

TYPES NOT MAPPED YET September 26, 2016 | TTR not mapped yet | Michele C. Kloeppel

# Key considerations for representation and warranty insurance

The allocation of risk through representations and warranties and the accompanying indemnification obligations is a primary source of contention in almost every private merger and acquisition transaction. Buyers aim to negotiate an expansive indemnification package as a means to cover the majority of post-closing losses (and may seek an escrow to facilitate recovery). Whereas sellers seek to limit their post-closing indemnification exposure by narrowing the scope of the representations and warranties, negotiating for short survival periods and inserting indemnity deductibles, caps and other limitations.

Representation and warranty insurance helps resolve this conflict by, in exchange for insurance premiums, shifting a majority of the risk from the transacting parties to a third-party insurance provider.

Representation and warranty insurance comes in two flavors: seller-side policies and buyer-side policies. Seller-side policies are purchased by or for the seller, and coverage terms generally track the survival periods and indemnification cap outlined in the underlying purchase agreement. A seller-side policy reimburses the seller for losses it incurs if it has to pay the buyer for a breach of a representation or warranty.

Buyer-side policies are purchased by or for the buyer, with coverage terms potentially being extended beyond the survival periods and indemnification cap. Buyer-side policies are more common in transactions, as they allow coverage to extend beyond the contracted limitations agreed upon by the parties and may cover the seller's fraud. These policies allow the buyer to recover its losses for breach of a representation or warranty directly from the insurer.

## Who should use representation and warranty insurance?

Representation and warranty insurance may not be suitable for every transaction. For example, insurance is generally not suitable for smaller transactions (e.g., transactions of less than \$20 million), as the premium costs and other expenses quickly outweigh the benefits. Therefore, careful consideration should be given to the specifics of each individual transaction when considering representation and warranty insurance.

Common situations where representation and warranty insurance may be beneficial include the following:

- **Buyer's inability to obtain satisfactory indemnification coverage.** Whether because of the seller's superior bargaining leverage, a nominal purchase price with a corresponding low indemnification cap, or some other reason, certain transactions impose little to no indemnification obligations on the seller. Even when indemnification coverage appears sufficient on paper, pragmatic factors (such as the seller's financial distress or the difficulties of enforcing indemnification obligations in a foreign jurisdiction) may render unsatisfactory a buyer's rights under the acquisition agreement. In these situations, a buyer-side policy to supplement or replace the limited or non-existent indemnification coverage may be desirable to buyer.
- **Protecting continuing business relationships.** A buyer often relies on the target's management to continue to run the daily operations of the acquired business following the closing. The retained management often includes the business's founders or others who were involved in the negotiation of the acquisition agreement, and these individuals may be responsible to the buyer for post-closing indemnification claims. Indemnification claims can quickly sour the relationship between the buyer and retained management. By shifting the indemnification obligations to an insurance provider, representation and warranty insurance can preserve the relationship between the parties.
- **Seller certainty as to purchase price.** Lengthy survival periods combined with escrows, holdbacks, and other mechanisms may prevent a seller from making a clean break from the business and may limit the amount of

cash available to the seller following the closing. These problems are magnified when a venture capital/private equity firm is the seller and its investors expect a return on investment or funds available for distribution or re-investment. Representation and warranty insurance allows the seller to negotiate shorter survival periods and reduce or even eliminate escrows, both of which free up the seller's cash post-closing.

- **A competitive advantage in a competitive bid process.** A seller may rely on the competitive nature of an auction process to maximize the sale price while simultaneously negotiating more favorable deal terms. Obtaining representation and warranty insurance may give a buyer a competitive advantage in the bid context by allowing it to limit the indemnification package it requests from the seller and causing more sale proceeds to be delivered to the seller at closing. Thus, a buyer's bid that takes into account representation and warranty insurance may be more attractive to a seller.

Accordingly, with regard to your M&A transaction, consider whether representation and warranty insurance may be worthwhile.

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