With 40 million new unemployment claims, an unemployment rate at more than 13%, and general economic distress continuing to grip the country, bankruptcy professionals are beginning to grapple with sharp increases in bankruptcy filings that are expected to continue in the weeks and months ahead. While all economic downturns share some common characteristics, this downturn is unique because the underlying cause was not economic, but rather the COVID-19 public health concerns that have disrupted the economy.

Bankruptcy practitioners that facilitate bankruptcy asset sales under Bankruptcy Code section 363 ("363 sale") will also likely see that this downturn differs from the great recession because of the now wide-spread use of reps and warranties insurance in M&A transactions. When properly utilized, reps and warranties insurance can increase the value of the distressed asset while simultaneously providing the asset purchaser with a backstop on the promises made in the purchase agreement. This is a win-win for both parties to the transaction. Much like reps and warranties insurance has fundamentally altered the way that traditional M&A transactions are conducted in the past decade, greater use of reps and warranties insurance in the bankruptcy context may slightly modify the typical "as is, where is" bankruptcy structure in ways that are helpful to both debtors and asset purchasers alike.

How a 363 Sale Works

First, a primer on the 363 sale process. To commence a 363 sale, the debtor first files a motion with the applicable federal bankruptcy court seeking to sell its assets free and clear of all liens, claims and encumbrances held by third parties. Prior to this formal filing, the debtor usually markets its assets in hopes of finding a "stalking horse bidder," whose first bid for the assets sets the floor price at the forthcoming bankruptcy auction. The stalking horse bidder enjoys numerous benefits in the 363 process. First, the stalking horse has more time for due diligence than the other bidders. The stalking horse also goes first in negotiating an asset purchase agreement with debtor, which then serves as the "template" agreement for the other bidders. After the stalking horse's bid has been submitted, a full throttle public auction process then ensues with other potential bidders trying to top the stalking horse. When the auction closes, the bankruptcy estate selects the successful bidder, and the sale is approved by the bankruptcy court.

Most 363 sales are "as is, where is" - a bankruptcy term of art meaning that the asset purchase agreement has no indemnities and the debtor is not standing behind the usually limited reps and warranties contained in the agreement. While the bankruptcy court's 363 sale order wipes-out third party claims against the assets, it does nothing for so-called "first party claims" – that is, the reps and warranties made between the debtor and buyer around the overall state of the assets. With the customary "as is, where is" structure, these risks are the sole responsibility of the asset purchaser. This system places a premium on the buyer's due diligence, which is usually done on an expedited time frame.

The Reps and Warranties Insurance Solution

The current 363 structure is risky for buyers. Purchasing assets from an insolvent entity on a truncated timeline with limited due diligence and no indemnities is not a process for the financial faint of heart. As a result, many 363 asset purchasers offer reduced bids for the assets to take account of the inherent risks involved in the process. The bottom line is that this results in less money going to the bankruptcy estate.

On the flip side, debtors are generally reluctant to move from the customary "as is, where is" model—and for good reason. After all, the bankruptcy estate already lacks sufficient assets to pay all claims and only exists until the matter is closed.

Reps and warranties insurance has the potential to bridge these gaps. For buyers, the ability to have an A+ rated insurance company back up the promises in the purchase agreement is an obvious benefit. This could be particularly important for the stalking horse bidder, as the negotiated purchase agreement with the inclusion of a reps and warranties insurance policy can become the baseline document for everyone else. While buyers are usually the insured under the policy, the value of the policy is arguably even greater for debtors. It's obvious that a distressed asset with an insurance company backing up the reps and warranties is going to be more attractive to an asset purchaser than a similar asset in the pure "as is, where is" form. As a result, the distressed asset should sell for more than a transaction without the policy. Given that one of the most important public policy goals of the entire bankruptcy process is that the bankruptcy estate receive as much money as possible for the distressed assets, reps and warranties insurance can play a critical role in effectuating larger public policy objectives.

Why Not Reps and Warranties Insurance? Overcoming the Common Objections

If reps and warranties insurance is a no-brainer for debtors and buyers, why isn't it being used already? Part of the reason is past practice. While the reps and warranties product has been around in one form or another for several decades, it has only exploded in popularity in the traditional M&A context in the past five years, and especially amongst private equity firms. The reality is that during the last economic downturn, the product simply did not exist in its current form and was not utilized in 363 sales. Accordingly, most bankruptcy professionals are simply not familiar with the product. Moreover, there is a longstanding institutional "as is where is" mindset in bankruptcy; the evolution of a new product from the insurance industry seems novel and raises skepticism.

Education is critical to the widespread adoption of the product in 363 sales. Hearing more about the product and the many benefits it provides should make bankruptcy professionals more comfortable with its use in the still ongoing economic downturn.

Beyond institutional inertia, we have heard several specific objections from bankruptcy attorneys to the product. These objections usually fall into three general categories: (1) concerns about the fees associated with the product; (2) questions about whether the product is truly necessary given the free and clear order and notice process; and (3) lack of clarity as to how the product would "transfer" from a stalking horse bidder to a winning top bidder.

At the outset, none of these concerns should be viewed as deal-breakers. One hallmark of the reps and warranties industry has been creativity. Carriers, brokers, and underwriting counsel have all worked together to formulate and adapt the product to the needs of the larger financial markets. This is not a stodgy product with set rules; carriers are flexible and want to work with debtors and buyers on making sure that the product meets their needs.

In addressing the specific concerns raised above, significant concerns about fees are likely misplaced. In traditional M&A transactions insurers usually charge insureds a one-time up front due diligence fee, ranging from $25,000-$50,000, and then charge another 10% of the premium at binding, with the remainder due at closing. In the 363 process, and especially for the stalking horse bidder, carriers could potentially consolidate all of the pre-closing fees into a single pre-exclusivity fee. Stalking horse bidders usually negotiate a break-up fee equal to approximately 2-2.5% of the bid amount in the event that the stalking horse bidder is not the successful bidder. For unsuccessful stalking horse bidders, the pre-exclusivity fee could then be recouped through the break-up fee. This break-up fee feature is not available in the traditional M&A context; if anything, the breakup fee makes the use of reps and warranties insurance less expensive and risky in 363 sales than traditional M&A deals.

In a similar vein, we have also heard the suggestion that perhaps the debtor could work with the carrier to help obtain the policy and petition the bankruptcy court to spend resources on the initial underwriting costs This approach has the benefit of providing the carrier with confidence that the bankruptcy resulted from legitimate financial problems and not more nefarious reasons that sometimes drive bankruptcy, such as massive fraud or criminal activity, and may frighten carriers away entirely. Again, here, the insurance markets are open to developing creative approaches to these types of issues.

With respect to questions about whether the product is truly necessary given the free and clear order and notice process, the marketplace will provide the answers. Current data generally shows that the use of reps and warranties insurance resulted in fewer escrows, holdbacks, and chargebacks and thus a higher sale price for assets. The results should be no different in bankruptcy. Moreover, rep and warranty insurance does something that a 363 sale order does not - it protects asset purchasers from overpaying for an asset based upon the existence of undetected liabilities, deficiencies, or defects related to the assets during the due diligence process. Ultimately, the use of reps and warranty insurance in 363 sales should lead to a more robust marketplace and higher sale prices.

Finally, as for how the product would “transfer” from stalking horse bidders to other topped bidders, here, again, we anticipate that the creativity of insurers, brokers, and underwriting counsel will smooth out any rough edges. For starters, other potential bidders must provide the bankruptcy court with notice when they join the bidding process. Enterprising brokers can notify these bidders that a reps and warranties insurance product is ready to be placed with the stalking horse and could potentially be transferred to the winning bidder. Another alternative is that the potential topped bid will seek its own reps and warranties policy through brokers and preferred carriers and can switch out this policy from the stalking horse when the bid is topped. Bankruptcy professionals should not be spooked by the quick time frames. Carrier due diligence is limited and depends heavily on the insured’s due diligence efforts Underwriting counsel are well-versed in how the process works and can usually turn around a deal in a matter of a few days.

Conclusion

We are in the opening innings of what could be a long economic downturn. Finding ways to curtail this decline and get moribund assets back on their feet again is both an important public policy goal and fundamental to any economic recovery. In that sense, reps and warranties insurance can play a valuable role by helping debtors get a better price for the insolvent or distressed assets, and buyers gain more confidence in what they are purchasing. The understandable objections to the product should not be seen as roadblocks, but, rather as opportunities to educate bankruptcy professionals about the value of a potential transformative financial product. In doing so, bankruptcy professionals may recognize what their M&A counterparts have already discovered: reps and warranties insurance can be a win-win for everyone.

Bryan M. O'Keefe is a partner at Seyfarth Shaw and leads the firm's transactional underwriting counsel practice. James B. Sowka is a partner at Seyfarth Shaw specializing in bankruptcy and Section 363 transactions.