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To be on the hook, or walk away in M&A: that is the question

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Representations and warranties (R&W) in an M&A transaction acquisition agreement can serve several purposes, including the allocation of post-closing risk between the buyer and the seller. The scope and extent of R&W is a matter of negotiation, but frequently reflects the bargaining power of the parties, as well as the due diligence carried out by the buyer and its advisors on the target. Seller R&W are generally more extensive and cover many corporate, business, operational, compliance, tax, asset and financial aspects relating to the target and its business, as well as other deal-specific considerations. They are meant to provide a snapshot at closing of what a buyer is buying. In contrast, R&W by the buyer are generally limited to aspects surrounding the execution of the purchase agreement, such as the buyer's capacity to consummate the transaction (including its financial capacity).

Indemnification

Breaches of R&W can give rise to damages. However, acquisition agreements commonly include pre-negotiated indemnification provisions that stipulate the manner and extent to which damages incurred by the buyer, and resulting from such breaches, will be compensated by the seller. Except in the case of fundamental or tax R&W, potential damages are usually limited by a basket, a threshold or deductible and a cap, each of which is often stipulated as a percentage of the purchase price or the enterprise value (EV) of the target. Further, certain portions of the deal proceeds are often held in escrow or held back for several months or years to guarantee that damage claims by the buyer can be fulfilled by the seller. Like R&W, the scope and extent of indemnifications is a matter of negotiation. Post-closing indemnification claims can be an important, yet a contentious aspect of managing and allocating deal risk, which is why, in Canada, R&W insurance has become an increasingly popular tool over the last decade or so.

Insurance

A seller's R&W can be insured under a policy that transfers to the insurer the risk associated with post-closing liability resulting from breaches of R&W. From the seller's perspective, shifting indemnity risk to the insurer can achieve significant reductions in post-closing exposure and increase deal proceeds certainty. It can be utilized to provide a "walk-away deal," where no recourse can be made against the seller and where all funds are immediately available at closing, without any escrow or holdback. The R&W can also be used to settle on lower post-closing indemnity caps and claims risk in view of bridging the gap between a reluctant seller to indemnify the buyer and a somewhat more risk-averse buyer.

From the buyer's perspective, R&W insurance can lead to superior indemnification coverage, longer protection terms and easier mechanisms for recourse under the policy. In fact, the policy period for general R&W is usually three years while a customary and market survival

period generally lasts between 12 and 24 months, though often settled at 18 months (i.e., at least one audit cycle after closing). It can also allow buyers to accept more 'seller-friendly' deal terms and make their bid more attractive, especially in the context of a competitive sale auction for a hot target. The R&W can further be helpful to avoid potential post-closing heartburn where the seller will be the buyer's management team of the acquired business after closing! While less common, R&W insurance also has been used in transactions where there is no one staying behind to backstop the R&W, such as a company acquired in insolvency proceedings, or in the context of a going-private transaction of a public company.

Although R&W insurance is one of the only realistic substitutes for traditional robust indemnity provisions, it is not a perfect alternative. The implementation of these policies requires time and a thorough due diligence to be put in place. Further, the cost can be high with premiums typically ranging from 2.5% to 4% of EV, topped up by an underwriting fee of between $40,000 and $60,000, without taking into account the incremental cost of all professional advisors conducting enhanced due diligence to successfully complete the underwriting call with the underwriter. As a result, R&W insurance may be a harder sell and less viable in smaller deals. Let it not be forgotten that recourse under the policy is generally limited to a small percentage of the deal value between 10% and 20% of EV, and recovery will be subject to a retention (read a deductible) of about 1% of the EV.

The policy also will contain exclusions and often will not cover all relevant types of liability. Some exclusions are general and always apply (e.g., projections, forward-looking statements, purchase price adjustments, unfunded or underfunded benefit plans, interim breaches between signing and closing, several tax matters such as attributes and transfer pricing, seller's pre-closing reorganization, etc.) while others are deal-specific (e.g., audits for failure to comply with sanctions, a class action against the target, taxes and breaches disclosed in the disclosure letter, or of which the buyer becomes aware as a result of diligence, etc.). R&W insurance also will not cover matters that the buyer had at signing or closing; actual knowledge (defined as conscious awareness) is considered breaches of R&W. Therefore, to adequately manage deal risk, it may be required to negotiate specific indemnities accompanied by special escrow accounts where insurance will exclude material risks.

Recent developments in R&W insurance

There is an emerging trend in the R&W insurance industry to provide platform solutions for tuck-in acquisitions. A tuck-in acquisition refers to a special purpose vehicle, usually backed by private equity or another financial sponsor, that acquires a platform company, followed by several smaller acquisitions under it. Platform companies are usually larger, making the use of R&W insurance in their acquisition far more attractive and cost-effective. However, because of its high cost, R&W insurance would not be palatable for the several subsequent smaller tuck-in acquisitions.

There are now underwriters that are eager to insure both the initial platform acquisition, as well as the subsequent tuck-in acquisitions, at a reduced cost and with a streamlined process. This new product also can be used to insure the tuck-in companies exclusively of the platform. Such R&W insurance can be an attractive solution for deals from $5 million up to $25 million in EV. The underwriting process will be simpler, tailored to the pipeline's business operation profile, and will come with pre-negotiated pricing for required insurance limits. This new solution has everything needed to become a useful tool for any investor contemplating a roll-up strategy.

Another recent development is the emergence of transaction liability private enterprise (TLPE) insurance, which is now being offered by certain underwriters. TLPE insurance is aimed at providing smaller business sellers with protection against claims arising from a breach of R&W. Among other things, TLPE insurance policies provide coverage for 100% of

enterprise value and defense costs in the event of a buyer claim, and generally have a longer coverage period. The low policy fee of $500 and broad coverage options make TLPE an attractive option for smaller deal size sellers. The filing process is also simplified and can be completed by filling in a short standard application form.