KIRKLAND & ELLIS

KIRKLANDPEN
Private Equity Newsletter

July 25, 2014

M&A Insurance - No Exclusion of Consequential Damages

PENpoints

A recent U.K. court decision involving a representation and warranty insurance policy underwritten by AIG may provide evidence that a properly drafted policy can protect a buyer from diminution in value arising out of a breach of seller's representations and warranties.

M&A, or representation and warranty, insurance policies have become an increasingly common element of many acquisition transactions. While usage varies, there are certainly some auction processes where the failure to largely replace the traditional survival/indemnity/escrow package with a policy (or alternatively to express a willingness to self-insure these risks) can place a bidder at a significant disadvantage. The terms of these policies vary, but the basic framework is that the insurer provides coverage (subject to a self-insured retention and cap) for damages suffered as a result of a breach of the seller's representations and warranties. Most often the policy is obtained by the buyer (with some sellers even providing a "staple" policy with the bid package) to replace or supplement the indemnification terms, but in some cases the policy is taken out by the seller as a backstop for its own potential indemnification obligations negotiated with a buyer.

One of the long-standing concerns of dealmakers considering representation and warranty insurance policies is whether these policies will in fact pay out in the event of claims and, more specifically, whether in appropriate circumstances the policies will pay out on a "multiple," "diminution in value" or similar basis. For example, where there is a misrepresentation in the financial statements that results in lower EBITDA for the target, would the buyer be able to collect damages under the policy that reflect the recurring valuation impact of the lower results or would insurers seek to limit their obligation to the actual amount of the shortfall?

Because there is little published information or data about claims and payout history, most of the knowledge around these issues is anecdotal. For example, in a KirklandPEN last year, we noted a settlement with an underwriter where the insurer agreed to a payout based on a calculation that largely reflected a "multiple-based" calculation of damages for a breach of the financial statement representation.

The facts surrounding a recent decision by the High Court in England, *Ageas v. Kwik-Fit*, provide perhaps the first publicly available evidence that a properly drafted M&A insurance policy can protect a buyer from diminution in value of the target where inaccurate facts, that the seller had warranted, were used in the buyer's financial model to determine price.

Ageas acquired all of the shares of a subsidiary from Kwik-Fit and in connection with the transaction bound a warranty and indemnity insurance policy underwritten by AIG. The parties to the case, including AIG, consistent with our experience in most claim situations, stipulated that there had been a breach: Two aspects of the bad debt reserves on the applicable balance sheets were inaccurate, breaching the financial statement representation and warranty. As a consequence, the buyer and seller settled their claim.

Ageas and AIG agreed that the attachment point of the policy – the seller's £5 million indemnification cap – would be exceeded. In the context of the litigation, AIG conceded that the damages should be calculated as the difference between the actual purchase price and the purchase price that the buyer would have agreed to pay had the correct bad debt reserves been used in its discounted cash flow analysis. The only remaining issues between Ageas and AIG were certain assumptions to be used in the projections of the future free cash flow.

One of the many benefits of M&A insurance policies is that some underwriters – for a higher premium than

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charged for their off-the-rack policies – will not exclude certain types of damages, such as consequential, special and multiple damages, which are regularly excluded in a seller-friendly purchase agreement with traditional indemnity provisions. The recent *Kwik-Fit* decision is further evidence that damages based on an EBITDA-multiple or other measurement of diminution of value – under a carefully crafted (and marginally more expensive) insurance policy and the appropriate circumstances – are available to compensate a buyer for its loss caused by the seller's breach of representations and warranties.

If you have any questions about the matters addressed in this *KirklandPEN,* please contact the following Kirkland authors or your regular Kirkland contact.

Dr. Markus P. Bolsinger
http://www.kirkland.com/mbolsinger
+1 212-446-4938

Jeremy S. Liss, P.C.
http://www.kirkland.com/jliss
+1 312-862-2286

PENbriefs

New Anti-Spam Law May Affect Portfolio Companies Marketing to Consumers in Canada

Effective July 1, 2014, Canada's new Anti-Spam Law (CASL) broadens liability for businesses that send marketing emails to consumers in Canada. Generally, the CASL prohibits sending commercial electronic messages (CEMs) to email addresses, social networking accounts, and text messages unless the sender (1) obtains the recipient's consent, (2) provides identification information, and (3) provides an unsubscribe mechanism. To learn more details and how CASL may affect your portfolio company, see our recent *Alert*.

PENnotes

PLI Hot Topics in Mergers & Acquisitions 2014
Chicago, September 9, 2014
New York, October 2, 2014

The M&A markets were relatively flat throughout 2013, punctuated by episodic but unsustained bursts of activity. By contrast, 2014 appears to be off to a more robust start. An expert faculty of lawyers, general counsels, regulators and investment bankers will explore the fascinating state of M&A and trends for the year ahead. Kirkland partners R. Scott Falk and Sarkis Jebejian are co-chairs of the event. Also, Kirkland partner Stephen Fraidin will speak at the Chicago and New York seminars. Click here for more information.

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Private Equity Practice at Kirkland & Ellis

Kirkland & Ellis' nearly 400 private equity attorneys have handled leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and the formation of private equity, venture capital and hedge funds on behalf of more than 400 private equity firms around the world.

Kirkland has been widely recognized for its preeminent private equity practice. The Firm was named "Private Equity Group of the Year" in 2012, 2013 and 2014 by *Law360* and was commended as being the most active private equity law firm of the last decade in *The PitchBook Decade Report*. In addition, Kirkland was awarded "Best M&A Firm" and "Best Private Equity Firm" in the United States at *World Finance*'s 2012 Legal Awards and was honored as the "Private Equity Team of the Year" at the 2011 IFLR Americas Awards.

In 2012, 2013 and 2014, Chambers and Partners ranked Kirkland as a Tier 1 law firm for Investment Funds in the United States, United Kingdom, Asia-Pacific and globally. The Firm was ranked as the #1 law firm for both Global and U.S. Buyouts by deal volume in Mergermarket's *League Tables of Legal Advisors to Global M&A for Full Year 2011, 2012 and 2013*, and has consistently received top rankings among law firms in Private Equity by The Legal 500, the Practical Law Company and IFLR, among others.

The Lawyer magazine has recognized Kirkland as one of its "Transatlantic Elite" every year since 2008, having noted that the firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent."

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EDITORS

Jack S. Levin, P.C.
Margaret A. Gibson, P.C.
Norbert B. Knapke II

SUBSCRIPTIONS

To subscribe to *KirklandPEN*, please email
kirklandpen@kirkland.com
+1 (312) 862-3356

www.kirkland.com