



On Target - December 2018

Warranty & Indemnity Insurance – 5 Things to Consider

Welcome to MJ Hudson's monthly *On Target*, where you'll find useful tips and insights to ease you through your M&A transactions.

This month we focus on five things to consider regarding warranty and indemnity (“W&I”) insurance for an M&A transaction. 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 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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Overview

On Target is produced by MJ Hudson's M&A and Private Equity transactions team. We provide expert legal advice to sponsors, managers and investee/target companies on domestic and cross-border M&A transactions. We work across the full spectrum of private market investments, from venture and growth investments to buyouts. Clients praise our entrepreneurial approach, commercial outlook and dedication to getting the deal over the line, regardless of the obstacles.

