LITIGATION MINUTE: REPRESENTATIONS AND WARRANTIES IN MERGERS & ACQUISITIONS: SAFETY NET OR SNARE?

DEAL LITIGATION SERIES: PART ONE OF FOUR

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WHAT YOU NEED TO KNOW IN A MINUTE OR LESS

2021 was an unprecedented year for mergers and acquisitions (M&A), with both the number of transactions and the dollar value of those deals hitting all-time highs. This record deal volume also often increased the speed in which transactions moved to signing and closing. Pressure to sign quickly, however, can abbreviate due diligence and short-circuit negotiation of deal terms in the sale documents. Enter transaction document representations and warranties.

The traditional M&A structure of representations and warranties and of indemnification is evolving to keep up with the new pace of deal closings and may vary based on the leverage of the parties involved in the transaction. As businesses manage the desire to close quickly against the need for due diligence and deal term negotiation, sellers may pressure bidders to accelerate the due diligence process or to reduce the scope of due diligence. This could present a recipe for surprised and disgruntled buyers post-closing, with an increased risk for deal litigation.

The Nuts and Bolts: Representations and Warranties

In an M&A transaction, the seller makes statements of fact about the business in order to induce a buyer to enter the transaction. These statements, referred to as “representations and warranties,” are heavily negotiated by the parties during the transaction process as a means of allocating risk between the parties. In a traditional M&A transaction, the seller (and/or shareholders) agrees to indemnify the buyer—subject to negotiated caps, baskets, exclusions, and time limits—for breaches of the seller's representations and warranties, in addition to any other negotiated specific indemnities.

There Has Been a Breach—Now What?

In a traditional M&A transaction, contractual indemnification provisions outline remedies for a breach of the representations and warranties, and often serve as a party's sole recourse for breaches other than fraud. Like representations and warranties, contractual indemnification provisions are heavily negotiated and allocate the risk between parties, generally without requiring any finding of intent or negligence before allowing recovery. Frequently, a portion of the purchase price is held in escrow for a certain period of time post-closing, and such funds are marked specifically for indemnification purposes in the event of a breach. Claims of indemnification for breach of representations and warranties can also be accompanied by claims for fraud.

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Capping Damages to Mitigate Risk

As indemnification rights in transaction agreements are contractual in nature, the parties can typically define the scope of their indemnification obligations. Sellers can limit potential exposure by restricting buyers to suing under an indemnification provision that provides a cap on recovery.

The Emergence of Representations and Warranties Insurance

The use of representations and warranties insurance (R&W insurance) has become a mainstay in M&A transactions, providing insurance coverage for breaches of representations and warranties in the transaction agreement.

R&W insurance is most often purchased by the buyer and enables a seller to exit the deal with greater certainty by limiting or eliminating the need for seller indemnity. By eliminating the escrow holdback, R&W insurance can make a deal look more attractive, extending the time given to the buyer to discover problems with the transaction and allowing the parties to more efficiently negotiate the transaction agreement. In the event of a breach of the representations and warranties, policyholders should look to their R&W insurance for recovery.

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