

## RECENT UPDATES TO INTERIM BREACH COVER

As deal volumes have dropped and the balance of power shifts back towards insureds, some representations and warranties insurance ("RWI") underwriters have been seeking creative ways (beyond simply dropping retentions/premiums) to win new business. One approach has been to broaden the scope of the RWI policy to more readily include cover for interim breaches.

### What is an interim breach?

An interim breach is a breach of a representation or warranty given at the closing of a transaction ("Closing") where:

1. The facts, matters or circumstances causing such a breach first come into existence after the execution of the purchase agreement ("Signing"); and
2. The buyer's deal team obtains actual knowledge of such breach in the period between Signing and Closing ("Interim Breach").

Akin to an anti-sandbagging provision in a purchase agreement, RWI policies contain an exclusion for breaches that the buyer's deal team has actual knowledge of at Signing and Interim Breaches. This position is less favorable than traditional indemnification measures that a buyer would benefit from under a purchase agreement (assuming: (i) a favorable governing law (e.g., Delaware) and no anti-sandbagging provision; or (ii) a pro-sandbagging provision).

### Typical cover for Closing reps (and how this impacts Interim Breach cover)

To secure cover for representations and warranties given at closing ("Closing Reps"), insureds are required to:

1. Execute a Closing No Claims Declaration ("NCD") confirming that the deal team members of the insured do not have actual knowledge of an Interim Breach; and
2. Undertake a bring-down call, where insurers ask a limited number of questions pertaining to the target company and its activities between Signing and Closing.

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Crucially North American RWI policies do not oblige insureds to make any inquiries of the seller/target company prior to the bring-down call. This greatly reduces the likelihood of the buyer obtaining actual knowledge of an Interim Breach. Given that purchase agreements will typically only require the seller to certify to the buyer any breaches of non-fundamental Closing Reps that constitute a material adverse effect ("MAE"), this entails the following:

| Scenario  | RWI Cover Position |
|---|--------------------|
| Buyer unaware of breach which first occurs during the interim period until post-Closing (even if the seller had knowledge pre-Closing). | Covered            |
| Buyer aware of Interim Breach.  | Not Covered        |
| Seller aware of Interim Breach which also constitutes an MAE; makes buyer aware at Closing in accordance with the purchase agreement.   | Not Covered        |

It should be noted that the above is only relevant to a breach where the facts, matters or circumstances first come into existence after Signing. If a breach of a Signing rep is discovered in the interim period, the RWI policy provides cover if Closing occurs without any waiver of a Closing condition.

## What's new?

In summary:

- 9 of the 25 active RWI underwriters will now offer some form of Interim Breach cover, but many are highly selective as to the deals they will offer it on – e.g., Interim Breach cover is less likely to be available for companies with concentrated customer contracts.
- Cover varies but most RWI underwriters offering Interim Breach cover have:
  - limited this offering to deals with an enterprise value of USD 750M or less;
  - a policy sub-limit of USD 15–25M (or in some cases 50% of primary limit, capped at USD 15–25M);
  - additional cover that can be sought from excess RWI underwriters, with the excess Interim Breach cover "dropping down" in the event the primary layer Interim Breach cover is insufficient;
  - a maximum period of 45–60 days, which in some cases can be extended, subject to additional premium and, depending on the RWI underwriters, an interim NCD; and
  - an additional premium of 15–30% for 45–60 days, more if it is extended.
- The default position is for Interim Breaches which constitute an MAE or otherwise allow for a termination right will be excluded, although this may be negotiated on a deal-by-deal basis.
- Some RWI underwriters will offer Interim Breach cover but only allow for losses to erode the retention under the RWI policy.
- RWI underwriters are likely going to be very focused on underwriting representations and warranties with a higher risk of an Interim Breach (i.e., customers and suppliers reps).
- Interim Breach cover is available to all brokers operating in the market.



## Is it worth it? The devil is in the detail

Most breaches discovered during the interim period arise from facts, matters or circumstances that existed pre-Signing and as such are covered under RWI policies, subject to the careful crafting of the representations. The table below outlines an example:

| Rep Language  | Breach Event   | Implication without Interim Breach Cover   |
|---|--|--|
| The company has not received notice from any tax authority relating to a tax audit. | IRS files a notice between Signing and Closing that they are instigating an audit of 2020 sales taxes. | <ol style="list-style-type: none"> <li>1. Not a breach of reps given at Signing.</li> <li>2. Is a breach of the Closing Reps – would be covered so long as the seller doesn't inform the buyer prior to Closing.</li> </ol>                          |
| The company has paid all taxes due.   |  | <ol style="list-style-type: none"> <li>1. Is a breach of the reps given at Signing (assuming the audit results in additional tax payments).</li> <li>2. Is covered irrespective of whether the seller informs the buyer prior to Closing.</li> </ol> |

Given it is extremely rare for a true Interim Breach to occur, why pay the additional premium to secure cover? In many cases the answer is "you shouldn't", but there are certain situations in which such cover would be extremely helpful.

Examples include:

1. **Customer and supplier contracts** – if a customer or supplier decides to cancel or reduce its orders and only decides to do so during the interim period, the insured would be able to claim for loss which may include multiplied damages.
2. **Pollution** – if an active manufacturing company experiences a pollution spillage event during the interim period, the insured would be able to claim for damages suffered. If the company has a pollution legal liability policy, the cleanup costs may be covered but cover for other costs, including reputational damage, loss of customers etc. would require RWI.
3. **Condition of assets** – if the condition of assets decline beyond fair wear and tear during the interim period (e.g., due to a fire), the insured would be able to claim for damages suffered. If the company has a property insurance policy, the re-build/replacement and business interruption costs may be covered but cover for other costs, including reputational damage, loss of customers etc. would require RWI.

Buyers must consider whether: (i) the target company's exposures during the interim period/if they can be offset via due diligence (e.g., customer calls); (ii) the 45-60 day time limits; (iii) the existing protections via the target company's insurance program; (iv) the existing protections already in place via RWI (as described above); and (v) the potential protections provided by the seller covenants and purchase price adjustments under the purchase agreement make the additional cost of Interim Breach cover a sensible policy enhancement to acquire.

Broadly we have seen private equity investors typically decline this coverage enhancement, whereas strategics are more likely to purchase it. This is likely because strategics are generally less familiar with RWI and frequently require more buyer favorable purchase agreements when negotiating transactions.

