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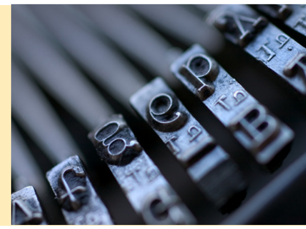

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The New Deal: Representations & Warranties Coverage

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Anyone who has been involved in the sale of a company knows it can be a complicated, time consuming, exciting and sometimes exhausting process. Much of the energy expended is focused on the warranties that are given in the Sale and Purchase Agreement. The questions of; by whom, about what, with how much escrow to back them up, and for how long a period of time they run provide the backbone of any transaction.

If there is a venture capital or private equity firm involved in the sale, this further complicates the situation. They often cannot or will not give warranties as this would prohibit their ability to close their fund.

Unresolved issues of this nature have been known to stop a deal in its tracks. There is a potential solution utilizing insurance market capital. It is not a panacea and is certainly not suited for every transaction. However, when it does fit it can really save the day.

Representations and Warranties coverage is relatively new in insurance terms and the sophistication of the product is evolving. The insurance contract becomes very tailored to the individual deal so if there is the potential to use this product it's worth talking to your broker as soon as possible.

WHAT IS THE TRIGGER?

The policy is triggered when there is a demand for financial restitution based on a breach of one of the warranties given by the seller in the Sale and Purchase Agreement. The amount claimed will be based on the diminution of value of the company as a result of the breach. For example, let's say one of the warranties in a Sale and Purchase Agreement states that they have all the licenses they need to operate their business. After the sale it's discovered that there was a permit required for one of their activities and niether party knew they were supposed to obtain it. Now the new owner not only has to get the permit but has been presented with a fine for all the years the company operated without one. Now the buyer would like to be made whole and sues for breach. Had he known that there was an outstanding permit missing prior to the sale he would have arranged to pay less money for the company to take that cost into consideration and it is this diminution in value that he is now claiming.

WHO SHOULD BE THE INSURED?

These policies can be written so that either the Buyer or the Seller is the insured. There are a number of factors to take into consideration when deciding who should pursue the policy.

Fraud. If the seller is the insured then there is no fraud coverage as you cannot insure against your own illegal behavior. However if the buyer is the insured then fraud coverage is available.

Subrogation. In the event of a claim underwriters have the right to take over the rights of the Insured and "stand in their shoes" in order to gain redress for the claim they have paid. So, if a buyer policy is triggered and a claim is paid then the Insurer has the right to pursue the seller for redress. This can prove to be a delicate issue. A seller may be prepared to deal with the buyer pursuing him in the event that they have a problem but be uncomfortable with the idea of being pursued by an insurance company.

It is sometimes possible to negotiate a buyer's policy so that the underwriter waives his right to subrogate against the seller in the event of a claim but this needs to be done on a case by case basis.

Process. The process is in two parts:

1. **Non-binding indication**. For this the Underwriter needs a draft of the Sale and Purchase agreement, an index of disclosure documents, an understanding of who the parties are to the transaction, which their respective advisors are and an idea of the strategic business rational behind the decision to buy/sell. Once all this information is gathered the Underwriter can provide a non-binding indication which will give an idea of price, likely exclusions and structure within a working week.
2. **Bindable quote**. If the client wishes to go ahead the underwriter will want to commission a legal review of the documentation provided, this is likely to be subject to a fee and take about a week. It is worth waiting until most of the documentation is close to finalization as changes occurring afterwards will have to be agreed by Underwriters.

WHAT IS THE UNDERWRITER LOOKING FOR?

The answer to this question is slightly different depending on who the insured is.

If the seller is to be the insured, the underwriter is looking at how reasonable the warranties are that are being made and what efforts the seller went to, to assess the accuracy of his statements. For example, when making the statement "except as set forth in the schedule there has been no, and there is currently no, suit, action, proceeding, investigation, grievance, claim or order pending, or to the knowledge of seller or any Owner, threatened against Seller," how did they confirm the truth of this statement? Was In-House Counsel asked or were all department heads also asked about any potential grievance? Were they asked verbally or did they put something in writing? Was there an interview process to ensure that all potential grievances where flushed out and disclosed prior to agreeing to the language of this warranty?

With a buyer policy the underwriter is looking at how thoroughly the buyer has completed his due diligence. He will examine the list of documents that the buyer requested and his external and internal due diligence reports, it is likely the Underwriter will also request a conference call with the team in charge of the due diligence process.

DOESN'T OUR D&O INSURANCE COVER THIS?

This is not an uncommon misconception. The logic goes that the Directors & Officers are making the warranties and so D&O insurance should step in. However, a Representations and Warranties claim is based on contractual breaches of warranty and the concomitant diminution of value that results. It is not a claim against the Directors for their actions as directors but a claim against warrantors for warranties made. The causes and remedies are different and so a separate policy is required.

REPS & WARRANTIES CASE STUDY

An environmental consulting firm had offices in 30 countries around the world. Each country had its own offices and its consultants acted independently, essentially as separate business units. When the consultancy firm was sold the buyer insisted the warranties needed to be given on a global basis and the limit of liability was to reflect the total consideration price of $80m.

However, each individual country was only getting a percentage of the consideration and was only able to comment on the warranties in relation to their own operation. The buyer was not prepared to accept piece-meal warranties or separate sub limits.

A policy was drafted that worked in conjunction with the sale and purchase agreement so that the warranties given globally and for a limit of liability of $50m but the individual warrantors were sub limited in value and geographical responsibility so that their liability was limited to "that which the insurance paid" and the single high limit worldwide policy was issued for the benefit of the buyers.

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