THE PROS AND CONS OF REPRESENTATION AND WARRANTY INSURANCE IN MERGER AND ACQUISITION TRANSACTIONS

Representation and warranty insurance ("RWI") has been around for some time. Historically, it was most commonly used in large transactions, often involving publicly traded companies. However, in recent years it has become much more common in smaller, private, "middle market" transactions. As the name implies, RWI provides insurance protection to a party (either the buyer or seller) in the event the representations of the seller in an asset purchase agreement, stock purchase agreement or merger agreement are breached and the buyer suffers damages as a result of such breach. In some cases, it may also provide protection for the buyer in the event of outright fraud by a seller.

Predictably, there are pros and cons to RWI that must be carefully weighed by both buyer and seller. Furthermore, that process needs to start early because the decision to seek RWI will impact negotiation of the purchase or merger agreement.

Benefits of RWI

The benefits of RWI include the following:

- Reduces the size of the typical holdback or escrow commonly required at closing as security for any future indemnification claims. This in turn increases the cash the seller receives at closing.
- Often increases the period of protection for the buyer (e.g., 3 to 5 years) beyond what the seller would be willing to negotiate in the purchase agreement.
- Significantly limits the seller's post-closing liability exposure.
- Preserves relationships with seller's management who are often employees of the buyer after the closing, because any buyer claims are made directly to the insurance carrier.
- Provides added protection for the buyer if the seller is financially distressed.

Negatives to RWI

RWI typically does not cover the following:

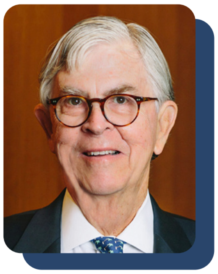
- Breaches of covenants (promises by the seller and its stockholders in the purchase agreement to do or refrain from doing certain things, like not competing with the buyer post-closing).
- Things known by the buyer before the closing, whether or not they are included in the disclosure schedules.

- Post-closing price adjustments.
- Forward looking statements and other things that are particularly difficult to assess (foreign corrupt practices, improper characterization of employees/independent contractors, violation of wage and hours laws, etc.)
- No protection for extraordinary losses above the policy limits and certain types of damages (punitive, etc.)

Some Practical Considerations

Applying for RWI is a 2-step process. An insurance broker will check with carriers to see which company might be interested in writing the insurance, based on the seller's industry, deal size and other factors. The next step involves a non-refundable underwriting fee in the range of $20,000 to $50,000. Upon receipt of that payment, the insurance company will undertake a detailed due diligence process and provide a firm quote for issuing the actual insurance policy at closing. This is a one-time premium of 2% to 3.5 % of the policy limit; not the deal size. However, there is often a minimum premium so RWI is not practical for small transactions.

The other financial consideration is the amount of the deductible. This will vary based on the seller's industry and other risk factors. It is also worth noting that because both the seller and the buyer benefit for the RWI, the premium cost is often shared by the parties. If you have questions about RWI or other business matters, please contact PLDO Partner William F. Miller at 401-824-5100 or email wmiller@pldolaw.com.



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