Representations and Warranties Insurance for Distressed M&A Transactions: Adapting to a Changing Landscape

A Practical Guidance® Article by Sanjay Hebbar, M&A Insurance Solutions

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The use of representations and warranties insurance (R&W Insurance) for M&A transactions has dramatically risen over the last several years and is now a familiar staple in many such deals. This of course has occurred only in the context of a period of continuous economic growth and a correspondingly strong M&A cycle. Due to the upheaval in the markets caused by the coronavirus (COVID-19) pandemic in 2020 and the subsequent slowdown and uncertainty in transactional pace, many M&A and bankruptcy professionals are perhaps for the first time shifting their focus to applying R&W Insurance in the realm of distressed transactions both within and outside of the bankruptcy process.

Distressed Deals Outside Bankruptcy Court Proceedings

The function of R&W Insurance for distressed transactions outside of the bankruptcy process is very similar to its function in conventional transactions. Given the recent downturn in their deal flow, R&W Insurance underwriters have been increasingly open to consider such distressed deals (especially where the acquisition target was operating normally prior to the COVID-19 pandemic). R&W Insurance is intended to cover unknown breaches of a seller's representations and warranties in the purchase agreement. In the case of a distressed asset, a seller may be neither willing nor able to stand behind such representations and warranties. In other circumstances, a buyer may be wary of the seller's ability to fulfill its indemnification obligations due to concerns about the seller's own financial distress. Regardless of the nature of the distress, buyers will need to get underwriters comfortable that they have adequately performed their due diligence on the acquisition target's performance and operations, and that the seller has made its disclosures in a satisfactory manner. Buyers should also pay particularly close attention to the insurance carrier's COVID-19 exclusion, which has become a common feature in R&W Insurance policies. A COVID-19 exclusion may be an issue if the pandemic has caused disruptions in the company's supply chain or workforce (facility closures, employee reductions, etc.), which can be quite severe depending on the nature of the company's business. In addition, any such R&W Insurance policy for a distressed acquisition will likely be subject to a higher premium.

Finally, when contemplating a distressed transaction, buyers should be aware of certain other risks which may fall outside the scope of R&W Insurance coverage. For example, third-party claims could be made for damages incurred prior to the closing date under a successor liability theory (particularly where the seller is no longer a going concern), or the sale of an asset from an especially distressed seller may be subsequently deemed to be a fraudulent transfer by a court. Since insurers may not be willing to cover these types of liabilities and may even explicitly list them as policy exclusions, buyers may consider standalone policies which specifically address successor liability and/or fraudulent transfer risks.

Section 363 Sales in Bankruptcy

Interest is also growing in applying R&W Insurance for acquisitions made as part of a federal bankruptcy proceeding (which would remove the fraudulent transfer and most successor liability risks mentioned above). Such transactions frequently occur in the context of a sale of assets under the auspices of Section 363 of Chapter 11 of the U.S. Bankruptcy Code (a 363 Sale). The principal benefit of a 363 Sale is that a buyer can purchase the assets free and clear of most liens, claims, and other liabilities which, of course, provides significant comfort when acquiring distressed targets. Before filing a formal bankruptcy motion, the debtor will first look to market the assets in a process similar to what one would see in a traditional M&A transaction in order to determine the stalking horse bidder for the subsequent bankruptcy auction. Not only will the stalking horse bidder provide the minimum bid for the 363 Sale, but it will also bear primary responsibility in negotiating the purchase agreement with the debtor. The bankruptcy process will also provide certain protections for the stalking horse bidder if it does not win the auction, such as a break-up fee and expense reimbursement.

363 Sales are usually made on an "as is, where is" basis, and thus the debtor typically bears no ongoing indemnity obligations after the consummation of the transaction. As mentioned, the bankruptcy court's free and clear order protects the buyer against most third-party claims against the acquisition target. However, the buyer is still left with no recourse for any losses it may suffer itself, such as those that might result from any breaches of the representations and warranties made by the debtor in the acquisition agreement. In a typical 363 Sale, the buyer will solely bear the risk of any such first-party losses which may substantially reduce bids for the target assets. Despite prior skepticism, bankruptcy professionals are now beginning to consider the coverage provided by an R&W Insurance policy to help alleviate these concerns. R&W Insurance may also help address the risk of certain third-party claims that may not be cleansed by a 363 Sale order in the bankruptcy process (e.g., certain product liability, environmental, and IP claims). With the assurance provided by the backing of an A-rated insurer, a buyer could be free to be more competitive in its bidding which would benefit the debtor's creditors by maximizing the value of the distressed asset.

Buyers should note, however, that debtors in 363 Sales will often object to including the broad set of seller representations which might be present in the purchase agreement under normal circumstances, and so a 363 Sale purchase agreement may contain a lighter set of representations than the buyer would prefer. In this case, the insurer may be open to providing certain synthetic representations in the policy which are not included in the underlying acquisition agreement, provided that the underwriter is satisfied with the buyer's due diligence and corresponding disclosures made by the debtor to support the synthetic representations. Moreover, as R&W Insurance is only meant to cover exposure to unknown risks, buyers may have to consider pursuing alternative contingent liability insurance options to address any known risks. For example, pending litigation prior to the transaction might give rise to the need for a litigation buyout policy to cap exposure, or the availability of net operating losses (often listed as an exclusion in R&W Insurance policies) might result in the buyer choosing a standalone tax indemnity policy to limit this risk.

Interestingly, pricing for R&W Insurance policies in 363 Sales may actually be lower than what would normally be expected in a traditional transaction due to the cleansing nature of the bankruptcy process, though this may be slightly offset by an increase in underwriting due diligence costs (e.g., insurers may need to retain specialist bankruptcy counsel for the deal). Insurers may also be willing to demonstrate some flexibility with handling pre-exclusivity fees for the stalking horse bidder, who frequently does end up as the buyer. For example, an insurer could forgo a pre-exclusivity fee entirely and simply charge the nonrefundable due diligence fees and 10% of the premium (due at the time of binding the policy) which the stalking horse bidder can recoup from its own break-up fee in the event it ultimately loses the bankruptcy auction. Debtors may alternatively seek to work directly with insurers themselves prior to filing the bankruptcy court motion and follow the model of the "seller flip" in a traditional M&A deal. In this case, the basics for policy coverage are worked out by the debtor with a broker and "soft stapled" into the purchase agreement. After the bankruptcy auction, the winning bidder would then engage an insurer to complete the underwriting process and pay for the policy (although note that any costs borne by the debtor itself in the course of the "flip" may need to be approved by the bankruptcy court).

As the COVID-19 pandemic continues to rage around the globe, the financial markets are still fraught with uncertainty, and we may yet witness a prolonged economic downswing. This is rather uncharted waters for R&W Insurance, and it will be interesting for observers to see how the product's application will continue to evolve in this

new environment after years of an extended M&A boom. The R&W Insurance sector (including brokers, underwriters and attorneys) has certainly done a remarkable job in recent years bringing innovation to the M&A landscape and is now in a position to adapt the product to new and novel situations. Just as it has become a go-to tool in the conventional M&A framework, R&W Insurance might also one day be seen as commonplace in the world of distressed M&A.

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Sanjay is a partner with M&A Insurance Solutions and is responsible for growing the client base in the U.S. while assisting M&A professionals with structuring their bespoke R&W/M&A insurance policies on their transactions.

Prior to joining M&A Insurance Solutions, Sanjay was a corporate/M&A attorney at several top U.S. private equity law firms including Ropes & Gray, Morgan Lewis, and Akin Gump. Sanjay is an attorney in good standing with the New York bar.

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