

REPRESENTATIONS AND WARRANTIES INSURANCE IN BUYING OR SELLING A BUSINESS

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Transactional Representations and Warranties

In a variety of business transactions, including mergers or acquisitions or stock or asset sales or leases, the seller will typically make contractual representations and warranties that form the foundation of the transaction. Those representations and warranties may relate to the financial condition of the seller or its assets, the accuracy of its financial statements, the state of its accounts receivable, compliance with tax and regulatory requirements, matters concerning employee benefits and other employment matters, ownership and non-infringement of specified intellectual property, the existence of threatened or pending litigation, and many other important topics.

When buying or selling a business, representations and warranties are an essential part of managing the risk associated with a transaction. The representations and warranties amount to a risk allocation – they catalogue those things that a seller can be held accountable for, and create “gaps in the coverage” for risks assumed by the buyer. They serve as a basis for a buyer to seek financial compensation from a seller if a representation or warranty provided by the seller turns out to be untrue, even if the seller was innocent of any wrongdoing.

Both parties will negotiate these statements very carefully to get the risk allocation the way they want it, will then reflect their final wording in the price and terms of the deal, and ultimately will rely upon them in arranging financing and closing the transaction.

Real and Potential Risks

The corporate transactions referred above involve two basic kinds of risks - real and potential.

We can identify, quantify and deal with real risks. There are lots of ways of dealing with such risks, including price adjustment clauses and outright retention by the seller.

It is the potential risks that cause all the problems. Although a party provides representations and warranties in good faith, there is always the potential for unknown or unanticipated issues to arise after closing. Our imaginations can usually come up with legions of them. The buyer generally wants the representations and warranties drafted so

that all those risks fall on the seller. The seller, of course, does not want to live with the uncertainty of not knowing whether or not they really get to keep all the purchase price they have so diligently bargained for.

Many a deal falls apart, or comes close to falling apart, when it comes to representations and warranties. Good lawyers will often prove their worth in dealing with these issues.

Secured Indemnities

Until recently, the most common way to protect against such risks was to seek a secured indemnity from the seller, but such indemnities are only as solid as the financial solvency of the seller or the extent or availability of the holdback or unpaid purchase price the buyer could resort to. As a matter of practice, a lawyer will require some form of guarantee from the seller to ensure that sufficient funds would be available to perform the indemnity obligations in the event of a breach of a representation or warranty. Frequently, companies will protect themselves from unanticipated liabilities by placing funds from the purchase price into an escrow account, or by similar means.

Representations and Warranties Coverage

More recently, the risks identified above may be addressed by representations and warranties insurance coverage purchased by the buyer or the seller.

The attractiveness of representations and warranties insurance is that the seller can easily evaluate the cost of representations and warranties protection based on the policy's importance to the transaction and the seller's cost of capital. This type of policy can dispense with the need to retain funds in escrow, thereby freeing those funds up for the immediate use of the seller. Representation and warranty insurance also covers existing claims against the company and so can supplement or even replace the need for an escrow deposit of a seller's indemnification. In addition, representation and warranty insurance generally provides coverage for legal fees incurred.

The certainty provided by this form of insurance coverage enables the parties to quantify the inherent risk of the transaction; the risk is quantifiable by (i) the cost of the policy; and (ii) the amount of the deductible. With this certainty in mind, the parties can assess whether it makes sense to proceed with the transaction.

Exclusions

There are a limited number of risks which insurers typically exclude from representations and warranties insurance coverage:

- personal injury and property damage;
- lack of environmental hazards;
- known misstatements; and
- fraud and dishonesty (but only in instances where the seller purchases the policy)

Practical Uses of Representations and Warranties Insurance

There are a number of situations where representations and warranties insurance can make all the difference in structuring the purchase and sale of a business.

In reducing buyer holdbacks or security: If a buyer's concerns are protected by representations and warranties insurance, the need for a buyer's holdback or security can be reduced or eliminated. Money that would otherwise be held back from the seller can be released to the seller in full. This can be important for a seller who is leaving a jurisdiction or retiring, or when the finances of the seller are such that almost all the purchase price is needed to clear title to the assets being sold.

In negotiating price and other terms: Since a party to a transaction may obtain representations and warranties insurance coverage without disclosing the existence of such coverage to the other party, the purchasing party has the ability to negotiate the other terms of the transaction with the knowledge that it is protected from the risks represented by the representations and warranties the other side is insisting on. With the comfort of such protection, a party can negotiate an adjustment in the purchase price that is significantly greater than the cost of the insurance, even when that party factors in the cost of the deductible. This advantage can help both a buyer and a seller.

In reducing or speeding up due diligence: The guarantees provided by representations and warranties coverage can substitute for a time-consuming due diligence process; if momentum must be maintained in a transaction, most insurers can do their review of the due diligence in about three or four days.

In an acquisition from multiple sellers or an acquisition from an estate or a trustee: Representations and warranties coverage can be purchased to satisfy the needs of multiple sellers where, for example, one of the sellers is active in the operation of the business and the other is inactive (such as, for example, where one is a passive investor), or in transactions where the seller is an estate or bankruptcy trustee, and thus may be reluctant to provide any representations and warranties to the buyer. In these kinds of transactions, the comfort the coverage would provide would more than offset the cost of representations and warranties insurance.

Some final points about such insurance:

- It can be purchased by either the buyer or the seller.
- It can be purchased to protect against a breach of representation against all, some, or even one representation and warranty.

Closing Thought

While it is unlikely that representations and warranties will be required in most transactions, the thoughtful and timely application of such coverage will turn out to be the difference between getting your deal done, or having all your hard work fall apart.