Feature

KEY POINTS

- A number of factors are leading to an increasing segmentation of the market in terms of territory and sector, radically different pricing, scope of cover and retention offers, but also to greater innovation.
- Sell-side flips are becoming more common.
- Insurers are placing greater emphasis on the need for thorough due diligence to be carried out by appropriately qualified personnel.
- Insurers continue to be cautious about insuring new incidents occurring between exchange and completion and about insuring synthetic tax deeds.

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Current trends in warranty and indemnity insurance in M&A transactions

This article looks at current trends and recent developments in the use of warranty and indemnity insurance as experienced by the authors and a number of insurers and underwriters in the UK market.

Warranty and indemnity insurance (W&I insurance) can mean different things to different parties. For the seller, it can be a mitigant to the liabilities which it has been forced or chosen to retain, potentially allowing the distribution of funds with no requirement for an escrow, while for the buyer, it will enhance the value of the warranties given by the seller, in that it can extend the duration, financial limitations and increasingly, the scope of the warranty coverage.

The use of W&I insurance has become an increasingly common feature of M&A transactions governed by English law. It is used particularly in private equity exits and in auction sales where sellers offer a so-called "sell-side flip" to the purchaser as part of the sale package. Indeed, bidders in an auction sale will themselves often propose W&I insurance as part of their bid to reduce the seller's retained liability and thus enhance the value of their bid.

MARKET SEGMENTATION

As recently as five years ago W&I insurance was a relatively esoteric product, which only a limited number of insurers offered. The market has grown and matured significantly since then and the range of products available has expanded and become more sophisticated. This is a function of clients themselves becoming more sophisticated and their requirements becoming more bespoke, of insurers also becoming more sophisticated and of a differing appetite for certain types of risk. These factors are leading to an increasing segmentation of the market in terms of territory and sector, radically different pricing, scope of cover and retention offers, but also to greater innovation.

Allied World Assurance Company's Andrew Graham comments that:

> 'the market position in relation to coverage, retentions and pricing is different in each territory and this in itself leads to differentiation within the market, with different carriers focusing more on certain jurisdictions. With regard to sectors, the financial services sector and heavily regulated sectors such as telecommunications and pharmaceuticals can be more challenging. The pricing for a transaction in these sectors would be higher than for a real estate transaction which is considered to be lower on the spectrum of risk.'

Tanya Nash of the Marketform Syndicate at Lloyd's says:

> 'Most interestingly for us, as warranty and indemnity insurance becomes more commonplace, clients are increasingly looking to insurance to solve complex deal issues with bespoke solutions which includes taking pragmatic views in short time frames.'

WHAT ARE THE POLICY LIMITS?

The policy limit purchased should reflect the client's tolerance and appetite for risk, which in turn will be driven by many factors, as discussed above.

The market is seeing a wide range of policy limits to equity value ratios. Tim Martin of Hunter George & Partners, and underwriting manager for various insurers comments as follows:

> 'the strength of a warranty and indemnity insurance policy is that it covers a wide scope of issues: the policy may respond to pay for debt-like items on a balance sheet (for example tax claims) or it may respond to a non-disclosure that goes to the root of valuation (for example IP issues for a tech company or title issues in a real estate deal). Claims for debt-like items would typically be at the lower end of equity value in quantum but claims that go to valuation can easily be much higher. We would normally expect an insured party to purchase 20% or more of the equity value in cover so as to be well insured for all eventualities'.

A seller's W&I insurance policy can cover the entire amount of liability agreed in the share purchase agreement (SPA) (subject to the usual exclusions, most notably for fraud, purchase price adjustments and forward-looking warranties) but more typically we are seeing a lesser amount of the first 10% to 30% of seller's liability. A buyer's warranty and indemnity insurance policy can have a policy limit of as little as 2.5% of the enterprise value of the target and can seek to protect as much as 100% of the

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enterprise value, although a typical range is 10% to 30% of the enterprise value.

As for retention amounts, 1% of enterprise value is the most common retention for non-real estate policies, although there is a downward trend and real estate policies can have retentions of as little as 0.1% of enterprise value.

SELL-SIDE FLIPS

Sell-side flips are becoming more common. A sell-side flip involves the seller's broker approaching the insurance market for indicative terms, normally including pricing, with the intention that the W&I insurance policy will ultimately be purchased in the name of the buyer (albeit commonly paid for by the seller). The significant challenge here is that any data on the insurance broker's file at the time of the transfer from working with the seller to the buyer will automatically become the file of the buyer and sellers should always be reminded of this issue. If all material information has been disclosed to the buyer, then this should not be a problem. However, a seller should, for example, be wary about expressing surprise that a buyer's due diligence on a given matter has not been as extensive as it would expect, as this could result in the scope of cover which the buyer will ultimately have being limited and exclusions applying, thereby making it harder for the buyer to claim under a policy than it would otherwise expect.

KNOWLEDGE

W&I insurance is priced on the basis that its purpose is to cover unknown risks, the scope for which has supposedly been reduced by a rigorous disclosure and due diligence process. Problems of which the insured is already aware, for example, risks uncovered in due diligence are not typically covered, nor are indemnities for known risks although there are still policies available to cover a number of specifically designed risks identified in the specific indemnities clause of a share purchase agreement. (An example of an insurable indemnity would be an indemnity for a risk of the Pensions Regulator finding a way through any barriers which the parties have sought to put in place to ringfence the target from any pension underfunding, although pure pension underfunding tends to remain a marketwide exclusion.) For this reason, insurers will invariably wish to ensure that the due diligence and disclosure process have been properly undertaken and, related to that, to pin down which persons within the insured (which is usually a corporate entity) have been most closely involved in the diligence process and who are therefore most likely to be aware of any problems.

> In recent years, the insured (along with their brokers and advisers) have frequently sought to limit the knowledge of the policyholder to the knowledge of a short list of specified individuals.

The starting point in any insurance contract (in particular when considering the insured's implied duty of "utmost good faith" and to disclose all material facts) is the knowledge of the policyholder. In recent years, the insured (along with its brokers and advisers) have frequently sought to limit the knowledge of the policyholder to the knowledge of a short list of specified individuals. This is not ideal for insurers given the difficulty in proving what an individual did or did not know (particularly if the relevant individuals have left the insured party before a claim arises) but insurers do accept it provided that they can verify that the named individuals are the correct people who did indeed carry out or oversee all significant areas of the due diligence process.

Rowan Bamford of Ironshore comments that:

> 'knowledge needs to be linked to individuals who are involved in the deal but we are relaxed about limiting the exclusion to the *actual* knowledge of those individuals. We would prefer the dataroom to be treated as disclosed as part of the transaction. If it is not treated as disclosed, which is often the case in the US, we can live with this but we would expect a very thorough and robust due diligence and disclosure process'.

The scope of due diligence is key. Allied World Assurance Company's Graham believes:

> 'a potentially challenging area for underwriters at the moment is where the due diligence process is extremely targeted and narrow in focus. While this approach is entirely reasonable on a stand-alone corporate transaction, it potentially provides problems for insurers, who have to make a judgment as to whether the report is a distilled product of a comprehensive review or is in itself a very limited review. Nil seller recourse structures are becoming more widespread, and while we are insuring an ever increasing number of these structures, where the seller has no "skin in the game" there is inevitably greater scrutiny on the quality of disclosure exercise and the negotiated position on the warranties. It is usually easier for insurers to take views on coverage positions on deals where the seller does have an element of residual liability on exit (save in the event of fraud), but nil-recourse structures provide an extremely attractive solution for exiting shareholders and are increasingly commonplace.'

The production of internal due diligence reports (ie reports drafted by the party seeking to be insured) is sometimes seen where there is a trade

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buyer. Such reports typically require the use of internal experts who have analysed the disclosure and conducted their own due diligence. Insurers are becoming more willing to accept such documents, but they do need to be detailed written reports and accompanied by the background to the deal and full details of the author and his qualifications. An internal email saying "all is OK" "internal" will be rejected, as will a report by an author who is not suitably qualified: 'We do require all information in the buyer's own due diligence reports to be treated as within the knowledge of the relevant individuals as we expect the insured to take responsibility for ensuring that the right people within its team have read and understood all of the information in the reports', says Nash.

ARTIFICIAL TAX DEEDS

Another current trend is the use of synthetic tax deeds (ie tax deeds under which the seller has refused to accept any liability but which are nonetheless insured). Insurers generally do not favour these unless they are satisfied with the underlying due diligence and disclosure. 'The key issue we have experienced most frequently is that the seller has not been incentivised to negotiate the tax deed and this places the burden on the insurer to negotiate the limitation provisions, which is not really the function of an underwriter on an insured transaction. However, provided there is a balanced set of tax warranties in the underlying sale purchase agreement, which are supported by a rigorous disclosure exercise by the seller, and a thorough due diligence exercise by the buyer, synthetic tax deeds are generally insurable', comments Allied World Assurance Company's Graham.

SPLIT EXCHANGE AND COMPLETION

The insurance market struggles with insuring new incidents which arise either in the period between exchange and completion or after completion itself (as opposed to incidents which arose before, but which were discovered only after, exchange). This is an issue particularly for larger transactions or transactions involving regulated businesses where there can be a protracted period between exchange and completion due to a requirement for antitrust clearances or some other regulatory approval, most notably in the case of financial services businesses. Insurance solutions at present tend to be limited in this regard: 'If there is a split signing and completion we would cover repeated warranties if disclosure is updated at completion [with the consequence that the buyer would be precluded from claiming for a breach of warranty]', says Ironshore's Bamford, 'but this does not solve the problem of new incidents occurring between exchange and completion which is a real issue for regulated businesses with their long time periods in this regard. Addressing how to deal with this is very much work in progress for the insurance market as a whole'.

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CHOICE OF INSURANCE PARTNER

What is clear from the above is that the scope of coverage needs to be carefully reviewed, and the insurer partner carefully chosen for the particular client and transaction. Examples of issues to consider when taking this decision include territory and sector class preference, the approach to policy wording, the size of team, the use of external reviewers, the longevity and experience of the team, the general approach to claims, the availability of a deal execution team, and jurisdictional licensing. This last point is important. Even if the SPA`s governing law is English, the policy will tend to be issued to the insured`s registered address. If that is an address outside of the UK and the insurer is not licensed to issue a policy into the jurisdiction in question, the parties might find that cover is not available.

THE PURPOSE OF THE COVER

W&I insurance is intended to cover the insured for 'unknown unknowns'. However, an emerging trend, and a risk for insurers, is the use of W&I insurance as a means of driving the deal negotiation rather than the other way around. The increased market penetration and growth of the product is positive for the industry. Insurers seek to cover transactions that are properly diligenced, negotiated and disclosed against as if there was no insurance in place.

CONCLUSION

As can be seen, the market has moved significantly over the past few years. Insurers and the products they offer have become far more sophisticated and insurers are now willing to offer bespoke solutions rather than a one size fits all product. Nevertheless, there are many lines which insurers will not be prepared or able to cross and parties seeking W&I insurance would be well advised to consider these at an early stage since actions and decisions which they might take at the outset of a transaction can have a fundamental impact on both the level and scope of cover which insurers will be prepared to offer at the end of the day and indeed could even result in cover being denied. ■

Further Reading:

- Insurance of finance transactions [2002] 9 JIBFL 357.
- Reverse due diligence: Seller beware [2012] 5 JIBFL 280.
- LexisPSL: Corporate Practice Note: Warranty and indemnity insurance in M&A transactions.