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Trending Issues in Negotiation of Indemnification Provisions

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Acquisitions Institute

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Panelists:

Craig A. Menden, Cooley LLP, Palo Alto

Mark S. Solomon, Andrews Kurth LLP, Dallas

Elizabeth C. Brandon, Barnes & Thornburg,
Dallas

Jessica C. Pearlman, Partner, K&L Gates,
Seattle

Tom D. Harris, Haynes & Boone, Dallas



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Overview of Representation & Warranty Insurance

Jessica Pearlman

jessica.pearlman@klgates.com

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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