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Warranty & Indemnity Insurance in the COVID Era

Introduction

Warranty & Indemnity Insurance¹ has been a popular and effective tool in facilitating and supporting transactions for a number of years. COVID has, of course, affected every aspect of our lives over the last two years. Similarly, COVID has affected every transaction since the beginning of 2020 to some extent. In many cases its effect has been significant and in some, particularly in the early days of the pandemic, the risks involved were too great for the deals to proceed.

However, after an initial slowdown in Q2 2020 as the business world came to terms with new ways of working and doing deals, deal volumes and cumulative value surged in the final six months of 2020. In 2021, global M&A deals have hit a new record high, both in terms of deal numbers and cumulative value. An abundance of capital, low interest rates and high levels of optimism for continued global economic growth suggest that the M&A industry will continue to be busy and competitive.

Against that background, the demand for W&I insurance increased to record levels and W&I insurance is likely to remain in high demand, not simply to support transactions but to assist competing buyers in gaining a competitive advantage.

Warranty & Indemnity Insurance

A sale and purchase agreement (SPA) will typically contain a set of warranties from the seller addressing all key aspects of the business being sold. Strong and well drafted warranties will provide clarity on the state of the target business and will necessitate disclosure, in the Virtual Data Room (VDR), as part of due diligence, of the key information relating to the target. The effect of a breach of one or more of these warranties will be that the buyer will have a claim in damages for breach of contract against the seller. Accordingly, the seller will seek to limit the extent of the warranties that it gives while the buyer will seek to expand the warranties as far as possible.

W&I insurance can provide a single solution to the concerns of both sellers and buy-

ers alike – removing or limiting the seller's risk while providing protection to the buyer, whose recourse will be against the insurer rather than against the seller. Although historically W&I insurance has been available in two forms, sell-side policies (where the seller is the insured under the policy) and buy-side policies (where the buyer is the insured), buy-side policies have been more popular for a number of years and are by far the more prevalent in 2021. Under a buy-side W&I insurance, cover is provided to the buyer for financial loss or liability arising from a seller's breach of a representation or warranty in the SPA.

The benefits of Warranty & Indemnity Insurance

W&I insurance can be used to support a deal, simply transferring the risk arising from a breach of warranty from the seller to the insurer. It can be tailored to expand the warranties that the seller is prepared to give to match those required by the buyer. It can give a buyer an advantage over other competing bidders by removing or limiting the extent of the seller's risk through the warranties given in the SPA.

With W&I insurance in place, a seller can make a clean exit from the business being sold, removing the risk of claims being made against it in the future and allowing it to distribute the sale proceeds while obviating the need for monies to be held in escrow against the possibility of such claims. For the benefit of both parties, the insurer can step in and offer warranties acceptable to the buyer, beyond those which the seller was prepared to give, both in terms of their extent and the length of time for which they are given, which will give the buyer more time to assess the acquired business and to discover potential issues which may lead to a claim.

For a buyer, it gains the security of an insurer being responsible for the financial consequences of a breach, rather than the seller, which may well not be as financially secure. Again, having the insurer in place of the seller is beneficial to a buyer who may not want to proceed against the seller as that would be damaging to the ongoing rela-

onship if the seller continues to play a part in the business, for example, continuing to manage the business on behalf of the buyer. Further, a buyer with W&I insurance, in a competitive auction process, is able to distinguish itself from other bidders by offering the prospect of no recourse or limited recourse against the seller in the event of a breach.

Features of Warranty & Indemnity Insurance

Extent of warranties and due diligence

Although there are certain provisions that will be common across all W&I policies, most policies will be subject to careful and detailed negotiation to tailor the policy to reflect the specific features of the deal and to address the subjective demands of both seller and buyer. A W&I policy may cover some, but not all, the warranties in the SPA and, as noted above, can cover warranties on a modified basis rather than as drafted in the SPA. However, having a W&I policy in place is not a substitute for comprehensive due diligence. Insurers will expect, and will confirm by enquiry, that the seller has provided proper disclosure, through a comprehensive and well-ordered VDR and a comprehensive disclosure letter, and that the buyer has carried out proper due diligence, with appropriate questions raised and answered, and has properly negotiated the terms of the SPA. The insurer will also make its own enquiries and carry out its own due diligence exercise.

Policy period

The W&I policy period will typically run from signing of the deal until the warranties and indemnities in the SPA expire. It is not uncommon to see a W&I policy cover a fundamental warranty for seven years from completion with other warranties covered for at least three years from completion. As noted above, a buyer may seek to extend any temporal limitations in the SPA to address the buyer's requirements.

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Retentions; de minimis

Many W&I policies will have a retention to be borne by the insured, though some policies are written without a retention and that will, of course, be reflected in the premium charged. Some W&I policies have a tipping retention mechanism, under which no claims are paid within the amount of the tipping retention itself but, once a covered claim or claims exceed(s) the level of the tipping retention, all covered claims are payable in full. Most policies reflect the deal value in the limits and the retention and, consequently therefore, in the policy premium. Many W&I policies will contain a de minimis provision excluding claims below that threshold which may mirror the approach in the SPA.

Exclusions

Although cover under a W&I policy will be linked to the warranties in the SPA, certain warranties will be excluded in all policies and other warranties excluded in most policies. It is common to see claims relating to transfer pricing, tax liabilities, pension underfunding, bribery/ corruption and environmental issues excluded. Further, issues addressed in the disclosure letter, issues appearing in due diligence reports, transaction documents or the VDR, forward looking warranties, issues known to the buyer (on a buy-side policy) and issues arising from fraudulent conduct by the seller (on a sell-side policy) are also typically excluded. A buy-side W&I policy will, however, usually cover seller fraud.

As noted above, COVID has, to some extent, affected every transaction since the beginning of 2020. In the early days of the pandemic, full COVID/ communicable disease exclusions were, at the very least, under consideration by insurers. However, the level of COVID risk in any transaction is a subjective issue, depending on the nature of the business being sold, and the policy will be tailored accordingly. In the calmer, booming market of 2021, while it is likely that any specific express COVID-related warranties will be excluded from cover under a W&I policy, it is equally unlikely that a blanket COVID or communicable disease exclusion will appear in the policy.

Subrogation

In accordance with the fundamental principles underlying W&I insurance, in

many instances, a buy-side W&I policy will remove all risk from the seller, in which case the policy will also prohibit the insurer from exercising rights of subrogation against the seller, except in cases of seller fraud.

Knowledge qualifications

Often certain warranties will be based on, and limited to, the actual knowledge of certain specified individuals at the target business. In these instances, insurers will require evidence as to the extent of the knowledge of those named individuals in assessing a claim for a breach of such warranties.

Claims under Warranty & Indemnity Insurance; extent of damages for breach of warranty

Making a claim

Again, reflecting the fundamental principles underlying W&I insurance, most W&I policies do not require the assertion of, or initiation of, a claim against the seller as a pre-condition to making a claim under the policy. W&I policies will usually have a comprehensive notification regime with notice of a claim to be given within a specified period from the date on which the information forming the basis of the claim came to the knowledge of the insured. The notice will typically need to be followed by a full statement of loss with information and documentation in support. Where warranties relating to accounts and financial statements are the subject of a claim, it is likely that expert evidence will also be required.

The extent of damages for a breach

Under English law, damages for breach of warranty are calculated on the basis that they will put the claimant in the position that it would have been, had the warranty been true. So, in looking at a transaction, the damages will reflect the difference between the value of the target business as warranted (generally the purchase price paid) and the actual value of the target business i.e. with the warranty breached. In cases where the purchase price was calculated by the application of a multiplier to profits, the damages will be calculated by applying the same multiplier to the shortfall in the profit figure relating to the breach. If a claim on a W&I policy is based on the application of a multiplier, the insured will need to provide evidence of the valuation model that it used in determining the purchase price.

¹ also known as Transactional Insurance and, in the United States, as Rep[resentation]s & Warranties Insurance