combuy'n
JANUARY - 2023

WARRANTY AND INDEMNITY INSURANCE – A TRANSACTION FACILITATING TOOL THAT EACH PE SHOULD BE AWARE OF

by Olena Vlasyuk, Head of M&A and Transaction Solutions, Aon France

In the current context where the M&A market is getting tougher, notably due to Russia's invasion of Ukraine, the associated political instability and the increased interest rates, it is important that buyers and sellers, who are eager to transact have in mind all of the transactional tools available to help them get the deal through.

In this article we would like to focus on one of the major transactional tools, which is still underused in France compared to other jurisdictions, which is a Warranty and indemnity insurance, also called "W&I Insurance".

In a situation where, for the buyer, it is inconceivable to purchase the target without seller's representations and warranties while, for the seller, it is inconceivable to give such warranties because of the financial exposure it would entail, W&I insurance allows the parties to bridge this gap. It certainly does not work miracles, but it highly facilitates the negotiations between the parties and helps get the deal through.

The number of the W&I backed transactions has increased in France in the last couple of years due to the increased awareness of the advisors of the product and the increased number of competitive processes where W&I Insurance was initiated by the seller. Despite this increase, less than 20% of transactions are insured in France, which puts us far behind the UK, Germany, or Nordic countries.

What is W&I insurance

W&I Insurance is an insurance product that covers a loss resulting from the breach of the warranties given by the seller to the buyer under the Share Purchase Agreement (SPA). All or part of the seller's financial exposure is externalized to the insurer.

It is not a standard insurance contract, but a tailor-made policy which responds to the specific needs of each transaction and the provisions of the SPA.

Historically used in the transactions above 100M€, the W&I Insurance market has become much more competitive with the arrival of new insurers and the use of W&I has been broadened to much smaller transactions.

Originally W&I Insurance was a sell-side product but today, a large majority of W&I policies are taken by the buyers, although often introduced on the sell side. A buy-side W&I Insurance policy gives a buyer the possibility to claim directly against the insurer and protects the buyer in the event of seller's fraud.

A sell-side W&I Insurance policy covers the seller against claims made by the buyer. The buyer claims from the seller, who then claims from the insurer.

► ***Why W&I Insurance is a transactional tool for private equities?***

W&I Insurance is a transactional tool with a number of advantages for both the seller and the buyer.

On the sell side W&I Insurance gives a clean exit and allows for the immediate distribution of proceeds to the investors, which is particularly important for private equity sellers. Typically, in an insured deal, the seller gives representations and warranties under the SPA and externalizes its financial exposure towards the insurer by capping its liability to 1€.

Also, W&I Insurance allows the seller to increase the target's attractiveness and thus obtain a higher price in a situation where the seller, who is reluctant to give any representations and warranties finally provides them, to enable the buyer to insure the deal.

Last, but not least, no one will argue that of the most difficult elements to negotiate in a transaction, representations and warranties are at the top of the list: W&I Insurance simplifies and accelerates the negotiation process between the parties since in the SPA with no seller recourse the provisions relating to retention, de minimis and survival period of representations and warranties are not required. Thus, parties can focus on more commercial issues and can deal more expeditiously.

As regards the buyer, the advantages of the W&I Insurance are just as important.

First of all, on the buy-side it contributes to economic certainty since it allows the buyer to claim directly against the insurer without having to claim against the seller and without having to worry about the seller's solvency. For the equity buyers this is particularly important in deals with multiple sellers.

W&I Insurance is also a huge competitive tool in an auction bid process since it improves the bidder's offer and allows requesting warranties from the seller without jeopardizing bidder's situation in the process.

Finally, for a private equity buyer, W&I Insurance can be seen as an important "preservation of relationships tool" in the situation where the seller is a business relationship or remains in the target management post acquisition. Instead of claiming against the seller (including the management), the private equity buyer will be able to claim directly against the insurer.

► ***How to enhance cover under W&I Insurance ?***

In order to get the best possible cover, we would recommend that the parties anticipate W&I Insurance as early as possible in the M&A process. This is generally the case in an open bid process structured by an investment bank, this is less often the case in a bilateral processes, partly because of the ignorance of the existence of this tool (at least in the French market).

W&I Insurance only covers the unknown risks. Known risks must be identified by the buyer through due diligence work and disclosed by the seller in order to be taken into account for the calculation of the purchase price.

For timing and financial reasons, the insurer does not conduct its own due diligence works on the target. To assess the existence of the risk, the insurer relies on the due diligence conducted by the parties. Therefore, neither W&I Insurance replaces the need for the buyer to conduct due diligence works nor does it fill the gaps of due diligence. Areas which have not been included in the scope of due diligence works would generally be carved out from the coverage.

With only a few exceptions, the insurers would also expect that the buyer conducts due diligence works in all jurisdictions in which the target operates.

Therefore, when we are approached by clients early enough in the M&A process, we can give them guidance on the scope of work for each due diligence workflow and on the jurisdictions that need to be captured to achieve optimal coverage under W&I Insurance.

It is important to mention that insurers accept some due diligence works be done internally, but financial, legal and tax due diligence needs to be done by external advisors.

Another point not to overlook by the parties when preparing a process with W&I Insurance is the materiality thresholds used for due diligence works. Insurers expect the de minimis under the policy to be the same or higher than such materiality thresholds. Therefore, thresholds that are too high will have a negative impact on coverage.

► ***How much does it cost and who pays the premium?***

The amount of the premium mostly depends on the business sector of the target, its geographical exposure, the number of employees, the enterprise value, the limit to be insured and the complexity of the deal.

Contrary to what one might think, the quantity of the representations and warranties does not impact the price.

The cost of the premium has been driven down thanks to the competition. Depending on the factors above, the premium on deals governed by French law varies between 0.45% and 1% of the insured limit for pure real estate deals (because of lower claim probability) and between 0.8% and 2% of the insured limit for operational deals.

Depending on the insurer, minimum premiums start from 40,000€.

The premium is also subject to insurance premium taxes (IPT), which depend on the domicile of the insured. It is a one-time premium payable on closing.

Whether the buyer or seller pay the costs for the W&I Insurance is a negotiation point and often depends on the context of the transaction. However, in practice, we often see that even if the buyer agrees to bear 100% of the cost of the premium, such cost will often be taken into account for the calculation of the purchase price.

► ***How to deal with identified risks?***

As a matter of principle, identified risks or disclosed matters are excluded from cover under W&I Insurance.

Most insurers are willing to consider covering low risks with a small quantum through an affirmative cover in W&I Insurance in consideration of an additional premium.

How to deal with specific known risks for which neither party accepts financial exposure, and which cannot be covered through an affirmative cover under W&I Insurance? For such risks, which can often be dealbreakers, a contingent risk insurance policy could be a solution.

Unlike W&I Insurance, which covers unknown risks, contingent risk insurance provides cover for specific identified risks that can be subject to legal analysis.

Contingent risk insurance can cover various identified risks such as tax, environment, contractual provisions, litigation, building permit, title to shares or title to property. Insurers generally have appetite for low probability but high quantum risks.

When used on an M&A deal, contingent risk insurance can be put in place in parallel with W&I Insurance and replace the need for the seller to give specific warranties for the risk at hand secured through an escrow, thus unlocking funds in a cost-effective manner.

In the last two years we've seen an increased demand for contingent risk policies on the French market with a predominance of tax risks (both in an M&A context and on standalone basis) and building permit issues. In parallel, we have also been able to witness the premiums driven down by an increased number of insurers having appetite for identified risks.

► ***Conclusion***

W&I Insurance has a promising future in the French market whose development will continue to be driven by foreign private equity buyers and a better awareness of the product by all players of the M&A market. If the M&A process is well anticipated and properly prepared by the client and its M&A advisors, the insurance will provide the private equity players with significant advantages whether they are acting as sellers or buyers.