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Trending Issues in Negotiation of Indemnification Provisions

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Overview of Representation & Warranty Insurance

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Rep & Warranty Insurance Summary

- **Typical coverage of rep & warranty insurance (“RWI”):**
 - RWI generally covers breaches of sellers’ reps and warranties in a definitive acquisition agreement

- **Potential benefits of RWI:**
 - Enhance auction bid or bridge negotiation gaps (price, length of claim period)
 - Reduce seller escrow amounts and overall indemnity exposure
 - Ease process by streamlining negotiation/documentation of agreement

Rep & Warranty Insurance Summary

- **Growth of RWI**
 - RWI introduced in US in late 1990s, but initially used sporadically
 - RWI usage has grown dramatically since 2012
 - Pre-2012, market wary of collectability of claims and viewed RWI as prohibitively expensive and time consuming to obtain
 - ~2012, perception shifted
 - lower premiums and increased demand
 - allowed insurers to expand capacity, enable more flexible and expedient underwriting, and simplify claims process (claims paid in ordinary course)

- **Impact on auctions**
 - Pre-2015, early users of RWI had a competitive bidding advantage and could often preempt auctions with favorable terms
 - From 2015, bidders may be at competitive disadvantage without RWI (or offer of RWI-like indemnity terms, self-insuring the risk)

Rep & Warranty Insurance Summary

- **Exclusions**
 - Known breaches of reps (“actual knowledge of actual breach” by identified deal team members of the insured)
 - Vary by deal (and specialty policies may cover exclusions), but often include:
 - Environmental issues (absent clean Phase I reports)
 - Employee classification / FLSA issues
 - Certain state tax issues
 - Specific issues identified in underwriting
 - Other matters usually not covered include any adjustments to purchase price, breaches of seller covenants, punitive damages

Rep & Warranty Insurance Summary

- **Typical context**
 - PE seller (seller seeks quick/unconditional return of capital to LPs)
 - Middle market between \$100-\$500MM of enterprise value (“EV”)
 - Not yet efficient for <~\$5MM of risk, but trending downward
 - Risk amounts >\$50MM may require syndication, which reduces certainty of coverage and thus utility of RWI in bid process
- **Pricing fairly consistent, assuming clean underwriting:**
 - Total cost: ~50 basis points of EV (for policy for 10% of EV)
 - Premium typically ~4% of policy limit plus minor underwriting costs
- **“No seller indemnity” deals**
 - Can utilize RWI to provide a public company style deal with no seller indemnity (“NSI”)
 - NSI policies available, but at higher price (+~25-75 BPs)
 - Buyers/insurers leery of removing seller’s incentive to get reps right

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