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MERGER AGREEMENTS

R&W Insurance: Allocation of Risk With Respect to Interim Breaches

BY MIKE KENDALL AND ED AMER

Participants in middle market M&A transactions, particularly private equity sponsors, have become well-acquainted over the past several years with representation and warranty (R&W) insurance as a tool for solving issues around risk allocation, especially in competitive auction situations. A R&W insurance policy is often the primary source—at times the sole source—of recovery for losses sustained by a buyer as a result of a seller's breaches of its R&W in the acquisition agreement. The increased prevalence of R&W insurance has been driven in part by additional insurers entering the R&W insurance market, resulting in improved pricing and terms due to greater competition to underwrite these policies, as well as increased efficiencies in the underwriting process. The market has evolved to the point that a buyer's willingness to rely on R&W insurance, coupled with a nominal indemnity escrow (or none at all), has become an expectation in competitive situations, and a buyer unwilling to use R&W insurance will likely be left behind.

Even though reliance on R&W insurance by buyers is more popular than ever, nuances exist in the allocation of risk between a buyer and seller that are not always fully-appreciated by users of this product, particularly with respect to the possibility of seller breaches that result from facts and circumstances arising between the signing and closing of a transaction. R&W insurance coverage for transactions with an interim period between signing and closing (e.g., those that require Hart-Scott-Rodino or other regulatory approvals, third-party consents, debt financing, etc.) will typically be bound at the time the acquisition agreement is signed. Buyer will then be covered under the R&W insurance policy for any unknown seller breaches that were in existence as of signing. R&W insurance will not cover any known breaches, whether disclosed in the disclosure schedules or otherwise known by buyer's deal team, and buyer will be required to execute a no claims declaration (NCD) at signing, confirming that none of the members of buyer's deal team are aware of any basis for making a claim under the policy. At closing, buyer will be required to execute an additional NCD, confirming that none of the members of its deal team are aware of any seller breaches as of the closing, and buyer will then be covered under the R&W insurance policy for any unknown seller breaches that were in existence of closing.

The typical approach described above, however, obviously leaves a gap in coverage for any breaches which did not exist as of signing (because there was no breach for which to seek recovery), but arise and become known to buyer between signing and closing (because, as noted above, R&W insurance will not cover known breaches). Buyer's recovery for any such interim breach would be limited to the nominal indemnity escrow from

Mike Kendall is a partner at Goodwin Procter LLP and co-chair of the firm's Private Equity Group. Ed Amer is counsel in the firm's Private Equity Group.

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the seller, if any, and only then if seller does not get credit for any disclosure schedule updates made prior to closing.

Suppose in a typical transaction that recovery for any breach of representation is limited to a 1% indemnity escrow, after which buyer can only seek recovery from the R&W insurance policy, that seller does not get credit for any disclosure schedule updates between signing and closing, and that buyer is required to close the transaction unless a breach of R&W constitutes a material adverse effect (MAE). If a breach of a R&W arises between signing and closing (not known by buyer as of signing because it didn't exist), buyer will not be able to recover under the R&W insurance policy. Accordingly, buyer can either (i) bear the cost of the pre-closing liability arising from the breach to the extent it is in excess of the 1% indemnity escrow or (ii) if the liability is significant enough, allege an MAE and purport to terminate the transaction – although many significant liabilities would not be found to constitute an MAE under applicable law, so declaring an MAE puts buyer at risk of additional liability for breaching the acquisition agreement. If buyer is using debt to finance the purchase price, the lender may also resist closing in light of the newly-discovered liability, which could subject buyer to additional claims by seller and/or a reverse break-up fee obligation. Needless to say, these are all rather unattractive options to buyer, and reflect a very different bargain than the one buyer believed it struck.

In considering which party more appropriately should bear the cost of the interim breach described above, it is useful to ask the question: how would the parties likely have agreed to allocate this cost if they had negotiated it in advance of signing the acquisition agreement, with perfect information and foresight? The answer to this question, not surprisingly, differs depending on whether you ask buyer or seller.

When buyers agree to forego a traditional indemnity escrow (e.g., 5-10% of the purchase price) in favor of R&W insurance, it is usually based on the assumption that the R&W insurance policy will provide comparable coverage. Assuming, as most do, that a traditional indemnity deal would provide buyer with coverage by seller of liabilities resulting from interim breaches, from buyer's perspective the result should not be different in a R&W deal and they should be able to recover directly against seller when the R&W policy does not respond, up to the amount that would have otherwise been recoverable from a traditional escrow. Under this approach, buyer would not be disadvantaged by its willingness to accept a nominal 1% indemnity escrow in a R&W deal, because any losses resulting from interim breaches that cannot be recovered from the R&W insurance policy would instead be backstopped by seller – i.e., seller bears the coverage gap with respect to interim breaches, and buyer is in more or less the same risk allocation position as in a traditional indemnity deal. Seller still gets the primary benefit of buyer's reliance on R&W insurance where only a nominal portion of the purchase price will be escrowed at closing. This approach is generally in line with buyer expectations in a traditional indemnity deal, although buyer faces additional collection risk when its recourse is against the seller directly rather than against an escrow.

Conversely, sellers tend to have a different view of the appropriate risk allocation. From a seller's perspective, given the MAE standard for the closing bring-down of R&Ws all risks with respect to the business of target should shift to buyer as of the signing, including risks with respect to interim breaches. Sellers usually argue that the comparison to a traditional indemnity deal is inapt, because seller was only willing to enter into a transaction with buyer based on seller's expectation that its exposure would be capped at 1% (perhaps subject to exception for breaches of certain fundamental R&W and/or fraud), and that all risks with respect to R&W insurance (including collection risk, policy exclusions and interim breach risk) should be borne by buyer.

Like most meaningful deal points, where this issue comes out in any particular transaction is usually a function of which party has the better leverage. Some buyers are successful in persuading sellers that R&W insurance is a benefit to both parties and that otherwise the risk allocation should follow the traditional indemnity deal model. Savvy sellers (and their advisors), on the other hand, anticipate the buyer position and require bidders to accept the interim breach risk as part of the bid process and avoid waiting to resolve the issue until after exclusivity has been granted and leverage lost. In the end, it is only the unwitting buyer or seller that, failing to appreciate and negotiate this subtle but important issue at the outset, discovers too late they were left holding the bag.

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