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Representations and Warranties Insurance: Drafting and Counseling

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R&W Insurance Provisions

A provision in an acquisition agreement providing for the purchase of representation and warranty insurance is typically straightforward. Most commonly, the requirement to obtain an R&W insurance policy will be built into the definitions of indemnity escrow and indemnity cap limitation clauses, or found in the list of closing conditions for the acquisition. At a minimum, the clause will state which party, buyer or seller, is responsible for purchasing the policy in connection with the closing. The clause may also include a reference to the amount of coverage provided under the policy, the name of the insurer, and the liability the policy is required to cover (i.e., indemnification obligations, breaches).

In transactions where an R&W insurance policy is being obtained, other provisions of the acquisition agreement may need to be revised to include references to the policy. Below are examples of provisions that may be impacted:

Purchase Price/Expenses

The acquisition agreement must address which party will be responsible, or whether the parties will share responsibility, for the payment of the premium on the R&W insurance policy. If the purchaser will be paying any portion of the premium, the payment will likely result in an adjustment to the purchase price that must be taken into account in the agreement. The parties may also specify the allocation of responsibility between them for the payment of the premium in the acquisition agreement's expense clause.

Covenants

For acquisitions in which there will be a gap between the signing of the acquisition agreement and the closing/funding of the transaction, the underwriting of the R&W policy may be secured at signing to cover this gap period. In such cases, it will be advantageous for the party charged with obtaining the policy to receive a covenant requiring all parties to cooperate in binding the policy at signing and satisfying the appropriate conditions to have that policy in effect at closing.

Indemnification/Recourse

The indemnification provisions of an acquisition agreement may need to be revised if an R&W policy is meant to be the sole recourse for certain types of indemnification liabilities or if it otherwise is going to affect the manner in which an indemnified party seeks or obtains payment for indemnified liabilities.

Checklist: Selecting the Right R&W Policy

	Without R&W Insurance Policy	With R&W Insurance Policy
Timing / Effectiveness of representations and warranties	Commonly negotiated as to when the reps and warranties must be accurate, often giving the buyer the right to walk away if the reps, which were held to be true as of signing become untrue as of closing.	Assuming there is a gap between signing and closing, most R&W insurers will provide for coverage to incept at signing, essentially allowing a buyer and seller to close over a non-MAC/MAE level breach of the signing reps.
Survival	Typical private transaction survival periods of 12-24 months for 'general' reps are negotiated between buyer and seller, with survival of fundamental reps often held to such statute of limitations.	The market R&W policy will generally provide for 3 years for general reps and 6 years (or statute of limitations) for fundamental reps (including tax, environmental and ERISA).
Knowledge	Commonly negotiated between buyer and seller as a way for Seller's to qualify their responsibility in providing reps and warranties. Common definition considerations typically range from a Buyer- friendly 'constructive' knowledge (that which should have been known upon reasonable investigation) to a more Seller friendly 'actual' knowledge.	The Knowledge concept under the R&W policy is used by the insurers to limit their risk by providing an exclusion for any 'known' breach. Actual knowledge is the standard in the R&W market and further narrowed by a limited number of Buyer deal team members that would need to have had such actual knowledge of a breach in order for such breach to be excluded under the R&W policy.
Damages	Significant negotiation is common for the type of damages that can be recovered by a Buyer through the definition of 'Loss' or Damages' with the most frequently negotiated items being consequential, multiplied and/or diminution in value as Buyer requests under the purchase agreement. In situations where a buyer and seller cannot agree upon what will be expressly provided/excluded for, the agreement can remain silent in respect to a Buyer's ability to recourse for such damages. Additional premium is required in most cases to obtain these enhanced definitions.	Most R&W insurers are willing to, at their own discretion, provide for coverage of consequential, multiplied and/or diminution in value damages by way of removing their standard exclusions for such items. In most cases the insurer will not expressly provide for such damages but is often willing to remain silent to the extent the underlying purchase agreement also remains silent to such recourse.
Materiality Scrapes for calculating loss and determining breach	Commonly negotiated as to the required accuracy of the reps and warranties at the time of bring-down with 'materiality' considered as a threshold for purposes of both calculating loss and determining whether a breach has occurred.	Most R&W insurers will provide coverage for materiality scrapes under the R&W policy, at their discretion separately or individually, for both calculating loss and determine breach. This is generally dependent upon the insurer's comfort with and perception of the Seller's disclosure practices and/or any materiality thresholds in regards to such practices.

Checklist: Selecting the Right R&W Policy (Cont.)

	Without R&W Insurance Policy	With R&W Insurance Policy
Subrogation (R&W Policy)	The legal right that allows one party (an insurer for instance) to make a payment that is actually owed by another party (the Seller) and then collect the money from the party that owes the debt (the Seller) after the fact.	R&W policies should provide a waiver of any and all subrogation rights to the insurer in favor of the Insured or the Sellers (except in instances of fraud).
Retention (R&W Policy)	N/A	The retention is the aggregate amount of loss that would need to be experienced before the R&W policy can be used as recourse for covered losses. This retention is most often split between both the Buyer basket and Seller indemnity cap and typically ranges from 1.0-2.0% of the enterprise value. Most insurers, at their discretion, will provide a drop-down to some lower amount after the survival period under the purchase agreement has expired (often to match the existing buyer basket).
Indemnity Cap	Caps are dollar limitations placed upon the Buyers indemnification rights and recourse for damages. 10% caps are frequently used for general reps but the negotiations between a Buyer and Seller to settle on the agreed to cap amount can be unnecessarily extensive.	The cap in most cases is now replaced, to the greatest extent possible, by the R&W policy. The cap under the purchase agreement is typically reduced to the lowest possible limit to match what the policy retention will allow (see baskets / deductibles). In most cases whereby an indemnity escrow exists, the escrow will also be lowered to match this minimal seller indemnity cap.
Indemnity Escrow	Indemnity Escrows are often more heavily negotiated than a cap as the Seller seeks to maximize their proceeds at closing. Indemnity escrows are used to provide the buyer with a level of certainty that funds will exist to pay breaches up to a certain limit. This limit can be up to the full indemnity cap within the agreement or some factor thereof, with 5-7% of the enterprise value being an average cited by various publications.	Whereby the R&W policy will effectively reduce the Seller indemnity cap (and provide an A-rated funding source), so too will the escrow be reduced, in most cases to match the limited indemnity cap provided for under the R&W policy structure. However, there is no rule by the insurers requiring that an indemnity escrow be present in order to obtain an R&W policy.
Baskets and Deductibles	Baskets/deductibles are frequently used by Seller's to eliminate the need to respond to what otherwise might be considered a nuisance claim. Baskets are either negotiated to be tipping (after a threshold has been met the Seller will provide recourse to the Buyer for losses under such threshold) or non- tipping (also considered a 'true deductible' whereby the Buyer actually absorbs losses under the threshold) and on average may range from 0.50% - 1.00% of the enterprise value.	Whereby a non-tipping ('true deductible') basket is used in the agreement, such losses will contribute towards and erode the retention under the R&W policy, and therefore the buyer basket and seller indemnity cap will generally equal the R&W policy retention. For tipping baskets, since the seller will be on the hook for all losses above the basket threshold, the Seller indemnity cap would generally need to equal the full R&W policy retention.

Checklist: Selecting the Right R&W Policy (Cont.)

	Without R&W Insurance Policy	With R&W Insurance Policy
Remedy / Recourse	In most cases the Buyer and Seller will agree for the indemnification to be their exclusive remedy/recourse for losses related to breaches of the reps and warranties.	Remedy/Recourse will now include the R&W policy and often will be the 1) sole and exclusive remedy, 2) exclusive remedy beyond the indemnity escrow or 3) exclusive remedy whereby such R&W policy would provide coverage (essentially leaving an indemnity structure of a traditional agreement as recourse should the R&W policy not provide coverage).

For further drafting guidance, see [Representations and Warranties Insurance for the Private Equity Industry – Indemnity Matrix](#).

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