Briefing

BURGES SALMON

Insurance

Warranty and Indemnity Insurance and other Transaction Liability Insurance Products

As life has started to return to the M&A market following the global recession there has been an increased use of transaction liability insurance ("TLI") products, such as Warranty & Indemnity ("W&I") insurance, to help apportion risk on M&A deals. Even with the reduced deal volume (when compared to the pre-recession days) the recent uptake in TLI has been significant suggesting that it is becoming a much more widely accepted and understood product. The increasing interest has also been driven by the significant reduction in the cost of obtaining such insurance since it first began being sold.

What is TLI?

At its most basic, TLI is an insurance contract that passes to an insurer the risk of either the seller or buyer on a particular aspect of an M&A transaction. The most commonly used type of TLI is W&I insurance, which covers losses that flow from a breach of warranties and indemnities in the SPA.

However, there are also other TLI products that can cover particular risks, such as contingent tax liabilities or existing litigation. The focus of this briefing is W&I insurance.

Why is TLI useful?

Some of the reasons why W&I insurance may be attractive to the seller and/or buyer on a transaction include:

- a seller is unwilling to stand behind the warranties/provide indemnities to the level sought by the buyer or for a sufficient time period;
- the buyer may want some additional comfort above negotiated seller caps;
- it can reduce the need for funds to be held in escrow;
- to limit shareholder exposure; or
- where there are doubts as to the ability of the seller to back the warranties and indemnities that have been given.

How does it work?

Unlike many insurance products, W&I policies are bespoke contracts rather than 'one-size fits all' standard wordings and it is of vital importance that they are carefully drafted so that they dovetail with the SPA to protect against the agreed risks. This requires insurers, brokers and lawyers to work together to put the policy in place within the often tight deal timescales.

It is important for clients to understand from the outset that insurers are unlikely to agree to provide cover in respect of all warranties and indemnities. For example, insurers often exclude warranties in respect of pension funding and certain tax issues (note: there are bespoke policies available for contingent tax exposures). The quality of the due diligence and what it reveals will be key to the insurer's decision on scope of the cover for the warranties and indemnities included in the SPA.

Seller side and Buyer side

W&I policies can be taken out by buyers and/or sellers. When this product first became available it was largely purchased by sellers but now it is often the buyer taking out the policy. When taken out by buyers, should a breach of warranty arise and the policy attachment point be reached (typically the cap on seller liability under the SPA), the buyer can then claim on the policy.

A seller W&I policy will respond to a claim against the seller by the buyer for breach of warranty and the limits will typically reflect the level of liability on the seller under the SPA. The insurer will normally take over the defence of the warranty claim; meet the defence costs; and, should the seller lose, meet the damages liability that ensues.

Other Forms of TLI

W&I insurance generally covers risks that are unknown when the cover is purchased. However, cover may also be sought in respect of contingent liability identified in the sales process. Contingent liability insurance provides protection in respect of known issues such as the risk that HMRC may challenge certain tax treatment. However, it cannot be purchased in respect of liabilities that are known to exist.

Litigation buy-out insurance may also be attractive for particular deals. It can be purchased for anticipated or actual litigation and enables the potential liabilities to be ring-fenced; either capping or removing the exposure from the litigation. For example, if the target company is facing a large piece of intellectual property litigation at the time of acquisition, the financial risk of losing the case can be covered by a litigation buy-out policy so that all adverse damages and costs awards fall to be paid by the insurer.

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Practicalities

From a practical point of view, TLI can be put in place very quickly. Historically TLI was perceived as a potential cause for delay to the completion of a deal. However, provided that insurers are engaged early on in the deal process, in our experience, this is no longer a fair criticism.

To ensure a smooth process when putting in place W&I insurance:

- engage with insurers early on
- have an experienced broker/legal team
- obtain clarity at an early stage as to the warranties the insurer is prepared to stand behind and those that it will not (or only to a limited extent)
- provide insurers with good quality due diligence information and use lawyers that have the expertise that insurers would expect for the transaction.

Contact

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