

**TRANSACTIONAL INSURANCE: MAXIMIZING SHAREHOLDER VALUE IN  
MERGERS & ACQUISITIONS TRANSACTIONS**

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In connection with the proposed sale of a company, a division or certain assets of a company, it is a well established principle that the directors of the seller have a fiduciary duty to shareholders to maximize shareholder value. Transactional insurance products can assist directors in discharging this fiduciary duty. These products can help maximize shareholder value by promoting a robust auction (which should accordingly yield a higher purchase price), by reducing or eliminating escrow requirements and post-closing contingent liabilities and by removing impediments to closing.

While this article will focus primarily on Representations and Warranties Insurance (“RWI”), we will also touch upon other transactional insurance products, including Tax Liability Insurance, Contingent Liability Insurance and Litigation Buyout Insurance. These products facilitate Mergers & Acquisitions (“M&A”) transactions by shifting certain transactional risks that are typically borne by the buyer or the seller to the insurance markets. As illustrated below, a seller and its board can use these products to achieve a fast, clean exit, while simultaneously increasing the proceeds payable to shareholders at closing

## **REPRESENTATIONS & WARRANTIES INSURANCE**

### **What is RWI?**

Representations and Warranties Insurance protects buyers and sellers from financial losses resulting from inaccuracies in the representations and warranties made in connection with an M&A transaction. Buyer-side policies enable the buyer to recover such financial losses directly from the insurer, without proceeding first against the seller (assuming the retention or deductible amount has been satisfied). Seller-side policies reimburse a seller for amounts paid or payable to the buyer in respect of such financial losses. RWI is best suited for private company transactions where the purchase price is between \$20 million to \$1 billion.

RWI is designed to address the typical impasse between buyers and sellers regarding the amount and scope of seller indemnification for breaches of the sellers’ representations and warranties. Sellers prefer the smallest indemnity possible, both in terms of dollar amount and duration, and strive to avoid leaving more funds than necessary in escrow. Buyers, on the other hand, favor large and broad indemnities, with high dollar caps and lengthy survival periods. RWI allows both parties to achieve their respective goals by transferring transaction risk to the insurance markets.

When seeking to ensure that shareholder value is maximized, a seller’s objectives include negotiating the highest purchase price possible, structuring a clean exit with limited recourse against the seller post-closing and striking the most advantageous deal terms. RWI can assist in achieving these objectives in a cost effective and expedient manner.

## Increasing Closing Proceeds

RWI can help a seller maximize the amount of proceeds distributable at closing in several ways.

First, a seller can propose early in the negotiations that a buyer-side RWI policy be employed, effectively replacing the bulk of the seller's indemnity with insurance. The buyer would have direct recourse against the insurer in excess of the deductible amount, while the seller's post-closing indemnity obligations would be minimized, allowing more of the sale proceeds to be distributed to shareholders at closing rather than being escrowed or otherwise held back to satisfy post-closing obligations. In recent years, as auctions have become more prevalent, deal makers have begun incorporating RWI into the bid package provided to potential bidders. As early as the planning stages of a transaction, the carrier can be engaged to provide an indication of pricing parameters and salient terms for buyer-side RWI. This indication of interest can then be shared with potential bidders as an alternative to a large seller indemnity, creating a more robust auction and enticing more bidders who otherwise may have been "turned off" by a seller-friendly indemnification structure.

Second, a seller can use seller-side RWI to insure its post-closing indemnity obligations, freeing up more proceeds for distribution to shareholders at closing. While we have worked with countless sellers to structure buyer-side solutions designed to minimize escrows and other post-closing obligations, some sellers are compelled to agree to buyers' demands for a large seller indemnity (for example when a buyer is paying a high premium or has enhanced negotiating leverage). If this is the case, a seller can still maximize proceeds payable at closing by meeting the buyer's demand for a large seller indemnity, but then insuring its indemnity obligations with a seller-side RWI policy, which alleviates the need to hold back proceeds to cover future indemnity claims. Agreeing to healthy post-closing protections for the buyer (backed by RWI) may also enable the seller to negotiate a larger purchase price.

Finally, to the extent the buyer demands a large cash escrow at closing to secure the seller's indemnity obligations, either buyer-side or seller-side RWI can be purchased to eliminate or minimize this requirement. Putting buyer-side RWI in place can sway a buyer to forego an escrow designed to secure the seller's indemnity obligations, as the buyer would have the security of direct recourse against a well capitalized insurance carrier that is in the business of paying claims. Alternatively, knowing that a seller-side RWI policy is in place and that a seller's indemnity is secured by insurance may also sufficiently comfort a buyer to forego its escrow demands. This buyer could gain further comfort by having itself named as a loss payee under the seller-side RWI.

## Ensuring a Clean Exit

To maximize shareholder value, a seller's board and management aim for as "clean" an exit as possible in order to protect the sales proceeds from being depleted first by escrow funding requirements at closing and subsequently by future indemnity claims. RWI is extremely effective at achieving this objective.

As discussed above, RWI is effective at ring-fencing a seller's liabilities with respect to a given M&A transaction—this can be accomplished with a buyer-side RWI policy that effectively reduces or eliminates the seller's indemnity obligations, or with a seller-side RWI policy that backstops the seller's indemnity obligation. Both solutions help achieve a clean exit for the seller by defining the scope of the seller's potential post-closing exposure to the transaction. As illustrated above, both buyerside and seller-side RWI policies can eliminate a buyer's need for an escrow by providing a buyer with its requisite security. Secondly, both policy forms shield a seller from future indemnity claims and provide a seller with greater certainty in the sales proceeds received at closing. Finally, RWI can be used to cap not just the quantum of a seller's future obligations, but also the duration of such obligations. A seller is generally loathe to extend the survival period of the representations and warranties beyond 12 to 18 months post-closing, while a buyer will seek to extend the duration both of the representations and warranties and any related escrow. Buyer-side RWI can be used to bridge this gap by extending the survival of the seller's representations and warranties beyond the period agreed by the seller for purposes of the insurance policy.

## Striking Better Deal Terms

In addition to a board's concerns about garnering a high purchase price and a low indemnity cap, a board must also be concerned about the other significant deal terms, such as the timing of the closing, certainty of closing, the nature of the representations warranties, covenants, closing conditions and other obligations of the parties, and the existence of separate indemnities to address issues detected in due diligence. While these issues may not directly impact the actual dollar amount of the purchase price or indemnity cap, they must be taken into consideration in evaluating the overall soundness of a particular transaction. RWI enables a seller to enhance these deal terms in several ways. First, a seller can strike a more advantageous deal with respect to the nature and scope of the indemnity for breaches of representations and warranties by in effect transferring this exposure to the insurance markets. Second, by taking the issue of indemnification for breaches of representations and warranties off the table, a seller may be able to reach better terms on the other key negotiating points. Many clients tell us that they would rather purchase RWI than expend their negotiating capital in an argument over the post-closing indemnification scheme. Such clients frequently make concessions regarding post-closing indemnification and then use these concessions as bargaining chips to win on other issues of particular concern, such as closing conditions or post-closing covenants. RWI can also expedite transactions and lower legal costs by eliminating the need for protracted negotiations about the size of the seller's indemnity cap and the nature of, and related survival period of, the representations and warranties.

## OTHER TRANSACTIONAL SOLUTIONS

In addition to RWI, there are a suite of other transactional insurance products that are designed to address potential or ripened exposures that may exist in M&A transactions. Insurance products can be used to insure the full gamut of liabilities that arise in the M&A context. These issues include: potential tax exposure arising from the structuring of the M&A transaction which can be addressed by Tax Liability Insurance; potential losses that may arise from existing litigation which can be addressed by Litigation Buyout Insurance; or other contingent liabilities that may arise in the M&A context such as successor liability or regulatory concerns which can be addressed by Contingent Liability Insurance. Much like RWI, these products have the effect of maximizing shareholder value by extracting these sticking points from a transaction and addressing them through insurance solutions, rather than through an allocation of the related risk either to the buyer (often accompanied by a decrease in purchase price) to the seller (often accompanied by an increase in the seller's post-closing contingent liabilities) or, worse, to neither party because the potential liabilities crater the deal.

## CONCLUSION

While it is an established principle that boards of directors must ensure that any proposed M&A activities maximize shareholder value, discharging this duty can often be problematic, especially in these turbulent economic times. The competing duties and objectives driving the seller on the one hand and the buyer on the other hand frequently result in the parties reaching an impasse that needs to be broken by some concession by the parties, lest the deal be abandoned entirely. Representations & Warranties Insurance and the other transactional insurance products provide the parties with effective alternatives in breaking such an impasse by essentially taking the points of contention off the table and shifting the related exposures to the insurance markets. The use of transactional insurance products allow sellers and their boards to structure clean, fast exits with enhanced deal terms and limited post-closing contingent liabilities, while at the same time maximizing the amount of proceeds payable at closing to the shareholders. Truly a "win-win" for both sellers and buyers.

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