

# Expanding the Use of Representations and Warranties Insurance in a Post-COVID-19 World

*Distressed M&A transactions and 363 bankruptcy sales*

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**SHOCKED BY AN ALMOST UNIMAGINABLE PANDEMIC, THE GLOBAL ECONOMY CURRENTLY PRESENTS SIGNIFICANT CHALLENGES TO MERGERS AND ACQUISITIONS (M&A) ACTIVITY.** Facing an economic slowdown, the length of which no one can accurately estimate, investors and M&A practitioners are preparing to pick up assets from distressed companies at attractive valuations, including through formal bankruptcy proceedings. Representations and warranties insurance (RWI) is a useful tool for these types of transactions, providing a source of recovery where one otherwise would not be available. Use of a RWI policy may potentially increase the price that a buyer is willing to pay for these assets, bringing additional value to sellers and to creditors in a bankruptcy process.

## Out-of-court vs. 363 sales

For acquisitions of distressed assets or companies outside of the bankruptcy process, a RWI policy functions in the same way that it has been traditionally used. RWI insurers are increasingly willing to consider underwriting these risks in the current economy, particularly for deals involving targets that were financially healthy prior to the COVID-19 outbreak. The coverage can provide recourse for breaches of reps where the seller is unwilling or unable to provide indemnification or can be used to mitigate the credit risk of a seller if the buyer has concerns about such seller's ability to stand behind its indemnity obligations.

Putting a RWI policy in place as part of a formal bankruptcy sale process (a 363 sale) has not received widespread attention to date, largely because the use of RWI did not gain traction until the mid 2010s, during a period of continuous economic growth. While the "free and clear" order given by a bankruptcy court in a 363 sale cuts off much of the significant historic third-party liability in these acquisitions, a buyer may still have first-party claims for breaches of a seller's reps. Since there is no recourse against the seller for such breaches under the purchase agreement in a 363 sale, RWI can provide the buyer with protection for any such unknown liabilities. With this protection, a buyer may be willing to pay a higher price for distressed assets, which in turn would benefit the creditors in the bankruptcy process.

## Timing and other key considerations

In a 363 sale, a RWI policy is ideally introduced in connection with the stalking horse bidder. Typically, this bidder has the best access to the target company and sufficient time to conduct appropriate diligence. The stalking horse also negotiates the reps in the purchase agreement and can factor in the cost of the RWI policy into the calculation of its bid price and break-up fee.

Fulsome buyer diligence is key in the successful placement of RWI policies in distressed M&A transactions, as insurers still engage in their typical underwriting process. Although the reps made by sellers in 363 sales are typically less robust than in traditional deals, underwriters still need appropriate buyer diligence to validate the reps that they are being asked to cover, in addition to thorough seller disclosure schedules. All parties involved, including the underwriters, may need experienced bankruptcy counsel to advise on which pre-closing liabilities will be cut off by the sale order and the appropriate scope of diligence in these transactions.

The interest of RWI insurers in underwriting distressed transactions should echo traditional deals, with factors such as audited financial statements, straightforward revenue recognition, and domestic operations all increasing the attractiveness of a risk. On distressed deals in particular, underwriters will strongly prefer targets with continuity at the management team level, since this stability provides additional comfort on the diligence and disclosure process. As always, RWI insurers will have little interest in target companies with a history of significant mismanagement or fraud.

## Policy costs

While out-of-court distressed sales may incur higher premiums, pricing for policies on 363 sales could potentially be even more favorable than market rates prior to the COVID-19 outbreak due to the cleansing process afforded by the bankruptcy proceedings. However, underwriting fees may be higher for 363 sales, as underwriters may incur the additional cost of engaging experienced bankruptcy counsel. Additionally, insurers and their counsel may need to do some primary diligence amidst the compressed timeline often dictated by the bankruptcy procedures.

When insurers are engaged to underwrite policies in connection with a stalking horse bidder and such bidder intends to bind coverage at signing, the insurer should not impose a pre-exclusivity underwriting fee. Since the stalking horse will pay a 10% non-refundable deposit of the RWI policy premium at binding, such amount will serve as a break-up fee to insurers if the stalking horse does not ultimately prevail at the auction. The amount of this deposit should be taken into account when the stalking horse negotiates its own break-up fee under the purchase agreement. In contrast, depending on the circumstances surrounding the auction, insurers may seek to charge a pre-exclusivity fee for other bidders in the auction process. As is typical, this fee will be credited towards the premium to the extent that such other bidder prevails at auction and ultimately binds a policy.

## Potential extensions of coverage

As noted above, a typical purchase agreement for a 363 sale has a lighter set of reps than a traditional acquisition. The use of a RWI policy may allow a buyer to expand such reps as long as appropriate diligence is performed. Further, some insurers may be willing to consider providing certain synthetic reps as part of their coverage, meaning such reps would be included in the policy despite not being a part of the underlying purchase agreement. To the extent that a buyer can get the insurer comfortable with the diligence done to support these reps, along with any necessary disclosures against them, this additional coverage may present an attractive solution to buyers who are unable to negotiate those reps into their purchase agreement.

In addition, while a 363 sale cuts off most pre-closing third-party liabilities, some risks can survive, such as certain employee, intellectual property or environmental liabilities. A buyer may therefore want to consider purchasing a successor liability policy in connection with the RWI policy to appropriately address such risk. If the buyer's legal counsel has done appropriate review of any potential successor liability issues, several insurance markets will be willing to offer this coverage.

## Conclusion

RWI policies can and should be used on many distressed transactions, including 363 sales. As with any transaction, buyers should engage experienced RWI brokers to guide them through the process and to work collaboratively with attorneys and underwriters to appropriately expand the use of RWI coverage and achieve the best possible coverage on these policies. Engaging thoughtful and seasoned advisors, with the flexibility and creativity needed to respond to quickly changing circumstances, will be particularly important in these unpredictable, and in many ways unprecedented, economic times.

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