

Representations and Warranties Insurance

A Powerful Insurance Product That Facilitates Deals



William Gallagher Associates
Phone: 888.261.8884
www.WGAins.com

At the heart of every merger, acquisition or other business transaction is the allocation between the parties of the risks and liabilities, whether known or unknown, that are inherent in the deal (collectively, the “Exposures”). One method used to effect this allocation is the making of representations and warranties by the seller in the purchase and sale agreement. These representations and warranties are statements of fact about the operational and financial state of the seller at the time of the deal and generally cover topics such as financial statements, taxes, litigation, environmental matters and intellectual property, to name just a few.

In most corporate transactions, the purchase and sale agreement also contains indemnification provisions, which provide the buyer with financial recourse against the seller for post-closing losses sustained due to the inaccuracy of any of the seller’s representations and warranties (a “Breach”). The indemnification provided by the seller is generally subject to certain limitations, which may include a deductible or threshold level below which claims may not be made, a period of time following the closing after which a claim may not be made and a maximum limit of liability above which claims need not be paid by the seller. Additionally, to ensure that there will be sufficient funds to reimburse the buyer for its losses in the event of a Breach, the buyer may require that the seller post a letter of credit or that a certain portion of the purchase price be set aside in an escrow account as security for the seller’s indemnification obligations.

Representations and warranties, together with indemnification provisions and the security supporting such indemnity, provide essential protections for the buyer in a business transaction. However, the inability of the parties to agree upon the appropriate allocation of the Exposures – manifested in disagreements over the precise language of the representations and warranties, the scope of the indemnification provisions and/or the appropriate type of security to support the indemnity – is often the reason that otherwise mutually beneficial deals fail to reach completion.

Representations and Warranties Insurance can help the parties reach their mutual goal – consummating the deal – by enabling the parties to resolve these disagreements in an efficient and timely manner. On the following pages are a few examples that illustrate how Representations and Warranties Insurance can help facilitate a transaction by eliminating obstacles that might otherwise impede its closing:

Reed Sussman, Esq.

Reed Sussman, Esq. is the Director of Mergers & Acquisitions within the Management Liability Practice. William Gallagher Associates (WGA) is a leading provider of insurance brokerage, risk management, executive and employee benefits services to companies with complex risks in industries that include high technology, life sciences, financial risks, healthcare, energy, and environmental services. WGA has offices in Boston, MA; Atlanta, GA; Columbia, MD; Princeton, NJ; and Paris, France.

Example #1:

Issue: The parties to a \$20,000,000 transaction had agreed to indemnification in the amount of \$5,000,000 but had reached an impasse over the period of time for which the seller would provide such indemnification following the closing. The buyer required that the seller provide indemnification for breaches of its representations and warranties for a period of 36 months while the seller, reluctant to have 25% of the deal proceeds at risk for such an extended period of time, was only willing to provide indemnification for 18 months.

Solution: A Representations & Warranties Insurance policy was issued to the seller that covered any indemnification claims made by the buyer for breaches of the seller's representations and warranties during the period beginning 18 months following the closing and ending 36 months following the closing. As a result, the buyer received the full 36 months of indemnification protection it desired and the seller was entitled to receive the funds remaining in the escrow account after only 18 months.

Example #2:

Issue: The parties to a \$50,000,000 transaction had reached agreement on all substantive deal issues other than the security supporting the indemnification obligations of the seller. The buyer, concerned about the financial viability of the seller following the closing, required that the entire indemnification amount, \$20,000,000, be placed in an escrow account for a period of two years to satisfy any indemnification claims made by the buyer for breaches of the representations and warranties by the seller. The seller, wanting to use the proceeds of the transaction to pay off certain outstanding debts, was only willing to place \$5,000,000 in such an escrow account.

Solution: A Representations & Warranties Insurance policy was issued to the seller in the amount of \$15,000,000 in excess of the \$5,000,000 the seller agreed to place in escrow. As a result, the buyer retained the full \$20,000,000 indemnification protection it desired, with the financial strength of an insurance company guaranteeing the seller's indemnification obligations in excess of the escrow amount, and the seller was able to use \$45,000,000 of the deal proceeds to reduce its debt immediately following the closing.

Example #3:

Issue: Two public companies were engaged in merger negotiations. The acquirer was principally interested in merging with the target to obtain its intellectual property assets. During the due diligence process, the acquirer discovered certain facts that caused it to be concerned that the target's intellectual property might infringe on the intellectual property rights of one of target's competitors (Company X). Since the target was a public company, its representations and warranties in the merger agreement, which stated that no such infringement existed, did not survive the closing. Therefore, if Company X brought an infringement suit against the acquirer (as the target's successor) following the closing, the acquirer would have no financial recourse against the target, even if the alleged infringement existed prior to the closing. As a potential solution, the acquirer proposed lowering the merger consideration, which proposal the target rejected. Consequently, the acquirer was considering withdrawing from the transaction.

Solution: A Representations & Warranties Insurance policy was issued to the acquirer. The policy provided that in the event that the acquirer incurred losses as a result of a breach of the target's intellectual property representation and warranty, the acquirer would be entitled to make a claim for indemnification directly against the insurer, notwithstanding the fact that the merger agreement did not, by its terms, provide the acquirer with any right to indemnification against the target.

Why do parties purchase Representations and Warranties Insurance?

- The parties are unable to reach agreement as to: (i) whom should bear the financial responsibility for certain risks and liabilities, whether known or unknown, that exist in the transaction; (ii) the scope of indemnification to be provided by the seller; or (iii) the appropriate security to support such indemnification.
- The seller wants to make a clean break from the deal and avoid the potential of being subjected to indemnification claims for an extended period of time following the closing.
- The seller wants to distribute the deal proceeds to its stakeholders immediately following the closing.
- The seller wants to utilize the deal proceeds to implement its strategic and financial objectives immediately following the closing, which may include: (i) deleveraging its balance sheet by paying down certain debt obligations; (ii) engaging in strategic acquisitions; or (iii) investing in research and development with respect to new products.
- The buyer wants to strengthen its ability to enforce the indemnification provisions it has negotiated – the buyer is either concerned that the seller will not have adequate financial resources to satisfy its indemnification obligations following the closing or the buyer is reluctant to incur the time and expense that may be involved in pursuing the seller for indemnification.
- The buyer desires a greater degree of certainty with respect to the valuation and the purchase price of its investment – the acquisition of the seller.
- The buyer plans to employ certain principals of the seller following the closing and desires to avoid being in the uncomfortable position of having to seek indemnification from some of its key employees.

For additional information regarding Representations and Warranties Insurance and other transactional insurance solutions, please contact Reed Sussman, Esq. at William Gallagher Associates at (617) 646-0328 or rsussman@WGains.com.

