



CAMBRIDGE
PROPERTY & CASUALTY

CONSIDERING A MERGER, ACQUISITION OR SALE OF YOUR COMPANY?

If So, You Need Representations and Warranties Coverage

In the sale of a business, the seller makes contractual representations and warranties that form the basis of a buyer's purchase decision. Such representations and warranties often relate to taxes, accounts receivable, financial statements, employee benefits, intellectual property of the business, environmental issues, liens on property, and many other areas.

Insurance coverage is available to protect both sellers and buyers from financial loss resulting from a lawsuit caused by a breach of one or more insured representations or warranties.

The purpose of this article is to identify some of the most prevalent insurance-related issues associated with mergers and acquisitions and to provide information regarding some of the insurance products available to address these exposures.

A. An Actual Case

Claims of alleged breaches of representations or warranties are common. In an actual case, a purchaser of a company sued the seller for breach of warranties regarding the salability and value of the company's inventory. In the sale agreement, the seller represented that the inventory was usable and salable and was carried on the books at a specific value. After closing, the buyer discovered that most of the inventory was not salable and that the books and records improperly stated the inventory. \$600,000 in damages was awarded in addition to interest and attorney's fees.

B. Commercial General Liability and Directors & Officers Liability Policies Do Not Solve the Problem

Sellers cannot rely on general liability insurance to provide protection for representations and warranties in connection with mergers and acquisitions. General liability insurance will cover bodily injury and property damage liability claims, as well as some personal injury claims as defined; however, it will not cover the financial risks of representations and warranties.

Directors and officers liability insurance also does not eliminate the need for representations and warranties insurance. This is because directors and officers liability coverage covers persons in their capacity as directors and officers of the company. However, in making representations and

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warranties in an asset purchase agreement, it is the selling shareholders, not the directors and officers, which are making the representations and warranties. Even if the selling shareholder making the representation or warranty in the asset purchase agreement is a director or officer of the seller, the typical directors and officers liability policy still will not respond if that person did not make the representation or warranty in his or her capacity as a director or officer.

Also, many director and officer liability insurance programs written for privately held corporations have contractual liability exclusions, which would specifically eliminate coverage for this type of situation.

The other problem with relying on the directors and officers liability policy is that in most asset purchase agreements, the seller itself is making representations and warranties, and most directors and officers liability policies do not cover these claims for the entity itself.

C. Representations and Warranties Policies are Available

A separate policy should be purchased by the buyer, seller, or both to address this serious exposure. There are a number of insurance companies that offer products to address the exposure of representations and warranties coverage, one of which is the Chubb Insurance Group.

Coverage can be purchased on a first or third party basis. Under the first party basis, once it is determined that there has been a breach of seller's representations or warranties, the buyer simply submits a claim affidavit and estimated loss amount to the insurer. This coverage type is often purchased by purchasers of the business to protect them from damages associated with representations and warranties in the purchase agreement or closing documents that were not accurate. Sellers can also protect themselves from damages arising out of lawsuits by purchasers alleging breach of representations or warranties.

Coverage Features Vary by Insurance Carrier

Under the Chubb program, coverage features applicable to both buyer and seller include availability of up to a \$25,000,000 limit of liability, insured's right to choose counsel, a transaction specific minimum deductible, aggregate (not each and every claim) retention, coverage for punitive damages where allowed by law and worldwide coverage. Typical exclusions relate to regulatory matters, bankruptcy, tax liability, illegal profit or remuneration, ERISA, prior or pending litigation, doubtful accounts receivable or failure to discharge obligations. Premiums are generally 2% to 8% of the limit purchased.

Some additional areas of coverage to consider in purchasing a representations and warranties policy are:

1. Being certain that spousal and estate coverage is also provided.
2. Making certain that the definition of "claim" is broadened to include non-monetary relief for services such as injunctions that force a seller to do something or refrain from doing something.

3. Confirming that there is a severability clause between insured persons and multiple entities to be certain that the fraud or dishonesty of one entity or person will not be imputed to the other.
4. Examine carefully exclusions for bodily injury, property damage, pollution, tax issues and so forth. Many representations and warranties policies will exclude, for example, pollution-related claims and those representations. A separate pollution legal liability policy could be arranged to provide this coverage (see our separate Special Report on this issue).
5. The application for insurance may become part of the policy, and you will want to be certain that every question in the application is carefully scrutinized so that the insurance carrier cannot deny coverage because of an omission or misstatement in the application for insurance.
6. The experience and knowledge of the agent on legal and insurance issues should be evaluated.
7. The limit of insurance should be carefully selected.

For more information regarding representations and warranties coverage for mergers and acquisitions, contact either Ken Hale or Michael Hale at Cambridge.