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Warranty & indemnity insurance: UK and Italian experience compared

Giuseppe Giusti, M&A and Financial Services, Dickson Minto W.S.

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This article addresses some of the most frequently asked questions regarding the use of warranty & indemnity insurance in M&A transactions with a particular focus on the UK and Italian markets.

1. What is warranty & indemnity insurance?

Warranty & indemnity insurance ("**W&I**") is an insurance policy that provides cover for losses arising from a breach of warranty or under a tax indemnity in the context of an M&A transaction.

W&I can be structured to indemnify either the warrantors (under what is known as a "seller policy") or the buyer (under what is known as a "buyer policy") depending on who is seeking to benefit from the policy.

Under a seller policy, the insurer agrees to indemnify the warrantors for any losses suffered by them as a result of the buyer bringing a valid claim for a breach of warranty or under a tax indemnity.

Under a buyer policy, the insurer agrees to indemnify the buyer for any losses suffered by the buyer as a result of a breach of warranty or under a tax indemnity that the buyer is unable or unwilling to recover from the seller or warrantors.

The three main features of a buyer policy are that:

1) the buyer effectively obtains additional warranty and indemnity protection not from the seller or warrantors but from a third party insurer;

2) the additional protection is governed by the terms of the insurance policy and not the SPA (but the SPA would still be relevant for quantifying any losses incurred by the buyer); and

3) any claim under the insurance policy would be brought by the buyer directly against the insurer and there is generally no need to involve the seller or warrantors in bringing any such claim.

Seller policies are now comparatively rare in practice and therefore this article focuses mainly on buyer policies, which a leading insurance broker has suggested represent more than 90% of all W&I policies underwritten by insurers.

2. When is a buyer policy used in practice?

A buyer policy is typically used when the financial cap that limits the liability of the seller or warrantors under an SPA is not considered to provide adequate protection to the buyer. In these cases, a buyer policy is put in place in order to provide the buyer with "top up" cover that would enable the buyer to recover from the insurer, within the policy limit, losses that exceed the liability cap that applies to the seller or warrantors.

A buyer policy is particularly useful where, in the context of a transaction such as a secondary buy-out, business warranties are given only by the management team and not the majority or principal seller and are therefore subject to a liability cap that reflects a small percentage of the purchase price and may be seen as not providing the buyer with any meaningful form of financial protection.

The potential availability of a buyer policy is sometimes used to support the typical position of a private equity seller in the UK market that it will not give business warranties to a buyer. In fact, in the context of an auction sale, it is not unusual for a private equity seller to make available to bidders a buyer policy as a "staple" to the SPA. The stapled policy may consist of a set of indicative terms or a fully or partly negotiated policy and the seller may or may not be prepared to contribute to the premium (ultimately this will be a point of negotiation).

A buyer policy may also be useful to a buyer that intends to make a substantial investment in the target company after completion. In this case, the total investment of the buyer may significantly exceed the sale proceeds payable to the seller under the SPA and thus the seller's liability cap under the warranties and tax indemnity.

Other circumstances in which a buyer policy may be useful are where:

1) a buyer is concerned that the seller or warrantors may not have the financial resources that are necessary to meet any claim the buyer might bring against them after completion (e.g. the seller or warrantors are in a precarious financial position or are expected to be liquidated shortly after completion); or

2) a buyer considers that there are likely to be practical difficulties in bringing a claim against the warrantors (e.g. there are 10 or more warrantors each having several liability under the warranties) or it may be undesirable in practice to bring any such claim (e.g. the warrantors continue to be involved in the running of the target company).

In these cases, the main purpose of a buyer policy is not to obtain protection in respect of losses that exceed the liability cap of the warrantors but to give the buyer the ability to recover from a credit rated insurer losses that the buyer could in theory recover also from the seller or warrantors.

3. Can a buyer policy be put in place where no warranties are given by the seller or warrantors in the first place?

It would be extremely unusual to put in place a buyer policy where no warranties are given by the seller or warrantors. Insurers generally require the presence of one or more parties having a fundamental knowledge of the target company and at least some financial exposure (also known as "skin in the game") in order to be reassured about the quality of the due diligence and disclosure process carried on in the context of the transaction – insurers will not look to replicate this work themselves. Insurers usually expect such financial exposure to be at least equal to 1% of the enterprise value of the target company.

There are however some exceptions to the general rule and, for example, a buyer policy can occasionally be put in place where no warranties at all are given by the seller or warrantors in the context of a real estate transaction. This may occur where the transaction involves the sale of an SPV that holds title to property but has no employees and very little trading history.

There are also some insurers that have begun to offer "£1 recourse policies" which cover warranties given by warrantors whose liability is limited to a nominal amount only (e.g. £1, $1 or €1). Such policies, which are fairly common in Australia and New Zealand, have recently made an appearance in the UK but are more expensive than traditional W&I policies and it is likely that a reasonably significant excess/deductible (e.g. at least 1% of the enterprise value of the target company) would still apply.

Given the smaller size of the Italian market, it is unlikely that a "€1 recourse policy" would be available in Italy.

4. What are the other main features of a buyer policy?

The other main features of a buyer policy are:

1) *Excess/Deductible*. As mentioned, insurers generally require an excess of at least 1% of the enterprise value of the target company (i.e. a €1m excess for a €100m EV transaction). The higher the excess, the lower is the premium.

Where the purpose of a buyer policy is to obtain "top up" cover (see question 2 above), a buyer will typically look for the excess to equal the liability cap that applies to the warrantors under the SPA in order to avoid any gap in protection.

2) *Liability Cap*. The policy limits the insurer's liability to an agreed amount. The higher the liability cap, the higher is the premium.

3) *De Minimis*. The insurer is not generally liable for any individual claims or series of connected claims that are below the *de minimis* specified in the SPA. However, if the insurer feels that the *de minimis* specified in the SPA is below standard market levels it may seek to impose its own limit within the policy.

It is unlikely that an insurer would find that a *de minimis* equal to approximately 0.1% of the enterprise value of the target company (i.e. €100k in the case of a €100m EV transaction) would be below standard market levels in the UK and in fact insurers may be prepared to provide cover in respect of claims that are subject to a lower *de minimis*.

4) *Time Period*. The starting position is generally that an insurer is not liable for claims that are brought by a buyer against the insurer after the expiry of the time period specified in the SPA for bringing warranty or indemnity claims against the warrantors. A buyer can however request a longer time period under the policy. Such longer time period is usually of up to seven years for tax warranties and two years for general warranties, in each case with effect from completion.

The longer time period can apply to the full suite of warranties or specific warranties only.

5) *Pricing*. The premium payable under a buyer policy depends on a number of factors including the nature of the business carried on by the target company, the competitiveness of the underwriting process, the excess under the policy and the amount insured.

In the UK, the premium is usually between 1-1.75% of the amount insured (i.e. a premium of £100-175k would be payable to purchase £10m of cover). In Italy, it is usually 1.25-2%. In the US, it is usually 3-4%.

The premium payable to underwrite an Italian transaction is slightly higher than the premium payable to underwrite a UK transaction because there are fewer underwriters operating in the Italian market. The main underwriters operating in such market are American International Group (AIG), ANV Syndicates (ANV) and Houston Casualty Company (HCC).

The premium payable to underwrite a US transaction is higher than the premium payable to underwrite an Italian or UK transaction because insurers experience a higher loss ratio in the US. According to an insurer, a claim is made under approximately 1 in 4 W&I policies in the US compared with 1 in 8 in Europe.

The premiums stated above exclude any applicable sales taxes. The premium payable by a UK buyer would typically be subject to insurance premium tax (IPT) at a rate of 6%. The premium payable by an Italian buyer would be subject to IPT at a rate of 21.25% but a Bidco incorporated in Luxembourg that acquires shares in an Italian target company would typically pay IPT at a rate of 4% (being the Luxembourg IPT rate).

6) *Deal Size*. By far the majority of buyer policies are placed for mid-market private equity transactions having a value of between €10m-500m (this is known as the "sweet spot" for W&I). Cover is available for transactions having a smaller value but it is unlikely that an insurer would be prepared to underwrite a risk for a premium of less than £50k (in the UK) or €75k (in Italy).

7) *Covered Warranties*. Insurers generally do not provide cover in respect of certain warranties such as pension underfunding, transfer pricing and asbestos or any forward looking warranties such as those relating to the ability of the target company to collect debts or accounts receivable after completion.

In addition, it is often the case that insurers provide cover in respect of certain warranties only "as if" they contained a materiality or seller knowledge qualification. So, for example, a warranty that "*there are no circumstances likely to give rise to any litigation against the group*" may be underwritten by an insurer "as if" it stated "*as far as the warrantors are aware, there are no circumstances likely to give rise to any material litigation against the group*".

In certain cases, it is possible however to achieve the opposite result and obtain cover from an insurer in respect of a warranty that is qualified by knowledge in the SPA "as if" such warranty did not contain a knowledge qualification. This process is sometimes referred to as "knowledge stripping".

The warranties that are covered, not covered or covered with modifications by the insurer are usually listed in an appendix to the insurance policy known as the "warranties schedule".

8) *Covered Indemnities*. Cover is generally available only for losses arising out of a typical tax indemnity. For the purposes of the insurance cover, however, a tax indemnity is treated as being qualified or limited by any matter identified by the buyer during the due diligence process or disclosed by the seller or warrantors during the disclosure process. This is because, as further explained in point 9 below, the function of W&I is not to provide cover for known issues or risks.

Known issues or risks that have been identified during the due diligence or disclosure process can be covered in certain cases under a separate insurance policy (see question 8 below for further details).

9) *Known Breaches*. As mentioned, insurers do not generally provide cover in respect of actual or potential breaches of warranty or indemnity that are known to the buyer at the

time of inception of the policy (and, indeed, a buyer will be required to confirm to the insurer that it is not aware of any such breaches).

Separate policies may be available for protecting against known risk (see question 8 below for further details). These policies are however a more specialist area and it will usually be easier for a buyer to factor known risks in the purchase price it pays to the seller under the SPA rather than to put in place an insurance policy covering such risks.

10) *Other Exclusions*. Cover is generally not provided in respect of criminal fines and, to the extent not insurable as a matter of public policy, civil fines or penalties. A buyer policy, in addition, does not provide protection for the failure by a seller to comply with any general SPA behavioural undertaking, such as gap period undertakings or restrictive covenants, or any purchase price adjustment mechanism.

The definition of "losses" used in a buyer policy generally includes any costs and expenses incurred by the buyer or target company in defending or investigating any third party claim which would, if successful, give rise to a claim under the policy.

11) *Applicable Law*. A buyer policy is generally governed by the law governing the SPA. Accordingly, English law typically applies in a UK transaction. In an Italian transaction, the policy is typically governed by Italian law and contains an arbitration clause.

12) *Changes to Transaction Documents.* Once a buyer policy is in place, any changes to the transaction documents should be approved by the insurer in advance in order to eliminate the risk of such changes invalidating the policy.

5. What is the process for putting in place a buyer policy?

The process starts with the buyer contacting an insurance broker specialising in W&I. Brokers can usually provide, within 24 hours from receipt of an outline of the proposed transaction and a draft SPA, their initial opinion as to whether cover is available, its likely cost and any potential problem areas. This initial review is sometimes referred to as the "broker's conceptual review".

If the buyer wishes to proceed to the next stage, the broker will approach potential underwriters who, within two or three days from receipt of the required information, are usually able to provide an indicative quote for the insurance. Before information is provided to insurers, however, it is sometimes considered desirable to arrange for the insurers to sign a short-form confidentiality agreement in order to preserve the confidentiality of the transaction. This is something that the insurance broker can arrange directly.

The insurance broker will then collect and compare the indicative quotes received from insurers and send the buyer what is known as a "broker indication report". The report is then discussed between the buyer and the broker and a decision is made as to whether to proceed to the next stage of the process, which is the underwriting stage.

At the next stage, the terms of the policy are fully negotiated between the buyer, the broker and the insurer. The time period for this process varies and can take a couple of weeks. The buyer may be asked to enter into an "expense agreement" whereby it agrees to pay the insurer a non-refundable "underwriting review fee" to cover the costs incurred by the insurer during this stage. The underwriting review fee is usually capped at £5-10k in the UK and €7.5-15k in Italy and is often deducted from the policy premium if the buyer decides to purchase the policy.

The policy typically becomes effective on the date the SPA is signed and after:

1) the due diligence reports prepared by the buyer's advisors in connection with the transaction have been finalised and sent to the insurer (usually on a no-reliance basis); and

2) a "no claims declaration" (see question 6 below for details) has been signed by the buyer.

The premium is generally paid in full shortly after the policy becomes effective. Any commission due to the broker is typically included in the premium and paid to the broker directly by the insurer.

There is no need for a buyer to inform a seller that a buyer policy is being put in place by the buyer (although the process may impact upon the drafting of certain sections of the SPA). Equally, there is no need for a seller to inform a buyer that a seller policy is being put in place by the seller.

6. What is a "no claims declaration"?

Before a buyer policy becomes effective, insurers request a buyer to sign a "no claims declaration" whereby the buyer confirms that it is not aware of any actual or potential breach of warranty or indemnity claim at the date of inception of the policy.

In the case of a private equity buyer, such declaration is usually signed by a member of the private equity deal team on behalf of Bidco and covers not only the knowledge of the signatory of the letter but also that of other named team members. The "knowledge group" usually comprises two to four individuals and advisors are not included within such group. A similar approach is taken in the case of a trade buyer.

When negotiating the terms of a no claims declaration, it is important to ensure that the declaration refers only to matters that are within the actual knowledge of the named individuals and not also matters that are within the buyer's:

1) constructive knowledge (i.e. knowledge that the buyer should have acquired as part of the due diligence process); or

2) imputed knowledge (i.e. knowledge acquired by the buyer's advisors and agents).

Where there is a split exchange and completion, the insurer usually requests the buyer to sign two separate no claims declarations, one at signing and the other at completion, but the one signed at completion should only be in respect of those warranties that are repeated at completion.

7. What happens where there is a split exchange and completion?

Where there is a split exchange and completion, it is usual for the buyer policy to be signed at exchange and for such policy to be subject to the following conditions:

1) completion of the acquisition taking place in accordance with the terms of the SPA;

2) the premium being paid in accordance with the terms of the policy within a short period after completion;

3) a signing no claims declaration being delivered to the insurer at exchange;

4) a disclosure mechanism against the completion warranties and tax indemnity being put in place; and

5) a completion no claims declaration being delivered to the insurer at completion.

A buyer policy invariably provides that, if completion does not take place, the buyer is not liable to pay the premium and is entitled to a refund of any premium already paid. It is likely however that, if completion does not take place, any underwriting review fee would still be payable by the buyer.

A buyer may also be able to negotiate with the insurer the inclusion in the policy of a provision giving the buyer the right to cancel the policy prior to completion in consideration for the payment of a break fee, which is usually between 5-15% of the premium.

8. What other insurance policies are available in the context of M&A transactions?

As mentioned, there are other types of insurance policies available in the context of M&A transactions, including policies intended to cover "known risk", i.e. risk relating to specific matters that have been identified by the buyer during the due diligence process or disclosed by the seller or warrantors during the disclosure process.

Known risk usually relates to specific tax, litigation or environmental matters or matters such as title to shares, product run-off exposure, historical planning issues or PAYE/social security contribution exposure arising from the use of consultants.

The process for obtaining cover for known risk is not dissimilar to the process for obtaining W&I save that, because the policy will be created in response to a particular issue, it is likely to take longer to negotiate and require the provision of specialist advice. The brokers that specialise in W&I are usually able to assist a buyer in arranging cover for known risk.

Cover may not always be available however and, for example, there appears to be some reluctance on insurers to underwrite known tax risk in Italy because of a concern that it may potentially be illegal to do so. It may also be the case that, where cover is available, it is not available at an attractive price.