

Using Reps & Warranties Insurance In Private Equity Transactions

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- Overview

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Risk Allocation

- Traditional Methods
 - Seller's Indemnification of Buyer for Breaches of Representations and Warranties
 - Traditionally, any of losses suffered by Buyers after closing due to breaches of the Sellers' representations and warranties.
 - Purchase price holdback, funds placed into Escrow.
 - Typically, 8-10% of the purchase price,
 - 12-24 month holdback.

Risk Allocation (cont.)

- Who bears the burden of the risk in the traditional indemnification arrangement?
 - Buyers bear the risk that the liabilities incurred by Buyer due to a breach of Seller's reps and warranties will exceed the amount held in escrow.
 - Seller bears the risk that inadequate disclosures by Seller during due diligence will erode the value of the deal by enabling the Buyer to use the escrowed funds to defend lawsuits.

Risk Re-allocation

- “Expanding the Pie”
 - Representations and Warranties Insurance (RWI) permits Buyers and Sellers to create value by moving away from the zero-sum nature of these negotiations.
 - Using RWI, Buyers and Sellers are able to shift some of the risk associated with breaches of reps and warranties and inadequate disclosures to a 3rd party insurer.

History of RWI

- The Beginning
 - RWI policies first started being written in the early 2000s
 - RWI was not widely utilized initially for a number of reasons, including:
 - Limited Track Record
 - Costliness
 - Limited Protection

RWI Pricing & Terms

- Historical RWI Pricing
 - Initially the cost of premiums for RWI was in the range of 5-10% of the coverage amount
- Historical Exclusions
 - Additionally, policies initially contained the broad exclusions that are customary in other forms of liability insurance

RWI Pricing & Terms (Cont.)

- Current Market
 - Today, RWI policies are typically priced between in the range of 2-3.5% of the coverage amount
 - US\$10,000,000 of Coverage would result in a premium between roughly US\$200,000 and US\$350,000 before taxes and fees.
 - Increased competition among insurers in today's market has resulted in lower premiums.
 - In European and Asia Pacific premiums as low 1% of the coverage amount.

RWI Pricing & Terms (cont.)

- Coverage Limits
 - Coverage limits vary from transaction to transaction, but policies can cover up to US \$50,000,000
 - Policies can also be combined to provide more coverage than available under any single policy – up to/above \$300,000,000.

RWI Pricing & Terms (cont.)

- Deductible
 - Generally, deductibles for RWI range from 1-3% of deal value.
 - The terms of the deductibles are usually negotiable
 - The deductible can be negotiated to the lower end of the range, but this may result in a higher premium
 - The deductible can be reduced gradually over the life of the policy

Key Considerations

- Who is the insured?
 - At the outset of any deal featuring RWI, clients and counsel should consider whether the policy will cover Buyer or Seller
- When can claims be made?
 - Recovery under RWI policies are available on a claims-made basis, so the claim must be made during the term of the policy in order for the party requesting payment to recover any amounts.
- Expansion of the Pie
 - RWI creates value for Buyers and Sellers by allocating some of the risk associated with breaches of reps and warranties to the insurance provider.

Applicability & Examples

- Seller's Perspective: Technology Deal
 - Recently we represented an emerging technology services company in its sale to a public strategic buyer
 - Facets of the Deal
 - The target was organized as a corporation with roughly 25 shareholders
 - Several of the selling shareholders were to become employees of the buyer post-closing
 - Buyer offered an attractive strategic alternative to the the company, so the buyer's bargaining position was strong vis-à-vis the sellers

Applicability & Examples (cont.)

- Seller's Perspective: Technology Deal (cont.)
 - Facets of the Deal
 - During negotiations, the buyer requested:
 - 10% escrow holdback for a full audit cycle
 - Standard reps and warranties
 - The sellers were obligated to jointly and severally indemnify the buyer for breaches of their reps and warranties
 - Under this construct, a breach by any seller of its reps and warranties would lead to each of the sellers of being liable for the full amount of the buyer's damages
 - An example of such a rep is included below:

Applicability & Examples (cont.)

- Ownership: “The Stockholder holds beneficially and of record all of the Stockholder’s Company Shares as set forth on Schedule XX of the Disclosure Schedule, free and clear of any Security Interests (other than restrictions on transfer arising under the Securities Act and state or foreign securities laws). The Stockholder is not a party to any voting trust, proxy, or other agreement or understanding with respect to the voting or transfer of any Company Shares.”

Applicability & Examples (cont.)

- Seller's Perspective: Technology Deal
 - Facets of the Deal
 - To protect the sellers from a scenario where one seller's breach of a rep specific to that seller leads to a liability for all of the sellers, the sellers have to agree up front to an indemnification contribution agreement, which can be time consuming and costly to negotiate
 - Due to the buyer's employment of certain of the selling shareholders, the buyer may have also been less willing to pursue indemnification claims against their own employees
 - In addition to each of the deal-specific issues, the sellers would have had no expectation of receiving full deal value until the amount in the escrow fund, if anything remained, was released

Applicability & Examples (cont.)

- Seller's Perspective: Technology Deal
 - How RWI created value for both sides
 - By introducing an RWI policy, which was paid for primarily by the sellers through a reduction to the purchase price, the buyer's recourse for breaches of the sellers' reps and warranties was limited to the policy coverage amount.
 - The sellers did not have to place additional funds into escrow
 - The buyer had single source for recovery in the event of any claims due to breaches of the sellers' reps and warranties
 - The sellers avoided the time and expense of negotiating an indemnification contribution agreement

Applicability & Examples (cont.)

- Buyer's Perspective: CPG Deal
 - Facets of the Deal
 - We represented a fast growing company seeking an acquisition by a private equity buyer
 - The company was closely held and an attractive target to a number potential private equity acquirers.
 - Auction Process
 - The winning bid included a low cap for the Sellers' with an RWI policy as the Buyer's sole recourse following the exhaustion of the funds in the escrow account.
 - The winning bid addressed the sellers' concerns and objectives.

Key Definitions

- “Loss”
 - Sell-side RWI Policy – “Loss” typically means the amount the insured party is expected to pay in the event of a breach, plus, defense costs
 - Buy-side RWI Policy – “Loss” typically means damages to Buyer resulting from a breach by Seller OR third party claims relating to a breach

Key Definitions (cont.)

- “Actual Breach”
 - “Any *actual* breach of, or inaccuracy in, the representations and warranties set forth in the covered acquisition agreement, or a specific section thereof.”
 - The prospective policyholder's advisors must take care to ensure that the word “actual” is not used to modify “breach” in the RWI policy if that’s the insured’s desire
 - Seller-side policies should not require proof of an actual breach

Key Definitions (cont.)

- “Knowledge”
 - The insured party’s actual prior knowledge of a breach of a rep or warranty is typically excluded from RWI coverage (in some cases, constructive knowledge is enough).
 - All exclusions due to the definition of knowledge should require a final judgment that the policyholder actually possessed and withheld relevant knowledge and that the loss resulted from the non-disclosure.

Key Definitions (cont.)

- “Deal Team”
 - RWI policy exclusions due to knowledge of breaches of reps and warranties generally only apply to the knowledge of the “deal team” members.
 - Thus, the definition of “deal team” should be defined narrowly—referencing specified individuals.

Typical RWI Timeline

DAY 1

DAY 21

The client engages an insurance brokerage firm familiar with RWI policies.

The broker and the potential insured party's counsel help guide the potential insured party in the selection of an appropriate insurer.

The insured party selects an insurer and makes the initial payment.

The insured party's advisors conduct due diligence

The insurer's counsel conducts due diligence separately.

Questions?

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