Representations and warranties

by Michael A. Rossi

In the last several years, more and more companies in the US have been looking at ways of transferring the risks inherent in corporate mergers, acquisitions and divestitures. Correspondingly, insurance products for those risks have developed to meet that demand. Risk managers in the US today have several insurance options from which to choose including, but not limited to, representation and warranty insurance, aborted bid insurance, tax opinion insurance and a variety of pollution liability coverages.

But how does a risk manager separate the substance from the hype? Brokers and underwriters are making all sorts of claims about the newer products versus traditional insurance products. To help risk managers understand these issues, this article attempts to address some of the more salient risk and insurance issues with respect to one type of corporate transaction -an acquisition or divestiture through the use of an asset purchase agreement. A discussion of this subject is not only relevant to the Australian market, where such products are also beginning to be offered, but may also prove useful to Australian risk managers who are insuring corporate transaction exposures abroad.

Representations, warranties and indemnity obligations

Corporate acquisitions can take place in various ways. One common way is through the purchase of the assets of a

company. Such an acquisition typically is documented in an asset purchase agreement (APA). In that APA, the seller makes a long list of representations and warranties about what is being sold, on such matters as environmental issues, intellectual property rights, real property rights etc. The seller also typically agrees to defend, indemnify and hold the buyer harmless against claims and loss arising from any breach of such representations and warranties.

This indemnity obligation impacts on corporate transactions in several ways. The seller looks at it as a nuisance -- a risk that is always out there, waiting to come to fruition. For the person who is trying to sell their business so that they can retire, the last thing that they want to think about is the indemnity obligations in the APA that they might one day have to perform.

For the buyer, they have to worry about the seller becoming insolvent after the deal, with no money to fulfill their indemnity obligations. Unless the buyer requires that the seller maintain money in an escrow account or similar arrangement, the seller's indemnity obligation is worth only the assets the seller holds at the time the breach of the representation or warranty comes home to roost. But a requirement such as an escrow account can sometimes kill a deal, because the seller usually wants to be able to use the money from the sale of the business.

One way to address these issues is with insurance. Insurance can serve to transfer the risk of a breach of a representation or warranty from both parties to an APA.

Risk-specific insurance

The past several years have seen a rise in the insurance of indemnity obligations in APAs in the US through amending insurance products for particular categories of risk. Perhaps the earliest activity in this regard was with property transfer liability insurance, which could be amended to insure the environmental liabilities associated with assets being sold. As the pollution liability insurance market has matured in the US, with products like cost cap and remediation stop loss insurance and broadened forms of pollution legal liability insurance, the use of such insurance to address environmental liability in corporate and general real estate transactions has become common.

The same development is also occurring on other lines of insurance as well. Such as intellectual property infringement and multimedia liability insurance. Such policies can be amended to insure the representations and warranties in an APA regarding intellectual property issues.

But what about more traditional forms of insurance in the US? How, if at all, do they play out in a typical corporation transaction pursuant to an APA?

General liability insurance

The seller's historic general liability insurance can be an important tool for insuring representations and warranties and corresponding indemnity obligations in US corporate transactions. However, there are pitfalls.

For example, the laws of some US states arguably do not allow a buyer of assets of a company to make a claim on historic insurance policies sold to or for the benefit of the seller. In such circumstances, the buyer's reliance on historic general liability insurance could prove very problematic (meaning, no protection against certain liabilities if the seller is not financially able to perform the indemnity).

Also, general liability insurance in the US covers only liability associated with defined categories of injury (specifically: bodily injury, property damage, personal injury and advertising injury). It could be that many, if not most, of the risks associated with representations and warranties in an APA do not fall within the definitions of these coverages provided by general liability insurance.

Even if these issues do not apply in the Australian context, what if the seller is selling the assets of only part of its business, and does not want the buyer to be able to access the seller's historic insurance at all? In such a situation, general liability insurance typically will be taken off the table by the seller.

Directors and officers' liability insurance

Using the seller's D&O liability insurance may be seen as eliminating the need for representation and warranty insurance. However, there are a number of problems with relying on D&O liability policies in corporate transactions.

First, D&O liability insurance might not apply at all to the risks at issue. Such insurance covers acts or omissions by the directors and officers made in their capacity as directors or officers of the company. But most natural persons making representations and warranties in an APA are selling shareholders, not directors and officers. Even if the selling shareholder is a director or officer, the typical D&O liability policy still will not respond if that person did not make the representation or warranty in his capacity of a director or officer.

In order to provide coverage, the D&O liability policy would need to be amended to include selling shareholders as insured persons. It is not clear how many D&O liability insurers would be willing to amend their policies in that way.

Second, most D&O liability insurance programs in the US are written differently for privately held corporations than they are for publicly traded companies. Most of the policies for privately held corporations have a contractual liability exclusion (ie, the policy excludes liability assumed by contract-indemnity and hold harmless obligations). Thus, if the buyer seeks to impose liability on the selling shareholder pursuant to the indemnity/hold harmless provisions in the APA, the D&O liability insurer might deny coverage for the claim based on the contractual liability exclusion.

Third, in most APAs the seller company is making representations and warranties. However, under most D&O liability policies in the US, the company (as opposed to the natural persons who are directors and officers of the company) is insured only for securities claims. A claim by a buyer to enforce the indemnity/hold harmless provisions of an APA would be unlikely to fall within such coverage. Even for those D&O liability policies that extend broader cover-

age to the company (such as many policies for privately held corporations), the coverage is usually subject to a breach of contract and/or contractual liability exclusion. The D&O liability insurer is likely to argue that a breach of a representation or warranty in an APAA is a breach of contract and therefore barred by the exclusion.

Finally, what if the seller does not even have D&O liability insurance? It seems inefficient, as well as ill-conceived, to buy a D&O liability policy for a company whose assets are just about to be sold when an insurance product specifically designed to address the risks at issue is readily available.

Representation and warranty insurance

Enter representation and warranty insurance. It is a relatively new product in the US - it has been around for about one year - although it has been used in the UK for approximately ten years or more.

Whereas the insurance products discussed previously can be problematic, representation and warranty insurance is designed specifically to insure the representations and warranties, and corresponding indemnity obligations, in a corporate transaction. Eliminated are the issues regarding the capacity of the person(s) making the representations and warranties, the ability of a buyer to access the seller's historic general liability insurance policies, and the uninsurability of certain risks.

In the US, the buyer or the seller, or both, can be an insured under a representation and warranty insurance program. So the buyer who wants peace of mind after the transaction can buy the insurance to help obtain that peace of mind. If the need for a large escrow account threatens to kill a deal, representation and warranty insurance can be used in lieu. If the seller wants its own peace of mind -in case it feels like the buyer might burn through all of his proceeds from the sale of the business (whether in bad investments or drinking piña coladas in the Bahamas) - it can buy representation and warranty insurance for itself.

Unfortunately, however, it is not always quite so straightforward. There are at least three fundamental issues that the contemplated insured - whether the buyer or the seller in the deal at issue - must consider when looking at representation and warranty insurance in the US.

Primary v difference-in-conditions cover

First, there are at least two different types of representation and warranty insurance programs in the US market. One group of insurers uses a typical 'primary' type of liability insurance coverage, subject to a standard 'other insurance' condition (ie, in most instances the insurer will be obligated to respond on a primary basis, with a right of contribution or reimbursement from other applicable insurance).

Another group of insurers, however, uses a unique approach that can be described as a combination of difference-in-conditions/difference-in-limits liability insurance and first-party property insurance. With this type of representation and warranty insurance program, the insured must first seek recovery from all other sources (eg other insurance, private party indemnity, etc) and then fill out a proof of loss form to present to the insurer. The proof of loss form describes the loss and the amount thereof, describes the amount collected, if any, from other sources of recovery, and seeks payment for the shortfall.

In very simplistic terms, the primary type of cover pays loss on behalf of the insured, so that the insured does not have to go out of pocket to cover insured losses. The DIC/ DIL type of cover reimburses the insured after the insured has paid the loss at issue and exhausted other sources of recovery.

Risk-specific insurance

Second, it could be that, for certain types of risks, using the risk-specific insurance products that exist is a better solution for some US deals. For example, environmental liabilities may be better addressed by a program combining a cost cap/remediation stop loss policy with a pollution legal liability policy. Such policies can be amended to work quite nicely with environmental liabilities associated with an acquisition or divestiture. Similarly, if the quirks of certain states' laws can be avoided, relying on historic general liability policies also might be better than using representation and warranty insurance for certain risks.

Cost

Third, representation and warranty insurance can be expensive - very expensive - in the US That is because, among other things, the market is so small and young (really only a year or so old in the US). However, the cost should come down as the market matures and more players enter into it. Coverage terms and conditions are likely to get broader at the same time. D&O liability and employment practices liability insurance in the US followed such a pattern.

The important point to realize, however, is that representation and warranty insurance is a viable product in the US today. Any Australian risk manager who is involved with a US transaction should consider the usefulness of these products for the transaction.

Concluding remarks

To address risk and insurance issues in any corporate transaction, all parties involved must understand the deal. As between buyer and seller, who will assume what risk? Will the seller's pre-existing and historic insurance playa part in trying to insure that risk? Will any new insurance product playa part in trying to insure that risk? Once these issues are decided, then, and only then, can the buyer and seller understand whether, how and to what extent the insurance policies discussed in this article can play a role in addressing the risks at issue.

A risk manager who can help advise a company on such issues and guide the company through an analysis and decision-making process regarding them can prove very valuable indeed. I hope that this article provides some useful information to help Australian risk managers address some of the risk and insurance issues involved with such transactions, whether they take place at home in Australia or abroad. ■

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