



Transactional Risk Insurance
FAQ - FREQUENTLY ASKED QUESTIONS
Representations and Warranties

1. Does Reps & Warranties Insurance mirror the seller's indemnity obligations?

Not quite, but the risks not insured under The Hartford's Reps & Warranties Insurance Policy are generally either immaterial or within the ability of the buyer to control. The areas of departure that a "form" Reps & Warranties Insurance policy would take from a "standard" indemnification provision are highlighted below. The rationale for each is summarized below. All policies, however, are typically manuscripted and their terms are, generally, subject to negotiation.

Basket v. Retention

The indemnity obligations often attach excess of a basket amount, which is generally an amount below which the claims are considered nuisance in light of the size of the transaction. Reps & Warranties Insurance usually requires a (self-insured) retention that is based upon customary measures of materiality: 3% of purchase price; 5% of gross assets or 5% of annual revenues – whichever is lowest. This may be higher than the "basket".

Covenants v. Reps

Most form policies do not cover indemnification for a breach of a covenant, as distinguished from a breach of a representation and warranty. However, for a Buyer's Policy, The Hartford is willing to cover Loss arising from the breach of typical covenants (both negative and affirmative) involving the pre-closing operation of the business (for example, a covenant that the acquired company will not increase compensation to its employees pending closing) in manuscripted endorsements to the basic policy if adequate monitoring of compliance with such covenants can be confirmed during The Hartford's due diligence. This approach makes a Buyer more comfortable in accepting an insurance policy in lieu of a large escrow or indemnification from the Seller. In a Seller based Policy, breach of these covenants will be excluded because compliance is within the control of the acquired company's management.

Materiality "Carve-Out"

Frequently, indemnity obligations have a "materiality carve-out" provision; which means that if a seller's representation was qualified by there being no "material" exception to the truth of the matter asserted, the indemnity obligation may provide that, for purposes of indemnifying the breach of a representation, it will read as if there were no materiality qualification. The Hartford is generally willing to provide an endorsement that contains a "materiality carve out" provision so that Loss under the Policy mirrors Loss recoverable under the Agreement for breach of a representation and warranty.

"Standard" Insurance Exclusions

Obviously, a Reps & Warranties Insurance policy will have "standard" exclusions that would not typically be excluded in an indemnity provision. Most significantly, a buyer's based policy will

exclude matters within the actual knowledge of the buyer. Thus, if a buyer closes and under the principle set forth in the “Ziff-Davis” case the buyer might be able to sue for breach of warranty, that remedy would not be available against the insurer. Typically, a buyer would close with the actual knowledge of a breach by the seller only because the breach is considered relatively immaterial. Accordingly, the loss not covered as a result of the actual knowledge exclusion would most likely fall within the retention for which the seller would, typically, remain liable.

“Heightened Risk” Evaluation

Lastly, as The Hartford undergoes its underwriting process, it may identify “heightened risks”, which may be excluded from coverage or else covered subject to an additional retention or additional premium.

2. What are the key policy provisions that distinguish markets?

Although the policies are often manuscripted to accommodate the particular concerns associated with a specific transaction, certain “standard” provisions may be compared and contrasted.

(1) Scope of coverage:

- (a) Are all representations covered?
- (b) Does insurance clearly attach to the representations made as of the time of closing (via a bring-down certification) or just as of the signing of the agreement?
- (c) Will the Insurer provide coverage for pre-closing covenants?
- (d) Will the Insurer provide coverage for additional items of indemnification (e.g., “Excluded Liabilities” in connection with an asset purchase)?

(2) Exclusions: Is the “Knowledge” exclusion appropriately curtailed to exclude constructive knowledge for what was not actually known by the deal makers?

(3) Other Provisions

- (a) Is the “Subrogation” provision appropriately curtailed so that (if buyer-based) both parties to the underlying transaction benefit by the risk transfer or (if seller-based) the seller’s due diligence professionals are not exposed.

3. What is the typical price and structure for Reps and Warranties insurance?

The most preferred structure is that all parties share in the risk. For example, the Buyer bears the risk with respect to the basket or threshold amount, the seller bears the risk with respect to the escrow amount and either or both parties bear the risk beyond the insurance program.

The Retention is typically established by reference to the lowest of the following three amounts:

- 3% of the purchase price;
- 5% of gross assets; or

5% of annual revenues.

The customary rate on line for “pristine” risks (i.e., no identifiable “heightened risk”) is 3-5%. If, however, a potential insured needs to bind coverage within three weeks of the submission, the rate on line is generally 4-7%.

In general, The Hartford does not require any up-front fees to be paid by the Insured prior to binding. Rather, an underwriting fee (net of commissions) is generally charged (at time of binding) in an amount equal to approximately ten percent of the rate on line.

4. What is the typical underwriting process for Reps and Warranties Insurance?

The underwriting process consists of the (1) the initial submission; (2) the issuance and acceptance of a preliminary quote letter; (3) due diligence confirmation; (4) the issuance and acceptance of a conditional binder with attached policy; (5) closing/payment of premium/submission of closing letter/issuance of policy.

In the initial submission, the carrier should receive the (near-final) acquisition agreement and financial statements of the company being acquired.

The following additional information would be helpful in our review of the initial submission:

- (i) background information, such as the client’s identity if not already apparent (e.g., one of several shareholders), the identity of the producer’s contact, how the matter came to the broker, etc.
- (ii) why seller decided to sell the business;
- (iii) why buyer decided to buy the business;
- (iv) timetable for transaction (date that preliminary discussions began; confidentiality agreement was signed; Information Packet was published; Letter of Intent was entered into; announcement of deal; signing of definitive agreement; SEC filings; FTC filings; and closing);
- (v) motivation for seeking insurance (begin with how it was first discussed by the parties); and
- (vi) whether both parties are (or will become) aware of the request for insurance (and, if so, whether the parties have or contemplate having contractual provision obligating the parties to cooperate in obtaining the coverage).

The Hartford will respond to the initial submission with a telephone call to confirm its receipt, ascertain the answers to our initial questions and to explain the process.

The Hartford will either decline to insure (by telephone and letter) or will provide a letter of preliminary interest (the “Quote Letter”). The Quote Letter will set forth the proposed structure and price for the insurance and will note any heightened risks identified in the acquisition agreement. For example, a seller may be representing that its receivables, net of reserves, will be collected within a stated time period. Generally, absent additional premium and/or a sub-retention, The Hartford would prefer to insure a representation regarding receivables that does not guarantee their collection. Although the buyer has negotiated such a

representation, our disinclination to insure the representation would not necessarily retract from the buyer's rights. The parties may have a purchase price adjustment provision that would, as a practical matter, serve as guarantee, without implicating a breach of a representation. Moreover, the buyer could still recover against the seller (and/or an escrow) even though the particular matter is not insured. By identifying the "heightened" risks as early as possible, the potential insured is given the opportunity to negotiate with the other party to the transaction and/or with us.

The Quote Letter will also enclose a copy of the proposed form of policy (e.g., two-step merger R&W policy), an application, a list of documents and information required and a summary of the process, including the persons likely to be sought for their input.

The Quote Letter should be executed and returned to The Hartford within the time frame set forth therein.

Once the executed Quote Letter and requested documents are received by The Hartford:

1. The Hartford will schedule with you any due diligence confirmation discussions reasonably required by us to underwrite this risk.
2. As we conduct our due diligence confirmation, we will promptly inform and discuss with you any "heightened risk" reasonably that appears to exist (e.g., unscheduled matters that ought to have been scheduled, lack of appropriate compliance program(s), aggressive tax position previously taken, failure to test key representations or to monitor covenants, etc.) . The Hartford will either request additional information, exclude the heightened risk from coverage (if the parties to the transaction will have satisfactorily resolved the issue between themselves) and/or insure such risk upon reasonably altered terms (e.g., additional premium, separate and additional retention, partial coverage, etc.).
3. At the conclusion of our due diligence confirmation, we will prepare a conditional binder with attached draft policy for your review. We generally will do so at least one day prior to the closing or pre-closing.
4. After the Closing, a Closing Letter and premium should be forwarded to us and we will thereafter issue the policy.

Contacts

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