REPRESENTATIONS & WARRANTIES INSURANCE

American College of Coverage and Extracontractual Counsel

Annual Meeting
May 5, 2015

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REPRESENTATIONS & WARRANTIES INSURANCE

- What is RWI?
  - Insurance that guarantees the Seller's Reps & Warranties in an M&A-type transaction.
- RWI around since late 1990s.
- RWI now part of many of "Middle Market" deals (*i.e.*, deal values of $25 million to $2 billion)
- The existence of RWI was once viewed as a positive distinction, but now the absence is viewed as a detriment

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REPRESENTATIONS & WARRANTIES INSURANCE

- Why is RWI popular now?
  - It took a while for deal players (execs, attorneys, advisors) to become comfortable with RWI on many fronts . . .
    - Evolution of RWI negotiation and placement process accommodating to deal timing
    - Standardization of concepts and terms
    - Familiarity with product, how it works, and that it works
    - Pricing at levels that make sense in the deal
  - Post-credit crisis increasing deal volume coincided with deal player comfort with RWI

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EXAMPLES OF R&W SUBJECT MATTER

- Seller has power, authority and consents
- Deal will not violate articles, bylaws, contracts, court/regulatory orders, or law
- Accurate Financial Statements, Books & Records
- Adequate Internal Controls
- Solvency
- Assets are clear and in good condition
- Compliance with Labor & Employment/Employee Benefits Laws
- Contingent Liabilities including Litigation
- Taxes, Environmental and other exposures

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WHAT HAPPENS IF R&W ARE FALSE?

- Buyer deprived of benefit of bargain
  - Buyer sues Seller
- Third Parties have rights against/sue Buyer
  - e.g., IRS, Regulators, Employees
  - e.g., Tax, Labor & Employment/Employee Benefits, Environmental

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TRADITIONAL SOLUTIONS v. RWI

- Traditional Solutions: Risk allocated with sales proceeds
  - Buyer pays discounted purchase price
  - Buyer holds back portion of purchase price
  - Parties escrow portion of purchase price

- RWI: Insurer assumes risk in exchange for premium
  - Need for Traditional Solutions mitigated or eliminated

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WHY USE RWI INSTEAD OF TRADITIONAL SOLUTIONS?

- Seller
  - More cash out of deal and quicker
  - Mitigate need for post-closing involvement
  - Relationship issues
    - e.g., Seller's ownership/management may continue as Buyer's management – awkward for Buyer to sue Seller
- Buyer
  - Wants more security than Seller is willing to give
  - Concerns about validity of reps & warranties
  - Concerns about Seller's ability to pay damages resulting from a breach
  - Concerns about costs of pursuing Seller for breach
  - Concerns about logistics pursuing Seller (e.g., cross border transactions)

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ALTERNATE FORMS OF RWI: "SELL-SIDE" RWI

- "Sell-Side" RWI
  - Seller is insured
  - Sell-Side RWI provides <u>Liability</u> coverage
  - Liability coverage
    - Applies in the event of a claim or suit against the Seller based on an alleged breach of R&W
    - Reimburses Seller for Defense Costs
    - Reimburses Seller for Settlements/Judgments

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ALTERNATE FORMS OF RWI: "BUY-SIDE" RWI

- "Buy-Side" RWI
  - Buyer is insured

- "Buy-Side" RWI provides First Party and Liability coverage
  - First Party Coverage
    - Insurer reimburses Buyer for losses associated with Seller's breach of R&W
  - Liability coverage
    - Applies in the event of a claim or suit against the Buyer related to Seller's breach of R&W
    - Reimburses Buyer for Defense Costs
    - Reimburses Buyer for Settlements/Judgments

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BUY-SIDE RWI v. SELL-SIDE RWI

- Buy-Side RWI used substantially more frequently than Sell-Side RWI
  - Seemingly easier way to shift exposure to insurer
    - If there's a breach that results in a loss to the Buyer, the Insurer pays
    - Eliminates need for Buyer to sue Seller to trigger Sell-Side coverage
    - Eliminates prospect of litigation against Seller -- Insurer's subrogation rights are usually limited to cases of fraud or other dishonest conduct

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BUY-SIDE RWI v. SELL-SIDE RWI

- Sell-Side RWI Disadvantages
  - Merely indirect, if any, benefit to Buyer; Traditional Solutions (e.g., discount, escrow, holdback) still required
  - Riskier to underwrite Sell-Side Policy--RW validity/breach is within Insured's control
    - Placement period is likely extended
    - Markets do not have access to buyer's due diligence
  - Exclusions and other limitations are stricter
  - Likely no price break over Buy-Side Policy

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RWI and DEAL STRUCTURE

- RWI is most often used in “Middle Market Deals” -- $25 million to $2 billion
  - Middle Market deal size is sufficient to bear RWI costs
  - Insurer capacity and appetite diminishes with substantially larger deals
  - Insurers reluctant to do smaller deals because margin is thin based on transaction costs
  - Check the market because insurers are adapting and some may be willing to underwrite smaller deals

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RWI and DEAL STRUCTURE

- RWI is subject to a retention – i.e., the insurance proceeds are only available in excess of specified losses
- Buyer and Seller structure deal agreement in collaboration with Insurer
  - Buyer and Seller may agree that Seller is responsible for first $X,000,000 of losses
  - Insurer would set retention at $X,000,000
  - Buyer and Seller consult with Insurer in structuring agreement to ensure that Insurer will provide coverage subject to retention of $X,000,000 (Insurer typically agrees to 1-2% of deal value)

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RWI and DEAL STRUCTURE

- RWI is subject to a limit – i.e., the insurer will only provide $XX,000,000 in coverage for the deal.
- Buyer and Seller structure deal working with Insurer
  - Buyer and Seller may agree to limit damages to the limit of the RWI insurance.
    - Insurer would set limit at $XX,000,000
    - Buyer and Seller consult with Insurer in structuring agreement to ensure that damages are limited to the amount of the coverage limit, which is $XX,000,000.
  - Buyer and Seller may agree not to limit damages to limit of the RWI insurance.

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RWI POLICY LIMITS and PRICING

- Pricing and availability of limits varies based on market conditions, but . . .
  - Many insurers offer $10MM as a minimum limit
  - Fewer insurers offer $5MM-$100MM
  - Handful may offer $2.5MM-$5MM
- Pricing is in the range of . . .
  - ~4.5-5.5% for limit of $2.5MM-$5MM
  - ~3.0-4.5% for limit of $5MM-$10MM
  - ~3.0- ~4.0% for limit >$10MM

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LIMITATIONS/EXCLUSIONS

- Coverage is provided during the pertinent Policy Period.
  - Policy may have multiple Policy Periods corresponding to particular Reps & Warranties
  - Policy Periods typically multiple years in duration

- Coverage is provided net of other recoveries to insured

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LIMITATIONS/EXCLUSIONS

- Exclusions
  - Matters identified in underwriting and described in schedule to policy
  - Matters of which members of "Deal Team" had knowledge
  - Matters disclosed in the deal documents
  - Fraud by the insured or a member of the Deal Team
  - Specific indemnity obligations
  - Employee benefit liability or withdrawal liability
  - Claims based on forward looking statements

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RWI PLACEMENT PROCESS--PLAN AHEAD

- Process takes time (usually at least two weeks)
- Broker is key facilitator of placement process
- Engagement of broker should occur in advance
- Experienced brokers and insurers are accustomed to lawyers and deadlines
- Placement process involves many steps

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STEPS IN RWI PLACEMENT PROCESS

- Execute Non-Disclosure Agreements with prospective insurers
- Provide deal documents, financials and related information to prospective insurers for purpose of getting indication of pricing and other terms for RWI
- Insurers provide indications of pricing and other terms to broker at (no cost)
- Broker works with Buyer (Seller) and lawyers to evaluate insurer indications and compatible integration with deal
- Buyer (Seller) selects insurer and pays non-refundable due diligence fee ($15-30,000) which primarily goes to law firm hired by insurer
- Insurer (Insurer's counsel) is given access to relevant due diligence information, which provides basis for insurer quote
- Buyer (Seller), Broker and Counsel consult, negotiate and finalize details of coverage with insurer
- Coverage is finalized and bound at closing, when premium is paid

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COMMENTARY

- It is vital to work with a Broker that has RWI and M&A expertise, as well as current knowledge of market players and conditions, which are fluid
- Insurers seem to be more flexible and nimble/responsive in placing this coverage than other types of coverage
- Insurers are willing to tailor policy terms and ability to recognize/implement reasonable and mutually beneficial terms and changes in language
- Favorable conditions are probably attributable to relative immaturity of RWI product, and new insurer entrants to the market
- Unlikely that the favorable conditions will be permanent – stay tuned

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THANK YOU FOR COMING

QUESTIONS?

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