

## **W&I insurance — overview and outlook**

Corporate analysis: The 2017 Lex Mundi Global Seminar on Cross-Border Transactions was held on 2 November 2017 in London, United Kingdom. The seminar brought together legal practitioners, financial institutions and advisers, commentators and market participants in the cross-border M&A sphere to discuss key trends and developments in cross-border transactions. This article summarises the discussions and conclusions in relation to warranty and indemnity (W&I) insurance which were considered in the fourth session of the conference.

### **The W&I insurance industry**

On average, W&I insurance features in 20% of private M&A globally and 30% of Private Equity M&A deals in Europe. It originated in Australia and moved west to Europe before gaining traction in the US in 2014. 90% of policies are buyer policies and there has been an increase in M&A deals featuring 'nil seller recourse' (ie, the sole recourse a buyer has is by making a claim under the policy).

Policies will usually try to address the issue of quantum and the survival period of warranties and indemnities.

There are a small number of W&I insurance policy providers but the market has seen a number of newer (smaller) market entrants providing coverage in more niche areas/areas not covered by the (larger) general W&I insurers. This has resulted in W&I insurance providers offering competitive quotes while simultaneously increasing the breadth of coverage resulting in a 'buyer's market' in terms of obtaining insurance.

### **Benefits of W&I insurance**

Advantages of W&I insurance policies include that they:

- are a powerful deal facilitation tool—can help to bridge the gap between the parties and close the deal
- provide a clean exit route for the seller (which is crucial from a PE perspective) while simultaneously providing recourse to the buyer
- are flexible and can be used as the sole recourse available to the buyer (there has been an increase in the number of M&A deals featuring 'nil seller recourse' and it has been common practice for W&I insurers to get involved early on in auction transactions)
- can assist in protecting the management team from claims — this will be of particular importance to PE investors (ie, in management buyout transactions)
- may provide comfort to certain buyers (eg, US buyers investing in Europe will expect a reputable W&I insurance to be in place before committing to an acquisition/funding)

- may ease administrative burdens and provide certainty to the buyer when making a claim, in particular, where there are multiple selling shareholders

### **Limitations of W&I insurance**

W&I insurance will not be suitable for every transaction, eg:

- where a buyer is not undertaking due diligence (or is not undertaking top up due diligence on a vendor pack in an auction situation)
- sales in jurisdictions in which an insurer does not operate / is not licensed
- certain asset classes where the insurer is not licensed / it is beyond the expertise of the insurer

The governing law of the W&I insurance policy and the share purchase agreement (or other deal document setting out the warranties the subject of the insurance) should be the same; this will assist in the interpretation of legal obligations, application of congruous legal concepts and quantification of warranties in the event that a claim is made under the policy.

### **The importance of due diligence**

Insurers have their own legal staff to undertake due diligence on the insurer's behalf. The insurer will:

- be particularly interested in the negotiation of warranties
- expect warranties to be given by persons who have the requisite amount of knowledge required to give meaningful warranties (eg, not management team members who have only been at the selling company for a few months)
- expect that it is an arm's length deal
- expect to see a full and comprehensive disclosure process
- expect to see focused due diligence
- will take some degree of comfort where the existing management team have some 'skin in the game'

### **Timeframes and processes**

Insurers aim to be able to provide an adequate policy within 2 weeks of first being approached — this period can be as short as 4 days in emergency situations, but it will of course come at a premium in terms of pricing.

The initial contact is usually made by a broker. Once the core documentation (eg, share purchase agreement, disclosure letter and due diligence report) is at an advanced stage, they will need to be provided to the insurer for its own review and verification. The insurer will within the next couple of days provide a non-binding offer of terms and match the warranties in the SPA (where possible).

There will be some mandatory exclusions from coverage which are market standard, eg:

- actual knowledge
- fraud

- forward looking warranties
- practice area specific risks, eg, asbestos, construction defects (but note that it is often possible to get separate specific insurance which covers these)
- pensions underfunding
- transfer pricing

The insurer will usually provide the front end policy, ask questions about the deal and the parties, review the due diligence report, ask further questions and then engage in a call with the underwriters and lawyers before issuing the policy.

There are certain challenges / obstacles that may need to be overcome, eg:

- how do you frame warranties where it has been decided early on that the buyer will have no recourse
- separate insurance may be required in certain circumstances (such as where there is some historic environmental liability)
- buyers from the US not being familiar with English law concepts of warranties
- in PE contract races
- where the seller is not transparent upfront or processes are not followed

### **Deal size and coverage**

The size of deals that can be insured (deal size parameters) varies according to the jurisdiction in which insurance is sought. In the UK, insurance is available for deals over £1bn. Excess insurance can be taken out from other jurisdictions if necessary (eg, Bermuda). Generally, there is a limit as to the level of insurance (usually, this is limited to a proportion of the deal value, often 10%).

In the last 12 months, new insurers have entered the market expanding the scope and availability (in terms of deal value) of W&I insurance. They have targeted SMEs with the outcome that it is now possible to insure deals valued between £2m and £5m. Accordingly, insurance is available at the lower and higher ends of the market. The mid-market range (between £20m and £60m) sees the most number of W&I insurance policies taken out in Europe.

In addition, the last 12 months has seen an increase globally in the availability of greater coverage (in terms of what risks are covered, eg, known risks, and the duration of coverage, ie, longer survival periods).

The result is that prices of W&I insurance have come down globally.

### **Known risks and specific area insurance**

Separate underwriting agreements may be needed for known risks and the insurers will often rely on external lawyers to conduct a legal review before estimating whether a known risk is likely to materialise. Accordingly, the time frames may be slightly longer where coverage of a known risk is sought.

A buyer who has taken out general W&I insurance may be able to take out supplemental insurance in certain areas, eg, in the life sciences and pharmaceutical industries to ensure there is comprehensive coverage in place.

### **Payouts**

Globally, areas which generally see the most number of claims made include financial statement warranties, compliance with law warranties and tax warranties .

Insurers will expect to see breach, losses and how the claim has been quantified before paying out on a claim. Claims will be allocated to a loss adjuster who, before determining whether a claim should be paid out, will examine whether:

- there has been a breach of warranty
- an exclusion applies
- the claim is within the parameters of the W&I insurance policy
- the claim has been correctly quantified