

## WARRANTY & INDEMNITY INSURANCE

### EXECUTIVE SUMMARY

Warranty & indemnity (“W&I”) insurances are becoming increasingly popular in Europe. Even though W&I insurances are still not the norm in Belgium, they are becoming more prevalent and in particular for transactions with a deal value exceeding 100 million that are managed through an auction process or where it concerns private equity firms seeking a clean exit.

Even though the concept is not often used in small and medium-sized transactions in part because of the costs involved, it could be interesting for both buyers and sellers to investigate the upside of a W&I insurance in a specific deal. Moreover, given the more frequent use of W&I insurances, this segment of insurances is becoming increasingly competitive and as more and more insurance companies offer W&I insurance products, this will have a positive outcome on the price, the underwriting process and the time schedule. These evolutions will most definitely be advantageous for smaller and mid-size transactions.

A W&I insurance can bring a lot of comfort to both seller and buyer. For example, for those issues covered by the W&I insurance, the seller will no longer be the financially liable party and as such there will be less need for a seller to provide financial guarantees. Also, in rollover equity transactions buyers are usually more reluctant to claim from a seller since it could damage their cooperation (which could finally have a negative impact on the target), this type of restraint will be less of an issue if a W&I insurance is in place. Nevertheless, a W&I insurance does not completely replace the indemnity and guarantee mechanisms included in the SPA due to the many exclusions and limitations that a W&I insurance puts in place.

### What is a W&I insurance?

W&I insurance is a tailored insurance product to cover losses caused by breaches in representations and warranties (“R&W”) given by the seller in a share purchase agreement with respect to the sale of the target. A breach of R&W can be due to such a R&W being inaccurate, incomplete, misleading or otherwise.

There are two types of W&I insurance:

- 1) a buy-side policy, *i.e.* the most commonly used, with main advantage that in the event of loss the buyer can directly address the insurer; and
- 2) a sell-side policy, *i.e.* where the buyer needs to address the seller who on its turn will address its insurer.

### Why & advantages?

An important aspect of the SPA negotiation concerns the R&W that a seller is expected to provide. Where a seller is inclined to limit the R&W (and thus its liability) as much as possible, a buyer will want the R&W to be as extensive as possible. To bridge this gap a W&I insurance was invented.

The most obvious advantage is that the risks for sellers and buyers in connection with breaches of R&W are shifted to a third party, *i.e.* the insurer. This means that the seller is no longer the financially liable party and that as a result the buyer no longer needs coverage for liability claims against the seller. This makes hold backs, escrows, first demand bank guarantees and other type financial guarantees redundant as a result of which the seller immediately receives the full purchase price (this can be particularly interesting for private equity firms in an exit process).

A big plus for a buyer is that the insurer will in principle be a solvent counterparty which might not be said for the seller. Hence, because of the W&I insurance a buyer need not worry (or at least less) about the seller’s credit risk post-closing. Furthermore, a buyer might be reluctant to claim for breaches against a seller if said seller is still active in the target company. Claiming against the insurer will most likely leave the relation between a buyer and a seller unharmed.

### Features of an W&I insurance

#### *Covered risks and exclusions*

An M&A transaction is usually subject to three different types of risks and/or liabilities, which is why a buyer shall perform a due diligence:

- 1) **Known risks and/or liabilities:** these are the risks that are disclosed by the seller to the buyer during the due diligence phase. These risk and/or liabilities will be covered in the SPA either by way of an appropriate warranty (subject to, and qualified by, disclosure by the seller as a result of which the seller

will not be liable anymore) or otherwise by way of a specific indemnity (which is not subject to disclosure as a result of the which the seller remains liable) or a price reduction.

- 2) As a subcategory of no. 1 above, there are those risks and/or liabilities that are known but not yet quantifiable at the date of closing or risks and/or liabilities that are known and are quantifiable but have not yet materialized on the date of closing. These risks and/or liabilities are typically covered by a specific indemnity.
- 3) Unknown risks and/or liabilities: these are the risk and/or liabilities that cannot be foreseen and which are covered by the R&W.

Of the three types of risks/liability set out above, a standard W&I insurance will, in principle, only provide cover for the third category. A buyer will not typically be able to rely on the W&I insurance for anything which is known at the time of the entry into the SPA. Such risks can be covered by means of other insurance products.

The scope of the W&I insurance will mainly be determined by the so-called warranty spreadsheets attached to the W&I insurance policy. These warranty spreadsheets set forth the scope of coverage for each of the individual R&W provided for in the SPA (deal specific exclusions). Additionally, insurers will also limit the scope of the W&I insurance by using general coverage exclusions, for example, it is market practice that the following topics are excluded from the W&I insurance: leakage; pensions underfunding; transfer pricing; consequential losses; fines and penalties; any forward looking R&W; fraud; certain environmental issues (note that this can be covered by a separate insurance). Policyholders should be wary for risks that seem to be covered according to the warranty spreadsheets but are eliminated by the general coverage exclusions.

Furthermore, when choosing an insurer it will be important to not only make a price comparison between different insurers but to also make sure that the insurer has not carved-out any risks that are considered material to the transaction.

#### *Definition of loss*

It is important that the definition of “loss” in the W&I insurance policy is the same or similar to the definition used in the SPA in order to maximise the back to back cover. A point of argument in Belgium is typically whether or not consequential damages (also known as indirect loss, for example, reputational loss) are included in the definition.

#### *Split signing and closing*

On the inception date the policyholder will provide a declaration to the insurer that it has no knowledge of any facts or circumstances which may lead to a breach of the R&W on signing (*i.e.* a “no claims declaration”). If closing does not occur on the same date as signing, R&W are generally repeated on the date of closing and it may occur that new R&W are given on the date of closing (a so-called “bring down” provision). The policyholder will then be required to provide a second no claims declaration on the date of closing and should the policyholder be aware of any facts that occurred in the interim period that constitute a breach of closing warranties it will need to disclose those facts to the insurer.

In the event of a breach during the interim period of a signing warranty, the W&I insurance should apply. Where it concerns a closing warranty which has been identified during the bring down disclosure process, the W&I insurance will not cover the breach. Finally, if there is a breach of a closing warranty which has not been identified during the bring down disclosure process and which only came to the attention of the policyholder post-closing, the W&I insurance should (principally) cover the breach.

#### *Limitations*

The W&I insurance policy is subject to several limitations, such as:

- *Deductible/excess/retention*: a deductible is typically set in accordance with the deal value. Deductibles range from 0.5 % to 1% of the enterprise value but are obviously subject to fluctuation based on the risks involved. Deductibles of 0.25% in asset heavy businesses are no longer uncommon.
- *Policy limit*: the W&I insurance policy limit is often calculated on the enterprise value of the target. As a general rule of thumb you could say that the higher the enterprise value is, the lower the policy limit. Policy limits range anywhere between 10% to 30% of the enterprise value.
- *Time limitations*: preferably these should be aligned as much as possible with the time limitations set out in the SPA with 7 years for tax and fundamental warranties and 2 - 3 years for non-fundamental warranties being common. However, deviations are possible.

#### **How to get a W&I insurance in place**

The process to put a W&I insurance in place is often managed by an insurance broker and takes in general about 3 weeks. In an initial phase the seller/buyer will enter into an NDA with the insurance broker and the seller/buyer will provide its broker with the main transaction documents such as a draft SPA (preferably in final form), the information memorandum, etc. The broker will in its turn contact different insurers and submit the transaction information to these insurers. It is key for the insurer to understand the transaction and the thoroughness of the disclosure and due diligence exercise. Based on the submission an insurer will provide its price and coverage quote (called a “Non- Binding Indication” or “NBI”) within two or three days.

After the seller/buyer has accepted a particular NBI, it will receive a list of due diligence requests, and likely a request of the insurer for data room access. The insurer will analyse the information and will discuss it during a call (the “underwriting call”) with the seller/buyer and its advisors. If all goes well, the insurer will issue a draft W&I insurance policy to be negotiated between the relevant parties.

Following negotiations on the policy wording, parties will execute the policy and give the date at which the insurer is ‘on-risk’ for any claims that are received.

### **Cost of W&I insurance**

W&I insurance is paid via a premium, payable in full when the policy is taken out. Typically a premium is calculated as a percentage of the policy limit, ranging from 0.7% to 1.5%. Additional premiums will apply in case of specific coverages requested by the buyer. For example if the buyer requests for a tax indemnity which is not included in the SPA (synthetic tax indemnity), often an additional premium will need to be paid.