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Five Things Every Risk Manager Should Know about Transaction Liability Insurance

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Private equity firms and companies use transaction liability insurance to manage the risk inherent in mergers and acquisitions. Representation and warranty (R&W) insurance is a type of transaction liability insurance that covers the risk of a target company's seller breaching representations and warranties in the applicable securities purchase agreement. R&W insurance was first created decades ago but has become increasingly popular in the past few years, particularly among private equity firms, which use it to facilitate the purchase and sale of portfolio companies.

Most often it is the deal team members and outside or in-house lawyers working on the transaction who purchase an R&W policy. But, given the increasing popularity of these policies, risk managers should also equip themselves to advise their organization concerning their purchase, and to facilitate payment of any claims that arise. This article covers five aspects of R&W insurance that every risk manager should know.

1. Most R&W Insurance Is Purchased by Buyers to Cover Loss Resulting from Sellers' Breaches of Representations and Warranties

The typical policyholder under an R&W insurance policy is the buyer in a securities transaction. Buyers purchase R&W insurance to facilitate a deal by limiting seller's liability for potential breaches of the representations and warranties in a securities purchase agreement. Limiting seller's liability to indemnify the buyer for a potential breach can entice the seller to accept a lower purchase price because it caps the amount of escrow required for the transaction and facilitates distribution of proceeds.

Purchase agreement representations and warranties ensure the accuracy of the target company's statement concerning, among other things, accounting compliance and the value of inventory and accounts receivable. Any misrepresentation concerning these assets could have substantial impact on the

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value of the acquired company and result in significant damages to the buyer. R&W insurance is intended to reimburse the buyer for the damages resulting from the seller's potential misrepresentations.

R&W policies may provide first-party coverage as well as liability coverage against third-party claims related to the transaction. They also extend the time period for discovery of breaches of representations and warranties by providing for a policy period of up to seven years in which to discover and notice a claim. Generally, an R&W policy will have a retention and may contemplate the seller's liability for a portion of the loss in the amount of the indemnification cap under the purchase agreement.

2. Coverage under an R&W Policy is Triggered by the Seller's Breach of the Representations and Warranties in the Purchase Agreement

Typically, coverage is triggered by the seller's breach of the representations and warranties in the purchase agreement. The policies generally contain broad coverage grants. One part of the policyholder's claim is showing that the sellers breached the agreement. Often coverage under the policy obviously has been triggered, and showing the amount of loss is the next step. For example, if the breach involves a representation in the purchase agreement as to the accuracy of the target company's financial statements or whether they comply with generally accepted accounting principles, the policyholder may include an accountant's view as to GAAP requirements and the seller's noncompliance. Insurance companies have an obligation to fairly review such claim information.

3. First-Party R&W Claims Focus on Valuation of the Buyer's Loss

Subsequent to an agreement that a representation and warranty has been breached, valuation of loss is a significant component of the claims process under an R&W policy. Investigation of a breach may take some time to complete and can involve detailed financial analysis by accountants and attorneys. The insurance company has a good faith duty

regarding valuation of the amount of loss as well. The bottom line is to calculate the loss resulting from the seller's breach.

4. R&W Policies Contain Notice and Cooperation Provisions Similar to Other Types of Insurance Policies

Facilitating the payment of an R&W claim usually involves providing the insurance company with information to support the claim, including responding to specific questions. Most policies contain a cooperation clause, which insurance companies often attempt to misuse to manufacture a breach by the policyholder. Usually the policyholder's best interests include fairly responding to proper information requests from the insurance company. Policyholders should keep a record of the information provided to forestall any failure-to-cooperate allegations.

Although an R&W policy may provide a window of several years for the policyholder to discover and provide notice of a breach, policyholders should note and comply with any potentially applicable time limitations — both with respect to notice and to litigation or arbitration against the insurance company. Attention should also be paid to any choice of law and/or venue provisions.

The policyholder may initiate litigation against the seller to recover the seller's portion of indemnity for the breach while their insurance claim remains pending. Under a buyer-side policy, the insurance company should pay the policyholder's claim regardless of whether any amounts have been recovered from the seller. Otherwise, to the extent that amounts due from sellers are uncollectable, coverage would be illusory. Indeed, this collection risk is a significant reason buyers purchase R&W insurance.

5. Claims Disputes Are Frequently Resolved via Arbitration

Most R&W policies include arbitration provisions that purport to require confidential arbitration under the rules of an alternative dispute resolution organization, such as the American Arbitration Association. Sometimes those clauses are improper and may be avoided in court. Risk managers should con-

sider whether arbitration of insurance claims is acceptable to their organization. Often, policyholders prefer to litigate claims before a jury, who are more likely to empathize with the policyholder, and avoid arbitration in which their fate may be determined by an arbitrator potentially with ties to the insurance industry and therefore very limited opportunities to appeal an unfavorable decision. But there may also be potential benefits to arbitrating a coverage dispute, including the ability to select an arbitrator with subject matter expertise, potential lower overall costs, and the possibility of a faster resolution.

To the extent a claim cannot be resolved without arbitration or litigation, an R&W insurance policyholder should act to obtain discovery of the underwriting file and communications between the insurance company and the insurance broker. Those communications may show the insurance company's intent in the purchase agreement to insure the seller's representations and warranties — and poten-

tial damages arising out of a breach thereof — at the purchase price and multiple originally contemplated by the buyer. Discovery of the claims file also may be key to resolution of the coverage dispute. Although many R&W insurance claim handlers, brokers and underwriters are attorneys, as a rule the claim file is not privileged as between the policyholder and the insurance company even if the claim handler is a lawyer.

Conclusion

The purchase and use of R&W insurance has grown exponentially in very recent years. Those who are integral to an organization's risk management should be familiar with R&W insurance and be prepared to evaluate policies and to advocate for their organization's R&W insurance claims, if and when they arise. Understanding a bit of the history and purpose behind this insurance is a good first step. ▲

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