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MERGER AGREEMENTS

Trends in M&A Provisions: Insurance Reduction Provisions

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Introduction

In merger and acquisition (''M&A'') transactions, the definitive purchase agreement (whether asset purchase agreement, stock purchase agreement, or merger agreement) typically contains representations, warranties, and covenants, along with related indemnification obligations, provided by the parties.[1]

One common limitation to the indemnification obligations of the parties seeks to reduce those obligations by the amount of any insurance proceeds received by the indemnified party with respect to the matter giving rise to the indemnity claim (referred to herein as ''insurance reduction provisions'').

In 2005, 2007, 2009, 2011, and 2013, the American Bar Association (ABA) released its Private Target Mergers and Acquisitions Deal Points Studies (the ''ABA studies''). The ABA studies looked at the M&A agreements of publicly available transactions that occurred in the year prior to each study. In each year, the studies reviewed 150, 143, 106, 100 and 136 private company transactions, respectively. These transactions ranged in size from $17 million to $4.7 billion, across a broad range of industry sectors.

This article examines trends in the prevalence of insurance reduction provisions in private company M&A transactions, as reflected in the ABA studies.[2]

Insurance Reduction Provisions

General

The indemnification obligations under an M&A purchase agreement generally cover breaches of the representations, warranties and covenants of the respective parties, but sometimes also apply to other legal or subject matters on a ''standalone'' basis, regardless of whether such a breach has occurred. Examples of these include seller indemnification for pre-closing taxes or for specific matters identified during legal due diligence.

The typical M&A agreement includes indemnification from the seller to the buyer, and vice versa. However, since the seller's representations, warranties, and covenants, and related indemnification obligations, are normally broader in scope and substance than those of the buyer, it is usually the seller who seeks to include an insurance reduction provision (since the seller is more likely to be the indemnifying party and is therefore more interested in including provisions which reduce indemnification liability, even if applicable to the buyer as well). Accordingly, this article looks at insurance reduction provisions based on the assumption that the seller is more inclined, and the buyer less inclined, to include such a provision in the M&A agreement.

A typical M&A indemnification provision in a purchase agreement may be similar to the following:

[1] Note that within this article we use the terms ''seller'' and ''company'' in the context of a stock purchase transaction - - the ''seller'' would be the selling shareholder(s) making the representations and warranties in the M&A purchase agreement, and the ''company'' would be the company being acquired. In an asset purchase transaction, the ''seller'' would be the target company itself but for consistency we are using ''seller'' in a stock purchase setting.

[2] This article looks at the usage of insurance reduction provisions in private company M&A transactions as reflected in the ABA studies. This article does not cover such provisions in other types of transactions or in public-to-public M&A transactions.

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> The Seller agrees to and will defend and indemnify the Buyer Parties and save and hold each of them harmless against, and pay on behalf of or reimburse such Buyer Parties for, any Losses which any such Buyer Party may suffer, sustain or become subject to, as a result of, relating to or arising from: (i) any breach by the Seller of any representation or warranty made by the Seller in this Agreement; (ii) any breach of any covenant or agreement by the Seller under this Agreement, (iii) any Taxes of the Seller or its Affiliates; or (iv) the matters set forth on Schedule X. . ..

These indemnification obligations are often limited in scope by various factors including time and types of damages covered. Another category of indemnification limitation can be referred to as ''no windfall'' limitations; that is, limitations designed to ensure that the party to which the indemnification is owed (the indemnitee) does not receive more from recovering on an indemnity claim than the indemnitee's actual damages. The three most common ''no windfall limitations'' are:

- limitations which measure the indemnity coverage taking into account any tax benefit realized by the indemnitee with respect to the underlying loss;
- limitations which prohibit multiple or parallel claims under different remedy sections of the purchase agreement with respect to the same matter;[3] and
- insurance reduction provisions.

A normal insurance reduction provision could read as follows:

> The Seller will not have any liability under Section Y with respect to any Losses if and to the extent that any such Losses are reduced by any insurance or other third party payments received by the relevant Indemnitee(s).

Seller's Usual View

The seller's argument as to insurance reduction provisions is typically straightforward: if the buyer suffers losses of $100 with respect to a matter which gives rise to a claim against the seller but as to which an insurer has paid $50, the buyer's real damages are $50, not $100. Accordingly, to pay the buyer $100 on an indemnity claim would result in an ''unfair'' $50 windfall ''at the seller's expense.''

Buyer's Usual View

As a practical matter, as noted above, insurance reduction provisions are quite common, and in the authors' experience, buyers routinely (though not always, of course) accept the provision with relatively little resistance. Instead, what buyers often seek to negotiate are provisions that don't require the buyer to actually pursue the insurer for proceeds and/or that state that any reduction should (as a related point) be tied to insurance proceeds ***actually paid*** to the buyer, not just those ''available'' under a policy. Sometimes buyers will agree to use commercially reasonable efforts to pursue insurance so long as the insurance does not result in a premium increase for its insurance or negatively change the insurability of the buyer's activities (whether in terms of coverable risks or otherwise).

Another Argument?

There may be more substance here than is normally discussed in M&A negotiations

Though in the authors' experience not heard all that often, a buyer may have credible arguments against the inclusion of the insurance reduction provision in the first instance. A buyer might argue that it is free to mitigate and/or insure against any particular risk as it sees fit, and the mitigation approach may be a combination of contractual indemnity from the seller and insurance contracts from insurers. The buyer may decide to pay for insurance even if it has possible indemnification claims against the seller, so as to increase the number of potential parties against whom it may have recourse. Furthermore, the buyer has paid for the insurance itself and accepted the risk that the insurer may be unable or unwilling to pay claims. Why should the buyer's own risk mitigation strategies be of any relevance to the scope of the seller's indemnification obligation?

Note in this regard that the buyer's argument might be more persuasive if it purchased the insurance itself, as opposed to having acquired seller-purchased insurance through a stock acquisition. Nonetheless, the buyer might still assert that in the stock sale, it ''purchased'' the insurance because the buyer's price for the transaction assumed that it would acquire the insurance without need to reduce claims of indemnification. In fairness, it's highly unlikely that buyers actually take the insurance reduction concept into account in pricing a transaction, but there is some logic to the argument on its face (even if it is unlikely to carry the day).

However (the seller could argue), the buyer's decision to purchase business insurance is almost certainly based on a constellation of risks entirely independent of whether the seller will be indemnifying or not, so why should the seller be required to ''subsidize'' the buyer's insurance purchasing decisions (and/or to provide a ''premium'' for the buyer's decision to take the policy and insurance risk described above)?

There are two potentially related concepts here. Both are meaty and complex topics beyond the scope of the article (and, not surprisingly, not often the topic of heavy discussion during M&A negotiations).

First, many states bar ''double recovery.'' However, this type of double recovery is a concept that generally applies to plaintiffs asserting: (i) insurance claims against multiple *insurers* for the same event, or (ii) different claims against the same defendant. By contrast, the collateral source rule, a well established US legal doctrine, generally prohibits a defendant from introducing evidence that the plaintiff has received amounts relating to the event at issue from another source (such as an insurance company).

Second, concepts of subrogation might also be relevant. Subrogation can be defined as ''the assumption by a third party (as a second creditor or an insurance company) of another's legal right to collect a debt or

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[3] For example, many purchase agreements have purchase price adjustments to reflect changes in working capital (which would include, as a component, accounts receivable) as well as representations from the seller with respect to working capital. If the seller's receivables at closing are lower than the level expected, that deficiency would cause a reduction in working capital and therefore result (under most formulations) in a reduction of purchase price. The deficiency might also trigger a breach of the sellers' receivables representations, but the buyer is often precluded from pursuing that breach to the extent a purchase price adjustment has already been made as a result of the deficiency.

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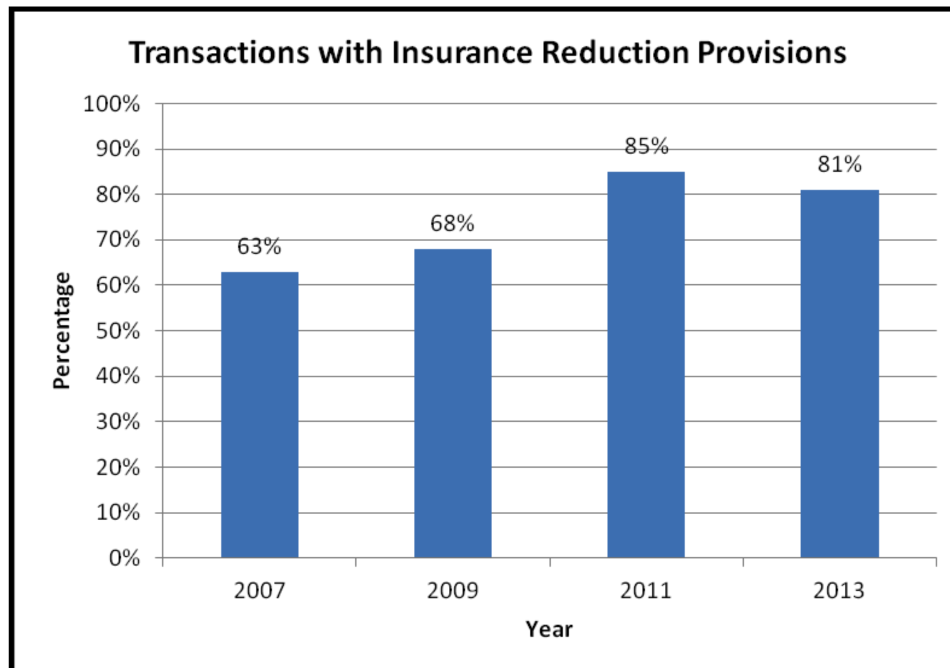
damages.''[4] In the insurance context, this normally means that if an insurer pays its insured with respect to an insured event, the insurer then ''steps into the shoes'' of the insured to pursue any rights of the insured against other third parties. Thus the issue here is whether an insurer, after payment of a claim to the buyer, would be able to pursue the related indemnity rights against the seller. This may depend upon the wording of the insurance contract and relevant state law.

[4] http://www.merriam-webster.com/dictionary/subrogation December 18, 2014

Trends in Insurance Reduction Provisions

According to the ABA studies, insurance reduction provisions were included in 81% of the deals reported in the 2013 study. The previous three studies showed 85%, 68%, and 63% of reported deals, respectively, as including insurance reduction provisions (the 2005 ABA study did not cover this topic).

The following shows the information above in chart format:



Conclusion

Insurance reduction provisions continue to be the rule rather than the exception, and are usually included within the purchase agreement with relatively little negotiation. Most of the negotiation on this issue relates not to whether the limitation should be required, but rather whether it should be tied to insurance proceeds actually received, as opposed to being simply available, and whether the indemnitee should pursue its insurer before asserting an indemnity claim. As noted above, however, there may be legitimate reasons, depending upon the overall dynamic of the transaction, to at least question whether an insurance reduction provision should be included in the M&A purchase agreement at all.

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warranty insurance and other transactional insurance) and outside the M&A context. http://www.forthillrisk.com/ This is the 13th installment in a series of articles being co-authored by Mr. Avery and looking at trends in private company M&A deal points. The previous articles can be found on Goulston & Storrs' ''What's Market'' web page at http://www.goulstonstorrs.com/WhatsMarket.

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