

REPRESENTATION & WARRANTIES INSURANCE

The below is to provide background information relative to Representations and Warranties Insurance ("RWI"). Briefly, RWI protects a party from financial losses resulting from inaccuracies in the representations and warranties made about the Target Company or business in connection with transactions.

What is Covered?

- Fundamental, General, and Tax representations and warranties
- Other specified indemnities (financials / pre-closing tax)

Benefits of RWI

- Transfer risk from both parties in the transaction
- Provides access to the insurance industry's capital to allow the transfer of certain transaction risks to the insurance market

Policy Options

In the market, 95% of policies are "Buy-Side Policies". A "Buy-Side Policy" indemnifies the buyer for sellers' breach in reps and warranties in the Purchase and Sale Agreement. This is a first party policy used in situations where there is a gap between the buyer and seller with respect to escrows and indemnity obligations.

"Sell Side Policies" can also be purchased, which indemnifies the "Seller" for breaches in reps and warranties in the Purchase Agreement. This is a Third Party policy, where the Buyer would need to pursue the Seller to trigger a claim. Generally it will sit in excess of the Buyer's [materiality] deductible (in the Purchase agreement – not the insurance term), and would include an exclusion for "fraud."

Exclusions: What is Not Covered

It is important to consider what is not covered by RWI in the context of the transaction, standard exclusions are:

- Actual knowledge of a breach ("Actual Knowledge" defined as conscious awareness)
- Projections or forward looking Statements
- Adjustments to the purchase price related to working capital
- Fines and penalties (except where insurable by law)
- Unfunded or Underfunded benefit plans
- Asbestos, PCBs (special substances - may cover via separate Pollution Policy)
- Interim Breaches between signing and closing
- Net Operating Losses

WHY BUYERS REQUEST COVERAGE:

- Enhance Amount / Duration of Indemnity
- Distinguish Bid in Auction
- Ameliorate Collection Concerns
- Protect Key Relationships
- Protect the Deal
- Ensure Certainty of Purchase Price
- Address Stakeholder Concerns

WHY SELLERS REQUEST COVERAGE:

- Distribute Sale Proceeds (Time Value of Money)
- Protect the Purchase Price through the due diligence process
- Supplement Disclosure Process
- Protect Passive Sellers
- Expedite Sale
- Reduce Contingent Liabilities
- Address Stakeholder Concerns

Policy Structure

Pictured below is a conceptual example of how a policy is structured. Policies will generally match the "Survival Period" of the Representations and Warranties in the Indemnity. Most policies are 3 Years for General Representations, 6 Years for Fundamental Representations, and 6 Years for Tax Representations.

There is an "aggregate policy retention" generally equal to 1% of the transaction value. The retention can be eroded by multiple claims over the entire policy period. The insurer will only pay once the retention is exhausted.

Recently, we have been seeing an increase in deals where Representations and Warranties in the Purchase Agreement do not survive closing, and the sole recourse is against the Insurance Company, except in the instance of "Seller Fraud".

Buyers and Sellers often share the cost of the policy (50/50), and generally settled via a purchase price adjustment. The retention is also often shared between the Buyer and Seller. We can negotiate that after 12 months the retention is diminished by 50% (.5% drop down retention after 12 months).

Cost:

Premium costs depend on the limit of insurance purchased. In general, pricing is between 2.5% and 3.2% of the limit purchased (10 M Limit approx. \$300K). Commissions are included within the premium (no additional fees). Insurers will hire outside counsel to review the diligence performed by the buyer, and review the data room – the underwriting fees are generally \$30,000 – \$40,000.

Process:

Generally we need 10 working days from the time we sign the NDAs to having a negotiated policy bound. Please see diagram below – attached is a detailed view of the process.

DAY 1

- Engage BFL and execute NDA

DAY 3-5

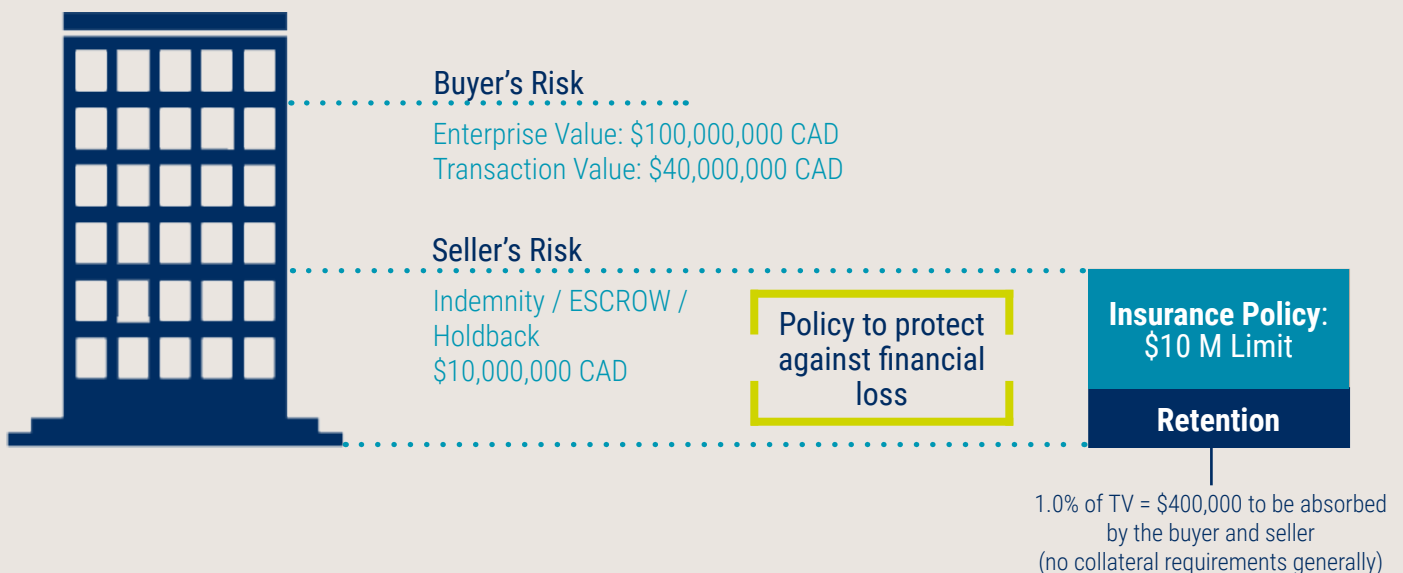
- Provide LOI / Seller financials (Audited)
- Obtain non-binding indications from insurers

DAY 5

- Review quotes
- Select insurer
- Pay insurer unwriting fee (due diligence)
- Underwriting from insurer commences

DAY 5-15

- Access data room
- Provide DD reports
- Draft disclosure schedules
- Conference call with deal team
- Negotiate final terms



Use Cases

Bid Differentiation:

On a transaction with significant management shareholder positions, the Buyer used the insurance to buy-out exiting partners and provide comfort to the current management (oldco shareholders) that they can continue to operate without the risk of claw-back of the sale proceeds. It was an important differentiator on both sides, as this was to be a strategic platform for future acquisitions and the buyer wanted to make sure that the management felt secure in the transaction.

Deal Facilitation:

Originally, the seller in the bid process forced the insurance upon the buyer who were prepared to purchase the company with limited ESCROW obligations. Late in the transaction process, the Seller included Withholding tax obligations within the R&Ws in the Share Purchase Agreement. The buyer opposed this, as this is a seller's risk, and requested a special indemnity with ESCROW. As the Withholding Tax risk was 25% of the purchase price, the Seller considered this critical to the transaction. BFL were able to negotiate with insurers able to cover the Withholding Tax risk based on the significant due diligence done by the buyer, and transfer the tax risk in the transaction.

Financial Statement Indemnity Claim:

A "Strategic" Buyer put in place a Representations and Warranties Insurance Policy. After closing the Purchaser noticed various inconsistencies in the financial statements including accounting of accounts receivable (collectability of accounts receivable is not covered), wage and benefit issues, and non-compliance with franchising laws. Given that this had an adverse effect on EBITDA, the Purchaser made a claim against the insurance policy contemplating the multiplied loss, which is equal to approximately 90% of the insurance limit.

What is Needed to Get Started

- Letter of Intent
- DRAFT Share Purchase Agreement
- Financial Statements
- NDA for insurers to sign

CONTACT US FOR MORE INFORMATION ABOUT OUR TEAM AND OUR SERVICES:

John Antonecchia

Vice President, Client Executive | Co-Head M&A Practice and Principal
P. 514-905-1783 | C. 514-451-1892
E. jantonecchia@bflcanada.ca

Sean Flinn

Vice President | Co-Head M&A Practice
P. 416-644-3571 | C. 647-678-6296
E. sflinn@bflcanada.ca

Most Common Claims

- Financial Statement Indemnity (accounting rules, misstatement of accounts receivable or payable, undisclosed liabilities, etc.)
- Breach or Material Contracts with Customers or Suppliers
- Intellectual Property
- Pre-Closing Tax Indemnity
- Compliance with Laws
- Employment Related (example: Bonus Accrual)

BFL is uniquely positioned in the Canadian market based on the following:



Experienced team of M&A insurance specialists active in the deal community



Equity partnership with Lockton Global
– Global Network of M&A insurance specialists (Canada, US, UK, Asia)



Cost advantage vs. our competitors and "right-sized" remuneration for the Canadian market