GODFREY & KAHN S.C.

GK QUARTERLY

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Welcome to the inaugural edition of GK Quarterly! In each edition, these pages will contain information that we think you, as a client or friend of our Corporate Team, might find useful, interesting or entertaining. We know you only have a few minutes, so, without further ado …

10 POINTS–REPS & WARRANTIES INSURANCE

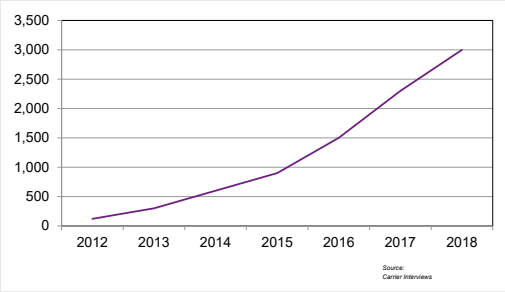
Use of Representations and Warranties Insurance (RWI) has exploded within middle-market M&A during the current economic cycle. Here are some perspectives from our M&A team, gained by leading buy- and sell-side transactions using the product and through market intelligence from agents and insurers:

1. RWI is now being used in transactions with targets priced as low as $20 million enterprise value. There is an inflection point where the premium and added procedure will not be supportable in the lower ends of the middle market, but it seems we're not there yet. Exiting the Great Recession, the prevailing view was that the product would not be viable below $100 million enterprise value.

2. In a competitive sale process, use of RWI where the acquirer pays all of the premium is commonplace, to the point it no longer is a significant bid differentiator. In a one-off transaction, it is generally more difficult to require the buyer to use RWI. Use by strategic acquirers is increasing as a percentage of total RWI policies underwritten (estimated to be approximately 40% of all RWI issued in 2018), but their experience using RWI, even sizeable publicly traded or privately held acquirers, can be spotty, making use of the product more challenging.

R&W INSURANCE GROWTH IN NORTH AMERICA

Total Estimated R&W Insurance Policies (North America)



3. Premiums, coverage limits (transactions with an aggregate of $1 billion or more of risk transferred to the insurers, and growing, are now achievable), covered industries and other coverage terms continue to evolve in favor of buyers/insureds, as more insurers enter the competitive marketplace (currently 20+ globally).

4. Pro-insured developments in the product include (i) full "walk away" transactions for sellers, (ii) coverages across multiple jurisdictions in cross-border transactions, (iii) coverage for targets in industries that were formerly difficult to obtain (e.g., health care), and (iv) coverage for "interim breaches" – new issues that develop between signing and closing.

5. Sectors of the space express discomfort with the concept of full "walk away" RWI. In this most seller-favorable version of the product, sellers have no liability post-closing for unknown issues affecting their company, absent fraud. The more traditional and, at least at this point, more utilized product would require sellers to bear the risk for approximately one-half of the retention for the RWI, typically 1% of enterprise value.

6. The scope of the policy is largely driven by the quality and breadth of buyer's due diligence effort, placing greater emphasis on the due diligence process, even for buyers who would otherwise be inclined to take a less rigorous approach. It can be challenging to find an insurer to underwrite the risk underlying areas not addressed in due diligence. While also evolving in favor of buyers/insureds by loosening the requirement, insurers have favored targets with audited financial statements and a comprehensive due diligence report prepared by buyer's outside counsel and other consultants across relevant subject matter areas.

7. More often than not, insurers are opting to define covered "losses" generally and, of note, without a specific inclusion or disclaimer of the most controversial types of consequential damages – multiples of earnings, diminution in value and lost profits. This is to say, the insurers will allow a claim from their buyer-insured that includes these categories of damages, and then negotiate over whether causation and loss have been established to the standards of a common law contract claim. In this manner, the insurance terms track our experience in negotiating this definition in a traditional indemnification regime.

8. "Fraud" is a risk always retained by the sellers and is the most common instance in which the insurers reserve the right to assert claims directly against sellers, even where buyer has not or is unwilling to do so. Sellers who are not experienced in M&A often dismiss this risk – of course we wouldn't be engaged in that type of conduct! However, in the context of a definitive purchase agreement that includes pages of representations and warranties about their business, and volumes of due diligence, negotiation and communications that preceded the sale, the importance of this exclusion should not be overlooked, and is why this definition has become a significant negotiated item. In our experience, the insurer will agree to incorporate the definition of fraud agreed to by seller and buyer for purposes of the RWI subrogation provision.

9. Insurers and agents are sensitive to the inevitable collectability question – in other words, as a buyer, if I have the choice, am I better off making my claim against the RWI or a traditional escrow and/or the sellers personally? Agents have internal claims assistance teams to help their insureds pursue their claims and highlight claim success stories. The product is arguably relatively nascent and claims history relatively opaque to potential insureds.

10. The current era of RWI has not yet experienced a down cycle in M&A, and we will watch closely how shifts in bargaining leverage affect the product.

CAPITAL FORMATION–HAVE YOU HEARD...?

SEC Corporation Finance Director Bill Hinman had a few interesting things to say at an August 2019 meeting of the SEC Small Business Capital Formation Advisory Committee:

- An estimated $2.9 trillion was raised through private placements in 2018, compared to "only" $1.4 trillion raised through SEC-registered offerings.
- The SEC is in the process of harmonizing its rules around private fundraising, evidenced in part by the June 2019 concept release requesting comments on private offering rule reform.
- He anticipates that the Corp Fin Staff will begin this effort with an update to the "accredited investor" definition, which is on the Staff's regulatory agenda for late in 2019. The current definition is largely unchanged since 1982, while fundraising strategies and information dissemination methods have changed dramatically during that period.
- The Staff has invited collaboration from the Investment Management Division in considering how smaller investors might participate through investment vehicles to have more access to private investment opportunities.

Another Staffer reiterated some of the big-picture matters addressed in the June concept release: Is it appropriate to expand the universe of accredited investors or find other ways to allow currently non-accredited investors to participate in more exempt offerings? Should the rules consider something other than just the wealth of potential investors in determining their eligibility? Should the current financial thresholds be revised? Should the rules consider different measures of sophistication, investment experience or other tests?

It's safe to say that final rules in this area are still some distance off on the horizon. Political and economic considerations also tend to change the SEC's rulemaking priorities and the way in which it balances investor protection against increased access to capital and investment opportunities. Still, it is clear that the topic is a high priority for the SEC as it endeavors to respond to calls for regulatory modernization coming from companies seeking capital and from the investment community alike.

WHAT'S THE DEAL?

In 2012, we began tracking our work in M&A and related strategic transactions. Each new annual update is distributed in January or February. Here we aggregate the data, which we believe helps demonstrate our deep transactional experience.

50 experienced deal lawyers

506 strategic transactions

Deal Types

- Mergers & acquisitions (private & public)
- Debt & equity financing & recapitalizations
- Portfolio sales of loans and other debt obligations
- Restructuring & recapitalizations
- Leveraged management buyouts
- Ownership transition and management succession plans

Aggregate deal value over $24 billion

Clients we serve

Public companies / Private companies / Family offices / Private equity firms / Early stage companies / Management teams in leveraged buyouts

UPCOMING EVENTS

Corporate Counsel Symposium

October 30, 2019
Fox Cities Exhibition Center | Appleton
1:30 – 4:45 p.m. Program

November 6, 2019
The Edgewater | Madison
1:30 – 4:45 p.m. Program

November 13, 2019
Discovery World | Milwaukee
1:30 – 4:45 p.m. Program

For more information on our events, visit www.gklaw.com/events.

LOCAL FIRM, GLOBAL REACH.

To date, our deals have spanned across all 50 U.S. states and 34 countries:

Through our TERRALEX network, clients benefit from our long-standing relations with other law firms around the globe.