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A Look at Insuring Distressed M&A Deals:
The Current Landscape of R&W Insurance (Part 2)

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The economic downturn engendered by the COVID-19 pandemic likely will lead to a significant increase in acquisitions of distressed targets. Representation and warranty ("R&W") insurance policies as well as related insurance products can facilitate these transactions. Below, we discuss acquisitions of pre-bankruptcy targets, asset acquisitions from targets that have already declared bankruptcy, and potential insurance options available in connection with each of the foregoing.

<u>Pre-Bankruptcy Targets, and Insurance for Fraudulent Transfers</u>

The process for obtaining an R&W insurance policy to cover a transaction involving a distressed target is similar to the process for obtaining an R&W insurance policy to cover a conventional transaction. As in a conventional transaction, the insurer will expect the buyer to conduct significant diligence and for the seller to provide fulsome disclosures. Insurers will pay particular attention to the target's operations during the period in which the target experienced financial distress and will expect the buyer to thoroughly diligence whether the target complied with laws and upheld its contractual obligations while operating in financial distress. Policyholders should additionally pay close attention to the impact of exclusions relating to COVID-19, given that a distressed business would likely have operated outside of the ordinary course of business during the height of the pandemic, which could implicate a number of representations. For example, mass furloughs or layoffs could trigger not only employment representations, but representations concerning compliance with laws, the absence of certain developments since the most recent balance sheet, employee benefits, customer relationships, etc.

In transactions involving financially distressed sellers, there is a risk that the seller may enter bankruptcy (either voluntarily or involuntarily) after the transaction is consummated. If that occurs, the buyer may be sued by a trustee, the seller itself, or a committee of unsecured creditors alleging that the transaction constituted a fraudulent transfer.[1] If the fraudulent transfer action is successful, the subject transaction may be unwound altogether, or, more commonly, the buyer may be required to pay a judgment equal to the difference between the value of the assets it purchased (as determined by the court or jury as applicable) and the consideration the buyer provided to acquire the assets.

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[1] Generally speaking, fraudulent transfer actions falls into two general categories: (1) actual fraudulent transfers and (2) constructive fraudulent transfers. Actual fraudulent transfers are transfers that occur with the intent to hinder, delay, or defraud creditors. While it is common for a plaintiff bringing a fraudulent transfer action to allege that both an actual and a constructive fraudulent transfer have occurred, the focus of most fraudulent transfer litigation is on the constructive fraudulent transfer claim. A constructive fraudulent transfer requires proof of the following elements (a) that the seller received less than reasonably equivalent value in exchange for the assets transferred (i.e., the buyer paid materially less than the value of the assets purchased) **<u>and</u>** (b) that **<u>either</u>** (i) at the time of the transaction, the seller was insolvent, (ii) the seller became insolvent as a result of the transaction, (iii) the seller was left undercapitalized (i.e., the seller was engaged in, or was about to engage in, a business or transaction for which its remaining property (after the sale) was an unreasonably small amount of capital), **<u>or</u>** (iv) the seller intended to incur, or believed it would incur, debts that would be beyond the seller's ability to pay as such debts matured.

The losses stemming from a potential fraudulent transfer action are not always covered by R&W insurance, either because fraudulent transfer risks fall outside the scope of the policy or because the insurer seeks to exclude fraudulent transfer liability from coverage under the policy. If that occurs, buyers may purchase a specialized policy specifically designed to insure against fraudulent transfer risks.

Generally, in order to obtain a fraudulent transfer policy, the buyer/applicant must demonstrate to prospective insurers that there is a colorable basis for concluding that (a) the seller is solvent at the time of the transaction and/or (b) that the proposed sale price is fair (i.e. that the purchase price is reasonably equivalent to the value of the assets being purchased). In a transaction involving a distressed target, a buyer will often be unable to demonstrate solvency and will therefore have to show that the proposed sale price is fair. Prospective insurers will seek to understand the context of the transaction and will look for indicators that demonstrate the fairness of the sale price. For example, the existence of any or all of the following circumstances make it more likely that an applicant will be able to convince a prospective insurer that the proposed purchase price is fair and therefore the transaction is a good candidate for fraudulent transfer coverage: (i) if an investment banker is involved with the sale, (ii) if a robust marketing process is implemented, whether through an investment banker or otherwise, (iii) if there are competing bidders and the applicant's bid is the highest bid, (iv) if the applicant and the seller have a wholly arms-length relationship, and/or (v) if the applicant retains a third-party to prepare a fairness opinion or an appraisal.

<u>Section 363 Sale, Foreclosure, or Assignment for the Benefit of Creditors</u>.

Where the target company is in severe financial distress, insolvent, or the subject of a bankruptcy proceeding, there are three common transaction scenarios: (1) a Section 363 asset sale under Chapter 11 of the Bankruptcy Code ("363 Sale"); (2) a non-judicial Article 9 foreclosure, either through a public or private sale, (a "Foreclosure Sale"); and (3) an asset sale in connection with an assignment for the benefit of creditors, a state law procedure in which the rights and interests in an insolvent company are assigned to an independent fiduciary ("ABC Sale").

To varying degrees, each of the foregoing transaction scenarios may provide a buyer with certain protections from historical liabilities. For example, in the 363 Sale context, the sale is "blessed" by a bankruptcy judge in the form of a sale order which typically decrees that the sale is being conducted "free and clear" of most claims, interests, and liabilities. Transactions conducted through a Foreclosure Sale or in connection with an ABC Sale may provide more limited protections.

Even in the context of a 363 Sale, and to a greater extent in connection with an ABC Sale or a Foreclosure Sale, there are a number of third-party claims that may not be "cleansed". For example, certain intellectual property claims, certain product liability claims, claims that attach to acquired property (including certain environmental liabilities), some contractual claims and certain employment claims may survive the sale. Buyers may seek to address liabilities not cleansed through the distressed transaction prior to closing by negotiating an agreement with the potential claimant. To the extent a potential liability cannot be adequately addressed by agreement with the claimant or potential claimant, the buyer may also reduce the purchase price to offset against the risks posed by surviving liabilities.

Even in transactions where most liabilities will either be cleansed or addressed by agreement or through a purchase price reduction, R&W insurance may still provide significant value as illustrated below:

> R&W Insurance Can Protect Against First-Party loss: 363 Sales, Foreclosure Sales, and ABC Sales do not cleanse "first-party loss." First-party loss is insurance jargon for all loss other than loss arising out of a third-party claim. Examples of first-party loss include the buyer's discovery that (i) the company's pre-acquisition financial statements were inaccurate; (ii) the acquired assets are defective; or (iii) an acquired office building has structural defects that must be repaired. 363 Sales, Foreclosure Sales, and ABC Sales are made on a "where-is, as-is basis" and usually without meaningful representations or warranties about the assets to be acquired. The buyer therefore is typically at an information deficit and at risk of overvaluing the assets it is acquiring. R&W insurance provides the buyer with recourse for first-party loss.
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> R&W Insurance Can Cover Unknown liabilities: When the buyer undertakes to identify and quantify the surviving liabilities, they assume the risk that they will omit, or underestimate the quantum of, certain liabilities. Insurance can provide protection against these unknown liabilities.
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> R&W Insurance Facilitates the Efficient Use of Capital: When the buyer voluntarily assumes a liability without compensation or proactively settles an unripe – or even merely potential – dispute with a third-party, this is an inefficient use of capital. Insurance allows a buyer to spread the risk of these liabilities among the broader society/economy instead of disproportionately burdening the buyer.
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> R&W Insurance Can Give a Bidder an Advantage in a Competitive Auction Scenario: When a buyer employs insurance to eliminate the risk of first-party loss and known third-party liabilities, the buyer may then increase the amount of its bid to reflect its increased valuation of the company. This may distinguish the buyer's bid and allow it to win an auction it might otherwise have lost.

Insurance Solutions.

There are three types of insurance policies that can facilitate distressed transactions.

First, **R&W insurance** offers the broadest coverage of any of the relevant types of insurance because it covers both first-party loss and loss arising out of third party claims. Transaction documents in 363 Sales, Foreclosure Sales, and ABC Sales typically do not contain the representations and warranties required to obtain coverage for first-party loss (e.g. a rep that the target's financial statements are accurate or that a piece of machinery is free of defects). The most obvious solution is for the buyer to insist that the necessary representations and warranties be included in the purchase agreement. If this is not possible, certain insurers will consider negotiating "synthetic" representations with the buyer in order to create coverage for first party loss.

The second type of insurance is **successor liability insurance**, which is a lesser known insurance product that was designed for asset purchases where the seller is no longer a going concern. Successor liability insurance therefore is a natural solution for 363 Sales, Foreclosure Sales, and ABC Sales. Successor liability insurance, however, covers only third-party liability risk and does not provide first-party coverage. Successor liability insurance policies can cover all liabilities that the buyer might assume or can be tailored to address only specific identified liabilities.

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The final type of insurance is **intellectual property ("IP") insurance**, which covers third-party claims alleging violations of the claimant's IP. IP insurance can be particularly useful where the acquisition includes significant IP assets. Also, unlike R&W insurance and successor liability insurance, which cover only historical liabilities, IP insurance can also cover going-forward liabilities.

A final note on process: typically, in a 363 sale, a single bidder is selected as the so-called "stalking horse" bidder, who negotiates the terms and conditions of the purchase agreement with the debtor. The stalking horse bidder is not guaranteed to win the auction, but it is best positioned to negotiate the terms and conditions of an insurance solution. If another bidder ultimately wins the auction, that bidder can take over the negotiations with the insurer and obtain a similar policy (with any necessary modifications).

Given the fast pace of developments, businesses are encouraged to seek advice from qualified legal counsel and insurance brokers concerning these matters.

For more information, please see the following resources:

- Part 1 - Shifting Pricing and Coverage: The Current Landscape of R&W Insurance (July 14, 2020)
- Clearing Through the Smoke: Understanding the Short- and Long-Term Impact of COVID-19 on R&W Insurance (March 27, 2020)

About the Authors:

David Taubenfeld is a partner in the Litigation Practice Group at Haynes and Boone and represents policyholders in all matters relating to insurance. He frequently works with deal teams to negotiate and secure insurance products to bridge stubborn risks. These types of policies include Representation and Warranty policies; Tax liability policies; environmental policies and other policies created to resolve contingent risks in transactions. He also handles all manner of insurance disputes, finding coverage where others may not look, and he attempts to secure coverage for his clients through negotiation and diplomacy before litigation becomes necessary. When litigation becomes necessary, he litigates aggressively, always with the goal of securing coverage for his clients quickly and economically. He has secured millions of dollars in coverage for his clients through negotiation and litigation.

Jarom Yates is a counsel in the Restructuring Practice Group of Haynes and Boone and his practice focuses on all areas of restructuring, both in and out of court. Jarom regularly represents debtors, secured creditors, purchasers of distressed debt, purchasers of distressed assets, landlords, equity holders, and trustees in all aspects of chapter 11 cases, out of court restructuring transactions, and bankruptcy litigation. Jarom has experience representing clients in a broad range of industries including E&P, oilfield services, healthcare, retail, hospitality and lodging, technology, construction, real estate, and manufacturing.

Tom Harris is a partner at Haynes and Boone and leads the firm's Mergers and Acquisitions Practice Group. He has been advising middle-market clients for more than 30 years, helping them successfully close hundreds of acquisitions, divestitures, and other corporate transactions. He has represented both buyers and sellers in public and private sale-of-business transactions and has also represented independent committees of boards of directors.

Brent Beckert is an associate in the Mergers & Acquisitions Practice Group of Haynes and Boone. He has experience in domestic and international acquisitions, divestitures, and other complex business transactions, and often helps clients navigate the R&W Insurance underwriting process in connection with such transactions. Brent has also advised companies of all types on potential relief available under recent state and federal legislation enacted in the wake of COVID-19, including the Paycheck Protection Program (PPP) and Economic Injury Disaster Loan (EIDL) program available under the Small Business Administration.

Peter de Boisblanc leads HUB's transactional risk practice in the United States. As a broker, Peter draws on his extensive prior experience as an underwriter on AIG's M&A insurance team, where he underwrote more than 150 R&W insurance policies. Prior to joining AIG, Peter practiced law for 11 years, most recently at Ropes & Gray, LLP, where he advised private equity clients with respect to the placement and negotiation of R&W insurance policies for both domestic and international transactions. Peter graduated, *cum laude*, from Fordham Law School in 2004 and from the University of Chicago in 1999.

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