WHITE & CASE

Insight: Mergers & Acquisitions

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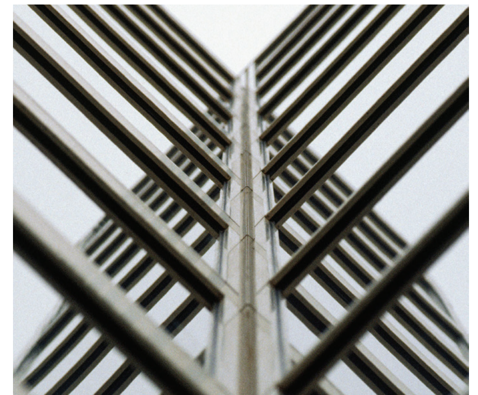
Overview of Recent Trends in Warranty Insurance in M&A Transactions

In the current economic climate, the appetite of purchasing parties to take on risk in an M&A transaction has greatly decreased. At the same time, sellers remain under intense pressure to contain outstanding liabilities, and achieve a "clean exit" through an M&A transaction. This Insight looks at the use of Warranty Insurance as an innovative way to "bridge the gap" between buyer and seller in negotiations and as a means to help close transactions where the risk gap between them would have otherwise blocked the signing of a deal. Warranty Insurance not only helps sellers achieve a clean exit, but also can be used by buyer parties to "sweeten their offer" in a competitive auction process, by providing a bidder with the means to accept lower liability thresholds from the seller than it would without Warranty Insurance.



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What is Warranty Insurance?

Warranty Insurance is a risk management tool for M&A transactions. For sellers, it can be a strategic tool to increase their rate of return and to achieve a clean exit through a transaction. For buyers, Warranty Insurance can increase their financial protection where there are concerns over recoverability from a seller, or afford them a powerful opportunity to differentiate their bid in an auction process. The warranties continue to play a key role in the underlying M&A transaction, both in flushing-out disclosures and in clarifying contractual liabilities. However, the dichotomy between the buyer's desire for maximum protection on a warranty breach and the seller's intent to accelerate receipt of sale proceeds can be eased or even removed through Warranty Insurance. The insurance market offers two types of product: Buy-Side Warranty Insurance (which indemnifies the buyer from the risk of failing to recover from the seller on a warranty claim) and Sell-Side Warranty Insurance (which protects the seller from financial liability to the buyer on a claim), with Buy-Side Warranty Insurance now the more common in the current climate.

Warranty Insurance can be used to (i) extend the period of warranty coverage (allowing the seller's liability to end at or soon following completion, and the Warranty Insurance coverage to extend the period of warranty protection for the buyer) and/or (ii) increase the warranty coverage through a "top-up" policy (where, for example, the Seller would be liable for the first portion of the liability under the SPA, and the Warranty Insurance coverage would apply for amounts sought by the buyer above the aggregate cap under the SPA).

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Why take out Warranty Insurance?

Warranty Insurance is commonly used where investor shareholders are exiting a business and not willing to give commercial warranties. For example, private equity firms usually cannot close their funds or make distributions to their limited partners where warranties remain outstanding. They rely on management to give business warranties, creating a "warranty gap" between the value of management's warranties and the full price the buyer pays. Warranty Insurance is a way to bridge the gap and help achieve a clean exit. Although consequently often regarded as a private equity seller tool, it should be treated as much as a tool for assisting buyers more generally (private equity or otherwise, and including trade bidders competing with private equity bidders). It gives buyers a chance to enhance their bid by taking a lower seller cap on liability or a shorter warranty period and obtaining top-up insurance to extend the cap and time limits.

Are there other benefits?

Effects include that the seller can achieve higher bids for the target, a more competitive auction process and faster receipt of sale proceeds (reducing the need for a retention/escrow). An effective strategy for a seller (in particular in an auction process) can be to "staple" warranty policies to bid documents in much the same way as vendor due diligence reports, giving rise to a new auction seller control device tool. In such cases, the seller typically mandates an insurance broker early on in the transaction process, and negotiates an appropriate draft insurance policy on the back of a draft SPA with an insurer before distributing the SPA to bidders. The related process letter makes it clear that the seller is not prepared to accept liability for the business warranties, however that the seller intends to help the buyer procure Warranty Insurance to cover such liability for the benefit of the buyer (and has already commenced discussions with insurers regarding such coverage). Even if the stapled Warranty Insurance is not used by a buyer, it can be a powerful negotiation tool for a seller to reduce escrow amounts or escrow periods, and/or warranty thresholds or periods. Other potential uses include: helping "stressed" or distressed sellers contain post-closing liability or buyers obtain cover where the seller or target is insolvent (although in such cases it is important that there is an opportunity for a buyer to undertake a robust legal and financial due diligence and there are knowledgeable parties to give the warranties and disclose against them as part of the sale); helping a buyer which prefers not to sue warrantors, who may be strategic partners or managers remaining in the business post-closing; helping avoid the need to sue multiple warrantors in different jurisdictions or, in any event, in individual claims; protecting against the credit risk of sellers who are individuals; and helping buyers investing in new jurisdictions.

Why is this topic hot now?

Previous concerns over the appropriate level of seller residual liability and related premium costs have now been addressed, and the market has opened up to more jurisdictions, including growth markets. Historically premia on buyer policies were higher, which previously disincentivised parties from taking them out. The key development is that premium levels on buyer and seller policies are now substantially the same, being between 1% and 2% of the insured limit on European deals (commonly 1% to 1.5% in the UK), which has greatly increased the viability of Buy-Side Warranty Insurance products. We note, however, that for certain transactions where the insurers perceive the risk to be higher for a variety of reasons (for example as a result of inadequate disclosure or issues raised through due diligence), the premia for Warranty Insurance could be higher (although rarely exceeding 2.5% to 3% of the insured limit on European deals).

A seller's residual warranty liability will in practice usually be at least 1% of the deal value, as insurers and buyers will otherwise be sceptical about the quality of disclosure. It has also become commensurately easier to obtain Warranty Insurance on deals in Central and Eastern Europe and in Asia, increasing its usage on international transactions and the benefits it can afford when measuring cost against the opportunities it brings to manage risk. We note that there are at least 13 insurance carriers offering Warranty Insurance, many of whom are Lloyd syndicates.

How do buyer and seller policies otherwise compare?

In an auction scenario Sell-Side Warranty Insurance may be faster to organise, as discussions with insurers may commence before the preferred bidder is chosen. This needs to be weighed up against the benefit to the seller in shifting responsibility for taking out the policy onto the buyer, as well as the greater opportunity to limit recourse or facilitate recovery which Buy-Side Warranty Insurance might afford. Whilst Sell-Side Warranty Insurance does not cover warranty breaches as a result of the seller's fraud, Buy-Side Warranty Insurance can by contrast do so, provided that the buyer had no knowledge (as below). A key benefit of Buy-Side Warranty Insurance is that a parallel liability policy can allow the buyer to claim under the policy without first pursuing seller liability. We note that, with respect to a seller policy, it is generally more difficult to secure such a policy without vendor legal due diligence being commissioned by the seller, as insurers generally like to see that a seller has "done their homework" and understands its potential warranty liabilities with respect to the target. This often is not an issue in the context of competitive auction processes, as vendor legal due diligence is quite commonly secured for such processes.

What about the other financial parameters?

A seller policy can in principle insure up to the full limit of liability under the SPA (subject to the excess and that the seller(s) remain liable for fraud or if the policy affords the insurer a defence or excludes liability) or a lesser amount (usually the first 10-30%). A buyer can choose the desired level of cover under a buyer policy. Factors affecting premium levels include: the insurance limit as a percentage of deal value; excess and de minimis levels; the

amount of the warrantors' residual liability; and the scope of the warranties and seller limitations. Insurance premium tax will also be payable, in the UK at a rate of 6% on the total premium. Brokers' fees are usually payable by the insurer, although a break fee may be required if the policy is not taken out. We note that insurers often require the payment of a non-refundable fee to cover due diligence costs in assessing the target and whether or not to provide the Warranty Insurance with respect to a transaction. This fee is normally deducted from the premium payable if the Warranty Insurance is secured. These costs need to be considered in the round – they are likely to compare favourably with the overall cost and commercial downsides of alternative warranty security structures, such as bank guarantees and retention/escrows.

Legal considerations?

Detailed consideration will need to be given to the insurance policy, to ensure it mirrors so far as possible equivalent aspects of the SPA and any gaps are identified and contained. For example, a buyer taking out a "top-up" policy on a private equity transaction will remain liable for the loss between management's liability cap and the insurer's excess if this is higher, unless the private equity seller remains liable for this gap in coverage. Ideally the policy cover will match the warranty period in the SPA and its de minimis and other seller limitations. Key issues to consider will include: whether the excess will be eroded by excluded losses (important in the case of a buyer top-up policy); interaction with conduct of third party claims clauses and seller limitations on losses recovered under insurance in the SPA; and exclusions from cover (such as known matters identified from the buyer's due diligence or the seller's disclosures; the insured's fraud; forward-looking warranties and purchase price adjustments). Careful consideration will need to be given to the knowledge exclusion, to ensure that this is limited to the knowledge of relevant identified individuals and reflected in the signing/closing no claims declarations required by the insurer.

Process and practical issues?

Warranty Insurance (as with any insurance) is secured through brokers who act as the in-between party between the insured and the insurers. Brokers raise a series of questions with the proposed insured before going out to market, designed to assess insurability of the transaction. In practice brokers do not approach insurers until they receive the buyer's mark-up of the SPA. On the basis of the draft SPA and other preliminary information, insurers issue non-binding indications of proposed cover. The broker summarises these in a report and the client selects the preferred insurer. The insurer then proceeds to conduct underwriting due diligence. An important part of this is an underwriting call with the client and legal and financial advisers. The parties then negotiate final policy terms.

What about timing implications?

It usually takes two to three weeks from when the broker was originally instructed to negotiate the policy. Aspects to factor into the timeframe include that insurers will need to review the transaction and due diligence documents, meaning that confidentiality agreements will be needed and usually arrangements to clarify the basis on which due diligence reports are released. There will also be a broker's formal engagement letter and possibly expense agreements with the insurers. If there are material changes to the warranties during negotiation the insurers will need to review these and the insured to ensure that liability gaps have not emerged between the policy and the SPA.

Special considerations with respect to Turkey

Special consideration should be given to the structure of an M&A transaction if Warranty Insurance is contemplated with respect to a transaction where the insured is potentially a Turkish party. Currently, special rules apply where the insured party is a Turkish party, including that (i) the insurer is required to be regulated by the Turkish authorities and (ii) the Warranty Insurance policy needs to be in Turkish. This can make securing Warranty Insurance more difficult as generally there are no specialized insurance brokers who speak Turkish, and there are only a few qualifying insurers who are willing to underwrite this type of risk. In most such cases where Warranty Insurance is contemplated for an M&A transaction involving Turkey, non-Turkish SPVs are generally used as the insured party for these reasons.

Tips for parties?

Warranty Insurance on M&A transactions is now more accessible than ever before. Its value should be judged in the context of the pressure on sellers in the current economic climate to achieve a clean break and the benefits that insurance products may afford compared to other warranty security devices. Parties would be well advised to give serious consideration to the help such insurance may provide to facilitate M&A deals on satisfactory terms in the future.

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