ACCEC
American College of Coverage and Extracontractual Counsel

Getting to Know You —An Introduction To Representations & Warranties Insurance

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I. PURPOSE

"Critical to a buyer's and seller's evaluation of the acquisition and sale of a company is the allocation of exposure between them with respect to *unknown risks and liabilities* of the business." H. Meshki and B. Vongsawad, *Why You Need M&A Reps and Warranties Insurance,* (https://www.kirkland.com/.../Law360%20(M&A%20Insurance_%20Meshki,%20Vongsa...)("Meshki"). As one commentator notes:

> A form of coverage designed to guarantee the contractual representations made by sellers associated with corporate mergers and acquisitions. For example, the seller of a company may represent that the company's underground storage tanks are in good repair. If a serious leak is discovered following the purchase, the buyer can seek recovery for repair and clean-up costs from the seller's representations and warranties insurance policy. The key benefit of the policies is that they provide a *viable alternative to escrow funds*, which have traditionally used to satisfy claims associated with representations and warranties contained in merger and acquisition documents.

(https://www.irmi.com/online/insurance-glossary/terms/r/representations-and-warranties-insurance.aspx)("IRMI").

This form of coverage has been around for over a decade, but it is in the last few years that the market has really taken off and the policies have been in demand. All of the major carriers appear to be offering various forms of this coverage. It now represents billions in premium dollars being spent by American companies. Joseph Verdesca

Paul Ferrillo, *Representations and Warranties Insurance: What Every Buyer and Seller Needs to Know,* 1(LexisNexis Corporate Law Advisory January 2016).

II. TYPES

A. Picking A Side

The perspective insured varies. Most are familiar with a "buy-side" policy, which of course covers buyers. "Sell-side" policies are also available. In some circumstances, the Seller may choose to purchase a "buy-side" policy for the benefit of the Buyer. Most policies written today are "buy-side" policies. Meshki, *supra*, at 1. In addition to the Buyer and the Seller, the policies involve to some degree the conduct of the Target Group. That is the company or companies being acquired. Finally, the typical policy differentiates as to "Deal Team Members," which shall include the principal persons who (i) supervised, reviewed or conducted any due diligence, analysis or evaluation in connection with the Purchase Agreement, and/or (ii) supervised, reviewed, prepared or negotiated the Purchase Agreement.

B. Blending With Indemnity—Excess of Retention Arrangements

Many insurers require a self-insured retention to be paid by the Insured before the carrier has to pay indemnity dollars. The retention is only eroded by payments for amounts that would otherwise involve covered claims under the policy. Retentions of a million dollars or slightly less are not unusual on policies providing an aggregate limit of $25 million.

III. BASIC COVER

A. The Unknown

Most obviously, R&W policies cover the unknown risks and liabilities of the company being acquired. M&A transactions also involve indemnity obligations, which may not be covered per se under many R&W policies.

B. Indemnity

Some R&W policies provide specific coverage for "general indemnities beyond the representations and warranties."

IV. BASIC BENEFITS

A. The Problem

One commentator explains the basic problems solved by R&W coverage as follows:

Issue

Merger and acquisition transactions generally require the seller to indemnify the buyer for breaches of the representations and warranties that are made in the purchase and sale agreement. Depending on the parties involved and the nature of the representations and warranties, the seller may be required to escrow a material percentage of the indemnification requirement. This requires the seller to maintain substantial illiquid capital following an exit. If the seller is a private equity investor, it may limit their ability to wind down partnerships, formed for investment purposes, and may further limit their ability to return funds to investors.

From the buyer's perspective, an uninsured indemnity provides only limited comfort, as there is no guarantee that they will be able to collect losses if a breach occurs. In many acquisitions, the representations and warranties do not survive after closing because there is no one left to provide indemnity.

Marsh, *Representation and Warranty Insurance—Private Equity,* (https://www.marsh.com/ca/en/services/private-equity-mergers-acquisitions/representation-and-warranty-insurance.html

B. To The Seller

- Takes the pressure off of indemnity obligations, depending on policy language.
- No need for escrows or hold-backs
- Frees more funds for distribution
- Replaces indemnity, thus lessening impact of partners who are not likely to help with contractual indemnity obligations in the purchase agreement.
- Remove tax contingencies

See Verdesca, *supra*, at 3.

C. To The Buyer

Direct path to recovery

- No conflict per se with Seller
- No disruption of operation from pre-occupation with litigation or with litigation costs
- Limit indemnity and escrow exposures
- Solvent source of funds
- Protection from successor liability
- Greater limits than might be available by using a percentage of the purchase price
- Longer survival period than parties will typically agree to.
    - Avoids issue regarding availability or not of indemnity (e.g., publicly traded companies).
    - Solvency
- Better than a "Sell-side" policy because knowledge of the buyer is all that is excluded under the "buy-side" policy.

D. Carrier Pitch

One carrier has summarized the respective benefits as follows:

Representations and Warranties Insurance provides buyers with:

- Competitive advantage in bid/auction processes
- Added protection above any negotiated indemnity cap
- Longer survival period for indemnification resulting from breaches
- Protection against collectability or solvency risk of an unsecured indemnitor
- Representations and Warranties Insurance provides sellers with:
- Cleaner exits by reducing escrows or purchase price holdbacks and enhancing returns on sellers' capital
- Alternative recourse to shareholders in take-private transactions

- Protection from financial loss resulting from representation and warranty indemnity claims

(http://xlcatlin.com/insurance/insurance-coverage/professional-insurance/representations-and-warranties-insurance.)

V. NAVIGATING THE TERMS—EXAMINING THE TERMS OF A BUY-SIDE POLICY

A. Hybrid Policy Terms—*Incorporation*

Most forms of R&W coverage expressly incorporate the underlying Purchase Agreement facilitating the sale or acquisition.[1] In Texas, as in many jurisdictions, "a separate contract [from the insurance contract] can be incorporated into an insurance policy by an explicit reference clearly indicating the parties' intention to include that contract as part of their agreement." *Urrutia v. Decker,* 992 S.W.2d 440 (Tex.1999); *see also In re Deepwater Horizon,* --- S.W.3d ---- (Tex. 2015)(holding that additional insured provision in policy referencing a requirement in a collateral contract requiring someone to be made an additional insured resulted in incorporation of the collateral contract into the policy). "[I]nsurance policies can incorporate limitations on coverage encompassed in extrinsic documents by reference to those documents." *In re Deepwater, supra.* As the Supreme Court noted in *In re Deepwater Horizon, supra,* "[W]hile our inquiry must begin with the language in an insurance policy, it does not necessarily end there. In other words, we determine the scope of coverage from the language employed in the insurance policy, and if the policy directs us elsewhere, we will refer to an incorporated document to the extent required by the policy. *Unless obligated to do so by the terms of the policy, however, we do not consider coverage limitations in underlying transactional documents." Id.* (emphasis added).

Some policy forms define "policy" to consist of the declarations, terms and conditions and attached Appendices. The Purchase Agreement and its schedules, exhibits or other attachments are often made a part of the Appendices and thus part of the policy.

[1] "The contents of a high percentage of asset purchase, stock purchase and merger agreements are likely to be very similar. Each of the agreements will likely (1) set forth the financial terms of the transaction; (2) have representations and warranties regarding the target's business and its legal and financial condition; (3) have affirmative and negative promises, called covenants; (4) have conditions that must be satisfied in order for the parties to be obligated to close; and (5) in the case of private company acquisitions, have indemnification provisions setting forth the rights of each party to recover damages resulting from the other's misrepresentations or breaches." (https://www.law360.com/articles/268750/defining-definitive-acquisition-agreements.)

B. Claims-Made

The typical policy requires notice of a breach or third-party claim as soon as practicable. It must be made within the policy period or within a defined period of extension. Prejudice is required so long as the notice is at least received in the policy period or extension.

C. Policy Limits

1. Limits Based On A Pecking Order

The policy is likely to have a general aggregate limit. This will likely have sub-limits tied to particular types of covered events, breach of (a) any insured representation (likely set at the lowest amount in the policy, i.e. $5 million; (b) loss from breach of a Fundamental or Tax Representation, which will have a higher limit reflecting the remainder amount of the aggregate over the Insured Representation sub-limit.

2. Self-Insured Retentions

Most carriers will require a self-insured retention. In some instances, the Buyer may demand that the Seller pay for any SIR. This requires separate and additional terms for the policy and the purchase agreement. Many Sellers justifiably will not front the SIR unless there is a waiver of subrogation as to the amount of the SIR, which again requires the consent and agreement of the carrier.

D. Duty to Defend?

Some policy forms include defense costs in the limit of liability. With such so-called declining limits policies, the insurer does not undertake any duty to defend. But, the carrier does have the right to associate counsel in the defense, much like an excess or umbrella carrier.

E. Types of Representations

1. General Representations

2. Fundamental Representations

3. Tax Representations and Tax Indemnity

F. Breach

A breach is required to invoke the insuring agreement. This can be shown by "any" breach of or inaccuracy in any of the insured representations, which are specifically set forth in the policy declarations. A breach can also be shown by establishing the failure the "Seller Indemnitors" (as defined by the collateral Purchase Agreement) to satisfy their indemnification obligations relating to tax indemnity as set forth in the Purchase Agreement. Any attempts to address materiality, substantial compliance, etc. in the Purchase Agreement shall be disregarded. But, qualifications set forth in schedules in the Purchase Agreement shall not be disregarded and may be considered in determining if a breach or inaccuracy has occurred.

G. Policy Period

In my experience, the policy period is in multiple parts, tying different periods to claims involving different types of representations. For example, the policy period would be (1) three years from the date of closing for "General Representations"; (2) six years from closing for "fundamental representations"; and six years from closing for

H. Exclusions

1. Actual Knowledge/No Claims Declaration

"Reps and warranties policies do not cover known issues, such as issues discovered during due diligence, described in disclosure schedules, or so-called "new new" matters both occurring and discovered by the insured in the interim period between signing and closing." Verdesca, *supra*, at 4.

The policies always include some sort of "actual knowledge" exclusion Below is an example:

> The Insurer has no obligation to pay Loss to the extent arising out of, relating to, or to the extent it is increased by (and then only in relation to such increase):
>
> A. any Claim
>
> (i) of which any **Deal Team Member** had **Actual Knowledge** prior to the **Inception Date**;

(ii) to the extent such **Claim,** or the facts, matters or circumstances which would reasonably be expected to give rise to such **Claim**, has been disclosed in the **Purchase Agreement**; or

(iii) for which the amount of **Loss** is less than the **De Minimis**.

B. fraud by the **Insured** or any **Deal Team Member**, as determined pursuant to a *final judgment* by a court or arbitrational panel of competent jurisdiction . . . .

"Deal Team Members" is broader than simply noting actual knowledge of the insured. The Appendix to the policy states: "**Deal Team Members** shall include the principal persons who (i) supervised, reviewed or conducted any due diligence, analysis or evaluation in connection with the Purchase Agreement, and/or (ii) supervised, reviewed, prepared or negotiated the Purchase Agreement.

The policy definition of "actual knowledge" accompanying this particular policy defined it as follows:

Actual Knowledge

- with respect to a particular fact, event or circumstance means *actual conscious awareness* of such fact, event or circumstance, and
- with respect to a Breach, means *actual conscious awareness that such fact, event or circumstance constitutes a Breach*.
- Actual Knowledge *does not include* imputed or constructive knowledge.
- The Insurer shall have the burden of proof that any Deal Team Member had Actual Knowledge of any underlying fact, event or circumstance and any Breach.

Many of these policies have other related provisions. For example, some policies require a "No Claim Declaration" at closing from the Deal Team or anyone reviewing the due diligence and/or the Purchase Agreement has knowledge of a breach. Verdesca, *supra,* at 5. The policy makes this a condition precedent to coverage. Similarly, one would expect applications to potentially

address this issues as well. Common law in most jurisdictions imposes the rule that one may not insure a known risk.

2. Indemnity

Some policies exclude some or a substantial part of the indemnity obligations in the Purchase Agreement:

> C. any covenant or specific indemnity set forth in the Purchase Agreement or breach of such covenant or specific indemnity (not including the tax indemnity set forth in Section _____ of the Purchase Agreement) . . . .

Note that tax indemnity is excepted.

3. Payments and Obligations Under Purchase Agreement

The policies will include multiple exclusions dealing with obligations set forth in the Purchase Agreement itself. For example, amounts paid or to be paid pursuant to adjustment provisions in the Purchase Agreement are excluded. Similarly, estimated tax benefits or relief to the Target Group and secondary tax liability of an entity other than the target group are also excluded.

4. Environmental

R&W policies often exclude specified environmental claims. For example, some specifically exclude claims relating to asbestos and polychlorinated biphenyls. Where the reps and warranties themselves specifically deal with environmental subjects, negotiations with the carrier are necessary to eliminate a dangerous gap.

5. Deal Specific Exclusions

While standard exclusions are few, underwriters will add manuscript exclusions to fit aspects of the deal they consider too dangerous. This most frequently comes up in the context of environmental or manufacturer/products exposures. Perkins Coie, *Representation and Warranty Insurance,* (https://www.perkinscoie.com/en/insurance-recovery-resource-library-1/representation-and-warranty-insurance.html.)

I. Subrogation

Sellers are subject to subrogation for acts or omissions that amount to fraud. No other subrogation appears to be reserved under standard policy terms. Subrogation is not permitted against the Target Group itself. This variation is a buy-side policy with seller protection. Again, the protection to the seller is in terms of barring the carrier from subrogating against the seller. This protects and assures payment to the buyer, but allows the seller to walk away without worrying about escrows and hold-backs.

The Insured/Seller may not waive its rights of subrogation or assignment. Thus, if a Seller fronts the retention, the policy and the Purchase Agreement must both be modified to reflect that no subrogation, even for fraud, is permitted as to amounts paid under a retention by the Seller.

VI. SOPHISTICATED INSURED DEFENSE BUILT-IN

Some policies call for an agreement that the rule of strict construction does not apply to the policy. Some recite that the policy is a fully negotiated agreement among commercially sophisticated parties.

VII. IMPACT OF POLICY ON PURCHASE AGREEMENT

A. Amendment or Assignment

The Purchase Agreement may not be amended or assigned without the consent of the carrier. Consent is not required unless the carrier's rights will be adversely affected. No term of the policy may be amended or waived without a prior written endorsement or other instrument executed between the insurer and the insured. Typically, the insured may assign rights to (i) an affiliate of the insured, (ii) a subsequent purchaser by merger or stock acquisition or sale of all or substantially all of the assets of the Insured or any of its affiliates, or (iii) to a finance party by way of granting of security or providing collateral provided that the Insured notified the Insurer of such assignment within 30 Business Days of such assignment.

B. Indemnity

An example of an indemnity clause used in a Purchase Agreement including R&W coverage is set out below:

Indemnification by the Seller Indemnitors.

From and after the Closing, and in addition to the indemnification provided in Section ____ hereof, each of the Seller Indemnitors, jointly and severally (except as set forth in Section ____), will indemnify, defend and hold the Purchaser, each Target Company and each of their respective Representatives, successors and permitted assigns (collectively, the "***Purchaser Indemnitees***") harmless from any and all Losses asserted against, relating to, imposed upon, suffered by, or incurred by a Purchaser Indemnitee as a result of, arising from or relating to:

(i) any inaccuracy in, or breach of, any (A) Fundamental Representation, (B) the representations and warranties of Seller or the other Seller Indemnitors made in any Schedule to any Fundamental Representation or (C) to the extent required by and subject to Section ____) and ____, any inaccuracy in, or breach of, any representations or warranties as identified, in any notice delivered under Section ____, and in the case of (A) or (B), any allegation by a third party that, if true, would constitute such an inaccuracy or breach; and

(ii) the breach of any covenant or agreement made by or on behalf of Seller, any other Seller Indemnitor or any Target Company in this Agreement or pursuant hereto, or any allegation by a third party that, if true, would constitute such a breach.

WITH RESPECT SOLELY TO CLAIMS ARISING UNDER ENVIRONMENTAL LAWS, INCLUDING CERCLA, THIS INDEMNITY IS INTENDED TO ALLOCATE, WITHOUT LIMITATION, STATUTORY AND COMMON LAW NEGLIGENCE AND STRICT LIABILITY CLAIMS AS WELL AS NEGLIGENCE, STRICT LIABILITY, AND ALL OTHER CLAIMS ARISING UNDER ENVIRONMENTAL LAWS, INCLUDING CERCLA.