELLER SIDE POLICIES: A seller purchases the cover to protect its financial liability (including defense costs), where buyer claims for breach of a warranty or under an indemnity given in the SPA.

Policy is written to respond **directly** to actions for breach of warranty or tax covenant in SPA by sellers/warrantors.

- Interests aligned with Insured – e.g., to defend a claim vs. buyer
- Benefit from assistance/experience from Insurer but give away full flexibility/discretion on claims management
- There has to be a liability which is being insured – i.e. the SPA allows for the possibility of a claim, otherwise policies may be voidable for lack of “insurable interest”
- Policy will mirror time, limits, and de minimis values in the SPA
- Policy will have a retention above which the limits of the policy are excess) to incentivise seller and align interests

BUYER SIDE POLICIES: A buyer of a company purchases it to replace its recourse under contract against a seller for breach of a warranty or an indemnity

- Policy is written as an addition to or, at times alongside, the liability of the seller/warrantor under the SPA
- Can increase financial recourse available or extend time periods, or both
- Will import/reference many of the SPA provisions but will expressly ignore the seller’s cap and the potentially time limitations
- Policy retention typically set at seller/warrantor cap
- Can be structured to achieve a seller “clean exit” , i.e. no post-close liability for seller – subject to adequate disclosure and the buyer retaining some first loss liability

WHAT IS THE UNDERWRITING PROCESS?

1. Interested parties provide initial information, providing an Overview of the Transaction
 - a. Who are the Buyer, seller, and advisors
 - b. Estimated/anticipated sale or purchase price
 - c. Most recent draft of sale and purchase agreement (SPA), (if available)
 - d. Audited financial statements of the target company
 - e. Estimated date of deal completion
2. Underwriter provides initial indication: likely limits, premium, retentions, and request additional information, which is likely to include:
 - a. A due diligence request list
 - b. Data room index and access
 - c. Disclosure schedules, if not already included in the sale and/or purchase agreement
3. Interested parties agree to a Legal Expense Agreement, committing to pay legal cost of outside counsel on behalf of underwriters. Note, the fees charged by underwriters vary. Depending on the deal, the fee is not likely to be waived or credited against the premium. If coverage is not bound, the fee is still payable to outside counsel.
4. Underwriters provide a bindable quotation and draft of the policy wording and agreed-to representations and warranties to be covered.

WHAT ARE THE PRICING PARAMETERS?

- 2-3% (on average) of limit of liability. Pricing determined on limits purchased, indemnity threshold or retention, complexity of or distressed nature of sale. Price may be higher, (e.g. 3-5%)
- Retention, depending on the insurer, may be as much as 1% to 2.5% of the Deal Purchase price. Typically, we see retentions of \$100,000-\$350,000 – again, depending on particulars of deal.
- \$10,000 to \$30,000 non refundable underwriting fee (due at time of legal review, or upon completion of the deal). Amount is payable directly to the outside counsel.

WHAT PERCENTAGE DEALS HAVE CLAIMS?

NORTH AMERICA

- Frequency: c. 15- 20% of policies written receive claim notices.
- Severity: some limit losses taken and outstanding
- 25-50% of claim notices are received within the first 12 months of policy inception.

INTERNATIONAL

- Frequency: c. 15% of policies receive claim notices.
- Severity: some large losses
- 75% of claim notices are received within the first 12 months of policy inception.

Information is provided by Underwriters at Lloyds of London

WHAT WARRANTIES OR REPRESENTATIONS ARE ALLEGED IN THE CLAIMS?

Issues arise from tax, financial statements and intellectual property warranties and indemnities, especially outside the U.S. Other issues arise from compliance with law, and over undisclosed liabilities.

- Tax Issues
- Financial Statements/Financial Disclosures
- Compliance with Laws
- Undisclosed liabilities, e.g., Non Disclosure of Product Liability issues
- Intellectual Property
- Property/environmental issues
- Employment Issues

WHAT ARE THE KEY DRIVERS FOR PURCHASE OF THIS INSURANCE?

- **The “clean exit”** Allows proceeds to be retained by Seller with no liability tail, and often, without significant indemnities or escrows (i.e., Private Equity Seller wants to distribute funds from the sale of a portfolio company, and uses it as a way to take all or most of the cash from the sale for that purpose).
- **The Trade Buyer** Who needs certain level of economic recourse with warranty package in order to get a board mandate to proceed with the transaction. If Seller cannot provide full amount of recourse required then Buyer can “top up” the recourse with a policy.
- **Sale of non-core division** Seller wants to refocus on core activities; it buys a Seller-side policy, in order that post-sale, it has limited all future financial exposure to the non-core division that has been sold.
- **Estate Protection Tool** This cover is sometimes used as asset protection strategy, both to be sure the proceeds of sale are not clawed back, and helping to avoid high cost of defending litigation for claims. This allows the individual or family to plan for the future unburdened by concerns over past issues.
- **Unwillingness of Buyer to sue** Where practical difficulties would exist for the Buyer to sue the Seller. Examples include where there is a continuing trading relationship between the two parties post-transaction; or where management of the Seller continue to have a role in the business after its purchase by the Buyer.
- **Auction process** Bidders in an auction sale can use a buyer-side policy to enhance their bid as by using a buyer-side policy they can ask for a lower financial warranty cap from the Seller - this may well be attractive to the Seller.
- **Distressed situations** For instance where a Buyer is acquiring the target company from a distressed seller. Although the Seller is willing to give the Buyer an appropriate level of financial recourse within the Transaction the Buyer is concerned about the Seller's strength of covenant and ability to pay any claims in the future. Using this insurance can transfer the financial risk of a breach to the insurer.