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The Evolving Use of Warranty & Indemnity Insurance in Mid-size M&A Transactions



Introduction to W&I

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Insurance to protect or mitigate from two types of risk typically arising from M&A transactions:

Unknown and Unforeseen Loss

Known and Quantifiable Loss

Warranty & Indemnity

Insurance

Contingent Specific Risk

Insurance

Warranty and Indemnity Insurance Motivations for use



- Originated in private equity and protects against liabilities arising from a breach of the representations and warranties set out in an acquisition agreement (SPA).
- Now predominantly used for either/both:

Seller-driven reasons

- PE/fund clean exit
- 'Sleep Easy'
- Diverse shareholder base
- Reduced claims period
- Auction/seller-friendly situation

Buyer-driven reasons

- Management rolling over
- Concerns about sellers' financial covenant
- Easing of negotiations
- Bid differentiation
 - Knowledge scrape
 - Nil seller recourse
 - Tax covenant/contingent coverage

Warranty and Indemnity Insurance Key coverage points



Can be placed for either the seller or the buyer

Bespoke policies tailored to transaction, designed to follow and dove-tail with the SPA

Pricing in the Netherlands is typically between 0.8% and 1.3% of limit purchased

The premium is a one-off premium due at completion

Policy excess (retention/attachment point) is typically 0.5% - 1.0% of enterprise value

Total amount of insurance available per deal is between c.€3m and c.€1bn for Netherlands transactions

Claims period typically 2-3 years for general warranties, 7 years for tax and 5-10 years for fundamental warranties

Warranty and Indemnity Insurance Enhancements



- No Disclosure of DD reports for policy purposes
- No Disclosure of VDR
- Loss calculated and paid on an indemnity
- Knowledge Scrape

Marsh Private Equity and M&A Practice Contact Details



The Transactional Risk team at Marsh has been a leading figure in developing M&A risk insurance solutions in the European market over the last decade and is one of the most experienced broking teams in the market for this class of insurance.

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Recent developments & Coverage

Sammy Shihab

Castel

What is insurable from an insurer's perspective



Base case exclusion position:

- Issues known or disclosed to the buyer
- Post completion purchase price adjustments (including leakage)
- Forwards-looking statements, future financial models or forecasts (whether in warranties or a hard exclusion)

Historically areas which are better covered by a **separate insurance policy** were excluded under a W&I policy. Now there is scope for insurer's to go excess to existing policies in this area. Examples include:

- Environment
- Product liability (insurance diligence might be required for more complete PL)
- Professional liability, negligence, errors or omissions
- Cyber loss and data breach

What is insurable from an insurer's perspective



Regularly there is discussion around the topic below. Insurer's are getting better at assessing these risks:

- Pensions
- Anti-bribery and corruption
- Condition of assets
- Compliance with GDPR
- Cyber
- Open source code
- The big three tax areas transfer pricing, secondary taxes and loss of tax losses

Tax Insurance / matching tax indemnity cover for insurance



AFFIRMATIVE COVER IN A W&I POLICY

How it works:

- Concept of disclosure and buyer knowledge are disapplied under a policy
- Policy holder still needs to prove breach of warranty before a claim.
- Tax risks available for affirmative cover typically include (1) low risk identified in tax DD and (2) medium risks not high in quantum

Benefits:

- Attaches to the existing deal process.
- Provides certainty of reduced seller recourse
- Cheaper when compared to separate tax policies: can increase a total premium by 5-10%.

TAX RISK IDENTIFIED IN A TRANSACTION?

SEPARATE TAX RISK IDENTIFED NOT IN A TRANSACTION STAND ALONE TAX
LIABILITY
INSURANCE POLICY

How it works:

- Bespoke insurance cover for an identified tax risk.
- Tax risk does not have to be related to a deal, it can be provided on a stand-alone basis.
- o Price range 2-6% of the liability.
- Insurance loss includes the tax liability itself, expenses in engaging legal advisors/accountants to resolve the dispute and/or interest, fines or penalties as well as additional tax if the dispute is lost.

Benefits:

- Removes deal blockers and price chips
- Efficiency in speed, price, and certainty compared to that of the tax ruling process
- Unlock amounts in escrow in a cost-efficient way for specific tax indemnities given in a transaction
- Eliminate or unwind certain liabilities prior to an IPO, trade sale, or as a general balance sheet clean up
- Reduces the risk of liability on the insured, counter parties and their advisors as tax risk insurance policies are typically structured so that there is limited recourse or subrogation rights
- Secure a tax function by insuring a certain tax framework on a look forward basis. E.g. the residency or substance of an entity, a particular VAT treatment, certain debt or equity classification, etc



Angenita Pex

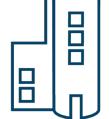
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- Auction process (sell side) mid-size deals:
- Decide in advance if W&I may be helpful
- If so, then
- take initiative as seller to arrange for a (buy-side)
 W&I policy
- involve W&I insurer (broker) from start
- inform bidders from start of W&I intentions
- decide if VDD can be helpful



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Structure 1st draft SPA to W&I:

- no liability seller v. limited liability seller
- adjust threshold, basket & cap to W&I coverage
- adjust warranties and indemnities to W&I coverage
- discussion between seller and purchaser adjusted to W&I; limited to exceptions to coverage
- no involvement Seller in claims post completion







Involve W&I at later stage transaction process:

- easier for purchaser
- sell-side W&I requires VDD
- if not ready before signing, structure SPA to be adjusted if W&I comes into place before completion



