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Rep & Warranty Insurance Doesn't Guarantee Purchase Price

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The purchase of buyer side representation and warranty insurance has become increasingly an integrated part of U.S. merger and acquisition transactions. Purchase of the product permits sellers to escrow less of the sale proceeds and immediately distribute more to their equity holders. It generally limits the maximum indemnification exposure of the seller (in today's market, to one half of one percent of the purchase price, or less), except in the event of fraud. Some insureds come to the product thinking that, among other things, they have purchased a guarantee of the price, measured as a multiple of trailing 12 month earnings before interest, taxes, depreciation and amortization (EBITDA), as set forth in the most recent income statements of the purchased business.

EBITDA is derived from historical or projected income statements by adding to net income, as shown on the income statement, the interest expense, provision for taxes and depreciation and amortization shown on the statement. EBITDA may be further adjusted by agreement of the parties to add back or subtract certain other amounts included in the financial records for a period.

Representation and warranty policies insure the loss arising from errors in the specified representations in accordance with the language of the purchase agreement relating to the acquisition of a business. The remedies provided in the purchase agreement are typically followed by the policy, subject to limitations, exclusions, deductibles and retentions set forth in the policy. Thus, in most cases, the liability of an insurer under a policy is not greater than it would be for the seller under the standards applicable to breaches by the seller in the purchase agreement.

Financial statement representations generally provide that certain enumerated financial statements:

- have been prepared in accordance with generally accepted accounting principles; and
- present fairly the results of operations of the business.

Where there has been a breach of a financial statement representation, the purchase agreement provides for the loss to be determined in accordance with the damages standards provided under the governing law specified in the agreement. Since Delaware is often the law chosen, this article considers the applicable Delaware law on contract damages.

Although insureds often refer to prices they have agreed to pay as a multiple of trailing 12 month EBITDA as of the end of the most recent income statement, the representations cover annual and interim financial statements identified in the financial statement representation. So any determination of a breach — whether related to a claimed deviation from GAAP or otherwise affecting the fair presentation of business operations — necessarily requires that the distinct financial statements be considered separately.

Delaware law provides that a finder of fact must measure the loss arising from such a breach of contract on the basis of "expectation damages," the difference between the value of the business as represented and the actual value of the business measured at the time of sale, after considering the true financial condition of the business. The cases suggest that courts will consider both expert testimony on valuation (was the business worth what was paid despite the breach) and contemporaneous evidence of intent — an analysis that is intensively fact and circumstance specific.

For example, if a buyer had acquired 30 businesses of the same kind and always set its price based on a certain formula of some historical financial statement measure, had consistently communicated that methodology to the seller and had revised the deal price consistent with that approach upon discovering adjustments to the presented historical financial information (through its due diligence efforts), a strong case for measuring loss based on that measure multiplied by the adjustment could be made.

More typically, however, persuasive expert testimony of alternative methods of valuing the business will exist, including forward looking methods. It often is the case that the contemporaneous evidence will suggest that the implication of an EBITDA multiple was an afterthought or a benchmark, but not the true means by which the buyer arrived at a price. Under those circumstances, a court following Delaware law could be expected to consider methods of valuation other than an historic multiple of EBITDA as the best method for determining damages.

Typically, professional buyers, such as private equity funds or strategic buyers, create a paper trail documenting their rationale for making a decision to purchase a business. While, in many cases, this may be short of a complete valuation of the target company, this documentation may provide direction as to whether the buyer's decision was weighted more to benefits the buyer would obtain from the investment during its expected holding period, rather than what the target company earned for its previous owners in the past, as reflected in historical financial statements. In these cases, breaches in historical reporting will result in damages only to the extent that they fundamentally change an objective view of the core earning ability of a business going forward, based on the mix of information known at the time of purchase.

The key question to insurers on confronting a breach of a financial statement representation is to what extent will a neutral conclude that the resulting shortfall is a temporary aberration. Stated another way, would it have changed the buyer's view concerning the core earning ability of the business. This determination is more likely to be based on the neutral's assessment of all the contemporaneous information, not solely on the testimony of a party, given with 20/20 hindsight.

Accordingly, buyers of representation and warranty insurance should understand that in most cases they have not purchased a guarantee of a historic EBITDA multiple, but have merely done what the contract provides — transferring the risk of an established loss, determined under the parties' acquisition agreement, from the seller to an insurer.

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