WHITE & CASE

Insight: Private Equity M&A

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Analysis of Recent Trends in Warranty Insurance in Private Equity M&A Transactions

Although Warranty Insurance in M&A transactions was a novelty product five to ten years ago, Warranty Insurance has now become an industry standard in Europe, largely thanks to its wide use by private equity firms who have been at the forefront of this trend. Not only is Warranty Insurance popularly used by private equity funds to "bridge the gap" between the buyer and seller in M&A negotiations, it has become a powerful tool to achieve cleaner exits through the reduction of residual seller liability (allowing private equity funds to return 100% of the purchase price proceeds to their investors immediately post-completion). This Insight looks at the current trends in the use of Warranty Insurance in private equity transactions.

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What is Warranty Insurance?

Warranty Insurance is a product designed to protect the seller or the buyer in an M&A transaction for a breach of the seller warranties. By way of background, there are two main types of Warranty Insurance: "Buy-Side Warranty Insurance", where the buyer is the insured party, and "Sell-Side Warranty Insurance", where the seller is the insured party.

Buy-Side Warranty Insurance covers the buyer for losses where the buyer is not able to recover from the seller for a breach of warranty as a result of either (i) the seller's aggregate cap on liability under the related SPA being too low, (ii) the time limit for recovery under the warranties having expired or (iii) the seller not being able to pay amounts due for whatever reason (such as insolvency, corporate dissolution, etc.). Buy-Side Warranty Insurance is generally structured either as "top-up policies," which extend the warranty period and/or the aggregate cap on liability for a breach of a warranty, or as "parallel policies," which allow the buyer to recover under the Warranty Insurance if the seller does not comply with its payment obligations for a breach of a warranty.

Sell-Side Warranty Insurance is less common than Buy-Side Warranty Insurance, and allows the seller to recover amounts it is legally required to pay a buyer for a breach of a seller warranty from the insurance provider.

It is important to note that Warranty Insurance does not cover liability for matters which the buyer (or, in the case of Sell-Side Warranty Insurance, the seller) had knowledge of. Indemnity Insurance is an alternative insurance product available on the market which covers known risks. The availability (and pricing) of Indemnity Insurance with respect to a known risk is typically determined by the insurer on a case-by-case basis.

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Warranty Insurance as a product is now much more commonplace, with at least 13 insurance carriers offering Warranty Insurance, many of whom are Lloyd syndicates.

Warranty Insurance in Sell- Side Auction Processes – Stapling Insurance to the Bid Documentation

Warranty Insurance has become a powerful tool for private equity sellers to reduce seller warranty liability in exits organized as competitive auction processes, thereby allowing private equity sellers to achieve a cleaner exit. For a variety of reasons, it may not be possible for a private equity seller to exit successfully through an auction process without offering business warranties under the related SPA. For example, although private equity sellers may prefer business warranties to be given by management through a deed of warranty, this may not be acceptable to certain strategic investors and may otherwise not be possible in transactions where management is not rolling over their shareholding as part of the transaction. In such cases, private equity sellers have found Warranty Insurance to be a helpful means of reducing their residual liability on an M&A transaction following an exit.

It has become common in certain private equity sell-side auction processes to "staple" (i.e. attach) Warranty Insurance to the auction documentation. In such cases, the private equity 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 prior to distributing the SPA to bidders. The related process letter makes it clear that the private equity seller is not prepared to accept liability for the business warranties, however that the private equity 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).

Stapled Warranty Insurance typically takes the form of Buy-Side Warranty Insurance, where (i) the liability of the private equity seller for business warranties under the relevant SPA is limited to a very low amount following signing or closing (which can be as low as EUR 1 provided there is a relatively clean target with robust disclosure and due diligence) and (ii) the Warranty Insurance extends the coverage for the buyer from EUR 1 to typically 10% to 20% of the enterprise value of the target. In order for stapled Buy-Side Warranty Insurance to be practicable, it is helpful (although not necessary) if the seller undertakes vendor legal and financial due diligence and the SPA deems the data room to be disclosed against the warranties. Further, insurers typically like to see that the buyer has undertaken a robust confirmatory due diligence itself, or if there is no vendor due diligence, a robust full due diligence process generally. Accordingly, it can be helpful to point out to bidders during an auction process that it is expected that each bidder will undertake the due diligence as required to secure warranty insurance.

Once the winning bidder is picked, it generally takes approximately a week to put the Warranty Insurance in place for a given buyer, during which time the insurance policy is finalised and the insurer reads the buyer's due diligence reports and otherwise satisfies itself that the buyer has conducted a thorough due diligence. This timing constraint needs to be taken into account when planning the overall timetable for a competitive auction process.

Using Sell-Side Warranty Insurance

As stated above, it is more common for Buy-Side Warranty Insurance policies to be stapled to the transaction documentation in a private equity led auction process. However, if the potential buyers are expected to be less sophisticated parties or the transaction documentation needs to be signed very shortly after the winning bidder is chosen, private equity sellers often find it beneficial to use Sell-Side Warranty Insurance in the context of the auction. In this scenario, the private equity seller entity (which customarily is an SPV with no assets other than the target being sold, and which will have no or few assets following closing) secures Sell-Side Warranty Insurance covering the seller's liability in the event of a successful warranty claim under the SPA. If a buyer is confident that the private equity seller's potential liability under the warranties is covered by Sell-Side Warranty Insurance, a buyer is more likely to accept the absence of an escrow or retention to secure such seller liabilities.

The main benefit of stapling Sell-Side Warranty Insurance as opposed to Buy-Side Warranty Insurance is that the private equity seller remains in full control of the process of securing Warranty Insurance, and can have the relevant policy ready to be executed at the time it picks the winning bidder. Accordingly, the execution of the transaction documentation would not be held up by the Warranty Insurance generally, and a signing is possible within a day or two of the winning bidder being picked (all else being equal). As discussed above, it generally takes about a week for the Buy-Side Warranty Insurance to be put into place once a winning bidder is picked. In certain competitive auction processes, a week may be too long to keep up the competitive tension between bidders (and accordingly a private equity seller could lose the associated benefit of a higher purchase price). Also, a Buy-Side Warranty Insurance requires a fair amount of cooperation from the buyer to put into place – if a buyer does not cooperate, it could draw out the process for putting the Warranty Insurance into place by longer than a week (and accordingly effectively delay the signing of the related SPA, which in turn could negatively impact the success of a competitive auction process generally).

It is possible under Sell-Side Warranty Insurance policies to make the buyer (or any other party) a loss payee under the policy. The loss payee under the policy would then be entitled to payment directly to it of any amounts paid out by the insurer under the Warranty Insurance. It is very common for a private equity seller to make the buyer a loss payee under Sell-Side Warranty Insurance

policies in competitive auction processes, as this provides buyers with greater comfort that they will receive the benefit of the amounts recovered under the Warranty Insurance without having to chase payment through other legal means.

Sell-Side Vs. Buy-Side Warranty Insurance from a Private Equity Seller's Point of View

In an exit scenario, it is generally more beneficial for a private equity seller to insist on Buy-Side Warranty Insurance rather than Sell-Side Warranty Insurance, as Sell-Side Warranty Insurance could create an additional administrative burden for a private equity seller following an exit. Buyers in transactions where a Sell-Side Warranty Insurance policy is secured often insist on a covenant being included in the SPA requiring the seller to undertake all actions required to recover any amounts claimable under the Warranty Insurance. Further, Warranty Insurance policies often require the prior consent of the insurers prior to a direct or indirect change of control of the insured party (i.e., the seller SPV). Insurers are generally reluctant to provide such consent with respect to transfers where the seller SPV ceases to be under the control of the relevant private equity Fund (including for example if such transfer is to a trust company or an administrator). Accordingly, under such a scenario the relevant private equity seller could be required to maintain ownership of (and incur the related cost of administering) an SPV seller for the duration of the Warranty Insurance. Lastly, the Seller is liable for any exclusions under the Warranty Insurance (if there are any) in the case of Sell-Side Warranty Insurance (whereas, under Buy-Side Warranty Insurance, the buyer is liable for such exclusions). For this reason, private equity sellers generally seek to put Buy-Side Warranty Insurance into place (rather than Sell-Side Warranty Insurance) in the context of an exit through a competitive auction process where possible.

Other Benefits of Using Warranty Insurance in a Competitive Auction Process

Even if the Warranty Insurance is not taken out in the end by the buyer or private equity seller, the fact that Warranty Insurance is stapled in a competitive auction process can be a powerful negotiation tool for a private equity seller to reduce warranty periods or caps on liability of the seller for business warranties under the relevant SPA. Where buyers are not comfortable with Warranty Insurance for whatever reason and insist on direct warranty liability of the seller, private equity sellers have been successful in using the fact that they have already secured Warranty Insurance to "horse trade" and effectively negotiate lower caps on liability, shorter escrow periods, lower escrow/retention amounts, or other beneficial terms under the relevant transaction documents.

Strategic Use of Warranty Insurance as a Private Equity Buyer

Private equity buyers have been successful in using Warranty Insurance to their benefit as well. In a competitive auction process where a private equity Fund is a bidder, Warranty Insurance can effectively be used to differentiate a private equity buyer's bid from those of other potential buyers on terms other than price. In particular, a private equity bidder can offer lower warranty periods or caps on liability (or effectively eliminate the seller's liability with respect to business warranties by capping its liability at EUR 1 for a limited period of time) and secure Buy-Side Warranty Insurance to cover a private equity buyer's warranty protection needs. Warranty Insurance can also be used to secure a lower purchase price generally for a private equity buyer, as the price reduction a seller may be willing to accept in lieu of liability under the business warranties is often much greater than the incremental cost of securing Buy-Side Warranty Insurance. Further, in a transaction where the target's management provided the business warranties through a separate deed of warranty, Buy-Side Warranty Insurance has been effectively used by private equity buyers to avoid the uncomfortable scenario of having to sue their current management team for a breach of warranty post-closing (which often acts as a disincentive for a private equity buyer to pursue a warranty claim post-closing generally).

Distressed Targets

In the current economic environment, private equity houses have been increasingly seeking distressed opportunities, often buying businesses out of receivership. In such transactions, the Seller is often (i) a court appointed liquidator who is unable to provide a private equity buyer with any warranty protection or (ii) a bank syndicate who have taken possession of the equity of the distressed target and are unwilling to assume any liability post-closing with respect to the distressed sale. Provided that (i) there is an opportunity for a private equity buyer to undertake a robust legal and financial due diligence of the distressed target and (ii) there are knowledgeable parties to give the warranties and disclose against them as part of the sale, Warranty Insurance can offer a means to private equity buyers to secure reasonable business warranty protection under circumstances where it would have been impossible to procure such protection in the absence of Warranty Insurance.

Recent Developments in the Terms/Costs of Warranty Insurance

The good news is that as Warranty Insurance has become increasingly common, the terms on which Warranty Insurance can be secured have improved from the perspective of private equity. Warranty Insurance is now generally available in any European country and throughout Central and South Eastern Europe and Turkey (with respect to Turkey, please note the caveat below). Historically premia on Buy-Side policies were higher,

which previously disincentivised parties from taking them out. One key development is that premium levels on Buy-Side and Sell-Side Warranty Insurance policies are now generally 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 Warranty Insurance generally. 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).

As a general matter, it is helpful (although not normally crucial) to have the seller on the hook for the first 1% of liability. The fact that a seller has capital at risk in connection with the warranties being insured generally provides insurers with comfort that the disclosure and due diligence process is likely to have been more robust (and accordingly the risk of a claim is lower). Where the seller has liability for a breach of warranty, the premia tend to be lower than in cases where the seller does not have any liability on the warranties post-closing.

Insurance premium tax will also generally be payable (depending on the jurisdiction); 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. Insurers may also charge fees for underwriting due diligence, although certain insurers deduct these from the premium.

The time required to put Warranty Insurance in place has also decreased as Warranty Insurance has become more commonplace. 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.

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