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A Snapshot of Representations and Warranties Insurance: What is it and how could it benefit my clients?

Article written by: *Laura Zaroski, Esq., Socius*

Socius has conferred with Ambridge Partners LLC, a leading managing general underwriter of Representations & Warranties Insurance (R&W), to present this article to provide important information you should know when considering if an R&W policy would be instrumental in helping your client facilitate closure of a transaction.

What is an R&W Policy? An R&W policy provides coverage for losses incurred as a result of breaches or inaccuracies of the representations and warranties made in business transaction agreements. As part of a buy-sell transaction, the seller typically makes numerous representations to the buyer and warrants to the buyer critical facts about the business. These attestations are an inducement to the buyer to enter into the purchase contract. While the parties both hope that the representations made are accurate, disagreements can often arise. Such disputes routinely arise in connection with the seller's representations pertaining to issues such as financial condition, accounts receivable position or intellectual property. Also, disagreements can arise over the scope of representations and warranties made, as well as the duration and/or amount of a seller's indemnification obligations.

Often, when a business transaction is nearly complete, final details or last minute issues can create an impasse to "sealing the deal". It is at this critical juncture that R&W insurance can be utilized to remove these obstacles and therefore, facilitate closure when one might not otherwise have been achieved. In addition, the preemptive purchase of R&W can remove fears regarding certain representations that might lead to litigation after the deal closes, providing both sides of the deal with peace of mind that each party received what they believe they bargained.

How are R&W Policies Structured? Each agreement is unique and an R&W policy can be tailored to meet the specific needs of each deal. Depending on the client's needs (whether the buyer or seller) R&W policies can be structured to achieve various things. These goals might include: (1) increasing the amount of indemnity available, (2) providing a "backstop" to the indemnity already available, (3) extending the expiration of the indemnity, (4) providing "ground up" coverage to replace an indemnity, or (5) increasing the scope or breadth of an agreed indemnity.

When should parties consider the purchase of an R&W policy? Most often, R&W policies are purchased in a merger and acquisition context. However, R&W policies are also secured in connection with restructurings, insolvencies, liquidations, financings or loans, or in connection with the licensing of intellectual property. In these situations, an R&W policy adds value as it can eliminate or reduce perceived or identified exposures and/or by addressing disagreements on the allocation of legal or financial risk for certain perceived or already identified exposures.

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For example, consider a transaction where the buyer requires that a seller retain liability equal to 30% of deal consideration in respect of breaches of representations and warranties, while seller is only willing to assume liability for up to 10% of deal consideration. An R&W policy could provide coverage for the buyer for loss resulting from breaches exceeding 10% of deal consideration up to a limit of 30% of deal consideration.

Or consider a situation where the seller's weak financial position causes the buyer to require that security be posted for seller liability for breach of any representations and warranties. An R&W policy could be designed to cover the buyer for loss resulting from breaches only if seller is unable to meet the liability it has agreed to assume under the sale agreement.

***Who* Can Buy an R&W Policy?** As noted above, R&W policies can be structured as a buy-side or sell-side policy. A **buy-side policy** is purchased by the company acquiring the target and enables the buyer, should a breach occur, to recover losses directly from the insurer often without having to locate and pursue the seller. Such a policy provides the buyer with assurance that the value of the acquired business will not be reduced by unexpected liability. Further, buyers can utilize R&W policies to improve their bargaining position by using the coverage to enhance its bid by reducing the indemnity ceiling and/or required escrow.

A **sell-side policy** is purchased by the seller and provides indemnification by the insurer for defense costs and loss resulting from claims made by the buyer for inaccuracies in the transaction which are the subject of seller representations and warranties. A sell-side policy also enables the seller to walk away from a closed deal confident that the proceeds it receives in the transaction will not be diminished by subsequent legal claims and claw-back. A sell-side policy provides a structure so that the seller can make a clean break once the sale has been executed by reducing or eliminating the need for an escrow account. As a result, through the purchase of an R&W policy, the seller can distribute more of the proceeds from the transaction thereby expediting shareholder return.

If I have a client who wants to consider R&W coverage, what information would they need to provide in order to get an indication? Generally, underwriters can prepare a non-binding indication with a minimal amount of key information. This information would include (1) the draft purchase agreement, (2) the draft disclosure schedules, and 3) the most recent audited or reviewed financials of the target. Typically, the premium rates are between 2-2.5% rate on line of the limit requested and the attachment or retention point would usually be excess of an order of 2–3% of the purchase consideration.

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Contact Us

If you have a prospect for an R&W policy, feel free to contact your local Socius representative.

San Francisco, CA
301 Howard Street, Suite1030
San Francisco, CA 94105
415.796.0608

Paul Lefcourt
Casey Bivens
Kirk Denebeim
Ryan Apgar

Los Angeles, CA
500 South Grand Avenue, Suite 1680
Los Angeles, CA 90071
213.243.1226

Kevin Kershisnik
Anna Vu
Ian Bell

Birmingham, AL
One Chase Corporate, Suite 400
Birmingham, AL 35244
205.796.2750

Hank Stickley

Chicago, IL
30 N. Airlite Street, Suite D
Elgin, IL 60123
847.695.6330

Rodney Nubin
Mike Morman
Laura Zaroski

Tampa, FL
1408 N Westshore Blvd., Suite 611
Tampa, FL 33607
813.288.8500

Eric Shapiro
Derick Stitik

Miami, FL
301 Arthur Godfrey Rd., Suite 550
Miami Beach, FL 33140
305.867.3300

Gregg Miller
Cynthia ZImmerman