BUSINESS, CORPORATE & SECURITIES

Prickly Pear: M&A Insights

Legal Alerts for the Arizona Business Community

March 2023

Services

Business, Corporate & Securities

Overview of Representations and Warranties Insurance

by Colson B. Franse and Mark E. Lasee

The increased volume of mergers and acquisition ("**M&A**") transactions has fueled the expansion and popularity of representations and warranties insurance ("**RWI**") in the United States. This article provides an overview of RWI and a glimpse into some of the deal components affected by RWI.

Outside of the purchase price, representations and warranties made by a seller drive M&A negotiations because they may materially affect the transaction long after its closing. While often referred to collectively as representations and warranties, a representation is a statement of fact relating to the current state of the business, true on the date it is made; a warranty is a forward-looking promise of fact as to the outlook or health of the company. Representations and warranties typically survive the closing for a period of 12-24 months and such period is also subject to negotiation. In addition to the promises themselves, buyers seek to ensure that there are funds available to respond should a warranty be breached or a representation be found inaccurate. Historically this would mean that the seller would commit to set aside resources to reimburse the buyer if any of the promises are untrue. In many instances, this has been best accomplished with an escrow holdback, "holding back" a portion of the sale proceeds and depositing them with a third-party agent instructed to give them to the seller after a certain period if they are not used to pay claims made by the buyer. Further, purchase agreements contain indemnification provisions allowing the buyer to "claw-back" part of the purchase price from the seller in the event claim(s) exceeds the holdback.

Representations and warranties cause a significant amount of uncertainty for sellers who would rather sell the business without the concern for claims months or even years after closing. Likewise, buyers are often concerned about the solvency of the seller for responding to claims exceeding the holdback or simply do not want to make a claim against the seller because they are still involved in providing services to the company. One way to mitigate these concerns is to consider RWI.

RWI is an insurance policy that provides coverage for damages resulting from breaches of representations and warranties made by the seller in a purchase agreement. RWI comes in two forms: a sell-side policy or a buy-side policy. A sell-side policy protects sellers from covered losses if the buyer seeks indemnification from the seller for the breach of a representation or warranty made in the purchase agreement. A sell-side policy can add certainty to the purchase price, speed-up the negotiation process (saving on legal costs) and alleviate the need for sellers to set-aside the same amount of reserves otherwise mandated by the buyer in a holdback escrow. A buy-side policy protects the buyer by allowing it to seek indemnification from the insurer instead of the seller if there is a breach of a representation or

Scottsdale Corporate & Securities Practice Group

Ken Witt
480.429.4864
ken.witt@kutakrock.com

Mark Lasee
480.429.4828
mark.lasee@kutakrock.com

Marc Lieberman
480.429.7103
marc.lieberman@kutakrock.com

Emily Smith
480.429.4886
emily.smith@kutakrock.com

Michael Tobak
480.429.5000
michael.tobak@kutakrock.com

Isaiah Wilson II
480.429.7122
isaiah.wilson@kutakrock.com

Matthew Ditman
480.429.5000
matthew.ditman@kutakrock.com

Colson Franse
480.429.4851
colson.franse@kutakrock.com

Christina Ribble
480.429.4844
christina.ribble@kutakrock.com

warranty made in the purchase agreement. A buy-side policy can protect relationships with seller parties who may remain involved in the business; make the buyer's offer more attractive to the seller because the holdback may be reduced or not required at all; and speed-up the negotiation process (saving on legal costs). For sellers with a large number of shareholders, either type of policy will obviate the problem of chasing numerous parties to collect damages for breach of representations and warranties.

While RWI often expedites the negotiation process between buyer and seller, each RWI policy involves its own negotiation and costs with the insurer. Obtaining RWI is typically a three-step process:

1. **Submit initial materials and obtain quotes.** The proposed insured discusses desired coverage terms and deal structure with their insurance agent and provides preliminary due diligence materials (draft purchase agreement, pitch deck, company financials, etc.). The insurance agent then reaches out to various insurance brokers to obtain non-binding indication letters which contain preliminary terms of an RWI policy to consider.

2. **Receive quotes and negotiate.** The proposed insured and agent review the non-binding indication letters and engage in some initial negotiations.

3. **Bind and underwrite.** If the proposed insured decides to move forward with an RWI policy, the underwriters will typically charge an underwriting fee to conduct due diligence, typically $30,000 to $50,000. The underwriter will review the data room, speak with management of the target company and speak with the proposed insured lawyers, accountants and advisors to understand known and anticipated risks.

RWI might not be the right option for some transactions. Both the buyer and seller must understand that RWI is not a full replacement of the classic holdback and clawback provisions because, like other insurance, each RWI policy has deductibles, limits of liability, carve outs and exclusions creating certain gaps in coverage and the proposed insured must be aware of the gaps or work with their attorney to ensure that the purchase agreement covers the gaps. Nonetheless, RWI is intended to cover those representations and warranties typically breached, thereby shifting the burden from the seller to the insurance company to respond to such claims. RWI does not come without a significant price. The underwriting cost and minimum premiums for RWI (typically $150,000-$200,000) may make it cost-prohibitive for smaller transactions under $50 million.

RWI significantly alters the structure of an M&A deal and it is important to begin conversations with your attorneys, accountants and advisors as early as possible. Be on the lookout for future *Prickly Pear* articles taking a deeper dive into RWI. If you have questions, please contact a member of Kutak Rock's Scottsdale Corporate and Securities Group. You may also visit us at www.kutakrock.com.