



A Guide to Transaction Liability Insurance

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Pivate equity firms 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 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.

It is most often the deal team members and the lawyers working on the transaction who purchase an R&W policy, but risk managers should also be prepared to advise their organization concerning such a purchase and to facilitate payment of any claims that arise. Every risk manager should understand five aspects of R&W insurance:

1. Insuring the Buyer

The typical R&W policyholder is the buyer in a securities transaction. Buyers purchase R&W insurance to limit the seller's liability for potential breaches of the representations and warranties in a securities purchase agreement. This may 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.

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. Generally, an R&W policy will have a retention and may consider the seller's liability for a portion of the loss in the amount of the indemnification cap under the purchase agreement.

2. Claims Focus on Valuation

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. Often coverage under the policy has obviously been triggered and the next step is showing the amount of loss. 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 (generally accepted accounting principles) requirements and the seller's noncompliance.

Insurance companies may try to prolong the investigation of claims, arguing that the complexity of the claim issues entitles them to more time before reaching a coverage determination. The insurer has a good faith duty regarding valuation of loss. The bottom line is to calculate the loss resulting from the seller's breach.

3. Cooperation and Proof

Facilitating the payment of an R&W claim usually involves providing the insurer with supporting information, including responses to specific questions. Most policies contain a cooperation clause and it is usually in the policyholder's best interest to fairly respond to proper information requests from the insurer. Policyholders should keep a record of the information provided to forestall any failure-to-cooperate allegations.

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 insurer 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.

4. Disputes Resolution Via Arbitration

Most R&W policies require confidential arbitration under the rules of an alternative dispute resolution organization. Sometimes those clauses are improper and may be avoided in court. Risk managers should consider whether arbitration of insurance claims is acceptable to their organization. Often, policyholders prefer to litigate claims before a jury, which is more likely to empathize with the policyholder, and avoid arbitration in which their fate may be determined by an arbitrator who may have ties to the insurance industry—with very limited opportunities to appeal an unfavorable decision. There may also be benefits to arbitrating a coverage dispute, however, including the ability to select an arbitrator with subject-matter expertise, potential lower overall costs, and the possibility of a faster resolution.

5. Discovery May Be Key

If a claim does go to arbitration or litigation, an R&W policyholder should act to obtain discovery of the underwriting file and communications between the insurance company and the broker. The file may show the insurer's intent in the purchase agreement to insure the seller's representations and warranties—and potential 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 resolving the coverage dispute. Although many R&W claim handlers, brokers and underwriters are attorneys, as a rule the claim file is not privileged as between the policyholder and the insurance company. ■

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