A lawyer's perspective: Surprising developments and new pitfalls in the W&I insurance environment

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In the last year, competition within the Warranty & Indemnity (W&I) insurance market intensified, not least due to the high level of deal activity and new market entries of W&I insurers. As a result, insurers provided greater flexibility on terms and the reduction of coverage exclusions. This shift not only affected the general coverage exclusions but also increased the usage of synthetic coverage solutions, which greatly impacted the relationship to the liability regime under purchase agreements (SPA). Consequently, W&I insurance policies are now gradually replacing more terms of the SPA in the overall liability regime. This trend is enabling the parties in an auction process to, on the whole, avoid lengthy negotiations on the respective SPA terms, thereby streamlining the overall process.

This article will highlight (new) further pitfalls, as well as surprising and primarily positive developments that accompanied this trend.

(New) further Pitfalls

In this consistently seller-friendly market, buyers should consider the following specific developments to optimise the risks stemming from transactions.

Full Exclusion of Seller's Liability for Fundamental Warranties

Recently, the sell-side has expected that, even for fundamental warranties such as title to the material target companies and/or all subsidiaries, the seller(s)' liability is fully excluded (i.e., the seller's liability cap is no longer equal to the purchase price but is now set at zero). Even though breaches of fundamental warranties are covered under W&I insurance, a title claim can lead to a fast erosion of the liability limit, which is usually set at 15%-30% of the transaction value. Subsequently, in mid-cap and large-cap transactions, the buyer is often forced to take out a separate title insurance to raise a protection to the level of purchase price paid for the target group. In case of smaller transactions, the buyer may alternatively buy a separate higher limit of liability for fundamental warranties under the W&I policy.

The costs of title insurance currently constitute between around. 0.1% and 0.2% of the purchased limit of liability. For example, a title insurance with a liability limit of €1 billion triggers costs of between €1 million to €2 million.

No Tax Indemnity Offered

In many recent auction processes, the seller no longer offered a tax indemnity in the SPA but explicitly requested that the buyer takes out a synthetic tax indemnity under a W&I policy. In such case only the W&I policy addresses tax risks, while the SPA stays silent on this matter, meaning the parties avoid lengthy SPA negotiations. Recent cases have indicated the seller's preference for this approach, despite the downside that, without a tax indemnity offered in the SPA, a buyer would usually not agree to SPA terms that require the target to pay tax refunds to the seller.

The coverage offered under the synthetic solution is often similar to the protection offered by most tax indemnities in the SPA, with the caveat that disclosed specific tax risks are only covered to the extent separately agreed with the W&I insurer (whereas risks with a high likelihood are not coverable). The disadvantage between a tax indemnity under the SPA and the synthetic tax indemnity under a W&I policy is therefore mostly commercial, as a synthetic solution leads to an increase in the W&I insurance premium from 10% to 15%. Moreover, identified risks to be covered under the W&I policy will increase the premium further.

Overall, parties should discuss with the broker, insurer, and the respective tax advisor whether a synthetic tax indemnity solution is the most feasible approach in the respective individual case.

Loss Definitions of the SPA

Loss definitions under the SPA still play an important role in the coverage of a W&I policy. While the W&I policy

can synthetically add certain loss elements (e.g., indirect losses), the SPA's loss definition forecasts what a W&I policy can cover. Parties should be mindful of the buyer's rights to claim loss calculated at the level of the relevant target company as opposed to loss calculated at buyer's level. In particular, buyers should avoid agreeing to loss definitions under the SPA excluding losses calculated on the target level, as such limited definition will likely be mirrored in the W&I policy. A correspondingly limited loss definition can harm the buyer's position in an insurance claim scenario if, following a breach of an accounts warranty, the buyer claims the relevant balance sheet deficiency to be replenished at the level of the affected target company. If the SPA (and consequently the W&I policy) further excludes damages due to the allegation that the purchase price has been calculated based on incorrect assumptions, the insurance coverage of accounts warranties is negligible.

Surprising Developments

"True and fair"-view warranty

Due to the fast-moving market and frequently tight timelines of the auction processes, sell-sides were often not prepared to present audited financial statements to potential buyers. As a result, many insurers declined to cover a "true and fair"-view warranty, but only offered coverage for a lower standard, e.g., that, to seller's knowledge, the relevant accounts do not materially misstate the target's financial position. Such limited coverage of the accounts warranty as one of the most important business warranties was obviously not beneficial for the insureds. In response, the insurance market offered the possibility of an endorsement under the W&I policy, under which the insurer is willing to synthetically offer a true and fair-view warranty if the buyer is able to present audited financial statements accompanied by inter alia a No Claims Declaration. One of the main advantages of this approach is that such audited financial statements can be presented after the closing of the transaction (for a certain period of time). Further, the seller needs only provide a lower quality warranty, rather than a true and fair-view warranty, while the buyer is still able to obtain the desired level of protection.

Pension Liability

Many W&I policies provide for limited coverage in regards to pension underfunding matters. The general exclusions regularly exclude coverage regarding pension funding or the respective funding obligations. However, the authors have recently noted policies that take back the exclusions scope for warranty breaches that result from insufficient disclosure made under the respective pension related warranty. The same is true for warranty breaches in case of lacking disclosure of material information or documents regarding funding obligations under any pension scheme or other arrangement. Such coverage can be crucial for respective insurance claims under placed W&I policies, which require particular focus on financial/HR/pensions due diligence and discussion with the broker and insurer.

Execution of W&I policies only after Signing

Many buyers are required to take out W&I insurance only after signing the SPA in the current market climate, partly because there is often not enough to complete the required due diligence exercise. The risk for the buyer in such a scenario primarily results from the potential for the buyer to obtain actual knowledge of facts or circumstances before the execution of the W&I policy relating to the period prior to the signing that would render incorrect a warranty provided on signing. Consequently, any damages resulting from an incorrect warranty would no longer be covered by the W&I insurance, thus resulting in a reduced coverage. However, the risk that the buyer obtains such knowledge after signing is de facto limited as the disclosure process usually halts after the SPA is signed.

Outlook

The authors expect that the negotiations in connection with a M&A process will, with regard to certain areas of the liability regime, shift more and more to the W&I insurance policy and will lead to a less burdensome and time-consuming negotiation process of the SPA.

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