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R&W Insurance in Middle-Market M&A

As competition for middle-market M&A transactions becomes more acute, prospective buyers, particularly private equity firms, wishing to distinguish themselves from others may employ representation and warranty insurance (“R&W insurance”) in their bidding strategies to replace traditional indemnification provisions. R&W insurance allows sellers to transfer risk while providing buyers with a source of recovery separate from the seller proceeds, and permits private equity sellers to quickly return cash to investors rather than leave it in escrow to satisfy future claims. As R&W insurance becomes more commonplace in middle market transactions, buyers should consider the following:

- o R&W insurance policies can protect a buyer from unknown liabilities arising from a seller breach discovered post-closing. However, known risks would require special indemnity coverage apart from the R&W insurance policy.
- o The disconnection between the disclosure and representation and warranty negotiation and the liability for indemnification for breach creates an incentive on the part of the seller to allocate resources differently from that which would be applied where there is material retained risk on the part of the seller.
- o The cost of an R&W insurance policy is usually paid at closing and is a percentage (approximately 2% to 3%) based on the amount of coverage. Buyers and sellers typically negotiate who will pay the premium, and at times purchase price is reduced in exchange for closing with a higher cash amount and less or no escrow or holdback.
- o Often, insurance carriers require some retention of risk by the seller to ensure that some level on moral hazard remains with the seller so that appropriate rigor is applied to disclosure. The premium can vary significantly depending upon the amount of risk that is retained by the seller.
- o There remains no substitute for due diligence on the part of the buyer to assess risk and business and earnings quality of the target.
- o The market has not experienced a significant number of claims to test the equivalence of R&W insurance to general, escrow-backed, indemnification.

James D. Rosener is a Partner in the Commercial Department of Pepper Hamilton, LLP. In addition, Mr. Rosener heads up the firm's International Practice Group and is Managing Partner of its New York office.