



## Briefing

# Warranty & Indemnity insurance: a useful tool in real estate transactions

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Recent years have seen an increase in the use of Warranty & Indemnity (“W&I”) insurance as a ‘deal tool’ for the disposal of real estate assets, with a growing number of real estate funds using W&I insurance on every deal.

This heightened interest has in part been driven by an increased focus on risk mitigation, a reduction in the cost of obtaining W&I insurance and a more widespread understanding of the product.

This note explains the mechanics and role of W&I insurance, its possible benefits, the likely costs involved and issues to bear in mind when purchasing it.

### What is W&I insurance?

W&I Insurance provides the parties to a transaction with insurance protection in the event of a breach of a representation or warranty (and in some cases of an indemnity) agreed within an SPA.

W&I policies can be taken out by the buyer and/or seller on a deal.

- In a **buyer side policy**, the insurance is taken out by the buyer so that it can claim directly against the insurer for loss flowing from a breach of warranty by the seller. Typically the policy will be structured to protect the buyer’s loss in excess of the cap on the seller’s liability under the SPA.
- In a **seller side policy**, the policy is taken out by the seller and will respond to a claim against the seller by the buyer for a breach of a warranty, typically up to the seller’s level of liability set out in the SPA. The insurer will normally take over the defense of the warranty claim, meet the defense costs incurred in defending or investigating the claim, and indemnify the seller for any liability.

### What are the advantages of W&I insurance in real estate funds transactions?

In the past, many real estate funds have taken the position of limiting the warranties and indemnities to title and capacity, with the buyer having to shoulder the risk of matters not disclosed during the due diligence process. However in recent years, buyers have started to demand fuller sets of warranties and indemnities, with seller liability capped at an appropriate level. Historically, the buyer has been protected from the risk that the seller will not be able to fund a subsequent warranty claim by either placing a proportion of the sale proceeds in escrow, putting in place bank guarantees or making a price adjustment.

W&I insurance may be an attractive alternative to these options for the following reasons.

- It can allow a transaction to take place with a seller unwilling or unable to stand behind warranties.
- It can help a seller liquidate sale proceeds quickly, by lowering, or even dispensing with, the need for funds held in escrow.
- Where a buyer considers the negotiated cap on the seller’s liability under the SPA to be insufficient, or the time limit for bringing a claim too short, W&I insurance can supply additional cover.
- It can provide comfort to a buyer who is concerned about the strength of the seller’s covenants or thinks that their ability to recover post-completion may be compromised, such as where the seller has been liquidated, is offshore or is financially weak.
- It can permit a buyer to avoid endangering their relationship with management sellers who have remained with the target post-completion.

### Considerations

Unlike many insurance products, W&I policies are bespoke contracts rather than “one-size fits all” standard wording and it is therefore very important that they are carefully drafted so as to mirror the suite of warranties given in the SPA (to the extent possible). The quality of the due diligence and extent of the negotiation of the SPA will be important factors in determining the extent of cover insurers are prepared to offer.

It is also important to appreciate at the outset that insurers are unlikely to agree to provide cover in respect of all warranties and indemnities. Standard exclusions include liabilities arising out of anything disclosed or otherwise within the knowledge of the insured party, forward-looking warranties, pension underfunding, certain tax issues and anything arising out of fraud and deliberate non-disclosure.

Insurers may also seek to exclude or limit cover for other specific issues depending on the nature of the business, for instance loss arising from environmental warranties where the business in question is environmentally sensitive or product liability risks which should be covered under specific insurance.

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## Costs of W&I Insurance

To obtain W&I insurance, the insured will need to pay a premium as a one-off cost for the duration of the policy period. The premium will be calculated with reference to the policy limit, which is typically 10-25% of the asset value, depending on the insured's requirements. Generally, premium rates are between 0.8-1.5% of the policy limit. In addition cover will be offered above a self-insured financial limit (the excess or policy retention). Most insurers look for a minimum excess of 1% of the asset value.

Factors which influence the premium rate include the transaction deal value compared to the policy limit purchased, the agreed excess and the coverage requests.

It is also important to note that further costs may be incurred by the insured, including:

- (a) applicable insurance taxes, levied in accordance with the domicile of the insured (at the time of writing UK insurance premium tax is 6%);
- (b) insurers' due diligence fees: depending on the size of the transaction, the insurer may use independent third party advisers to assist with due diligence. The insurer will typically require that the associated costs be met by the proposed insured in the event that the insurance is not purchased; and
- (c) some brokers also charge an abort fee. However, if the insurance is purchased the broker fee is paid by the insurer by way of commission.

## Practicalities

W&I insurance can be put in place very quickly. To ensure a smooth process, the prospective insured should:

- 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); and
- provide insurers with good quality due diligence information and use lawyers that have the expertise that insurers would expect for the transaction.

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