a few things you should know …

Representation & Warranty Insurance

This edition of *A Few Things You Should Know* concerns Representation & Warranty Insurance. "Representation & Warranty Insurance" ("R&W Insurance") is a type of insurance policy purchased in connection with corporate transactions, and covers the indemnification for certain breaches of the representations and warranties in the transaction agreements. It is designed to provide additional flexibility in addressing these obligations, for example, by reducing or eliminating the need for an escrow by the Seller.

- **THE USE OF R&W INSURANCE IS INCREASING**
  The use of R&W Insurance is becoming more popular, and the volume of R&W Insurance sold has increased considerably in recent years. One recent estimate suggests it is now used in 20-25% of U.S. private transactions.

- **POLICIES CAN BE "SELLER SIDE" OR "BUYER SIDE"**
  R&W Insurance can be purchased as either Seller Side or Buyer Side coverage. Seller Side coverage is a form of liability policy, covering the Seller's liability for claims of breach of a representation or warranty. Buyer Side coverage is a form of first-party coverage, directly compensating the Buyer for alleged breaches by the Seller. One common variation is a Buyer Side policy that also protects the Seller (by barring the insurance company, except in cases of fraud, from pursuing the Seller after it makes a payment to the Buyer for a breach). This variation is often used to reduce a Seller's escrow or other exposure to representation and warranty claims, while still providing a source of recovery for the Buyer in the case of breach.

- **LIMITS AND RETENTIONS CAN BE NEGOTIATED**
  A key point of negotiation of R&W Insurance is the amount of the limits and retentions. Limits are often set at 10% of enterprise value, with retentions typically 1-3% of enterprise value. Premiums generally range from 2% - 4% of limits. The responsibility for the amount within the insurance policy's retention is often split between the Buyer and the Seller, in the form of a deductible in the transaction agreement.

- **R&W INSURANCE CAN PROVIDE BENEFITS FOR A BUYER**
  There are several ways R&W Insurance can benefit a Buyer. In an auction situation, it can make a bid more attractive, by reducing the Seller escrow, while still providing Buyer with protection. The Buyer can purchase insurance to cover higher amounts than the cap the Seller is willing to accept, and with longer survival periods (generally 3 years for general representations and 6 years for fundamental and tax representations). R&W Insurance can also provide a mechanism for recovery when pursuing the Sellers is expected to be difficult (for example, if Sellers are numerous, in foreign jurisdictions, may be insolvent, or have stayed on in the target's management).

- **R&W INSURANCE CAN ALSO HAVE DOWNSIDES FOR A BUYER**
  Buyers should be aware, however, that R&W Insurance does not provide as broad coverage as a Seller escrow of the same size, and so is not a perfect replacement. R&W Insurance does not cover known breaches (which must be disclosed), so if the Buyer, for example, has particular concerns about the way the Seller has been handling a tax issue, R&W Insurance coupled with a tax representation is not the solution. In addition, there are certain standard exclusions (such as asbestos and underfunded pension liability), and the insurance company will perform a detailed underwriting and may add deal-specific exclusions directed at high risk areas for the target (for example, excluding environmental and products liability representations for a manufacturer of heavy equipment). Indemnification from an escrow is not limited to breaches of representations and warranties, but can also include breaches of covenants and

special indemnities; by contrast, these would not be covered under an R&W Insurance policy. Thus, to the extent R&W Insurance is used to replace part of the Seller's escrow, the recovery available to the Buyer will not be as broad. The insurance also involves payment of a premium and an upfront underwriting fee, and will have a retention that leaves some of the risk on the Buyer.

- **R&W INSURANCE CAN PROVIDE BENEFITS FOR SELLERS**
  R&W Insurance is typically used to reduce or eliminate the need for an escrow from the Seller, allowing more of the proceeds to be distributed right away. It can provide a cleaner exit for the Seller, with fewer contingent liabilities. It may also be purchased to protect a passive or minority investor that was not in direct control.

- **THE R&W INSURANCE UNDERWRITING PROCESS IS ACCELERATED**
  The underwriting process to purchase R&W Insurance can be as short as seven days, though the initial phase of the effort can start much earlier. The first stage of the process involves working with an insurance broker to provide basic information and drafts of the transaction documents to one or more insurance companies. The insurance companies then provide non-binding indications of the coverage they would be willing to provide, with premium estimates. If the parties proceed, there is a non-refundable underwriting fee (usually between $15,000 and $40,000) for the insurance company to proceed with its diligence. After it has performed its diligence, the insurance company will provide a draft insurance policy, and this is often followed by some negotiation over the coverage.

- **COUNSEL CAN PROVIDE ASSISTANCE IN THE PURCHASE AND NEGOTIATION OF R&W INSURANCE**
  A key issue for counsel is coordinating the retentions, definitions of loss, and subrogation clauses in the R&W Insurance to match the purchase agreement, and the parties' intent as to the risk borne by each party in different situations. Counsel can also assist in pushing back to seek to limit or eliminate the insurance company's deal-specific exclusions. Other features of the policy may also be subject to negotiations, as well.

- **R&W INSURANCE IS NOT THE ONLY INSURANCE RELEVANT TO M&A TRANSACTIONS**
  Certain types of transactions may call for specific other types of insurance, including environmental impairment liability policies, political risk policies, and policies that cover the failure to qualify for expected tax or regulatory treatment. In addition, an M&A transaction may affect the target's existing or historic insurance program in various ways. *See A Few Things You Should Know: Insurance and M&A Transactions.*

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A FEW THINGS YOU SHOULD KNOW is a periodic publication of the Mergers & Acquisitions practice group of Perkins Coie LLP. Each edition covers a discrete topic related to M&A, including identifying key issues to be addressed and related market trends. We also share our experience-based insight into current approaches to resolving common deal issues. *A Few Things You Should Know* is intended as a high-level issue-spotting guide and quick-reference resource for buyers, sellers and their professional advisors. Please contact the Perkins Coie LLP attorney listed above for more information.