Negotiating Favorable RWI Policies: *Lessons Learned From Litigating Claims*

The Real Deal

A Webinar Series for M&A and Securities Professionals

WINSTON & STRAWN LLP

Speakers

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Prior to joining Aon's Transaction Solutions team in June 2014, Gaurav was an associate most recently at Fenwick & West LLP in Silicon Valley (from 2011 to 2014) and previously at Shearman & Sterling LLP in New York (from 2007 to 2011), specializing in public and private mergers and acquisitions, private equity and venture capital investment transactions and other strategic corporate transactions, as well as fund formation and corporate governance matters for private equity sponsors and U.S. and global strategic clients spanning a wide range of industries.

Bill O'Neil

Partner, Private Equity

Winston & Strawn

Bill's practice focuses on representing private equity funds and their portfolio companies. Bill frequently represents both buyers and sellers in representation and warranty and working capital disputes. He also represents buyers in claims against representation and warranty insurance carriers. Additionally, Bill represents numerous public company clients in corporate governance litigation, shareholder strike suits, internal investigations, and other complex business litigation. He has significant antitrust and pro bono experience as well.

Stephen Davidson

Managing Director

Aon Transaction Solutions

Stephen is responsible for overseeing transaction liability claims as well as helping to develop insurance solutions to address litigation and other contingent risks. Prior to joining Aon's Transaction Solutions team in 2016, Stephen was a commercial litigation partner in DLA Piper's New York office, where his insurance and reinsurance practice included arbitration, litigation and counseling for global insurance companies involving directors and officers liability and professional liability coverage and complex reinsurance disputes, and his commercial litigation practice concentrated on business litigation for public and private companies as well as the officers, directors and employees of those companies.

Tim Kincaid

Partner, Private Equity

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Tim's practice focuses on private equity transactions and mergers and acquisitions. He principally represents publicly and privately held companies and private equity funds in connection with a variety of corporate transactions, particularly focusing on mergers, acquisitions and divestitures. He has represented corporations, private equity funds, and investment banks in documenting and negotiating acquisition and sale transactions, capital-raising transactions, and equity purchase and sale transactions. He also has experience counseling clients on day-to-day corporate and LLC matters, including entity formation, contracts, and corporate governance.

Agenda

I. RWI Policy Basics

II. The Claims Process

III. Lessons Learned From Litigating RWI Claims

- A. Single Insurer v. Syndicate
- B. Prosecution Costs
- C. Multiplied Damages
- D. Dispute Resolution Clause
- E. Actual Knowledge

IV. Final Consideration

Disclaimer: The views expressed in this presentation are the views of the presenters and not necessarily the views of Aon Transaction Solutions and Winston & Strawn LLP.

RWI Policy Basics

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Background on RWI

- Why Use?
  - Sell-friendly market dynamic compels it
  - Favorable loss experience by underwriters has contributed to competitive terms and conditions
  - Insurers are willing to assume the risk related to RWI policies because: (i) their required RoR is more conservative; and (ii) of the diversity of their risk portfolio
- How Does It Work?
  - Insurance capital efficiently removes risks and often is a cheaper and more efficient vehicle than an escrow or purchase price adjustment
  - Most policies are transferrable
  - All insurance markets and brokers are now staffed by attorneys (most ex-M&A) and work on "deal time"
  - Pricing is more attractive, coverage has improved and product usage has dramatically increased over the past few years
  - Extends survival period of reps to buyer without expanding seller's liability, plus full coverage for all reps including the financial statements
  - RWI is now used strategically to buy/sell companies in a more cost effective manner with one-time premiums paid up-front
- Current Market Statistics – Aon-Specific Data
  - 2013: 100 policies; $3.5B in policy limits
  - 2014: 150 policies; $6B in policy limits
  - 2015: 200 policies; $7B in policy limits
  - 2016: 330 policies; $12B in policy limits

RWI Mechanics

- Coverage Limits: Typically 10% to 15% of Transaction Value
- Policy Costs
  - Premium: Typically 3% to 5% of coverage amount
  - Buyer-side policies slightly more expensive due to knowledge exclusion
  - Underwriting Fee: $25k to $50k
- Retention Under RWI Policy
  - Similar to a deductible
  - Typically 1% to 3% of transaction value
  - Can decline to lower amount at certain times or events i.e. indemnification escrow release
- Interaction between Purchase Agreement Terms and RWI Policy
  - Retention amount under RWI policy typically equal to sum of Purchase Agreement (i) indemnification basket plus (ii) indemnification cap/escrow
  - Generally, indemnification claims satisfied in following order:
    1. The Purchase Agreement indemnification basket
    2. The Purchase Agreement indemnification cap/escrow
    3. The RWI policy. At this point the retention amount is used up by previous 2 bullet points
- Policy Periods

RWI Market & Players

- Increased popularity: 1,000+ policies underwritten in the U.S. in 2016
- Insurance market well-developed
  - Multiple market entrants expected in 2017

The Claims Process

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The Claims Process

- Investigation
  - Review the Purchase Agreement and identify the breach
  - Review the policy
  - Identify subject matter experts and counsel
  - Collect back-up documentation
  - Quantify damages

- Notice to insurers
  - Make sure notice complies with policy requirements
  - Prepare notice based on information obtained to date even if not complete
  - Include communications with sellers and status of indemnity claim

The Claims Process (cont'd)

- Insurer review
  - Claims works closely with the underwriter who is familiar with the deal and the policy
  - Is there a breach?
  - Exclusions?
  - Does loss flow from the breach?
  - Are multiplied damages appropriate?
  - Differences in first- vs. third-party claims
  - Use of outside counsel and experts

- Communication and negotiation
  - Oral communications before written analysis
  - Review ROR letter and provide additional information
  - Prepare detailed proof of loss
  - Parallel track with seller to resolve escrow issue

Lessons Learned From Litigating RWI Claims

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Issue #1 – Single Insurer v. Syndicate

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Selecting an Insurer

- The threshold decision in obtaining a RWI policy is selecting an insurer.
- This decision is frequently based on price and breadth of coverage; however, buyers should also consider the structure of the insurer (single insurer versus syndicate).
- Many RWI policies are written by managing general underwriters (MGUs) underwriting for multi-party (typically three-party) syndicates who apportion the risk of loss amongst themselves.

Strategic Considerations

Claims Handling and Settlement

- Typically, the MGU has claims handling and settlement authority, but only up to a designated threshold.
- Beyond this threshold, Buyer is forced to deal with (and sue, if necessary) each of the underlying insurers, none of whom is jointly and severally liable to Buyer.

Strategic Considerations (cont'd)

Disaggregation of Risk

- The disaggregation of the risk among multiple insurers may make each of the insurers less likely to settle claims. An example:
  - Buyer has a $15M policy and a strong claim for policy limits.
  - Scenario A – single insurer is on risk for the entire $15M.
  - Scenario B – three-party syndicate is on risk for $15M each.
  - In Scenario A, the insurer may be willing to settle a strong claim for $9M to save $6M in exposure and avoid paying $2M in legal fees to defend the claim.
  - In Scenario B, the three insurers may be less willing to settle for $3M each to save only $2M in exposure, particularly where the $2M in defense costs are shared in thirds. In this scenario, it is much easier for the carrier to "roll the dice" and try to defeat the claim.
  - The business and marketplace pressure to handle claims fairly is also disaggregated in Scenario B.

Issue #2 – Prosecution Costs

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Buyer's Legal Fees

- RWI policies typically define "Loss" to include legal fees incurred by Buyer in connection with a third-party claim.
- Unfortunately, the definition of "Loss" typically does **not** include the legal fees incurred by Buyer in respect of a dispute with Seller, i.e., a first-party claim.
- Why does this matter to Buyer?

Buyer's Legal Fees (cont'd)

- In a transaction where Buyer only has access to a modest indemnification escrow and, notwithstanding Seller's limited exposure, Seller disputes the claim made by Buyer, Buyer is forced to engage in expensive litigation with Seller before it erodes the retention under the policy.
- In so doing, Buyer would incur significant legal fees in its dispute with Seller and those legal fees may not be considered a "Loss" under the policy.
- Solution: Include first-party prosecution costs within the definition of "Loss" under the policy.

Issue #3 – Multiplied Damages

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Three Options

1. **Multiplied Damages Expressly *Excluded*** – may be found in carrier's initial draft policy, but no longer "market" and therefore easily negotiated out.
2. **Policy Silent** – most typical, but will not stop carrier from arguing that such damages are inappropriate / unavailable in a dispute.
3. **Multiplied Damages Expressly *Included*** – harder to negotiate for and usually requires payment of additional policy premium.

Strategic Considerations

- Does the purchase agreement have to mirror the RWI policy with respect to the treatment of multiplied damages? In other words, can the purchase agreement be silent as to multiplied damages (as is customary), but the RWI policy expressly provide for such damages?
- What is the typical additional premium cost for a multiplied damages *inclusion*?

Issue #4 – Dispute Resolution Clause

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The Problem With Arbitration

- Most purchase agreements provide that any dispute between Buyer and Seller be heard in Delaware state court (or another state or federal court).
- Alternatively, most RWI policies provide that any disputes between Buyer and Insurer be arbitrated before the AAA or JAMS.
- This divergence presents a practical issue not frequently considered by Buyers—the “two-front” war.
- An aggrieved Buyer is forced to sue the Seller in DE and the Insurer in an arbitration for the exact same injury.
- To make matters worse, many RWI arbitrations are “closed universe” proceedings based upon the proof of loss and response thereto, meaning that Buyer is forced to wait until the factual record is complete for the Buyer-Seller litigation before even initiating the arbitration against the Insurer.

A Typical Example

- Buyer acquires Target from Seller
- Seller escrows $5M escrow; Buyer obtains $15M RWI policy for total protection of $20M
- The purchase agreement has a mandatory venue provision favoring Delaware state court; the RWI policy has a mandatory venue provision favoring an AAA arbitration in NY
- Post-closing, Buyer discovers Target's financial statements are misstated and suffers a loss of $10M
- To be made whole, Buyer must sue Seller in DE for $5M and must then sue the Insurer before the AAA for another $5M.
- The ~$2M in legal fees Buyer spends on these two lawsuits are typically **not** recoverable from either Seller (because of the cap) or the Insurer (because of the policy does not provide for them).

The Solution: Improved Policy Language

Any dispute arising out of or in connection with this Policy which cannot be otherwise resolved by the ***Insurer*** *and any of the* ***Insureds*** *shall be referred to and finally resolved by binding arbitration conducted in accordance with the JAMS, then-prevailing Commercial Arbitration Rules except as modified herein;* ***provided, however, that solely in the event of litigation by the Insureds against Sellers for breach of a representation or warranty under the Acquisition Agreement for an alleged Loss in excess of the Retention, the Insurer consents to jurisdiction in a state or federal court in [City, State] to allow the Insureds to pursue a single lawsuit against both Sellers and Insurer****. Any other dispute between the* ***Insureds*** *and* ***Insurer****, however, shall be resolved consistent with the dispute resolution provision set forth in this section.*

Issue #5 – Actual Knowledge

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Effect of “Actual Knowledge” Exclusion

- Every RWI contains an “actual knowledge” exclusion which prevents a Buyer from sandbagging (i.e., bringing a claim arising from a representation it knew was false when made).
- In light of this exclusion, Buyers should be thoughtful about their approach to the due diligence and underwriting processes.

Best Practices

1. Provide **all** diligence information to the Insurer (whether they ask for it not) and retain records of what was transmitted/accessed. You want the Insurer to have the same "actual knowledge" as you with respect to information learned in diligence.
2. Provide your Quality of Earnings report (and all drafts) to the Insurer. Understand it will be used against you in subsequent litigation with the Insurer.
3. Clearly articulate to the Insurer in writing how the purchase price was calculated. Be specific about the EBITDA, the TTM period in which it was calculated, and the multiple that was used.

Final Consideration

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Brokers

- Work with high-quality, high-volume brokers
- Involve your broker *early* in the claims process
- Future business from your broker is one of the most significant “checks and balances” on an insurer’s claims handling process

Questions?

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- MARK YOUR CALENDARS!
  - Three more 75-minute webinars:
    - **June 27** – Recent Trends and Developments – Mergers and Acquisitions
    - **July 25** – Current Trends in M&A Finance
    - **September 26** – Delaware Law Developments/Recent Judicial Decisions Affecting M&A Transactions and Corporate Governance