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Larry Braun and Zachary Turke are corporate lawyers with the Los Angeles office of Sheppard Mullin who advises clients ranging from family-owned businesses to multinational corporations in many diverse industries, including technology, healthcare, consumer goods, aerospace and defense, financial services, and manufacturing. Their principal areas of practice are merger and acquisition transactions, joint ventures, general corporate law, corporate finance and securities law, contractual matters (including licensing and distribution arrangements), healthcare transactions, and general business counseling. Sheppard Mullin is a full-service law firm with 15 offices throughout the world, including seven local offices in California.

| INSURANCE |

Mergers & Acquisitions Insurance

The growing use of rep and warranty protection in M&A transactions

The good news is that you can insure almost anything! In M&A transactions, buyers and sellers spend a great deal of time allocating risk relating to known and unknown pre-closing liabilities.

The buyer's view of the transaction is that other than specifically assumed liabilities, the buyer should bear no risk for pre-closing liabilities. The seller's view is that the buyer is acquiring a living and breathing business and should take on those risks.

These differing views result in extensive negotiations of representations and warranties and related indemnities in the purchase agreement. In order to complete transactions and avoid conflict, buyers and sellers are increasingly turning to rep and warranty insurance ("RWI") to have a third party bear some of these risks.

What Is RWI?

RWI is an insurance product that covers losses stemming from inaccurate representations made as part of a sale of a company. It can be purchased by buyers and/or sellers, either before or after the closing of a transaction. RWI can cover one representation or all of them and serve as one of several avenues of recovery for losses or the sole means of indemnification.

So why are you hearing more about this insurance now? "Representations and warranties insurance has been around

for over 15 years," says Paul Albarian of insurance broker Lockton.

"It's popularity has grown significantly in recent years, due in part to decreasing premiums as well as more robust coverage than previously available."

When Is RWI Used?

RWI can be used in any deal where either a buyer or seller wishes to mitigate against risks of unintentional and unknown breaches of reps and warranties. Buyers can obtain coverage for knowing misrepresentations by a seller that the buyer is not aware of. The following are a few of the common situations where its use may make sense:

- ▶ *Risk-Averse Buyer/Seller.* Some people just sleep better knowing they have risks covered by insurance. If you fall into this camp, purchasing RWI can help give you peace of mind that you have done everything you can to minimize the risk you will need to come out of pocket for unknown liabilities that are not already covered by other insurance.
- ▶ *Large Number of Sellers/High-Risk Sellers.* In deals in which there are a large number of sellers or some of the sellers are not financially sound, purchasing RWI backstops the risk that one or more of them cannot be

found later or are insolvent at the time of the claim and cannot make a required indemnification payment.

- ▶ *Selling a Business You Acquired.* Many representations require a seller to verify certain historical statements about the target business. For example, a seller may be required to certify that there have been no violations of law during the 5 years preceding a sale. If the seller purchased the target during that 5-year period, the seller will not know this information. RWI may be used to bridge this gap.
- ▶ *Buyer Differentiation.* Typically, RWI is purchased by its beneficiary. In auction sales involving numerous bidders, buyers may actually agree to purchase policies for the benefit of the sellers as a way to make that buyer's bid more attractive.
- ▶ *Means of Reducing Escrows/Holdbacks.* Escrows and holdbacks are the traditional means buyers use to ensure that money will be available to pay indemnification claims. Since RWI provides an alternate means of payment from a financially sound third party, the buyer may be willing to accept a smaller escrow or holdback, allowing sellers to take home more money at closing. This feature has

taken on additional value in recent years when interest rates for escrow accounts have been at historic lows.

- ▶ *Seller Unwilling/Unable to Provide Indemnification.* RWI can also be used when the seller is unwilling or unable to provide indemnification. For example, seller representations in public company deals typically do not survive the closing. ESOPs are also generally unable to provide indemnification. In these circumstances, RWI may be the buyer's sole post-closing source of recovery.

Weighing the Costs and Benefits

If you are considering RWI, it is imperative to fully understand whether its benefits justify its costs based on your specific risk tolerance. Premiums commonly run 2 to 4% of the policy limit.

Like any other insurance policy, RWI also has a deductible, approximately 1% of transaction value. Note that this deductible is paid by the beneficiary and is in addition to any deductible "basket" negotiated as part of the purchase agreement's indemnification provisions (the risk of which is borne by the buyer).

To evaluate whether to obtain coverage, consider an example where a seller sells his or her business for \$50mm in a transaction that has a deductible

indemnification basket of \$500,000.

The seller wishes to purchase a RWI policy of \$10mm. Based on those assumptions, he or she would likely pay a one-time premium of approximately \$150,000 for this policy. The purchase agreement might provide that the buyer would then bear the first \$500,000 of indemnification losses, after which the seller would bear the next \$500,000 of losses as a result of the insurance deductible, before the RWI policy would kick in up to the coverage limit of \$10mm. The question is whether it is worth spending \$150,000 to get coverage after \$1mm of losses. Only the seller can evaluate the risk and value.

One Size Does Not Fit All

If you've decided that RWI is appropriate for your transaction, note that this is not an off-the-shelf product. "Rep and warranty insurance policies are individually negotiated and tailored to the specifics of your transaction," says Paul Albarian. "As a result, it's critical that you work with an insurance broker and M&A attorney who are both familiar with this very specialized product to make sure you're getting the coverage that is right for you." And since these policies can take some time to negotiate and bind, he also recommends that you start the process in motion as soon as you execute a letter of intent.

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