Representations and Warranties
Insurance for M&A Transactions

December 11, 2014
INTRODUCTION

A Representations & Warranties ("R&W") Policy provides an insurance option that may assist parties to a merger or acquisition in closing gaps and mitigating transactional risks

• The Policy protects against direct financial losses resulting from the breach of representations and warranties relating to the target company or selling shareholders
Introduction

BUYER

$ → Release of Escrow →

$ → Earnout Payments →

$ → Closing Payment →

Entity Transferred Pursuant to PSA

SELLER - Shareholders

← Representations ←

← Indemnity ←

← Ownership ←
Today’s Agenda

1. What are the potential exposures in a merger transaction to which an R&W Policy might respond?
2. How might an R&W Policy respond to such exposures?
Two Contracts

• The Entity Acquisition Agreement between the Buyers and Sellers (the “Acquisition Agreement” or the Purchase and Sale Agreement (“PSA”))

• The Representations and Warranties Insurance Contract between Insurers and the Buyers or the Sellers (the “R&W Policy”)

Acquisition Agreement and R&W Policy

 Buyers

 Underwriter

 $

 Sellers

 Underwriter
Overview

• Acquisition Agreement and R&W Policy are “bespoke” agreements
• Negotiated among sophisticated parties represented by experienced counsel and advisors
• Specialist insurance brokers
Overview

• “8” corners
• Contracts reference each other
• R&W Policy incorporates provisions of the Acquisition Agreement
• Both contracts negotiated in context of pending corporate acquisition using terminology common to mergers and acquisitions arena
Recovery Overview

General damages at law for breach of contract and fraud

For recovery of breach of contract damages under the Acquisition Agreement, look to its indemnity and limitation provisions

For recovery of Loss under the R&W Policy, look to its indemnity and limitation provisions
Recovery Under The Acquisition Agreement
WARRANTIES

– Specific or general contractual undertakings found in a PSA that are made by a seller to a purchaser about the company being purchased.

– “The Acquired Entity owns the patents, trademarks and copyrights necessary to produce its widgets.”

– Tangible assets have, in the aggregate, been maintained in accordance with normal industry practice, are in good operating condition and repair (subject to normal wear and tear) and are suitable for the purposes for which they presently are used.

– Each of the Company and its Subsidiaries has valid title to or leases each of the tangible assets used in the conduct of, and that are material to, the business . . .
• There are no Proceedings pending ... or, to the Knowledge of the Company, threatened ... against or affecting the Company or any of its Subsidiaries ...

• Financial Statements have been prepared in accordance with GAAP on a consistent basis.... The Company and its Subsidiaries have no Liabilities, except ...
Indemnity Obligations and Limitations Under SPA

- “Loss” is defined in the Acquisition Agreement as “any and all claims, damages, liabilities, injuries, demands, settlements, judgments, awards, penalties, Taxes, fees, fines, penalties, liens, losses or other obligations” arising out of the inaccuracy of any representation or the breach of any warranty.

- Extent of Indemnity for Loss defined by other provisions.
Indemnity Obligations and Limitations

• “Limitations and Exclusive Remedy” provision of the Acquisition Agreement limits extent of any indemnity.

• Disputes concerning “Working Capital Adjustments” will be resolved as set forth within that Section and subject to monetary limitations and special resolution procedures.
Entire Agreement

• The final written agreement will contain the entire agreement between the parties relating to the merger/acquisition and that it supersedes all previous agreements, representations and other negotiations between the parties (whether written or oral).
  – Thus, the Representations & Warranties become all important
Indemnity For:

• Third Party Lawsuits
• Environmental issues
• I.P. Infringement
• Product liability claims
• Third party guarantees
• Tax issues
• Disputes over ownership of property and physical activity
• Disputes over ownership of shares
Traditional methods for managing risk in M&A transactions:

- Reduce purchase price
- Raise escrow amounts
- Impose more restrictive earnout provisions
- Increase contractual protections with respect to R&W, indemnities, etc.
- Obtain third-party guarantees
Difficulties Encountered with Traditional Methods of Risk Allocation:

- Frustrates and prolongs negotiations
- Exposes buyer to credit and collection risk as against selling shareholder who may have retired
- Potential for arbitration/litigation
Recovery Under The R&W Policy
Transaction Solutions Insurance

Transactions (ex. Merger, Recap, Asset Purchase)

Purchase and Sale Agreement (PSA)

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<th>Seller</th>
<th>Buyer</th>
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Unknown issues:
- Representations and Warranties policy
- Either buyer side or seller side

Known issues:
- Contingent Liability policy
- Tax Opinion Policy
- Loss Mitigation Insurance
- Loss Portfolio Transfer
R&W Policy

• A non-renewable policy that covers unidentified financial loss arising from breaches of Seller representations

• Designed to bridge the gap between buyer and seller

• R&W insurance can be purchased by either the buyer or the seller in the transaction. No need for other side to know about insurance

• The insurance is not a substitute for the normal negotiations and due diligence that you would expect to be conducted in an M&A transaction.
Use of Reps & Warranty Insurance

**Buyers**
- Increase seller cap on liability or extend survival period for warranties
- Corporates: concern over counterparty security risk - need to meet minimum security levels for board approval
- Private buyers: use insurance strategically to improve their bid position in auction
- Can be used if the buyer has concerns about the ability of the seller to service claims (distressed seller)
- If Management is continuing on to NewCo
- No exclusion for fraud of the seller

**Sellers**
- Corporate Sellers – do not want to be hampered with liabilities from disposals of non core assets as funds required by the business (particularly if distressed)
- Clean exit for sellers (particularly individuals)
- Private equity seller avoids tying up funds in escrow
The R&W policy will not cover

- Known breaches or other issues (i.e. matters in the disclosure letter/buyer’s due diligence)

- Price adjustment features, including “working capital adjustments”

- Fraud by the seller on a seller-side policy

- Forward-looking warranties e.g. warranty guaranteeing future collectability of debts/accounts receivable
R&W Claims examples

Example #1:
Sale of stock in Media company to a Private Equity Firm for over $400M.
Seller-side policy responds to a claim for breach of the various representations resulting from a third party consumer action that arose after the deal close date, but dealt with matters prior to the policy binding date.

Example #2:
Acquisition of a sporting goods store by a strategic purchaser for over $300M.
Buyer-side policy responds to a claim brought by buyer (against the policy) for breach of, among others, the financial statements and accounts receivable R&Ws in connection with the target’s issuance of over $5M of gift cards which had not been properly recorded in the financial statements.
Example #3:
Acquisition of a software company by a larger strategic purchaser for over $1 billion.
Seller-side policy responds to a claim for breach of the Intellectual Property representation resulting from a third party patent infringement action that arose after the deal close date, but dealt with patents existing prior to the policy binding date.
R&W Underwriting Process

1. Receive submission from broker once executed necessary NDA’s;
   **Submission:**
   - a. Audited Financials for Target Company;
   - b. Current Acquisition Agreement,
   - c. Disclosure Schedules (if available)
2. Issue Non Binding Indication (NBIL)
3. If selected proceed with review of legal, financial and tax due diligence reports and disclosure process;
4. Using Legal Engagement Fee, instruct outside counsel to review diligence/disclosure
5. Underwriting call with Insured & their advisors
6. Draft and subsequently negotiate policy

Process completed in ‘deal time’
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