Warranty and Indemnity Insurance in UK M&A Deals

2 JULY 2015

Introduction

The warranties and indemnities are typically the most frequently contended (and therefore time consuming) area of a sale and purchase agreement (“**SPA**”) negotiation. This is because the buyer will want the scope of the warranties to be as wide as possible to increase its protection, while the seller will want to limit the scope of the warranties to reduce its risk of a claim.

Warranty and indemnity insurance (“**W&I Insurance**”) provides cover for losses arising from a breach of a warranty or, in certain cases, an indemnity. It is increasingly acting as a means of closing the gap between the needs of the buyer and the seller in private M&A transactions.

The benefit of the cover can be offered either to the seller under a sell-side policy or, more commonly, the buyer under a buy-side policy. The aim of the policy is to provide coverage ‘matching’ the warranties, the *de minimis* and threshold amounts, the conditions and the exclusions in the SPA, so as to avoid any gaps in the protection of the insured party. A standard policy does not provide protection for matters which a buyer has identified in its own due diligence or in the disclosures which have been made by the seller. These areas can sometimes be insured either within the W&I Insurance policy or under a separate policy.

In the past, W&I Insurance was often disregarded on the grounds that it was too expensive, had limited coverage and/or risked slowing down the deal timetable. In recent times, however, the use of W&I Insurance has increased significantly as a result of lower costs, wider terms, positive claims experiences and a more streamlined underwriting process.

Reasons for the use of W&I Insurance

The table below lists possible reasons why both buyers and sellers are increasingly looking to take out W&I Insurance private M&A transactions:

FOR A SELLER	FOR A BUYER
Reluctance or inability to provide warranties (e.g. a private equity fund) or financial support for warranties (e.g. an insolvent seller).	Gives the buyer the protection of a AAA rated insurer, which is important if the financial worth of the seller or group of sellers is a concern.
Allows a cleaner exit from the business, providing greater certainty of keeping deal proceeds.	Increases the attractiveness of bid in a competitive auction.
Reduces risk of sale proceeds being lost to unknown future losses caused by a breach of warranty.	Provides an alternative route to contractual damages in respect of a particular issue.
Helps avoid having proceeds tied up in an escrow account or subject to a holdback.	Usually gives the buyer the protection of a AAA rated insurer.
Useful way to limit tensions where there are multiple sellers and the buyer is seeking is joint and several liability.	Can be obtained without knowledge or assistance of the seller.

Buy-Side Insurance

Buy-side insurance developed as a result of a seller either being unable or unwilling to provide the necessary level of warranty cover to the buyer. A buyer's insurance policy can be arranged to enhance the level of the buyer's protection over and above the seller's warranty cap and extend the coverage to the level that the buyer requires.

Under such a policy, if the buyer suffers a loss, it may bring a claim against the seller up to the agreed warranty cap in the SPA but would also, simultaneously, notify a claim against the insurance policy. If the claim is valid, the buyer would have recourse to the seller for the extent of the seller's liability under the SPA and also look to obtain settlement from the insurer. If the buyer cannot claim under the insurance due to any terms and exclusions, the buyer retains the loss having exhausted its options against the seller. Therefore, it is important to match the SPA and the policy coverage and identify any gaps before completion.

Insurers typically prefer a buyer to have 'skin in the game' and so will usually look for the buyer to bear the first portion of any warranty claim by way of an excess. This means that insurers will not typically cover the first amount of risk, so that a buyer must bear any excess before a claim can be made under the policy. This excess will often equate to the agreed 'basket' claims threshold in the SPA (often 1%).

Sell-Side Insurance

Whilst less common than a buy-side policy, a sell-side policy will insure a seller giving the warranties for any losses suffered as a result of the buyer bringing a valid claim against it for a breach of warranty or a covered indemnity. If the seller takes out W&I Insurance, it will retain its legal liability to the buyer under the SPA for the total amount of any loss suffered by the buyer (up to the negotiated liability cap in the SPA). However, in the event of a successful claim by the buyer, it will then seek recovery for amounts over the excess under the insurance policy. Such policies also typically include any defence and investigation costs incurred.

As with a buy-side policy, insurers will usually look for the seller to bear the first portion of any warranty claim by way of an excess.

Exclusions

Insurers will attach a cover spreadsheet to their policy wording in which each warranty will be listed and a comment made as to whether or not the insurer in question is unable to provide cover for the entire warranty or just part of it.

Insurers' policies will also contain general exclusions which will include the following:

- fraud and deliberate non-disclosure on the part of the insured;
- liabilities arising out of anything disclosed or otherwise within the knowledge of the insured party, findings in the due diligence reports (if the insurer has access) or issues covered by specific indemnities in the SPA (unless covered separately);
- changes to transaction agreements without prior approval of insurers;
- fines and penalties to the extent uninsurable by law;
- purchase price adjustments which are normally dealt with by completion account adjustments;
- forward-looking warranties, for example, the ability to collect debts after completion; and
- pension underfunding.

Amount Insured and Premiums

The policy coverage will reflect the agreement between the parties regarding the apportionment of risk.

The amount insured will be reflected in the cost of the premium which is calculated as a percentage of the total limit of the insurance. On a typical deal, the net premiums on a UK and European transaction are currently between 1.2% to 1.8% of the insured limit for both a seller policy and a buyer policy. The party paying the premium need not necessarily be the insured; and it is up to the buyer and the seller to negotiate (if they so choose) who bears the cost of the insurance.

The premium for a W&I Insurance policy is generally payable in full at the time the policy is taken out or shortly afterwards. In addition, insurance premium tax in the UK is payable on top of the premium, at the current rate of 6% of the total premium. Other additional costs include applicable underwriters' due diligence fees and any brokers' fees.

Arranging a Policy

In order to be in a position to offer a binding quotation, insurers will generally require discussions with the parties and their advisers to ask questions and to get comfortable with the due diligence process (buyer) or disclosure process (seller). The insurers will also require a copy of the SPA and disclosure letter and to be kept up to date on the negotiation of the documents.

The insurer will then begin the underwriting process which will include a review of the transaction documents and negotiation of the policy terms but should not reproduce any existing due diligence or disclosure processes.

On completion, a signed representation letter or no claims declaration (“**NCD**”) will be requested from the insured which will state that it is not aware of any circumstances which may lead to a claim under the policy.

Duration and Timing

The process of putting in place W&I Insurance typically between 2-4 weeks. Policies are usually taken out at completion and will cover the period of the duration of the warranties in the underlying SPA. This is normally two years for general warranties and seven years for tax warranties. In general, insurers will accept that the policy can be assigned within the insured’s group of companies.

Conclusion

W&I Insurance has been available in the market for over 25 years, but it has only become increasingly mainstream in the UK M&A market in the last 24 months. This is thanks to falling premiums, an increasing need or desire to manage risk more effectively and the ability of the insurance providers to understand and meet the needs of their clients in terms of deal timings and processes. For these reasons, we expect W&I Insurance to become a more regular feature in the UK M&A market in the future.

View PDF

6 Min Read

Related Locations

London

Related Topics

M&A

Insurance

UK Mergers

Related Capabilities

Mergers & Acquisitions

Related Regions

Europe

Related Professionals

Nicholas Usher

© 2024 Winston & Strawn LLP.