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Representations and Warranties Insurance as Deal Making Tool

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In an ever changing mergers and acquisitions landscape, Representations and Warranties insurance has become a strategic option that can help clients mitigate risk and successfully buy and sell businesses. While merger and acquisition activity has generally slowed since the high points that it reached in 2006 and 2007, the use of Reps and Warranties insurance has grown significantly with brokers and underwriters reporting that submissions for such insurance have been on the rise. Over the past 15 years, Reps and Warranties insurance has evolved to become a useful tool for getting deals done, and as deal practitioners have recognized this evolution, use of the product, has become increasingly popular.

Introduction

In general terms, a Reps and Warranties insurance policy protects the insured in the event that there is a breach of the representations and warranties provided by a seller in the acquisition agreement. Customarily, sellers are obligated to indemnify buyers for material breaches of representations and warranties. Reps and Warranties insurance steps into the shoes of the seller to make the buyer whole in the event of such a breach.

Over the years, this insurance product has undergone substantial revisions, including, in certain cases, reduced pricing, streamlined underwriting and introduction of more insured-friendly terms, which have made it more accessible to the parties to a transaction. Today, it is possible to obtain insurance for most deals for between 2 percent and 3.5 percent of the amount being insured. In some cases, policies can be underwritten in just a few days, with indemnification terms that, for the most part, are at least as favorable as those that can be negotiated between a buyer and a seller at arms' length.

Reps and Warranties policies come in two types—buyer-side policies and seller-side policies. The names of the policies reflect the identity of the named insured, and there are specific situations in which each type of policy is appropriate. When a buyer obtains a buyer-side policy, the insurance is often intended to replace the indemnification obligations of the seller. If the seller is unable to convince the buyer to accept insurance to replace the seller's indemnification obligations, then a seller-side policy may be used instead to backstop the obligations that the seller has to the buyer under the acquisition agreement.

As Reps and Warranties insurance has become more accepted among deal parties, sellers have had greater success convincing buyers to accept insurance in lieu of requiring a higher cap on the sellers' indemnification obligations for breaches of representations and warranties. In addition, buyers have been using this insurance for years to supplement the indemnification obligations that they are able to obtain from sellers through negotiations.

Buyer-Side Policies

When a buyer-side Reps and Warranties policy is used as a replacement for a more complete seller indemnity, the seller's obligations under the acquisition agreement to indemnify the purchaser for breaches of representations and

warranties will often be capped at the amount of the deductible, with the insurance policy providing for indemnification coverage above that cap.

While this type of insurance is attractive to the seller because it reduces the potential liabilities to the buyer after closing, it may also provide the buyer with the opportunity to negotiate certain policy terms to supplement the indemnity, such as extended survival periods for all representations and warranties and higher caps on indemnification. In some cases, terms available from insurance companies may be more favorable to buyers than the terms that can be negotiated with a seller in the current M&A market.

Seller-Side Policies

To the extent that sellers are unable to convince buyers to accept a buyer-side Reps and Warranties policy in lieu of an indemnity, sellers may instead turn to the insurance markets to backstop their indemnity obligations. Policy terms for seller-side policies have evolved to the point that, in some cases, a seller may be able to obtain a policy that matches its representation and warranty indemnification obligations to the buyer, subject to a deductible that is typically about 1 to 3 percent of the transaction value.

The benefit of such a policy is that the seller can walk away from the transaction at closing without having to worry about trailing liabilities arising from unanticipated inaccuracy in the representations and warranties made in the acquisition agreement.

Seller-side policies are often used by private equity or venture capital funds that need to distribute all proceeds to their limited partners after closing without any risk of having to request the return of monies in order to fund indemnification obligations. Other users of seller-side Reps and Warranties insurance include sellers who plan to use the proceeds from a sale for their retirement or to repay indebtedness or passive investors in a business who are not in position to comfortably verify the representations and warranties made by the controlling shareholders, and therefore want to protect downside risk after closing.

Resistance From Deal Parties

Like any approach to deal-making, Reps and Warranties insurance has certain drawbacks. For instance, some practitioners may worry about introducing an additional party to negotiations that are already complex. However, as Reps and Warranties insurance has evolved, underwriters have developed processes that are more streamlined and less obtrusive. Depending on the stage of the deal, the underwriting process can take as little as a few days, and rather than a full-scale due diligence review, insurers may choose to take a high-level approach by reviewing the due diligence process undertaken by the buyer, which requires less additional time commitments by the deal parties than may be anticipated.

Another source of resistance from deal parties may be due to a lack of familiarity with the product. Seller indemnities have long been the accepted custom, so practitioners may be reluctant to concede that this relatively new product can resolve a stalemate and effectively replace or supplement the time-tested practice of seeking indemnification from sellers.

In addition, like other insurance policies, Reps and Warranties policies contain exclusions to coverage. For example, typical Reps and Warranties policies will exclude fraud, breaches that the buyer is aware of at closing and breaches of covenants. Certain specific issues like known environmental conditions or tax audits may also be excluded. Nevertheless, recent history demonstrates that Reps and Warranties insurance can be a good fit for certain transactions. In some cases, Reps and Warranties insurance may provide benefits to insureds that would not be available in a traditional indemnification arrangement. For example, issues concerning relationship protection, credit protection, choice of jurisdiction and good faith obligations may provide an additional level of comfort with regard to claims.

Relationship Protection

In an M&A transaction, management of the target company often continues to run the business after the closing of the transaction. Frequently, those managers will have been owners of the business prior to the sale and therefore will have been sellers in the transaction. In many cases, these members of management will acquire an equity stake in the business after closing, or the sellers will otherwise continue to be involved in the business as consultants or board members. Other times, sellers may continue to interact with the business as a customer or supplier or continue to provide other types of services to the business. Buyers may find that bringing indemnification claims against equity partners or the individuals entrusted to run the business can be both awkward and counterproductive to the ongoing health of the business.

Reps and Warranties insurance may allow buyers to be made whole for breaches of the representations and warranties by sellers without damaging ongoing relationships. Further, many of the insurers that provide Reps and Warranties

insurance have multiple lines of business, which benefit from ongoing relationships with insureds. Refusing to pay a claim can damage these relationships and can also cause damage to the insurer's reputation. As a result, insurers may in some cases be motivated to take a more reasonable approach to claims than a seller who owes a one-off indemnity obligation.

Credit Protection

After the completion of a transaction, sellers may use their proceeds to pay off debt, make distributions to investors, build a vacation home in the Cayman Islands or otherwise spend the proceeds. In these cases, even if the buyer has a clear-cut claim against the seller for a breach of representation, it may be very difficult to collect from that seller. While holding back a portion of the proceeds in an escrow account may alleviate some of these risks, such escrow arrangements are usually for limited time periods and may not always provide protection up to the full amount of a loss.

In contrast, insurers are strictly regulated to ensure that they have the capacity to pay out claims. Although it is important to verify, for the most part, the insurers participating in the Reps and Warranties insurance markets are backed by significant reserves and are highly rated by ratings agencies.

Jurisdiction and Good Faith

M&A transactions are increasingly globe-spanning affairs with complex, cross-border structures. The global nature of these deals can create uncertainty regarding the jurisdiction in which a dispute will be resolved. Although buyers may acquire businesses in distant locations, not every jurisdiction is suitable for addressing claims.

Many of the insurers that provide Reps and Warranties insurance have underwriters across the world and subsidiaries that can issue policies in a number of jurisdictions. As a result, buyers of the insurance may be able to choose to have the policy issued in an appropriate jurisdiction that provides certainty as to the legal regime and the ability to enforce a judgment.

In the event of a breach of a representation, sellers may be very reluctant to make payments on an indemnity, and in some cases, will go to great lengths to avoid cooperating with buyers when a claim arises.

Conversely, insurers are obligated to respond to claims under their insurance policies in good faith. Acting in bad faith with respect to a claim can expose insurers to liability beyond the limit of an insurance policy. Accordingly, insurers may be more likely than already breaching sellers to pay claims without drawn-out litigation.

Conclusion

Every deal is different, and it is important, as always, to review the specific terms of the proposed insurance policy to make sure that it meets the needs of a particular transaction. However, in the right circumstances, Reps and Warranties insurance can be used strategically to provide a practical way for deal parties to allocate their risk and potentially resolve issues that might stand in the way of completing their transactions.

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