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Representation and Warranties Insurance in Mergers and Acquisition

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ABSTRACT

In today's world we come across the phenomenon of mergers and acquisition but in layman's term we know of this as a conglomeration or joining up of two entities of distinct or same nature or course of business. But certainly, there are reasonable technicalities that are involved in this procedure one of them being the liability and the addressing the same. Therefore, a practise of representations and warranties insurance is a new thing to be nurtured in India but it has its wide spread practise in countries like UK and the USA, therefore this type of insurance works upon the coherence principle of indemnification wherein the seller or the buyer of the business vouch to indemnify each other in case if there is a breach made on the part of representations. Therefore, depending upon the situation the agreement or the insurance can be drafted in seller side format or in buyer side format.

Keywords: *Mergers, Acquisition, Representations, Warranties, Indemnification, Insurance.*

I. INTRODUCTION

The concept and practise of mergers and acquisition in India is on a all time high wherein new conglomerates and new merged and acquired entities are evolving and coming to life. But certainly, the concept of mergers and acquisition is a bit complex and involves various legal aspects and approaches so as to get a perfect result out of the merger. In a single merger and acquisition transaction there can be an enlisted number of issues and problems that can arise during the merger or after the merger is complete. The transaction also gets affected from the historical performance which ultimately leads to the future portfolio development. Under the specific provisions of the Companies Act, 2013 merger and acquisition have been categorically defined and illustrated. Whenever there is a merger or an acquisition in transition then in those cases there are certain sets of technicalities are involved like the risk liability, the indemnity the due diligence performance, etc. therefore it is crucial to take these steps critically and carefully. This article shall be imbibing the principle of representations and warranties

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insurance under mergers and acquisition transactions. The aspect of R&W insurance comes into play the pivotal role when it discusses the likelihood of the transaction or the deal to be completed in solace. In India, this concept is still not developed rather it is discussed in a grey area with less of participation from the corporate industry. Not representation, but certainly misrepresentations have been defined under section 19 of the Indian Contract Act, 1872, and the warranties has been a definition postulated under section 12(3) of the Sales of Goods Act, 1930. The R&W insurance works upon the fundamental principle of caveat emptor which means that the buyer be aware. Under this type of insurance practise there are basically two sides which are the seller and the buyer, the seller is the one who is selling the business in the merger or acquisition and the buyer is the one that is buying the business from the seller. Therefore, both the parties to the transaction need to lay down a set of pre-decided and critically evaluated ground rules which shall thereby limit the liabilities of both. Therefore, during the drafting of the R&W insurance from the seller side, the seller vouches to disclose in all the relevant information about the business or any of the pending suit or litigation or the information about the intellectual property therein held by the seller side company, and the buyer will evaluate all the future prospects of the transaction and the information that is supplied by the seller. The parties shall try to critically specify and evaluate the indemnity and liability upon each of their behalf[3]. The role of this type of representations and warranties insurance is to protect the seller and the buyer from the misrepresentations and also the fraud. Therefore, these misrepresentations and other liabilities are red flagged under the clause which is known as the R&W clause in the merger or acquisition agreement. Representations as a term imbibing the meaning is the presentation of a particular thing whereas the warranty is a type of guarantee which runs upon the principle of indemnity in the R&W insurance. A company that is duly registered in India in compliance to the laws in force, this statement can play a crucial role under the R&W clause. Till date there is no statute or a notification in play that governs the R&W insurance and is purely a concept of practise.

II. WORKING OF THE R&W INSURANCE- AN APPRAISAL

The representation is the statement about the conduct of business that is specifically made by the seller to the buyer, or by the buyer to the seller in a particular merger or acquisition agreement, and coherently the guarantee is the guarantee about the accurate representation is being made in the agreement. The R&W agreement and the transaction is critically appraised

[3] Sharkey, Michael, Insurance and Mergers and Acquisition, Perkins Coie, (8th May, 2022, 5:42PM), https://www.techriskreport.com/2019/08/insurance-and-mergers-acquisitions/?msclkid=ab8e4cf3ceb111ec88c17e44d49a494f.

by the buyer and seller so that they can progressively restrict their respective liability in the agreement. Also, the nature and the scope of the representation that is to be made upon the side of the seller may vary greatly depending upon the particular nature of the transaction. Some of the points inclusive under the ambit of R&W agreement clause are as follows[4]:

1. Intellectual Property ownership of the seller or the buyer of the business being made subject matter of the transaction;
2. Appropriate compliance with the taxation laws;
3. Information about the related-party or third-party transactions;
4. The financial statements;
5. Completed and elucidate information about the shares of the target company;
6. The insurance policies that are to be made applicable.

The representations play the role of a primer which helps the buyer and the seller about each other's portfolio and prospects. But it is really not comprehensible to bring in each and every point of information about the business of the party to the buyer as well as to the seller. Also, with the smooth flow of the information from the end of the seller or of the buyer, this allows either of the parties to walk away from the transaction or from the merger agreement if there seems to be a substantive breach of the provision of the agreement. Even of the buyer has performed to its fullest extent the research about the business of the seller and certain information seems to have been marked absent then in those cases the seller will have to indemnify the buyer for the breach. In the landmark case of All India General Insurance Company Limited and Another v. S.P. Maheshwari[5], it was held that, the duty to disclose information comes under two aspects that are representations and warranties, representation is the inducement of the certain traits of the insurance cover to be made collateral to the information being given or supplied.

THE EQUATION OF RISK ALLOCATION

Under the American market of practise on mergers and acquisition, the risk is allocated in various ways. The most common practise is to address the breach of the R&W insurance and also for the seller to limit the liability, the seller can mark a limit wherein a particular amount shall be described for the compensation to be made in the form of indemnification, if loss takes

[4] Marialuisa S. Gallozzi & Eric Phillips, *Representations and Warranties Insurance*, 14 ENVTL. CL. J. 455 (2002).
[5] All India General Insurance Company Limited and Another v. S.P. Maheshwari, AIR 1960 Mad 484

place for the amount less than the described sum of money then the indemnification shall not stand. In practise, the claims of the indemnity and the insurance cover is already pre-negotiated and there are several methods that are used for the funding of the indemnity and the insurance cover, these are:

1. Purchase price holding back;
2. Escrow account statements and the indemnification of the same;
3. Concept of future payments and to set off the liability against the same;
4. Bank guarantees.

Amongst the above-mentioned type, the escrow account and the indemnification of the same is the most common and the most prevalent practise, wherein a third-party plays the role of a payment regulator so that there is no dispute in respect to payment to be given. In the initial development stage of the said concept there was a bleak clean passageway that was given to the seller in terms of selling up of the business. The policy can work from two ends, the one being the buy side and the other being the sell side. Under the buy side the buyer is indemnified without even resorting to the contractual agreements and terms the seller on the other hand is indemnified for the claims put forth by the buyer. In common global practise the retention subjects to 1-2% and the premium is stained till 3.5%. in general lieu there are certain benefits which are bestowed on both sides that is seller and the buyer for the buyer the indemnification being given to them act as a catalyst for successful M&A deal, also, there can be a recourse wherein the distressed assets can be divulged. On the seller side, the regime of contingent liability is significantly reduced, the investors from the business are thus given a clean exit from the private equity portfolio.

ASSERTION OF CLAIMS

All the claims that are made in the insurance and policy can be asserted against the policy indemnifier and the policy holder can get the relief under the assertion of the claims. The person that is being insured should always keep and bear in mind that the insurance should be claiming the part within the tenure of acquisition or merger, anything past that period shall not be eligible to be covered[6]. Most of the RWI policies cease to exist after two to three years of the transaction getting executed. With the changing scenario and gaining momentum of the private equity market and model the low-cost debt has increased and is on a all time high.

[6] Robert E. Keeton & Alan L. Widiss, *Insurance Law: A Guide to Fundamental Principles*, Legal Doctrines and Commercial Practices, 599 (West 1988).

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COST CALCULATION OF THE R&W INSURANCE

For the systematic calculation of the R&W insurance there are basically two steps which are considered these are, Phase one consisting of the Underwritten Process and Phase two that is the Premium and Deductible Cost. Phase one includes within its ambit the underwriter and the due diligence report to be made and published in accordance to taxes and fees, also it is important to note that the underwritten process fees can be ignored if the coverage is prima facie purchased. On an average this process costs Rs. 8Lacs to Rs. 15Lacs. Phase Two imbibes the premium settlement and the deductible cost, the self-insured retention vouches for a total of 3% of the transaction value and the premium covers till 4% of the total limit.

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