A Practice Note providing guidance on how to best address representation and warranty insurance (R&W insurance) when drafting and negotiating the acquisition agreement, including sample language. This Note also provides drafting tips and key considerations for the R&W insurance policy.

The use of representation and warranty insurance (R&W insurance) has become increasingly popular in private M&A transactions, particularly in middle market deals with values ranging from $100 million to $500 million. This is largely due to the broad coverage offered by most R&W insurance products, coupled with the proven claim-paying ability of most reputable insurers.

Despite the increased reliance on R&W insurance as a strategic tool to close an M&A transaction, there is no established practice among M&A professionals on how to properly integrate R&W insurance into the terms of the acquisition agreement. Most insurers also do not provide standard language for use in acquisition agreements. While some parties choose to remain silent about R&W insurance in the agreement, most address provisions related to R&W insurance in some manner. Counsel for both the buyer and the seller should:

- Draft R&W insurance provisions that accurately reflect the parties’ agreement.
- Understand the interplay between the R&W insurance policy and the acquisition agreement.

Buyer-side policies, which are purchased by or for the buyer with the buyer as the insured, are the most popular R&W insurance product. They generally work with the indemnification provisions in the acquisition agreement to replace the seller with a third-party insurer as the primary source of recovery for the buyer’s covered losses.

This Note provides:

- Guidance on how to best address a buyer-side policy when drafting and negotiating the acquisition agreement, including some proposed language.
- Drafting tips and key considerations for the buyer-side policy.

For more information on R&W insurance, see Practice Notes, Representation and Warranty Insurance for M&A Transactions (w-000-4767) and Incorporating Representation and Warranty Insurance into M&A Transactions (w-003-3851).

**DRAFTING TIPS FOR THE ACQUISITION AGREEMENT**

Once the parties have agreed to include R&W insurance in their transaction, counsel should:

- Structure the terms of the acquisition agreement to appropriately shift the claim risk to the insurer.
- Confirm that the R&W insurance policy provides adequate coverage.

Provisions related to R&W insurance are generally added to the covenants, closing conditions, and indemnification sections of the acquisition agreement.

When conforming the R&W insurance policy to the transaction, the insurer relies on certain provisions of the acquisition agreement, such as the definition of “Loss” (including any carveouts for consequential or multiple damages), the definition of “Knowledge,” and the materiality scrape. The R&W insurance policy will be drafted to match the coverage and limitations agreed to in these provisions (see Practice Note, Representation and Warranty Insurance for M&A Transactions: Policy Terms (w-000-4767) and Drafting Tips for the R&W Insurance Policy).

**COSTS OF THE R&W INSURANCE POLICY**

The parties generally negotiate who pays for the R&W insurance premiums, the fees and expenses of the underwriter and broker, and other related costs. If the buyer is using R&W insurance to add value to its bid in a competitive auction, the buyer may volunteer to cover all associated costs. However, if R&W insurance is being obtained to accommodate a seller who does not want to place a large portion of the purchase price in escrow (a practice that is particularly common with private equity sellers who plan to disburse proceeds from the sale at closing), the buyer may require the seller to cover all or a portion of the costs. The parties may also split the insurance costs or set a cap on a party’s liability for insurance costs.
R&W insurance costs are often addressed in the acquisition agreement as part of the definition of “Transaction Expenses.” For example:

“…Transaction Expenses’ means … including (x) [(PERCENTAGE)% of] the aggregate amount of the premium, underwriting fee, brokerage fees, legal fees (if any) for counsel engaged by the underwriter, surplus lines tax and any other costs and expenses associated with obtaining the R&W Policy[, up to an amount equal to $[NUMBER] in the aggregate].”

R&W insurance costs may also be included in a covenant of the payor in the acquisition agreement (see, for example, Standard Clause, Purchase Agreement: Representation and Warranty Insurance Provisions: Section 2.01 (w-003-4372)).

CLOSING CONDITIONS
Since buyer-side policies do not cover issues the buyer knows about when the R&W insurance policy is bound, binding the R&W insurance policy at signing may be advantageous to a buyer. Most policies are bound at signing (assuming a staggered sign-and-close structure), which not only prevents an insurer from denying coverage for issues that are discovered between signing and closing, but also helps streamline the negotiation process with the seller by making a closing condition unnecessary. However, having an R&W insurance policy bound at signing requires the parties to negotiate the R&W insurance policy simultaneously with the acquisition agreement and incur the underwriting fee (usually between $25,000 and $50,000) before the parties have committed to a deal.

If the R&W insurance policy is not bound at signing and the buyer is relying entirely on R&W insurance for its indemnity coverage or is agreeing to obtain R&W insurance to accommodate the seller, the buyer should add the availability of the R&W insurance policy at closing as a closing condition. For example:

“The Insurer shall have bound coverage under a representation and warranty insurance policy (the ‘R&W Policy’) and the R&W Policy shall be in full force and effect.”

The closing condition may be further tightened to 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. For example:

“Buyer shall have obtained a representation and warranty insurance policy (the ‘R&W Policy’), [substantially in the form attached hereto[,] in form and substance reasonably acceptable to Buyer,] to become effective at or prior to Closing, that provides coverage for breaches by Seller of no less than $[NUMBER] with respect to the transactions contemplated hereby and a retention no greater than $[NUMBER].”

For another example of an R&W insurance-related closing condition, see Standard Clauses, Purchase Agreement: Representation and Warranty Insurance Provisions: Section 3.01 (w-003-4372).

If the buyer is using R&W insurance as a deal sweetener in a competitive auction, it should consider adding a covenant agreeing to comply with the R&W insurance policy and not to make any material modification that may negatively affect the seller, such as reducing the policy limit, to strengthen its position. For example:

“Buyer shall use commercially reasonable efforts to obtain representation and warranty insurance, solely for the benefit of Buyer, related to Losses arising from breaches of Seller’s representations and warranties contained in this Agreement that are in excess of the Escrow Amount[, with coverage of no less than $[NUMBER] and retention no greater than $[NUMBER]][, substantially in the form attached hereto][, on terms reasonably acceptable to Buyer] (the ‘R&W Policy’). [At Buyer’s reasonable request, Seller shall cooperate with Buyer and provide commercially reasonable assistance to obtain and bind the R&W Policy].”

INDEMNIFICATION
The seller commonly indemnifies the buyer not only for liabilities from any inaccuracies or breaches of the seller’s representations and warranties, but also for specifically identified liabilities known to the parties before signing. When incorporating R&W insurance into an M&A transaction, one approach is to create a specific indemnity for any losses that the R&W insurance policy fails to cover due to the seller’s bad acts (which losses would generally not be subject to a cap, basket, or mini-basket). For example:

“Seller shall indemnify, defend and hold each Buyer Indemnitee harmless from and against, and shall pay and reimburse each of them for, any and all Losses incurred or sustained by the Buyer Indemnitees arising out of or by reason of any Losses that are not covered by the R&W Policy as the result of Seller’s submission of false or inaccurate information or omission of accurate and responsive information to the Insurer.”

Another, more buyer-friendly, approach is to create a specific indemnity for any issue that falls outside of the R&W insurance policy’s coverage (such as any exclusions arising out of any known matters that the seller would need to disclose on any “no claims” declarations at signing or at closing). For example:
“Seller shall indemnify, defend and hold each Buyer Indemnitee harmless from and against, and shall pay and reimburse each of them for, any and all Losses incurred or sustained by the Buyer Indemnities arising out of or by reason of: (a) any breach of or inaccuracy in any representation or warranty made by Seller in this Agreement that is within the scope of coverage under the R&W Policy; and (b) any (i) breach of or inaccuracy in any representation or warranty made by Seller in this Agreement that is not within the scope of coverage under the R&W Policy pursuant to Section [NUMBER] of the R&W Policy or (ii) portion of a Loss excluded pursuant to Section [NUMBER] of the R&W Policy.”

SOURCE OF RECOVERY
Because most insurers prefer that the seller retain some risk, the parties generally agree to escrow a small percentage of the purchase price to cover the retention amount under the R&W insurance policy. In many transactions, the seller’s exposure is capped at the escrow amount. However, sellers typically remain liable for certain negotiated liabilities above the R&W policy coverage amount when the retention and R&W insurance policy limits are exhausted. The indemnification provision in the acquisition agreement should then be revised to require that the buyer seek indemnity payments from the escrow account and the R&W insurance policy before seeking payment from the seller. For example:

“All claims for Losses made by any Buyer Indemnitee under Section [NUMBER] shall be satisfied solely out of funds available in the Escrow Account, subject to the terms of this Agreement and the Escrow Agreement, and the Escrow Account will be available as a primary source of recovery for Buyer Indemnities for any other indemnification obligations of Seller under this Article [NUMBER]; provided, however, that claims pursuant to Section [NUMBER] and Section [NUMBER] shall be satisfied: (a) first, from the Escrow Account; (b) second, if the entire retention under the R&W Policy has been exhausted, by submission of claims by Buyer pursuant to the R&W Policy until such time as the policy limit set forth in the R&W Policy has been reached; and (c) thereafter, against Seller subject to the limits set forth in this Article [NUMBER].”

For another example of an indemnity payment provision, see Standard Clauses, Purchase Agreement: Representation and Warranty Insurance Provisions: Section 4.01 (w-003-4372).

LIMITATION ON LIABILITY
In addition to negotiating baskets, caps, and sources of recovery for indemnity claims, depending on their negotiating leverage, each party may want to explicitly set out additional boundaries around their indemnification obligations (in the seller’s case) or indemnification rights (in the buyer’s case).

The buyer may want to provide the seller with assurance that the buyer will not double dip when making indemnification claims while simultaneously protecting its indemnification rights under the acquisition agreement. For example:

“Seller acknowledges that Buyer is entering into the R&W Policy and that, in connection therewith, a Buyer Indemnitee may make claims for the same Loss or series of related Losses under both this Article [NUMBER] and the R&W Policy; provided, however, that in no event may a Buyer Indemnitee recover amounts from Seller and pursuant to the R&W Policy, aggregating an amount in excess of its Losses with respect to such claim, and any such excess amounts received by any such Buyer Indemnitee shall promptly be paid over to Seller in accordance with Section [NUMBER]. Seller further acknowledges and agrees that the denial of any claim by any Buyer Indemnitee under the R&W Policy shall not be construed as, or used as evidence that, such Buyer Indemnitee is not entitled to indemnification under this Article [NUMBER].”

However, the seller may want to limit its indemnification obligations to the four corners of the acquisition agreement and place the burden of complying with the terms of the R&W insurance policy solely on the buyer. For example:

“Notwithstanding anything to the contrary in this Agreement, Buyer, on behalf of itself and each other Buyer Indemnitee, acknowledges and agrees that the sole and exclusive remedy of any Buyer Indemnitee beyond the Escrow Amount for any claim related to or arising under Section [NUMBER] or Section [NUMBER] shall be to make a claim against the R&W Policy. Buyer, on behalf of itself and each other Buyer Indemnitee, further acknowledges and agrees that the provisions of this Section [NUMBER] shall apply regardless of whether (a) Buyer obtains at or following Closing or maintains following Closing the R&W Policy, (b) the R&W Policy is revoked, cancelled or modified in any manner after issuance, or (c) any Buyer Indemnitee makes a claim under the R&W Policy and such claim is denied by the Insurer.”

SUBROGATION
The insurer generally has no subrogation rights against the seller under an R&W insurance policy, except for the seller’s fraud. Because insurers maintain subrogation rights for the seller’s fraud, buyer-side policies do not typically include an exclusion for the seller’s intentional fraud. In a competitive auction, particularly where the target has several shareholders, a buyer could strengthen its position by adding an R&W insurance product that covers the seller’s fraud and limits the buyer’s recourse against the seller. For example:

“If the R&W Policy by its terms provides coverage for claims of intentional fraud, then prior to asserting any claim against Seller for intentional (but not constructive) fraud in the making of the representations and warranties under this Agreement, Buyer shall have used commercially reasonable efforts to recover all amounts due under the R&W Policy in accordance with the terms thereof.”

INSURANCE COLLECTION EFFORTS
If the seller is responsible for any losses that are not covered by the insurance policy (subject to indemnification caps and other limitations), it should propose language requiring the buyer to use a minimum level of effort to pursue claims under the R&W policy. For example:

“With respect to any Losses for which any Buyer Indemnitee is entitled to indemnification under this Article [NUMBER], Buyer shall (and shall cause its Affiliates to) use commercially reasonable efforts to diligently make and pursue claims for such Losses under the R&W Policy. Buyer (for itself and on behalf
of the Buyer Indemnitees) acknowledges and agrees that in the event a claim under the R&W Policy is denied and Buyer or any Buyer Indemnitees’ actions (or inaction) is the sole cause of such denial, the Buyer Indemnitees shall not be entitled to indemnity by Seller to the extent prejudiced thereby.”

If the buyer agrees to this type of covenant, it may want to include a covenant that places conditions on its obligation to pursue claims under the R&W insurance policy. For example:

“With respect to any Losses for which any Buyer Indemnitee is entitled to indemnification under this Article [NUMBER], Buyer shall (and shall cause its Affiliates to) use commercially reasonable efforts to make and pursue claims for such Losses under the R&W Policy. Buyer’s obligation to use commercially reasonable efforts to recover Losses under the R&W Policy shall not include any obligation to litigate such claims with the insurer if the insurer has denied coverage in writing; provided, however, that if Buyer declines to litigate any such denial of coverage, Seller shall have the option, in its discretion and at its expense, to contest such denial of coverage through litigation or other appropriate means].”

DRAFTING TIPS FOR THE R&W INSURANCE POLICY

The R&W insurance policy has transformed from a form insurance policy, with terms largely dictated by the insurance carrier, to a highly negotiated, highly customized document that is meant to function like the structured indemnification provisions that it is typically replacing in part or in whole. Though there are many important nuances throughout the document and counsel should consider the interplay between the R&W insurance policy and the acquisition agreement, some provisions warrant special attention in every R&W insurance policy.

KNOWLEDGE CONSTRUCT

All R&W insurance policies have an anti-sandbagging feature, where issues known by the buyer when the policy is bound are not covered. However, in recent years, “knowledge” for purposes of the R&W insurance policy has evolved into an actual knowledge standard (as opposed to any type of constructive or implied knowledge standard) and is typically limited to the actual knowledge of a specified list of individuals at the buyer. For example:

“‘Actual Knowledge’ means, with respect to a particular fact, event or condition, an actual conscious awareness of such fact, event or condition, and with respect to a Breach, that the relevant person had an actual personal conscious awareness that such fact, event or condition actually constituted a Breach. The Insurer shall bear the burden of proving that any person had Actual Knowledge of any such fact, event or condition and that such fact, event or condition constituted a Breach. Actual Knowledge shall not include (a) any imputed or constructive knowledge or (b) any knowledge of any outside advisors or agents. For the avoidance of doubt, Actual Knowledge does not require any duty or obligations of inquiry, except as specifically set forth in this R&W Policy.”

While the concept of limiting this exclusionary item to an actual knowledge standard is rarely negotiated, buyers should ensure that they fully understand the implications of the knowledge construct which flows through the R&W insurance policy.

DEFINITION OF “LOSS”

If there is an underlying general indemnification obligation on the seller’s part, the definition of “Loss” or “Damages” in the R&W insurance policy should effectively track the corresponding definition in the acquisition agreement. For example:

“‘Loss’ means the amount to which the Insureds are contractually entitled in respect of a Breach pursuant to the terms of the Purchase Agreement, including any related Defense Costs payable hereunder, without regard to Section [NUMBER].”

If the R&W insurance policy is serving as the buyer’s sole recourse (in other words, there is no general indemnification obligation for breach of a representation or warranty on the seller’s part), the parties generally negotiate a separate definition in the R&W insurance policy. For example:

“‘Loss’ means the amount to which the Insured has or would have a right of indemnification pursuant to the Purchase Agreement and, if there are no applicable indemnification rights in the Purchase Agreement, the actual damages that would be recoverable at law with respect to a Breach, disregarding any per claim dollar threshold, dollar basket, dollar cap or limitation, deductible, time limitation or survival period.”

R&W insurance policies generally track a customarily broad, buyer-friendly definition of “Loss” if the definition stops short of an affirmative grant of certain special damages, such as consequential damages, diminution in value, damages based on a multiple of earnings or EBITDA, or a similar metric. Therefore, silence in this regard in the acquisition agreement (if there is an underlying seller indemnification obligation) creates the broadest coverage under the R&W insurance policy.

Buyers should also make sure that any general indemnification limitations within the acquisition agreement do not apply to the R&W insurance policy. The definition of “Loss” should properly speak to an aggregate amount under the R&W insurance policy, which will have its own set of negotiated limitations, such as exclusionary items.

EXCLUSIONS

Much of the transaction-specific negotiation of an R&W insurance policy will be about subject matter exclusions, which serve to limit the definition of “Loss” under the policy. The three general categories that these exclusions fall into are:

- Standard exclusions that are found, in some manner, in every R&W policy (see Practice Note, Representation and Warranty Insurance for M&A Transactions: Exclusions (w-000-4767)).
- Transaction-specific exclusions that were proposed at the quoting stage as part of the insurer’s initial indication of interest.
- Transaction-specific exclusions that have resulted from the underwriting (either because there was a gap in the buyer’s diligence or because a known issue was discovered from the diligence and underwriting efforts).

As with any drafting and contract negotiation exercise, the language of any exclusion is critical. Buyers should seek to be as precise as possible in describing exclusionary items, ensuring that the subject matter of an exclusion is appropriately compartmentalized and not subject to
ambiguity or misinterpretation should a claim arise. Therefore, the buyer should pay special attention to the lead-in to any exclusion, such as “arising out of,” “resulting from,” “relating to,” and “for.”

RETENTION
All R&W insurance policies feature a self-insured retention, which can be thought of as a deductible. However, the limit of liability under the R&W insurance policy is distinct from the retention (for example, the insured will only begin to exhaust the limit of liability once the retention is fully exhausted). The retention is customarily constructed through a combination of:

- A non-tipping basket, or true deductible, borne by the buyer under the acquisition agreement.

- The seller’s indemnification cap (whether backed by an escrow or the subject of a holdback or a simple contractual indemnity).

For example, a policy may have an aggregate retention equivalent to 1.5% of the purchase price, comprised of a 0.5% non-tipping basket borne by the buyer and a general indemnification obligation on the part of the seller capped at 1% of the purchase price. If the seller is not providing any general indemnification and the buyer’s sole recourse is the R&W insurance policy, the retention will effectively be the buyer’s basket, and the buyer will need to bear the entirety of that retention to access the policy.