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UPDATE

Warranty & Indemnity Insurance: becoming a staple in M&A transactions

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The use of warranty and indemnity insurance (W&I insurance) has grown in recent years to the stage where it has now become a standard feature of the private mergers and acquisitions landscape. W&I insurance can play a key role in pulling a deal together, not just by reducing the seller's exposure to a claim, enabling the seller to have a cleaner exit, but also by narrowing the range of commercial issues in contention and thereby potentially expediting transactions.

Here we take a brief look at what W&I insurance is, what's being seen in the market and how it can help both the buyer and seller get their deal across the line.

1 What is W&I insurance?

In a merger and acquisition (**M&A**) transaction, W&I insurance provides cover for losses suffered in connection with warranty or indemnity claims under a share purchase agreement (**SPA**). The insurance policy can be taken out by either the seller or the buyer, depending on who is seeking the benefit of the policy. Under a seller policy, the seller remains solely liable to the buyer under the claim, but the insurance policy will indemnify the seller for losses suffered from the buyer's claim and defence costs incurred. The insurer will generally control any defence or settlement of the claim.

In contrast, the vast majority of the W&I insurance policies being placed in the UK market at present are buy-side policies in which the buyer claims against the seller up to the agreed cap under the SPA, and then claims against the insurance for liability above that cap. Recent trends indicate that there is increasing appetite for sellers to limit their liability at £1.00 and require the buyer to rely on a buyer insurance policy should a claim be made. The limited liability subsequently increases the premium, but we are seeing clients prepared to pay the additional amount when coupled with full-form due diligence and disclosure.

With respect to asset classes, around 40 per cent. of these policies are real estate driven (primarily using an SPV) with the other 60 per cent. involving operating businesses across a diverse range of sectors including financial services.

2 The benefits of taking insurance

W&I insurance can provide the following benefits:

- Bridging the liability gap: In some cases, the seller may be prepared to give warranties, but wants to cap its liability at a level the buyer isn't comfortable with. In this situation, W&I insurance can be taken out to increase the overall cover available for the buyer.
- Clean exit for the seller without the need for retention funds: Sell-side or buy-side warranty cover enables both sides to have financial security as to how any claim will be funded, dispensing with the need for retention arrangements and enabling the immediate distribution of the entirety of the sale proceeds
- It is unattractive to sue the seller: Certain deal dynamics may make it unattractive for a buyer to sue a seller (or other warrantor) such as where they have an ongoing management role during an earn-out period or a under a trading relationship that is key to the business. In these circumstances, W&I

insurance is helpful as liability sits with the insurers instead (however, insurers will generally require management warrantors to stand behind some warranties in order to keep them accountable).

- Strength of the covenants: The covenant strength of a seller (or warrantor) can be a serious concern for a buyer going into a transaction. For example, if the seller is a special purpose vehicle, where there are multiple individual sellers or a seller is in financial distress.

3 What amount can be insured?

The limit of policy coverage will be dictated by the negotiations between the buyer and the seller, and their respective appetites for the retention or transfer of risk. The minimum limit of insurance available is generally steered by the minimum levels of premium, which are typically £50,000 to £75,000. As a result, if the limit of cover is less than £1 million, the premium level can be uneconomical.

A buy-side policy can (if desirable) obtain coverage for 100% of the purchase price paid under an SPA, provided the buyer is willing to pay the increased premium. However, a buyer may seek less cover and a reduced premium in circumstances where the buyer is comfortable with the assets being acquired (i.e. real estate backed assets). In these circumstances, a buyer may only seek policy cover to 10 per cent. of the enterprise value of the structure being acquired.

4 What risks are not included?

The insurers under a W&I insurance policy will generally not provide cover for the following (non-exhaustive):

- Changes to underlying agreements (the SPA) without approval or consent of underwriters. Consideration needs to be given to any completion condition, waivers or alterations in relation to this exclusion.
- Fraud and matters which were either identified by a buyer during the due diligence process or were otherwise disclosed by a seller (through the provision of a disclosure letter at signing and again at completion) – this exclusion can give the insurer the opportunity to avoid a payout on claims. However, in certain circumstances (for an increased premium) insurers seem to be willing to underwrite specific policies insuring certain known facts or matters on a case-by-case basis. Should an act of fraud or misrepresentation be committed by the seller, on a buyer policy the buyer can still claim under the policy however the insurer will seek to subrogate the loss against the fraudulent seller.
- Specific indemnities (for known issues). Specific insurance products are available to deal with these matters (such as tax indemnity and litigation) and in limited circumstances, an insurer may be prepared to wrap this into the W&I insurance policy (for an increased premium).
- Forward-looking warranties, such as the target company achieving post-completion profit targets.
- Civil or criminal fines or penalties that may not legally be insured against.

5 How does due diligence and disclosure affect a policy?

W&I insurance offers back-to-back cover for the warranties in the SPA. It does not provide protection for known matters which the buyer has identified during the due diligence exercise or which have otherwise been disclosed. As a standard, an insurer will expect that due diligence and disclosure, as well as negotiations regarding the respective warranties, are conducted between the parties on an arms' length basis. An insurer may refuse cover where a very limited due diligence report has been prepared, a disclosure letter is light on specific disclosures, or an SPA is finalised containing very extensive or un-negotiated warranties.

In any event, it is in the seller's interests that a full disclosure exercise is undertaken because the insurer will usually retain:

- rights to pursue the policy holder in the event of fraudulent or dishonest statements; and
- subrogation rights against warrantors to the extent that liability under the policy arises from their fraud or dishonesty (discussed below).

6 Who pays for the premium of the policy coverage?

Given it is the seller's liability that is reduced, the cost of the premium is often borne by the seller, although this may be subject to commercial negotiations if it is the buyer that is insisting on the policy. If sell-side liability is agreed, the seller should, at the same time, cap the premium it is willing to fund to prevent a buyer seeking to obtain a superior policy at the seller's expense. The seller will want to do this at an early stage, when the sale process remains competitive, and when it typically has greater bargaining power.

7 When should an insurer be engaged?

Notwithstanding the insurer will seek to rely, to an extent, on the due diligence reports prepared by the buy-side or sell-side lawyers and the respective tax advisors, the insurer will need to review the sale documentation and undertake its own independent form of due diligence, which will usually involve appointing its own legal counsel and an underwriting call with the client and their advisors. This additional review can, at times, be time consuming so the parties to the transaction should build this timeframe into any transaction timetable and engage with the insurer and its advisers at an early stage in the process to allow this work-stream to be completed. Once an insurer has quoted, the insurance policy will need to be reviewed against the SPA and any enhancements negotiated. The insurer and the policy will need to be kept updated as negotiations progress.

8 How long will the cover under the policy last?

It is common that the cover under the policy will match the claims period under the SPA. The standard for this is up to two years for general warranties and seven years for tax warranties. Broader timescales can usually be negotiated if necessary.

9 Things to consider when drafting

The SPA and W&I insurance policy should be carefully reviewed and read together to ensure that there are no unexpected gaps in cover, and that any exclusions under the policy are negotiated and drafted into the transaction documentation.

The following points may be relevant when negotiating the SPA and W&I insurance policy:

- An insurer may not cover every warranty given by the seller. If this is the case, the buyer may insist on the seller "standing behind" those warranties not covered under the policy to ensue coverage is provided in some capacity.
- Despite W&I insurance being used, any limitations of liability of the seller under the SPA should not apply in the event of fraud, negligence or dishonesty by the seller.
- The seller may want to link the maximum liability threshold of the seller under the SPA to the aggregate claims threshold under the W&I insurance policy.
- If an insured party wants to assign the benefit of a W&I insurance policy this will need to be discussed with the insurer and reflected in the policy drafting.
- A seller should insist that the right to subrogation against it should be waived by an insurer under any buyer-side W&I insurance policy. If this is not done, an insurer which has paid out money to an insured (the buyer) under a buyer-side policy may be entitled, as an equitable remedy, to "step into the shoes" of the insured and recover all or some of that money from the seller (or warrantor).

Whilst W&I insurance policies are being seen with more frequency in M&A transactions, it should be understood that W&I insurance may not be right for every M&A transaction and circumstances will often dictate whether a policy is appropriate and represents value for money relative to the size and nature of the transaction.

Mourant Ozannes M&A team is market leading in Guernsey for complex private and public merger and acquisition transactions. If you'd like more information on W&I insurance policies or to discuss a proposed transaction, please feel free to get in touch.

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