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Evolution of M&A Due Diligence – Issues in a New World

Representation and Warranty Insurance

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W&I insurance

When negotiating warranties and indemnities on the sale and purchase of shares or on the sale and purchase of a business as a going concern (private M&A), the parties' interests are often far from aligned. The buyer of a target company or business will typically want the warranties in the sale and purchase agreement (SPA) to be as extensive and unqualified as possible, giving it the best chance of making a claim should the need arise. The seller will typically want to limit the warranties as much as possible, giving it the cleanest possible exit. The seller may also not want any sale proceeds deferred, retained or held in escrow.

These differences between the parties' expectations could easily result in a deal not proceeding. W&I insurance is a specialist insurance product increasingly being used in private M&A to bridge that gap. Most frequently used on private equity (PE) exit deals, W&I insurance has now become more prevalent in other types of transactions.

W&I insurance is designed to cover against financial loss that may arise from a breach of warranty in an SPA or other transaction document such as a management warranty deed or, on a share sale, from a claim under a tax covenant.

In the US, and on some cross-border deals, W&I insurance is known as Reps and Warranties (R&W) insurance.

Two types of policy

There are essentially two types of W&I insurance policy, depending on whether the policy is taken out by the buyer or the seller.

W&I insurance was originally conceived of as a sell-side product, providing sellers coverage in respect of the recourse buyers had against them under the warranties and tax indemnities in the SPA. However, the vast majority of W&I insurance policies today are taken out by buyers, often in the context of deals where recourse against the seller under the sale agreement is nil.

Buy-side policies

In the case of a policy taken out by the buyer, W&I insurers effectively step into the shoes of the seller with the intention of providing, as far as possible, back-to-back cover with the position agreed in the SPA and other transaction documents. With the insurer providing recourse for the buyer, the seller may be able to cap its liability at a nominal or at least lower amount than would otherwise have been possible, enabling it to achieve a cleaner exit.

Among the attractions to the buyer of a buy-side policy are that:

- The buyer can claim directly against the insurer without having to pursue the seller.
- A buy-side policy will provide cover in respect of the seller's fraud.

A buyer may also be able to use a buy-side policy to effectively increase or extend the breadth, scope and duration of the warranties and indemnities that it has been able to negotiate in its favour in the transaction documents.

Each buy-side policy is individually negotiated from a W&I insurer's template position, with its provisions tailored to the liability regime negotiated and agreed between the seller and the buyer. The process runs in parallel with the negotiation of the SPA and other transaction documents.

A buy-side policy can also be put in place retrospectively, either post-exchange or post-completion, with retroactive cover effective from exchange or completion subject to a no claims declaration given on the policy inception date. Any known breaches at the inception date must be disclosed to the W&I insurer and will be excluded from cover. For this reason, it is advisable wherever practicable to incept cover on the date the warranties are first given or as soon as possible thereafter.

A buy-side policy is a "claims made" policy: it provides coverage if a claim is made against the insured during the policy period.

"Stapling" W&I insurance

A variation on the above is a buy-side policy instigated by the seller. This is increasingly common, particularly on PE auction sales, where the seller proposes, or insists, that the buyer enters into a buy-side policy to underpin the seller warranties and indemnities. Hence it is often referred to as "stapling" W&I insurance to the transaction.

Where legal, tax, financial and technical vendor due diligence (VDD) is available, the seller has an opportunity to go a step further by driving the W&I insurance process: selecting the W&I insurer and making it a precondition of any successful bid that the buyer takes out a pre-packaged W&I insurance policy. This is referred to as a "hard staple". Among the benefits of a hard staple are:

- Enabling the seller to achieve a cleaner exit.
- Giving the seller increased control over the W&I insurance process, including coverage and cost. The seller chooses the insurer and offers a warranty and, where applicable, tax indemnity package that is insurable and structured in its interests, potentially including:
    - limiting its financial liability under the SPA and other transaction documents to a nominal amount;
    - limiting the time period any warranties and indemnities are given for, with enhanced or extended coverage provided by insurers only;
    - qualifying all warranties to the seller's knowledge, with the general knowledge qualification synthetically removed for the purposes of the policy (a so-called "knowledge scrape"); and
    - (where applicable) using a standalone management warranty deed in conjunction with the SPA to limit a corporate seller's liability.
- Sell-side pre-underwriting can advance the auction process using VDD. An advanced tailored draft buy-side policy reflecting the findings of the VDD can be made available to all bidders with the auction draft SPA and other transaction documents.
- Identifying any gaps or issues early on, potentially mitigating the risk of price-chipping.
- Creating a level playing field for bidders.
- Obtaining the best insurance solution available. Some insurers can only work with one potential bidder, which could result in an uncompetitive bidder preventing a leading insurer from offering its terms to other potential bidders. This scenario could be avoided with the sell-side M&A insurance broker controlling the W&I insurance placement process.
- A controlled W&I insurance process can also avoid negatively impacting the chosen insurer's coverage position due to any issues of which the insurer might become aware from its review of due diligence conducted by unsuccessful bidders.

Sell-side policies

A sell-side policy is a W&I insurance policy taken out by the seller. In contrast to a buy-side policy, a sell-side policy:

- Will only respond if the buyer makes a valid claim against the seller under the SPA or other transaction documents, and this claim is covered by the policy. The interests of the insurer and the seller, in defending any claims made under the SPA by the buyer are therefore closely aligned. If there is a buyer claim, the seller cannot walk away and leave the claim to insurers; it will be required to co-operate with the insurer to benefit from the protection provided by the policy.
- Does not cover fraud on the seller's part.
- Is inherently less flexible, as it can only reflect the underlying contractual liability agreed by the seller in the SPA.

For these reasons, sell-side policies are far less common than buy-side policies. Also, some W&I insurers can only underwrite sell-side deals if there is VDD, which is often not the case.

Reasons for buyers to get a W&I insurance

Buyers typically choose to take out buy-side W&I insurance for the following reasons:

- W&I insurance alleviates concerns that inadequate protection is available from the seller or that the prospects of recourse against the seller are too uncertain. It offers the prospect of significantly greater contractual protection and an A-rated counterparty to recover from.
- It provides additional reassurance when investing in unfamiliar jurisdictions or territories and serves to mitigate enforcement difficulties where the seller and buyer are in different or multiple jurisdictions.
- It helps preserve commercial relationships, offering an alternative to suing either the seller or, on a secondary buyout, a management team that has remained in the business.
- It further reassures investors, shareholders and other key stakeholders as well as giving extra comfort for lenders (who may be assigned the benefit of the policy proceeds or, less commonly, be included as a loss payee).
- It can be used by buyers as a component of their bids in an auction process to enhance their prospects of success. As W&I insurance has become more widespread however this has become less of a differentiating feature.
- The seller has made it a condition of the deal that the buyer take out a buy-side policy. For the seller it helps facilitate a cleaner exit, by:

    - enabling the seller to significantly limit possible recourse against it, commonly avoiding the need for escrow arrangements; and
    - permitting a faster distribution of the sale proceeds.

    This is especially attractive to PE sellers, for whom a clean exit and improved internal rate of return (IRR) are key.

Why sellers take out W&I insurance

Sellers may still choose to take out sell-side W&I insurance in more limited circumstances for the following reasons:

- It may be attractive to fund managers contemplating a voluntary liquidation in an "end of fund life" scenario. W&I insurance helps avoid or reduce ongoing administration costs and facilitates maximum and faster distribution of investment returns to investors, improving IRR.
- It may provide peace of mind to individual sellers, for example in a family concern. If there is a claim however, the family members cannot simply leave the claim to insurers; they will be required to co-operate with the insurers to benefit from the protection provided by the policy.
- Disposals have already occurred and the seller is to be wound up.
- The buyer has rejected using W&I insurance outright.

Buy-side policy common coverage

The terms of the specific policy will always prevail but the starting point is that a buy-side policy aims to provide, so far as possible, back-to-back cover for the warranties and, where applicable, tax indemnities in the SPA and other transaction documents.

This is on the assumption that the transaction documents, both as regards warranties and indemnities:

- Provide for a disclosure process that is consistent with those customarily found in other transactions of the same size and scope, involving parties engaged in similar operations.
- Reflect arm's length and balanced negotiations between the parties.

However, the policy will typically only cover unknown issues in areas which have been the subject of due diligence. It follows that a key area of interest to underwriters will be the quality and scope of the due diligence exercise.

On the other hand, a buy-side policy may be crafted in such a way as to extend the protection afforded to the buyer beyond that available on the face of the SPA and other transaction documents.

Warranties and tax indemnities covered

A European-style buy-side policy typically contains a warranty spreadsheet which confirms which provisions in the SPA and other transaction documents are covered, partially covered or excluded.

The availability of tax assets has traditionally been excluded from cover under W&I insurance policies. However, more recently, some W&I insurers will consider covering the availability of tax assets to the extent that:

- The buyer can demonstrate that it has paid for such tax assets.
- Adequate due diligence has been undertaken on such availability (both pre- and post- completion).

Extent of cover

Whilst the amount insured varies from deal to deal, many insureds buy a policy limit of between 10% and 30% of the target's enterprise value (EV), seeking to replicate the position that might be reached in a negotiated SPA where either the seller is liable for meaningful recourse or there is an escrow arrangement.

More conservative clients, particularly those with restrictive investment guidelines or prescriptive lender requirements, may also buy anti-embarrassment cover to the full EV for fundamental warranties, particularly on corporate real estate deals or in unfamiliar jurisdictions.

Maximum

The maximum limit available for a single risk is, in theory, currently in excess of €1 billion, as part of a programme of W&I insurance. In such a case, the deal would be underwritten by one of a select group of leading W&I "primary" insurers, negotiating a primary policy wording with the proposed insured with a policy limit for the first defined percentage of loss.

Additional insurance capacity is then sourced and structured by the M&A insurance broker in the most efficient way possible up to the desired policy limit of liability from additional "excess" insurers.

A typical primary layer is €30 million to €50 million, with additional excess layers up to the desired policy limit.

Minimum

The minimum limit of insurance available is generally dictated by the minimum levels of premium offered by W&I insurers. An insurance limit of liability of €5 million or below will typically attract minimum premiums from W&I insurers ranging from €40,000 to €60,000.

Thanks in large part to new entrants focusing on the SME market, even more competitive pricing may be available for smaller deals.

Selection of policy limit

The policy limit will be dictated to some extent by the negotiations between the seller and the buyer, which party is paying the premium and their respective appetites for retaining or transferring risk.

When choosing an overall policy limit, the buyer should also consider whether the limit will be sufficient to cover the defence costs associated with potential third-party claims. Whilst these costs are typically covered by a W&I insurance policy, they may erode the policy limit.

Tax is another factor to consider. It is not always clear whether insurance policy proceeds paid as the result of a covered loss under a W&I insurance policy constitute taxable income. W&I insurance policies have thus evolved to include relatively standard gross-up language stating that loss will be grossed up under a policy were this to be the case, subject to the overall policy limit. Insurers will also offer a policy limit to include such grossed-up amount if deemed necessary.

Policy period

The policy period will either reflect the corresponding provisions in the SPA and other transaction documents or, more commonly, be extended synthetically for the purposes of the policy, typically up to a maximum of:

- Three years for general warranties.
- Five years for employment and environmental warranties (in certain jurisdictions).
- Seven years for fundamental warranties, the tax warranties and tax covenant.

Maximum policy periods are typically between 87 and 90 months, allowing time for any gap between exchange and completion. However, they vary from insurer to insurer.

Exceptional sign-off is also potentially available from certain insurers, for an additional premium, for liabilities in jurisdictions where the statutory limitation for liability or challenge is longer.

Buy-side policy common exclusions

A common misconception is that W&I insurance policies cover known issues, for example which a seller discloses or which a buyer has identified in its due diligence or in respect of which a seller agrees to provide an indemnity. This is not the case. Whilst the terms of the specific policy will always prevail, a standard buy-side policy is designed to cover only unknown issues in areas which have been the subject of due diligence. This applies both to the warranties and tax indemnities.

Coverage of known issues may sometimes be obtainable either as a specific sub-limit within the W&I insurance policy itself or in a standalone policy.

Policy retention

W&I insurers typically require that the parties involved accept a certain portion of the risk, and this is reflected in the policy retention (also known as the excess, attachment point, franchise or co-insurance). However expressed, this is the financial threshold at which the insurer will become liable under the policy and below which it is generally not liable. It effectively performs the same function as a basket in a SPA.

Different retentions may apply within the same policy, for example by applying a higher retention to specific issues such as tax, or where a higher materiality or disclosure threshold may have been applied to certain warranties, or where multiple SPAs are covered by the same policy.

Interaction with SPA

Typically, the policy retention mirrors the overall seller liability cap negotiated in the SPA in order to avoid the buyer/insured having "double cover". However, an established trend over recent years has been for recourse against the seller to be limited to a nominal amount (as low as €1).

The existence of the nominal €1 seller liability remains important:

- From a theoretical insurable interest perspective: there must be an underlying liability amount to disapply and therefore insure in the usual construct of a W&I buy-side insurance policy.
- Since the €1 limit could be disapplied in the event of seller fraud: a W&I insurer will always reserve the right in the policy to subrogate against the seller in the event of fraud, and this provides a direct contractual nexus where it has already paid out to the buyer under the policy.

Policy de minimis

The policy will include a de minimis provision which is designed to replicate the small claims threshold in the SPA. This is usually 0.05% EV to 0.1% EV (other than on very large deals where this remains a very high figure) or, on simpler corporate real estate deals, a fixed figure such as €10,000. This needs to match:

- The disclosure materiality thresholds used by the seller in compiling the data room and the general and specific disclosures.
- The materiality thresholds used in the (ideally) external buy-side legal, tax, financial and technical due diligence reports.

The policy de minimis will usually follow the formulation in the SPA which is typically a "series of claims" formulation. As with policy retentions, different de minimis thresholds may apply within the same policy, for example by applying a higher de minimis to specific issues such as tax, or where a higher materiality or disclosure threshold may have been applied to certain warranties, or where multiple SPAs are covered by the same policy.

Buy-side policy exclusions

Buy-side policies will typically exclude:

- Matters within the actual knowledge of the deal team on inception of the policy.
- Buyer (as opposed to seller) fraud.
- Purchase price adjustments. On a completion accounts deal, these would normally be dealt with by means of completion accounts adjustments, not warranty claims. On a locked box accounts deal, leakage and permitted leakage will be excluded, as being within the control of the parties.
- Fines which are uninsurable by law or which might constitute a breach of any sanctions.
- Pension underfunding.
- Secondary tax liabilities, diverted profits tax liability and transfer pricing.