Forensic and Valuation Services Section

Association of International Certified Professional Accountants™

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# Representations and Warranties Insurance

Issued by the AICPA Forensic and Litigation Services (FLS) Committee

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# M&A Disputes:
## Seller Indemnity versus Representations and Warranties Insurance (RWI)

Historically, post-acquisition disputes arising from alleged breaches of seller's representations and warranties made as a condition to a deal were matters handled directly between the buyer and seller. As part of the closing process, the buyer and seller would often agree to place a portion of the deal proceeds in escrow to serve as funding for indemnification should a liability arise due to a seller's breach of its representations and warranties. This seller indemnification was limited to a fixed period of time, known as the survival period. In addition, the indemnification was capped by a dollar limit, typically expressed as a fixed percentage of deal value, and was subject to certain named exclusions.

In instances when the buyer sought indemnification from the seller for a breach, any covered liability would be paid out of the indemnification escrow, with any liability in excess of that amount to be borne by the buyer. When the buyer and seller did not agree, the matter may have been subject to a more formal adjudication process, whether through mediation, arbitration or litigation.

Although seller indemnification is still prevalent in many deals, the introduction of representations and warranties insurance (RWI) has changed the dynamics of disputes related to breaches of representations and warranties. In mergers and acquisitions (M&A) transactions where RWI is purchased, direct seller indemnification no longer serves as the sole recourse for a buyer. Instead, a third party — the insurance carrier — is introduced into the process. In exchange for premium paid by the buyer or seller, the insurance carrier provides insurance coverage for breaches of the seller's representations and warranties, subject to coverage limits, a limited period of time during which a claim can be made and certain exclusions. Although in certain deals RWI will fully replace seller indemnification (often referred to as no indemnity deals), in others seller indemnification will be supplemented by RWI.

# Parties Involved in RWI

Various parties are involved in the RWI life cycle, from the initial solicitation for insurance to the settlement or adjudication of a claim. These parties include the following:

- **Buyer.** The buyer is the party purchasing the stock or assets from another entity in an M&A transaction.
- **Seller.** The seller is the party selling stock or assets in an M&A transaction. To induce the buyer to close on a transaction, the seller makes a series of representations and warranties regarding the business or assets being purchased.
- **Insurer.** The insurer, also referred to as the insurance company or carrier, is a third party that provides RWI coverage. In the event that the seller breaches one or more of the representations and warranties made in the operative transaction agreement, the insurer pays the insured, whether buyer or seller, for resulting losses that are covered by the policy.
- **Insurance broker.** An insurance broker serves as the intermediary between the insurance carrier providing the RWI and the buyer or seller obtaining RWI. Although certain insurance can be obtained directly from an insurer carrier, RWI is often purchased through an insurance broker. The insurance broker is typically compensated a fee equal to a percentage of the premium paid for RWI, which is included within the total premium paid by the insured. Once a buyer or seller expresses interest in obtaining RWI, the broker will solicit offers from insurers. In addition, the broker will assist with communications between the insured and insurer, such as during the underwriting or claims processes.
- **Outside counsel.** Given the complexities of M&A deals, outside legal advisers may be involved during numerous phases of the RWI life cycle. The buyer and seller will hire their own deal attorneys to assist with drafting the operative transaction agreement and due diligence. In addition, the insurer may retain legal advisers to assist during RWI underwriting. Moreover, when RWI claims arise, the insured and insurer typically each retain outside counsel to assist with coverage determination.
- **Accountants.** Accountants (or "practitioners")[1] are often involved in deal due diligence, RWI underwriting, and RWI claims. *Role of the Practitioner* (page 24) describes common roles that practitioners serve with respect to RWI.

[1] For purposes of this supplement, the terms "practitioners" and "accountants" are used throughout. Generally, these terms are used interchangeably. Note that services provided by practitioners with respect to RWI claims may be subject to AICPA Statement on Standards for Forensic Services No. 1, depending on the purpose for which the practitioner is engaged.

# Development and Overview of RWI

RWI emerged as an effort to shift a portion of the risk of a breach from either the buyers or the sellers to the third-party insurers. Influenced by steady M&A activity and recognition of the product as an alternative to managing indemnification, RWI experienced a surge in growth, particularly beginning in 2014.[2] As the product continues to grow in popularity, purchasers, rates, limits, coverage, and the breadth of insurance participants are constantly evolving. The decision to purchase RWI for a particular transaction may be made by either the buyer or seller, resulting in the following two types of RWI policies:

- **Buy-side.** In these RWI policies, the buyer is the insured party. Buy-side RWI policies provide indemnification to the buyer, similar to the role of seller indemnification.
- **Sell-side.** In these RWI policies, the seller is the insured party. Sell-side RWI policies provide indemnification to the seller, effectively reimbursing the seller for a portion of or all amounts paid to the buyer for its liability.

Other than the named insured, buy-side and sell-side RWI policies offer similar coverage terms. The basic components of a typical RWI policy are as follows:

- **Premium.** To purchase an RWI policy, the insurer charges a premium to assume the risk. In addition, a portion of the premium represents brokerage commissions paid to the insurance broker for serving as the market maker and intermediary between the insurer and policyholder.
- **Retention.** Before an insurance carrier will pay on a loss resulting from an alleged covered breach, most policies are subject to a retention, or an amount that the insured must first retain. The aggregate loss (whether due to one breach or multiple breaches) must exceed this retention before coverage by the insurance carrier is triggered. Retention amounts are often equal to a percentage of the total deal value. For example, a deal with a base purchase price of $50,000,000 may have a retention equal to 1% of deal value, or $500,000. In this example, the insured will retain the risk for the first $500,000 of its loss, with the insurance carrier covering the loss for the amount in excess of the retention, subject to a limit of liability. In some cases, the retention amount may be covered by escrowed funds from seller indemnity. In such cases, the buyer may make both a claim against the seller to recoup the escrow amount and an insurance claim against the insurer to recover the losses above the retention amount.

[2] Industry statistics reflecting the number of RWI policies written are based on survey results. Although results vary depending on the survey population, the growth beginning around 2014 is a frequently noted observation.

- **Limit of liability.** Each policy will specify a dollar limit of liability the insurer is willing to accept. Most limits of liability are expressed on an aggregate basis, thus limiting the amount of coverage to a single amount, regardless of the number and value of individual breaches. Policy limits are often equal to a percentage of the total deal value, which varies depending on market trends. For example, a deal with a base purchase price of $50,000,000 may have a policy limit equal to 10% of deal value, or $5,000,000. In the event of a loss resulting from a covered breach, any portion of the loss that exceeds this limit of liability would be borne by either the buyer or seller depending on the specific terms of the transaction agreement and whether litigation or an alternative dispute resolution process is pursued.[3]

For large deals, the buyer or seller may purchase multiple RWI policies such that each policy will cover the excess amount of liability remaining after the limits of liability below such amounts are exhausted. For example, consider a situation in which a buyer purchases two RWI policies, one with a limit of liability of $5,000,000 (Policy A) and one with a limit of liability of $10,000,000 in excess of the first $5,000,000 (Policy B). Policy A has a retention of $1,000,000 and Policy B has a retention of $6,000,000. If the insured sustains a loss of $14,000,000 due to a covered seller breach of a representation in the operative transaction agreement, the allocation of the loss among the policies would be as follows:

| Responsible party | Amount paid by party | Cumulative amount of claim paid |
|---|---|---|
| Insured (Policy A's retention) | $1,000,000 | $1,000,000 |
| Insurer for Policy A | $5,000,000 | $6,000,000 |
| Insurer for Policy B (Note: Policy B's retention is exhausted in the cumulative amount) | $8,000,000 | $14,000,000 |
| Remaining Policy B coverage | $2,000,000 | N/A |

[3] The form and venue for adjudication is specified within the transaction agreement.

- **Policy term.** Similar to survival periods for seller indemnification, an insurer's willingness to accept the risk of a breach in exchange for a fee is limited to a finite period of time, known as the policy term or policy period. The policy term represents the period of time during which an insured can notify the insurer of a breach. Although many policies allow for a grace period after the expiration of the policy term (45 days, for example), in general, insureds must notify the insurer of any breach within the policy term in order for the resulting loss to be covered.
- **Transaction agreement.** Because the RWI policy covers representations and warranties made by the seller within the operative transaction agreement, the transaction agreement document itself is a component of, and is referred to within, the RWI policy. The RWI policy may refer to certain terms or sections of the operative transaction agreement when defining the scope and terms of coverage.

Although the components of an RWI policy provide a basic framework of policy terms, every policy is different. It is important to carefully read each policy to understand the scope of coverage, because some policies may differ from this framework.

# Types of Specific Representations and Warranties Insured

An RWI policy generally covers the representations and warranties made by the seller in the operative transaction document. As the demand for RWI policies changes and as claims are noticed and paid, an insurer's appetite to accept the risk of breach for certain representations and warranties similarly changes. Further, the types of representations and warranties that are covered by an RWI policy may vary by industry, the size of the deal, whether the transaction is public or private, and deal-specific circumstances. Seller representations and warranties that may be covered by an RWI policy include the following:

- Capitalization
- Tax matters
- Compliance with laws
- Employee disputes
- Financial statements
- Intellectual property
- Legal proceedings
- Material contracts
- Undisclosed liabilities
- Organization and standing
- Permits
- Real property
- Title to personal property
- Valuation of assets
- Vendors and customers
- Business practice or ordinary course

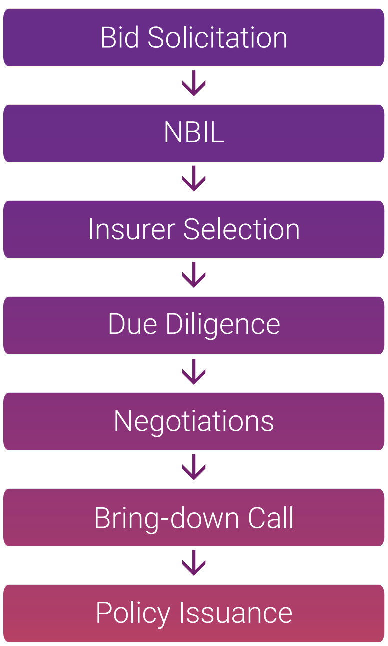
Other representations and warranties may not be covered by an RWI policy. Policies may, for example, exclude coverage of the following:

- Representations and warranties that are subject to great uncertainty or difficulty in estimation, such as certain environmental hazards and underfunded benefit plans
- Actual knowledge by one of the deal team members of a breach prior to closing
- Covenants, forecasts, and forward-looking statements
- Interim breaches of which knowledge is obtained during; the date the operative transaction agreement is executed; and the date the deal closes
- Net operating losses and other tax matters
- Purchase price and working capital adjustments that are settled by the buyer and seller as part of calculating the closing balance sheet

# The Underwriting Process

A summary of the underwriting process is illustrated in exhibit 1. Each stage is discussed further in this section.

Exhibit 1:




To solicit initial bids from insurers, the buyer or seller will work with its insurance broker to provide high-level information to potential insurers, such as a draft transaction agreement and the target entity's financial statements. Interested insurers will express their interest to the broker in what is known as a non-binding indication letter (NBIL), which represents the insurer's initial quote based on its limited review of the information provided.

Once the buyer or seller selects the insurer, the insurance broker and carrier will enter into a non-disclosure agreement with the deal parties so that the insurer can obtain documents and information for its underwriting process. During this process, the insurer gains an understanding of the deal and parties to evaluate and determine the risk it is willing to assume. As a result, the insurer may decide to charge a higher or lower premium, adjust limits of liability, require specific exclusions, or otherwise tailor coverage.

During its process, the insurer may communicate with various parties involved in the deal due diligence process. The insurer may ask about the due diligence process undertaken by the buyer, whether any issues arose, and risk-related questions.

During the underwriting process, the insurer will also issue a draft insurance policy. The final policy terms are often the result of subsequent negotiation between the insurer, the insured, and the insured's advisers (outside counsel and the insurance broker). Once the parties come to a mutual agreement on policy terms, the insurer will ask the insured to sign a disclosure asserting that there are no known undisclosed breaches prior to issuing the final policy.

In many cases, the policy is bound upon deal signing, instead of deal closing. In these instances, the last part of the underwriting process involves what is known as a bring-down call. During this discussion, the insurer will request receipt of any changes to the operative deal agreements or updates to due diligence, along with asking about any issues that have arisen since closing. The insurer will also request that the insured provide such representation in written form.

### Comparison of RWI Underwriting Diligence and Deal Diligence

Prior to executing a transaction, both buyers and sellers may perform due diligence. A seller may perform sell-side due diligence for the purpose of assessing the value of its company, identifying risks that may arise during a buyer's due diligence process, or identifying weaknesses in its business. A buyer may perform buy-side due diligence to serve as the basis for representations and warranties it will seek from a seller as part of the deal, to support or revise the purchase price it will pay for the target entity, or to identify risks or synergies of the target entity.

Many third-party advisers are involved in the buy-side and sell-side due diligence. Accountants, financial consultants, investment bankers, and outside counsel bring expertise in financial, operational, strategic, legal, regulatory and other aspects of the deal.

To facilitate the transfer of confidential information, a data room will often be created to store documents, data, and other information that is responsive to the due diligence process. Depending on the size and complexity of the deal, the due diligence process conducted by a buyer or seller may take place over multiple months.

When an insurer performs due diligence for the purpose of underwriting RWI, the insurer will often rely on diligence that has already been performed by the buyer or seller. In addition, RWI due diligence is focused on the risk that a seller will breach one or more of its representations and warranties in the operative transaction agreement and will not cover any areas that are excluded from RWI coverage. Further, the results of the insurer's due diligence may result in changes to the RWI policy terms, such as additional exclusions for specific representations and warranties that the insurer will not cover. In contrast to buy-side or sell-side due diligence, RWI due diligence often is conducted over a relatively short time frame, such as one week.

### Information Considered During RWI Underwriting Diligence

As mentioned, an insurer often relies on due diligence already performed by the buyer or seller for purposes of carrying out its own due diligence. Given the accounting, financial, tax, legal, and other technical components of a seller's representations and warranties, the insurer will often retain outside counsel and financial experts to assist during the due diligence phase. Sources of information reviewed by the insurer and its advisers often include the following:

- The deal data room. The repository for information exchanged between the buyer and seller during the deal due diligence process.
- Buy-side or sell-side internal or third-party diligence reports. These reflect the findings by the buyers, sellers, or their advisers after due diligence is conducted in a particular area (for instance, financial).
- Discussions. With the deal team and target entity management.
- Deal-related documents. Such as operative transaction agreements and disclosure schedules.
- Deal-specific requests. For example, if a particular area of concern is highlighted within one of the buyer's due diligence reports, the insurer may request more specific information regarding this risk to determine whether any related representations and warranties will be covered by the RWI policy.

# Description of Typical Representations and Warranties

The following sections provide further detail of the representations and warranties typically included in standard transaction agreements. A practitioner would most commonly be engaged to assist with the following representations and warranties:

- Financial statements
  - Audited or reviewed
  - Materiality
  - Interim reporting
  - Normal year-end adjustments
- Undisclosed liabilities and contingencies
- Collectibility of receivables
- Inventory
- Internal controls
- Material contracts
- Forecasts and forward-looking statements
- Environmental / product liability / asbestos
- Compliance with laws
- Intellectual property
- Real property and tangible property
- Fundamental representations
- Taxes
- Labor matters / employee benefits
- Business practice / ordinary course
- Solvency

The following contains further description of the common RWI terms.

### Financial Statements

One of the most common and essential accounting-based representations relates to the financial statements of the target entity. Representations related to financial statements are essential components of transaction agreements because the financial statements report the financial results of the target entity on which buyers may rely in determining the purchase price. Depending on the level of sophistication of the target entity and the structure of the target entity, the exact nature and content of financial statement representations may vary.

A typical financial statement representation includes the following core components:

- Reference to the actual financial statements to which a party makes a representation (balance sheet, income statement, statement of cash flows, statement of shareholder equity, and notes thereto)
- The dates of such financial statements
- An indication whether such financial statements are for an entire year or an interim portion of the year
- Whether such financial statements were audited or reviewed
- The accounting basis on which such financial statements are prepared (U.S. GAAP, IFRS, cash basis, tax basis, or some other comprehensive basis of accounting). A reference to the “books and records” as being an accurate basis for the financial statements and the consistent historical application of reporting basis may also provide important descriptions of the bases on which the financial statements are prepared.

An example of a typical financial statement representation is as follows:

> Set forth on Section [ - ] of the Disclosure Schedule are: (i) the audited consolidated balance sheets and statements of income, cash flows and members' equity of the Company as of and for the years ended December 31, 20[XX] and December 31, 20[XX], together with all related notes, and accompanied by reports thereon of [Audit Firm], the Company's independent auditors (the "Audited Financial Statements"), and (ii) the unaudited balance sheet of the Company as of March 31, 20[XX], and the related statements of income and cash flows of the Company for the three-month period then ended, together with all related notes and schedules thereto (the "Interim Financial Statements"). The Audited Financial Statements have been prepared from the books and records of the Company in accordance with GAAP applied on a consistent basis throughout the periods covered thereby. The Interim Financial Statements have been prepared in accordance with GAAP (except that such unaudited financial statements do not contain all footnotes required under GAAP and are subject to normal year-end adjustments, which will not be material individually or in the aggregate, and include assets of other subsidiaries of the Company). Each of the Interim Financial Statements and the Audited Financial Statements present fairly in all material respects the consolidated financial position, results of operations and cash flows of the Company as of the dates thereof and for the periods covered thereby, in each case except as disclosed in the Interim Financial Statements or the Audited Financial Statements (or in the notes thereto).

Other additional language may apply in certain situations; for example, in cases where the target entity of the transaction is carved out from the seller, additional caveats and limitations may be included in the financial statement representations.

Accuracy and completeness of financial statements are among the most common claims filed under RWI policies. Further description of common RWI exclusions are contained in the section on *Exclusions* (page 18).

### Audited or Reviewed

Where applicable, financial statement representations will typically include a representation that the year-end financial statements were audited (or reviewed for smaller entities or non-year-end financial statement dates). Buyers and insurers often request audited financial statements to provide an additional level of comfort over the completeness and accuracy of the financial statements. Buyers and insurers should consider whether a modified audit opinion was issued (namely, a qualified opinion, adverse opinion, an explanatory paragraph, or a disclaimer of an opinion or a reservation in the context of a review report). Even in cases where audited financial statements are provided, appropriate diligence should still be exercised because there may still be certain concerns with such financial statements.

*Materiality*

Financial statement representations typically include a materiality qualifier that further limits the representations. Deal participants should carefully consider which transaction agreement provisions are qualified by materiality considerations (for example, the presentation of the financial statements versus GAAP). Analysis of these transaction agreement provisions often focuses on how certain parties may determine materiality in case of a breach and the various different legal standards that may apply. Both quantitative and qualitative factors can affect the determination of materiality in instances of potential breach. Depending on the quantitative and qualitative factors, deal participants may argue that a breach in a relatively small amount may be material. For example, a buyer may believe that materiality is based on its own reliance on the financial statements and that any breach in a financial statement representation would have affected the price a buyer would have paid; conversely, an insurer may believe that materiality is based on the dollar value of a misstatement to the financial statements as a whole or that materiality should be determined using the same materiality threshold of the auditors.

*Interim Reporting*

It is also common for financial statement representations to include a representation regarding interim financial statements. An exception to this expectation occurs when a transaction agreement is signed within approximately a month of the most recent year-end financial statements. Interim financial statements are often the most recent quarter-end or month-end prior to the expected signing date of the transaction agreement. Representations regarding interim financial statements should set forth the basis of preparation of such financial statements (U.S. GAAP, IFRS, cash basis, tax basis or some other comprehensive basis of accounting). Typically, interim financial statements are not audited and normal year-end adjustments or footnotes are not disclosed. Depending on the accounting practices of the target entity, careful consideration should be given to the “normal year-end adjustment” disclosure.

*Normal Year-End Adjustments*

Interim financial statement representations frequently exclude “normal year-end adjustments.” For example, this may indicate that certain liability accruals have not been adjusted using the most recent information and instead are trued up only at year end. Additionally, what constitutes a normal year-end adjustment may be subject to varying interpretations and is often not defined within transaction agreements. For this reason, it is important to consider how such language is interpreted. For example, certain parties may interpret normal year-end adjustments as only those adjustments that would have historically been proposed as uncorrected or corrected errors by an auditor, whereas others may interpret normal year-end adjustments as any adjustment that may be normally made by management at year-end. The types of adjustments normally made by management at year-end can vary significantly depending on the accounting practices of an entity. In another example, for some entities, year-end adjustments may consist of updating only a limited set of reserve accounts, such as asset retirement obligations or legal reserves, whereas for other entities, normal year-end adjustments may be the only time an entity reviews and updates its bad debt or inventory reserve. Buyers and insurers should consider the need to specify what constitutes normal year-end adjustments if the RWI policy applies to interim reporting.

### Undisclosed Liabilities/Contingencies

Transaction agreements often include a representation from the seller that the target entity does not have any liabilities other than those reported on the financial statements and those liabilities incurred in the ordinary course of business since the date of such financial statements. Like financial statement representations, undisclosed liability representations are typically a heavily negotiated part of transaction agreements. Careful consideration should be given to the words and qualifiers utilized in such representations. Certain qualifiers, such as a reference to U.S. GAAP or other relevant financial reporting standards, can alter the meaning of such a representation. More often than not, sophisticated parties will negotiate the transaction agreement to include a qualifier limiting such representation to liabilities required to be reported on a balance sheet prepared in accordance with U.S. GAAP or other relevant financial reporting standards. Known contingent liabilities identified during the insured's diligence will often not be covered by an RWI policy.

The following is an example of an undisclosed liability clause:

> The Company has no material liabilities, and, to the best of its knowledge, no material contingent liabilities not disclosed in the most recent Financial Statement, except current liabilities incurred in the ordinary course of business since the date of the most recent Financial Statement.

Notably, the example is not qualified by language (such as, "liabilities required to be reported on a balance sheet prepared in accordance with U.S. GAAP") and therefore, one could reasonably interpret that this representation applies to any and all actual or potential liabilities.

### Collectibility of Receivables

Accounts receivable representations typically relate to the accuracy and validity of the listing of receivables as of a certain date, including the customer, the balance, and that the customer has no claim or offset against such receivables. In certain cases, however, these representations are enhanced to include a representation that all such receivables will be collectible as of a certain date.

An illustrative representation regarding the collectibility of receivables is as follows:

> All Accounts Receivable of the Company included in the Balance Sheet (i) arose out of arm's length transactions made in the ordinary course of the Business consistent with past practice; (ii) to the knowledge of the Company, are the valid and legally binding obligations of the Persons obligated to pay such amounts (except to the extent of any accruals for promotional discounts); (iii) are not subject to any written or oral dispute (except to the extent any such dispute is reflected in the reserves for doubtful accounts shown on the Balance Sheet).

### Inventory

Depending on the nature of the target entity, transaction agreements may include representations regarding inventory, including recorded value, quality, quantity, and salability or usability. An illustrative representation regarding inventory is as follows:

> All of the Company's inventories, materials and supplies consist of items in good condition and usable or salable in the ordinary course of business. The recorded values of the inventories stated in the financial statements reflect the Company's normal inventory valuation policies and were determined in accordance with generally accepted accounting principles consistently applied.

### Internal Controls

Transaction agreements may also include representations regarding the internal controls of the target entity, including its information technology infrastructure. A representation regarding internal controls might be stated as follows:

> The Company maintains a system of internal accounting controls sufficient to provide reasonable assurance that (i) transactions are executed in accordance with management's general or specific authorizations; (ii) transactions are recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles and to maintain asset accountability; (iii) access to assets is permitted only in accordance with management's general or specific authorization; and (iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences. The Company's internal control over financial reporting is believed to be effective, and the Company is not aware of any material weakness in its internal control over financial reporting.

### Material Contracts

Most transaction agreements include representations related to material contracts, such as those relating to customers, vendors, or insurance. This representation will specifically identify material contracts. The definition of a "material contract" will typically be set forth within each transaction agreement and could include those with income or expenditures over a certain dollar value; those with the target entity's largest customers, key employees, partnerships, or joint ventures; or those related to insurance and contracts with government entities. The representation will also typically include certain representations regarding the contracts, such as that each contract is valid, legal, binding and enforceable; that neither party to a contract is in breach of or default under (or is alleged to be in breach of or default under) the contract; and that neither party has provided or received any notice of any intention to terminate the contract.

### Forecasts and Forward-Looking Statements

Often, the seller may present forecasts or other forward-looking information as a component of the financial package shared with potential buyers for the transaction. Such forward-looking information may include items such as projected financial performance of the company; the expected development of the company's business, projects, and joint ventures; execution of the company's vision and growth strategy, including with respect to future M&A activity and global growth; sources and availability of third-party financing, future liquidity, working capital, and capital requirements; completion of the company's projects that are currently underway, in development, or otherwise under consideration; and renewal of the company's current customer, supplier, and other material agreements. Transaction agreements often contain language to clarify that such forward-looking information is not a guarantee of future performance and that undue reliance should not be placed on them because forward-looking statements necessarily involve estimates, known and unknown risks, and uncertainties. Further, transaction agreements often include that the company has no obligation to update forward-looking statements if circumstances or management's estimates or opinions should change except as required by applicable securities laws. Accordingly, forecasts and forward-looking information are typically not covered by RWI.

### Environmental/Product Liability/Asbestos

RWI coverage offerings on environmental representations are carefully evaluated on a case-by-case basis depending on the target entity's environmental footprint and risk exposure. Often RWI policies include specific exclusions for environmental conditions and are not designed to provide coverage for known contamination, active remediation, or tort allegations. A common reason for denied coverage by an insurer is that the claim is within the type carved out by the policy. Deal participants would typically consult with legal counsel regarding these types of representations.

### Compliance with Laws

Sellers commonly represent that they have operated the target entity in accordance with applicable laws. This representation is typically negotiated and included in transaction agreements to provide buyers comfort that the target entity is in compliance with all applicable laws, which is typically subject to a materiality qualifier, and that to the knowledge of the seller, the target entity is not aware of any investigation with respect to the violation of any applicable laws. Deal participants would typically consult with legal counsel regarding these types of representations.

### Intellectual Property

There are many types of agreements that may include the transfer of intellectual property rights as a component of the larger transaction. Intellectual property could include the following items:

- Patent rights, patent applications, and patents, as well as reissuances, continuations, continuations-in-part, divisions, extensions, and reexaminations thereof
- Trademarks, service marks, and trade names; applications to register trademarks or service marks; and registrations of trademarks and service marks
- Copyrights, and all applications to register copyrights; all registrations of copyrights; and renewals thereof
- Trade secrets and other proprietary rights
- Any other intellectual property

Generally, the transaction agreement will include a listing of the intellectual property to be transferred, as well as a representation that such intellectual property is valid, in full force and effect, and has not expired or been canceled, abandoned, or otherwise terminated, and payment of all renewal and maintenance fees and expenses in respect thereof, and all filings related thereto, have been duly made. Further, the transaction agreement may contain representations that the operation of the business of the company is not infringing, misappropriating, diluting, or otherwise violating any intellectual property of any other person or entity and that to seller's knowledge, no person or entity is infringing, misappropriating, diluting, or otherwise violating any of the company's intellectual property. Note that certain types of deal structures (for example, asset sale or stock sale) may exclude certain intellectual property from the overall transaction.

### Real Property and Tangible Property

Transaction agreements often contain a representation that the company owns and has valid title to all real property and tangible property reflected on the books and records of the company, free and clear of any liens other than permitted liens. The representation may also include that the tangible property is in good working order and that no material capital expenditures are necessary to operate or maintain such tangible property in the ordinary course of business. Deal participants would typically consult with legal counsel regarding these types of representations.

### Fundamental Representations

In many deals, key, significant representations are termed "fundamental representations and warranties." The determination of what representations and warranties will be deemed fundamental is a negotiating point in the transaction agreement. Fundamental representations and warranties typically have a longer survival period relative to non-fundamental representations and warranties; for example, fundamental representations and warranties may have a three to five-year survival period, whereas non-fundamental warranties may have 18- to 24-month survival periods. In many deals, the seller's liability to the buyer for breach of non-fundamental representations and warranties is limited to a percentage of the purchase price. In the same deals, however, the seller's potential liability for breach of fundamental representations and warranties may be the entire purchase price (or potentially subject to no cap at all).

### Taxes

Transaction agreements typically contain provisions to represent that the company's tax returns have been timely filed (taking into account any available extensions) and that such returns have been accurately prepared in all material respects. Further, the company may represent that tax amounts that the company has been required to withhold in connection with amounts paid or owing to any employee, independent contractor, creditor, stockholder, or other third party have been duly withheld and collected and have been timely paid. Tax representations may also include items relating to tax audits, examinations, tax liens, filing extensions and specialized applications of the tax code.

### Labor Matters/Employee Benefits

Transaction agreements typically include a disclosure of the target entity's current employee benefit plans. Representations relating to employment matters often pertain to the continuation or termination of disclosed employee benefit plans for current and former company employees.

### Business Practice/Ordinary Course

Most transaction agreements also contain a number of covenants obligating the parties to act in a specified manner. A covenant is a formal agreement or promise to do or not do certain acts. Covenants are forward-looking and relate to the conduct of a party either between signing of the acquisition and closing of the transaction or after closing. Pre-closing covenants may require the target entity to operate the business in the ordinary course of the business and that no extraordinary actions be taken, without the consent of the buyer that could have a negative effect on the target entity. For example, a transaction agreement may include covenants precluding the seller from declaring dividends or distributions, incurring any indebtedness above an agreed-upon level, or acquiring or disposing of material assets, without prior approval by the buyer. Although, not technically representations or warranties, covenants may or may not be excluded from RWI policies.

### Solvency

Typically, solvency provisions represent and warrant that the target entity

- will be solvent (in that both the fair value of its assets will not be less than the sum of its debts and that the present fair salable value of its assets will not be less than the amount required to pay its probable liability on its recourse debts as they mature or become due);
- will have adequate capital and liquidity with which to engage in its business; and
- will not have incurred and does not plan to incur debts beyond its ability to pay as they mature or become due.

# Exclusions

RWI policies often contain language that excludes recovery on claims relating to certain breaches. Common exclusions include the following: actual knowledge; multiple exclusions; materiality; working capital adjustments; and other issues identified in due diligence.

### Actual Knowledge

RWI policies may prohibit recovery of breaches, if the insured had prior knowledge of the breach. Such terms generally refer to the actual knowledge of truth or falsity and are often limited to the actual knowledge of a group of people or the deal team, specifically defined in the transaction agreement. A common reason for denied coverage by an insurer is that the issue was known by the insured prior to the closing of the transaction. RWI policies may include an “anti-sandbagging” provision, which expressly limits or excludes coverage for damages arising out of any breach that the buyer was aware of prior to closing.

### Multiple Exclusions

A common method used to determine the purchase price of a business is based on a multiple of EBITDA (earnings before interest, taxes, depreciation and amortization), which is a measure of a company’s ability to generate operating earnings. A buyer seeking recovery for a breach of financial statement representation resulting in an inflated EBITDA figure may claim that because the purchase price had been based on an EBITDA multiple, the purchase price had been inflated as well. RWI policies may contain exclusions that prohibit using multiples in calculating indemnification recovery amounts. In such cases, the insured will need to determine its losses for any breach based on a methodology other than at a multiple (on a dollar-for-dollar basis or in some other manner).

### Materiality

A “materiality scrape” is a provision sometimes contained in a transaction agreement that effectively eliminates, for indemnification purposes, any materiality qualifiers in a representation and warranty when determining whether a breach of the representation and warranty has occurred. Materiality scrapes are generally either embedded within the indemnification provisions of the transaction agreement or set forth as a standalone provision. A materiality scrape may be referred to as a “single” or “double” materiality scrape.

- A “single” materiality scrape provides that the materiality scrape will apply only when determining the amount of damages or losses, meaning that the materiality qualifiers would not be scraped in determining whether a breach of a representation or warranty has occurred, such that an immaterial breach would not trigger a breach of representations and warranties under operative transaction agreements. For example, a single materiality scrape provision could be drafted as follows:

  For purposes of calculating the amount of any losses that are incurred in connection with a breach of a representation and warranty in this transaction agreement, such representation and warranty will be read without regard and without giving effect to the term “material” or “material adverse effect” (fully as if any such word or phrase were deleted from such representation and warranty).

- A “double” materiality scrape provides that the materiality scrape applies to determining both whether a breach has occurred and the amount of indemnified losses resulting from the breach. For example, a materiality scrape provision could be drafted as follows:

  For purposes of determining whether there has been a breach and the amount of any losses that are the subject matter of a claim for indemnification, each representation and warranty in this transaction agreement will be read without regard and without giving effect to the term “material” or “material adverse effect” (fully as if any such word or phrase were deleted from such representation and warranty).

### Working Capital Adjustments (Duplicate Recovery)

Transaction agreements may contain exclusions that would prevent a buyer from recovering amounts from the seller more than once (also known as double recovery). For example, with this exclusion in place, a buyer would be unable to recover an amount under the working capital adjustment process and also through a claim of breach of the financial statement representation if the adjustment and the claim were related to the same item or amount.

### Other Issues Identified in Due Diligence

Transaction agreements may contain an exclusion relating to the buyer’s opportunity to conduct due diligence with respect to the company prior to the transaction closing. These exclusions may stipulate that the seller will not have any liability to the buyer with respect to a breach of representation, warranty or covenant under the transaction agreement to the extent that the buyer knew of such breach as of the closing date.

# Recovery of Losses

An RWI policy specifies the types and amounts of losses the insured is entitled to recover if a breach occurs. Losses may be determined in a variety of ways depending on the individual facts associated with the claim. Common types of claimed losses include the amount by which a buyer overvalued a company due to its reliance on an incorrect representation or warranty and direct out-of-pocket costs the buyer incurs to remedy an issue (for instance, payments for an undisclosed liability). Regardless of type, such recoverable losses are typically based on (a) the amount the insured is entitled to receive in respect to a breach pursuant to the terms of the underlying transaction agreement, plus or minus (b) any adjustments based on terms unique to the insurance policy.

### Losses Calculated Based on the Underlying Transaction Agreement

With respect to determining losses under the terms of a transaction agreement, see Chapter 5 (titled "Representation and Warranty Disputes") of the 2012 original publication of the AICPA FVS Section's *Mergers and Acquisition* practice aid (copyright updated in 2020). Common issues about determining losses under the terms of a transaction agreement include whether losses should be calculated on a dollar-for-dollar basis (commonly used for one-time events) or using a multiple (commonly used for permanent reductions of earnings that will continue to affect the business into the future). Moreover, in assessing a loss, the insured should evaluate whether the transaction agreement prohibits recovery through a representation and warranty claim, because the loss has already been recovered through a different provision of the transaction agreement (for example, a working capital adjustment).

One unique element regarding the evaluation of losses under RWI claims involves the information that may be available to the insurer regarding the original purchase price negotiations; for example, evaluating how the original purchase price was arrived at by the buyer and seller (for example, a market approach versus an income approach) may be an important consideration in calculating losses. Because the insurer was not directly involved in the buyer's and seller's negotiations, it may be unaware how those parties determined the final purchase price. If a large portion of those negotiations occurred verbally or without detailed documentation (or if documents conflict), this may increase the difficulty an insurer has in assessing loss calculations. In such instances, the insurer may need to assess the reasonableness of the buyer's assertions without access to information controlled by the seller that could support or refute such assertions. If the insurer ultimately concludes the buyer did not rely upon a certain valuation technique used as the basis of its claim (for example, a multiple of EBITDA), the insurer and insured may be unable to resolve the claim without the formal dispute resolution process specified in the RWI policy.

### Adjustments to Loss Calculations Based on Unique Terms of the Insurance Policy

An RWI policy may contain unique terms that adjust losses that would otherwise be determined under the transaction agreement. For example, an insurance policy may contain exclusions that prohibit recovery in certain instances (for instance, prior knowledge of the breach). As a result, the insured should evaluate its policy closely prior to calculating any losses to confirm that such losses are not prohibited.

Conversely, an insurance policy may have unique provisions that increase the amount of losses that the insured can claim. For example, some RWI policies contain provisions that permit the insured to recover costs associated with investigating, negotiating and adjudicating a claim. Such provisions may encourage a more expeditious resolution of the claim by incentivizing the insurer to avoid costs associated with a protracted claims resolution process. An insurance policy may also expand the calculation of losses by containing one or more provisions (for example, materiality scrape provisions referenced in subsection on *Materiality*, on page 18).

The amount recoverable under the policy will be subject to the policy limits and retention amounts discussed in *Development and Overview of RWI* (page 4). Although a policy limit and a retention amount affect the amount an insured can receive for a loss, it does not directly affect the insured's calculation of its losses. For example, an insured may calculate its losses associated with a breach to be $25 million, even if the policy limit is $10 million. In such an instance, the most the insured could receive under the policy would be $10 million, even though it asserts it was damaged by $25 million.

### Mitigation

RWI policies typically require the insured to take reasonable steps to mitigate losses after becoming aware of a breach. Moreover, RWI policies often state the costs to mitigate a loss are recoverable under the policy. The failure to mitigate the loss may be a basis for the insurer to reject or reduce the insured's claimed loss. For example, consider a buyer that acquires a manufacturer with limited production capacity and only a few large customers. The buyer subsequently becomes aware that one of the manufacturer's customers canceled its supply arrangement with the company shortly before the acquisition. The associated transaction agreement may contain a representation that the manufacturer had lost no major customers, and thus, a breach occurred. The buyer may have the ability to mitigate this loss after closing by finding a replacement customer or selling additional output to current customers, which may reduce the losses the buyer suffers. If the buyer does not attempt to take such actions, the insurer may assert the buyer failed to mitigate its damages. Often, however, mitigation may be impractical or impossible for many RWI claims. Each claim must be evaluated on its specific facts and circumstances.

### Case Law

Most RWI policies require the parties to resolve disputes through binding arbitration rather than litigation. As such, minimal public case law currently exists specifically with respect to quantifying losses under RWI policies. In the absence of such specific case law, we would expect the parties to consider prior cases relating to representation and warranty disputes that have been tried between buyers and sellers. Because case law is continually evolving, parties to a dispute and their accountants should consult with legal counsel familiar with the laws governing the applicable matters.

# Resolution of a Claim

The RWI policy typically specifies procedures for the insured to pursue a claim. The process allows the insured to file a claim, the insurer to evaluate the claim, and the parties to resolve the claim.

## Claim Process

The process identified in the insurance policy typically contains the following steps:

- **Insured's filing of a claim notice.** The policy provides specific procedures to file a notice, including the address to which notices should be sent and a format in which the insured should submit a claim. Typically, a claim notice will identify the breach alleged by the insured, a description of the issues that resulted in the breach and a quantification of the loss amount.

- **Insurer's review of documentation.** Upon receipt of a claim notice, an insurer may request additional documentation to analyze the claim, such as accounting documentation or other records demonstrating a breach occurred; documentation concerning the insured's loss calculation, such as detail underlying the line items specified by the insured in its claim or the buyer's original calculation of the purchase price; or correspondence to other parties (such as the seller) relating to the claim notice.

- **Insurer's coverage position response.** The insurance policy typically provides a specified amount of time following receipt of a claim notice in which the insurer must respond with its coverage position (agreeing to make a full or partial payment for the claim or explaining why it is not covering the claim).

- **Settlement discussions.** In the event the insurer does not agree to make full payment of the claim, the insured and insurer may have discussions to reach a mutually agreeable settlement. These discussions may include each party having its representatives (external accountants or counsel) present information to the other party's representatives. The parties may agree to participate in nonbinding mediation to help them reach a settlement.

- **Arbitration or litigation.** If the insured and insurer are unable to settle the claim, the insurance policy will typically specify how they will resolve the dispute. Most RWI policies currently require binding arbitration to resolve such disputes and designate an organization (such as the American Arbitration Association) to which the parties will submit such disputes. Policies also identify the law that shall govern such disputes (State of Delaware or State of New York law, for instance).

### Subrogation

Upon payment of an insurance claim, most RWI policies provide the insurer with certain subrogation rights, in which the insurer may be able to pursue claims against the party that originally caused the insured's losses. With respect to RWI, such losses typically relate to representations made by the seller in the underlying transaction agreement. As such, subrogation would often relate to losses resulting from the seller breaching representations; however, RWI policies typically permit the insurer to subrogate against the seller only in instances where the seller commits fraud. Accordingly, the most typical subrogation action associated with an RWI policy would be the insurer pursuing a fraud claim against a seller. If the insurer does attempt to pursue a subrogation claim against a party, the RWI policy typically requires the insured to take reasonable efforts to preserve the insurer's subrogation rights. In such instances, the insurer frequently is required to reimburse the insured for costs it incurs aiding the insurer in this process.

# Role of the Practitioner

Both the insured and the insurer may require assistance regarding RWI policies from their respective practitioners for numerous issues. Following is a description of the role of practitioners in providing certain services to clients with respect to RWI policies. In providing such services, a practitioner may be engaged directly by the client or by the client's legal counsel. If the practitioner is engaged by counsel, the practitioner should confirm with counsel what steps the practitioner should take to maintain attorney work product privilege in the applicable legal jurisdiction.

- **Financial due diligence.** As discussed in *The Underwriting Process* (page 8), both the buyer (insured) and insurer typically perform due diligence prior to the execution of a transaction agreement and the related RWI policy. In performing financial due diligence, buyer's accountants may do the following:
  - Analyze critical balance sheet accounts of the target entity.
  - Evaluate the earnings and make certain adjustments to remove one-time or nonrecurring items from historical income statements to analyze the potential future earnings capabilities of the target entity.
  - Note key internal control issues that come to the practitioner's attention.
  - Analyze earnings projections presented by the seller or the target entity.

The insurer may request that its accountants independently perform similar types of procedures (or a subset thereof) or simply review the due diligence performed by the buyer's accountants or seller's accountants.

In providing due diligence services, practitioners may be required to rely on professionals with expertise in specific elements pertinent to the deal. These may include individuals with specialized credentials such as Accredited in Business Valuation (ABV), Certified in Financial Forensics (CFF), or Certified in Entity and Intangible Valuations (CEIV) among others.

- **Claim notice preparation assistance.** A practitioner may assist the insured in preparing its claim notice filing. In providing such assistance, a practitioner may do the following:
  - Assist the insured in evaluating the strength of its arguments under GAAP or other applicable accounting standards
  - Identify documentation relevant to the claim
  - Prepare preliminary loss calculations relating to the alleged breach
  - Help the insured identify questions or additional detail the insurer may have regarding a potential claim notice

- **Assistance in insurer's evaluation of a claim.** Upon receiving a claim notice, insurers often request services from accountants. In providing such assistance, a practitioner may do the following:
  - Prepare a list of documents to request to assist the insurer in evaluating the claim. Depending on the circumstances and the nature of the claim, the insurer may request information such as internal financial statements or accounting records; investment memos or valuation models; due diligence reports; audit working papers; or emails or correspondence relevant to the claim
  - Review documentation and hold discussions with the insured's accountants to document any pertinent basis for the insured's claim
  - Provide an analysis of elements of the claim or loss calculation with respect to GAAP or other applicable accounting standards
- **Settlement negotiations.** If the insurer does not agree to pay the claim in full, the parties may ask their respective accountants to participate in a potential settlement process. In such processes, a practitioner may do the following:
  - Continue to gather information regarding their client's position and the opposing party's position
  - Present analyses to the opposing party or its accountants
  - Present information to a neutral mediator
- **Arbitration or litigation (consultant or testifying expert)**. If the parties are unable to settle the matter, they may have their accountants provide services to them in arbitration or litigation. In such settings, a party may engage a practitioner either as a consultant or as a testifying expert. The practitioner should be aware of the requirements for providing either type of service under the AICPA's standards and under applicable requirements of the governing jurisdiction.

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