

Reps And Warranties Insurance Key In Gov't Contractor M&A

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Buyers in mergers and acquisitions are usually at an informational disadvantage vis-a-vis the seller. And even with comprehensive due diligence, the buyer may still lack a full understanding of the risks and liabilities that it will inherit through the transaction. This is especially true of mergers and acquisitions involving defense and government contractors, which operate within a complex regulatory environment.

Recognizing the information asymmetry, transaction documents typically include a set of representations and warranties accompanied by indemnification provisions that allocate post-closing risk to the seller for breaches or inaccuracies in those representations or warranties. The importance of indemnification issues to both parties to the transaction means that these issues can often become deal breakers during negotiations.



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Together, the parties must agree on, among other things:

- The overall scope of the seller's representations and warranties, including the allocation of known and unknown risks;
- The dollar limit of the seller's indemnity;
- The time period within which the buyer must bring its claims for breaches of the representations and warranties (the "survival period");
- The amount of escrow (if any); and
- The threshold of buyer losses, if any, triggering the seller's liability.

When parties would otherwise come to a standstill over indemnification issues, transaction risk insurance, commonly referred to as representations and warranties insurance, may bridge the gap.

The Basics of Representations and Warranties Insurance

R&W insurance facilitates mergers and acquisitions by providing a vehicle through which the buyer and seller may reach an agreement on indemnity terms for breaches of representations and warranties. For example, the buyer may want a higher limit on the seller's potential indemnity and a longer survival period, while the seller may want to limit its liability post-closing so it can freely distribute the sale proceeds to its investors. In such a case, R&W insurance could provide the buyer with the coverage that

it seeks, while allowing the seller to limit its post-closing liability to give it the freedom to distribute the sale proceeds. R&W insurance protects against unknown and unforeseen losses by offering coverage for losses that result from a seller's (or target company's) breach of the representations and warranties in the transaction documents.

Specifically, an R&W insurance policy typically covers "losses" from "claims" brought by the buyer for a breach of or alleged inaccuracy in any of the representations and warranties made by the seller. Policies usually provide blanket coverage for all representations and warranties, subject to some basic exclusions. R&W insurance can also be written to cover only specific representations and warranties, and in some cases, contingent risk insurance can be obtained to cover specific risks identified by the buyer.

R&W insurance policies are not a "cure-all." R&W insurance policies contain exclusions for purchase price adjustments, and known issues, including those discovered by the buyer during the diligence process, set out by the seller in the disclosure schedules or known by certain members of the buyer's "deal team." R&W insurance policies also frequently exclude claims for fraud, consequential damages, fines/penalties and claims for injunctive/nonmonetary relief. In addition to the more standard exclusions, R&W Insurance policies may also include deal-specific exclusions that depend on the particular representations and warranties in the transaction documents, including subject matters where the underwriter determines the buyer did not complete adequate due diligence or that the risk is generally uninsurable.

R&W insurance policies are either structured as "buyer-side" or "seller-side" policies. Buyer-side policies are first-party policies, meaning that when the buyer discovers a breach of or inaccuracy in a representation or warranty, the buyer brings its claim directly to the insurance carrier. In a buyer-side policy, the seller need not be involved in the claims process.

Seller-side policies, on the other hand, are third-party policies, meaning that the seller first receives a notice from the buyer alleging a breach of or inaccuracy in a representation or warranty and then the seller tenders the claim to the insurance carrier. Under a seller-side policy, the seller may remain obligated to pay to defend the buyer's claim but the seller can typically receive an advancement of these costs from the insurance carrier.

Through R&W insurance, it is possible for a buyer to obtain more favorable representations and warranties than it otherwise would because the policy may have a longer survival period and a higher claim limitation than the sellers would have been willing to agree to in the transaction documents. A buyer can also use R&W insurance to enhance its bid — by enabling the buyer to offer, for example, little to no seller escrow — and thereby increasing the likelihood that the buyer's bid wins a competitive auction process.

RWI and Government Contracts Considerations

Mergers and acquisitions that involve government contractors require specialized due diligence. Given compressed deal timelines and other practical concerns (such as the inability of a buyer to conduct even rudimentary diligence on classified contracts), a buyer may not have the ability to accurately identify and cabin all of the potential risks.

There are also other issues specific to government contractors where the costs incurred, time involved and disruption caused by thorough diligence make such efforts impractical. For example, when it comes

to certain intellectual property issues, deliverables must be marked accordingly or such rights can be waived. Thus, there are serious practical challenges to diligence.

In a similar vein, the counterfeit parts rule requires government contractors to pay close attention to supply chain matters. To verify this, a potential buyer might need to access lower-level employees at the target entity who may not have been read into an otherwise confidential transaction and to whom the buyer may not have easy access during the diligence process. Due to the impracticability of more fulsome diligence, buyers typically collect information on the target's policies and procedures and diligence a sampling of the target's transactions. But this might be insufficient to validate compliance in every respect.

As a result of the uncertainties in the diligence process and the considerations unique to government contracting, M&A transactions involving government contractors commonly require a robust set of representations and warranties. For example, the transaction documents will often include representations and warranties that apply to, among other things:

- All of the target's contracts, including any classified contracts;
- The risk of suspension and debarment and contract termination related to the target's present and past compliance with specific laws, rules and regulations; and
- The risk of termination or exclusion from future government contracting related to the target's compliance with socio-economic requirements.

The nature of these representations and warranties make them all the more important to the parties and all the more likely to become deal breakers during the negotiations. Thus, R&W insurance can play a particularly important role in bridging the gap between buyer and seller in mergers and acquisitions that involve government contractors.

Conclusion

R&W insurance can help to facilitate all types of M&A transactions. But in government contracts M&A transactions, even the most comprehensive due diligence might not enable the buyer to ascertain the scope of nature of all risks, and the transaction documents must include robust representations and warranties to address these uncertainties and other considerations unique to government contractors. As a result, R&W insurance may be particularly useful when the M&A transaction involves government contractors and may even make the difference between a closed transaction and a busted deal.

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