Dealmaking and M&A

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Warranty & indemnity insurance – 5 Things to consider

Authors: Andrew Mills

> This month we focus on five things to consider regarding warranty and indemnity ("W&I") insurance for an M&A transaction. warranty and indemnity ("W&I") insurance provides the insured seller or buyer with cover for losses suffered from warranty breaches and claims under the general tax indemnity under a sale and purchase agreement ("SPA").

1. Why W&I insurance?

A key advantage of W&I insurance for a seller is that it limits its liability and offers a "clean exit" from an investment. This is particularly important for private equity sellers who may be unable to take on liability under their fund terms and/or need to make immediate distributions of sale proceeds to their limited partners. W&I insurance also has many advantages for a buyer. For example, a buyer may prefer to claim against a W&I insurance policy rather than the sellers/warrantors who remain with the management team of the acquired business, or the buyer may have concerns regarding the covenant strength of a seller/warrantor. W&I insurance policies are almost always taken out in a buyer's name (so it has direct recourse to the insurer). If a seller introduces W&I insurance into an M&A transaction, it will most likely "flip" the policy to the buyer just before completion of the transaction.

2. Think about W&I insurance early (and tactically)

Sellers and buyers alike should consider W&I insurance early in the M&A process, particularly in an auction context. A seller running an auction process may wish to "staple" a W&I insurance policy to the auction draft SPA it provides to bidders. Recently, some sellers have gone further by offering a suite of warranties that have been pre-agreed with an insurer and are broader than the standard set of auction warranties. This may potentially enhance the value and comparability of the bids a seller receives as it enables buyers to more easily “price in” transaction risk at an earlier stage.

Conversely, where a seller does not take this approach, a proactive buyer may consider agreeing coverage for a suite of warranties (and potentially a tax indemnity) in advance with a W&I insurance provider and submit that W&I insurance policy to the seller together with its draft SPA mark-up. This may help improve a buyer’s bid as the negotiation of warranties then largely becomes a matter between the buyer and the insurer (not the seller), reducing the seller’s time and cost during the auction process.

3. How much does it cost and who pays?

W&I insurance premiums for UK M&A transactions are generally 0.9 to 1.5% of the limit of cover purchased. However, premiums can be as low as 0.6% for target assets that have a lower claim probability, such as corporate real estate and renewable energy assets. In monetary terms, W&I insurance premiums can be as low as £30,000 (excluding fees and taxes). Competition between insurers has driven down the cost of premiums as W&I insurance is being used increasingly in UK and European M&A transactions, from upper to mid/lower-market transactions. Lower pricing has been particularly attractive to buyers with asset-backed or buy-and-build strategies in the lower mid-market.

In an auction context, a seller will typically expect the buyer to pay for the W&I insurance (which the buyer may wish to “price in” when considering its offer) or it may have a capped premium (over which the buyer will need to pay the additional premium). If specific issues are uncovered during due diligence that require additional W&I insurance coverage, the buyer will generally be in a good position to ask the seller to pay for additional coverage. Alternatively, where appropriate, a buyer may ask a seller to provide a specific indemnity to cover the specific issue concerned.

4. What can/can’t be covered?

Matters disclosed by a seller or identified by a buyer in its due diligence and known facts are the main exclusion from W&I insurance coverage. However, insurers have been increasingly willing, for the right price, to underwrite known facts or matters. The most common category of known risks in UK M&A transactions for which cover may be obtained is tax risks. In certain circumstances, these may include PAYE/NICs claims and the transfer pricing exposures arising out of the use of shareholder loans.

Other exclusions from cover include forward looking warranties, such as those relating to a target’s financial projections, no-leakage indemnities in locked box transactions and purchase price adjustments.

There are also variations in the type of W&I insurance cover available. A buyer can elect to take out a “US style” W&I insurance policy which provides more buyer friendly coverage (which reflects the more buyer friendly terms of US M&A transactions compared with those in UK/European transactions). A US policy will generally provide:

- payments for warranty claims on an indemnity basis (i.e. without the insured having to show they have suffered loss);
- no general disclosure of the data room; and
- no general exclusion for matters disclosed in due diligence reports.

However, a US style policy will generally attract a higher premium of around 2% to 3% of the limit insured.

5. Mind the (coverage) gap

In any M&A transaction a buyer should ensure that financial materiality thresholds contained in its advisers’ due diligence reports no lower than the small claims (de minimis) threshold for a breach of commercial warranties under the SPA. An insurer may be not be prepared to “bridge the gap” under a W&I insurance policy where an adviser’s liability threshold is higher than the de minimis level under an SPA. Therefore, a buyer should seek to align its advisers’ liability threshold with its desired level of insurance coverage as early as it can in the M&A process.

Importantly, a buyer should be particularly focused on obtaining from the seller a financial assessment of any particular risks that are disclosed against a warranty to ensure full coverage of that warranty. This is to ensure that all warranties (or as many as possible) are fully covered under a W&I insurance policy.

With special thanks to Hemsley Wynne Furlonge, an M&A specialist insurance broker and adviser, who provided expert input for this article.

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