Warranty and Indemnity Insurance – bridging the gap between Buyers’ and Sellers’ risk appetites

In this first in a series of articles on the W&I insurance market, Stephen Reilly, Partner, and Jason Bird, Trainee, overview the market for this increasingly used insurance product which oils the wheels of M&A transactions around the world.

W&I insurance has come a long way in the last 5 -10 years, from what was previously regarded as a relatively unknown esoteric product moving into the mainstream thinking of and use by M&A lawyers, advisers and their clients. In turn the number and capacity of Insurers offering the product has increased, along with the number of experienced brokers, inevitably meaning that premium rates have come down materially for this increasingly generic product.

Until recent years the market was held back by the fear of the lack of demonstrable claims experience with M&A lawyers and their clients unsure about how useful the product was and how Insurers would respond to claim situations. That has now changed and brokers are able to point their clients to a wide and varied experience of Insurers paying meaningful claims in this area, while applying sensible and appropriate coverage responses and claim strategies.

What is W&I insurance?

The interests of the Buyer and Seller on either side of a Sale and Purchase Agreement (SPA) selling a business are not aligned. Their respective lawyers will spend a material amount of time, money and effort negotiating where the future risks of the business transfer should ultimately lie. The SPA will contain
both Warranties (representations from the Seller as to the financial state, assets and potential liabilities etc. of the business) and Indemnities (indemnities are used to ensure there is compensation available to the Buyer for known risks eventuating or where a breach of warranty does not give rise to a claim in damages. With an Indemnity, the Buyer does not need to establish that it has incurred loss caused by a breach of Warranty).

Buyers will require Warranties and Indemnities as extensive and broad as possible to increase their potential to claim/make recovery against the Seller in respect of liabilities which arise post completion and which were known, unknown or undisclosed at the time of completion. Sellers seek to limit as far as possible the Warranties and Indemnities they give and the requirement for any monies to be held for long periods in escrow to meet such potential liabilities.

This misalignment of interest can lead to unsatisfactory risk outcomes for one or both of the parties and can sometimes lead to M&A deals collapsing. W&I insurance seeks to plug this gap between the risk appetites of the Buyer and Seller, inserting the Insurer to take part of this risk. In its most common form, it is a product designed largely to cover the risk of unknowns and undisclosed liabilities which impact post completion although related contingent insurance is also available for certain known risks eventuating.

Insurers offer sell-side (i.e. the Seller is the Insured) or buy-side (i.e. the Buyer is the Insured) policies albeit the vast majority of policies now sold are Buyer side polices. Where coverage is triggered, the policy allows the Buyer to recover direct from the Insurer rather than having to pursue the Seller. Insurers’ rights of subrogation against Sellers on such policies are generally restricted to Seller fraud scenarios.

Benefits of W&I insurance

As well as potentially removing negotiating blocks on certain deals, the benefits of W&I insurance are wide ranging and include:

For a Seller:

+ the possibility of a clean exit with a manageable cap on liability. The policy can give peace of mind to Sellers as they reduce or eliminate their exposure to a future claim against them and at a significantly
lower level than a Buyer would usually accept, allowing them to distribute sale proceeds earlier than otherwise.

+ A more straightforward transaction process. The existence of a W&I policy can speed up negotiations regarding the Warranties a Seller may be hesitant to give.

For a Buyer:

+ A straightforward claim on the policy. The Buyer does not have to chase the Seller who post transaction might have dissipated assets. Rather the Buyer's recourse is through the Insurer. The policy is also a safety net against insolvent Sellers as the policy can reduce or eliminate this risk.

+ A wider extent and duration of protection with enhanced certainty of recovery. The Buyer can potentially obtain broader Warranty coverage with longer time protection than the Seller might have been willing to give.

+ A chance to enhance bidder status. With multiple potential purchasers including auction processes, a Buyer with W&I insurance can be taken more seriously by a Seller.

Insurers' risk appetite

Insurers’ appetite including the breadth of coverage available, retentions required and pricing varies depending on the bespoke elements of the deal in question. Insurers are often staffed by ex M&A lawyers who understand how deal due diligence works, the key transactional issues and stumbling blocks to negotiating SPAs. Key factors include how comfortable Insurers can get with the level and quality of due diligence conducted on the deal (e.g. has it been undertaken by respected law firms/accountants and other due diligence reviewers), the amount of risk the Buyer or Seller is prepared to retain including within the policy excess, the law of the country governing the SPA, the industry sector involved (e.g. pharmaceutical, biotechnology and financial services being considered more high risk) and the precise nature of the warranties actually given – warranties are usually drafted to be limited by reference to the knowledge of the key individuals giving those warranties.

Given the frictional costs of doing business in this area and premium cost, W&I insurance is less likely to be cost effective for M&A transactions of less than £10m sale value.
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W&I claims experience

Market data compiled by AIG shows that claims frequency has increased with approximately 14% of W&I policies from 2011-14 increasing up to 21% of W&I policies in 2016, registering a claim. Perhaps stating the obvious, those businesses with more complex trading/regulatory/jurisdictional contexts, tend to show a higher rate of claims, as do transactions valued at over $1B. Nearly 50% of claims appear to arise from 3 core areas – being issues arising from financial statements (including accounting rule breaches, receivable/payables, asset issues and undisclosed liabilities), compliance with law issues and material contract issues.

Commentary

W&I insurance has moved to the mainstream and any M&A law firm advising on either side of a sufficiently valued deal will be required to advise its client on the availability and potential benefit of a W&I policy. This trend of increasing use on M&A deals will only continue. As the market has deepened, the generic product has become more user friendly and increasingly sits easily and back to back with the SPA. In turn, Insurers are pushing the boundaries of the type of M&A related risk they are prepared to take on as the search for new business continues.

In a follow up article on W&I Insurance, Stephen will take a closer look at the nuts and bolts of W&I policies including structure, terms and conditions as well as highlighting some more recent innovations in the W&I market.

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