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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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Marsh UK, Private Equity and M&A Insurance

Transactional Risk Solutions

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

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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

TAX RISK IDENTIFIED IN A TRANSACTION?

SEPARATE TAX RISK IDENTIFED NOT IN A TRANSACTION

STAND ALONE TAX LIABILITY INSURANCE 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%.

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.
- 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

Effects on transaction process

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Effects on transaction process 1

- 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

Effects on transaction process 2

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

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Effects on transaction process 3

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

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