Reproduced from PLC Corporate with the permission of the publishers. For further information visit www.practicallaw.com or call 020 7202 1200.

Covering the risks

Warranty and indemnity insurance

Illustration: Getty Images

Alena Watchorn and **Richard Winborn** of **Willis Limited** consider the key features of warranty and indemnity insurance for buyers and sellers in private acquisitions.

When it comes to negotiating the warranties in a sale and purchase agreement (SPA) on a share or asset purchase, the parties' interests are not aligned:

- The buyer will want the warranties to be as broad and extensive as possible so it has the best chance of making a valid claim for recovery for a loss and sometimes it may even look for security through an ***escrow*** (*see Glossary*).
- The seller will try to limit the warranties as much as possible to reduce the chances and financial consequences of a claim and will not want any proceeds deferred or held in escrow.

The difference in these expectations can, and sometimes does, prevent transactions going ahead and can result in a buyer's bid being rejected. Warranty and

indemnity (W & I) insurance and other transaction insurance products are increasingly being used to bridge this gap.

This article looks at:

- W & I insurance policies available for sellers and buyers.
- Key features of policy coverage (including exclusions, amount of cover, excess, duration, premium and other costs).
- The process for arranging a W & I policy.
- W & I insurance providers.
- Frequently asked questions (including coverage under a tax deed, coverage where there is non-simultaneous exchange and completion, assignment of policies and bespoke transactional insurance products).

Warranties and indemnities

Warranties

The warranties in a sale and purchase agreement are assurances or representations from the seller (or ***warrantors*** (*see Glossary*)) as to the target company's condition and, in particular, any existing liabilities, at the time of completion. If a warranted fact turns out to be untrue, that constitutes a breach of contract which may give the buyer a remedy in damages. Warranties will cover all aspects of a target's business, for example, profits, assets, accounts, books and records, compliance and litigation, intellectual property rights, insurance, employees, pensions and real property. Warranties are expressed in specific terms and any qualification of or exception to the warranties is set out in the the wording of the warranty, and limitations or disclosure letter.

Indemnities

The purpose of an indemnity is to provide a secure compensation (subject to the seller's financial strength) for the buyer in circumstances where a breach of warranty does not necessarily give rise to a claim in damages, or to provide a specified remedy which might not otherwise be available at law. Unlike a claim for breach of warranty, there is no need for the buyer to establish that he has suffered loss which stemmed from the liability. Indemnities are commonly given against specific tax liabilities.

WHAT IS W&I INSURANCE?

W & I insurance is the generic name for insurance which provides cover for losses arising from a breach of warranty or in certain cases under an indemnity (*see box "Warranties and indemnities"*). The policy can be structured to indemnify either the ***warrantors*** (under a seller insurance policy), or the buyer (under a buyer insurance policy) depending on who is seeking the benefit of the policy (*see "Sellers' insurance" and "Buyers' insurance" below*). It is important to clarify the policy structure required because the correct policy structure can significantly enhance a party's objectives.

Like most insurance policies, careful consideration needs to be paid to the wording of the insurance contract, particularly the exclusions and conditions, to ensure there is no mismatch with the SPA. W & I insurance aims to offer as close as possible "back-to-back" cover with the warranty language in the SPA as well as liability under any tax indemnity for claims arising out of matters which have not been fairly disclosed or known to the insured (*see "Does the policy cover loss under a tax deed?" below*). The definition of loss under the policy should track the provisions in the SPA (and tax deed if applicable).

A standard W & I insurance policy does not provide protection for specific indemnities for known matters which a buyer has identified in the disclosure or its due diligence and for which the buyer seeks a separate indemnity not limited by disclosure or sellers' limitations. These can sometimes be insured either within the W & I policy or separately, if the insurers are provided with details and can get comfortable with the risk.

W & I insurance should not be considered a panacea for all risks and there is, of course, a cost associated with buying insurance (*see "Premium and costs" below*). The cost benefit should be viewed in the context of the overall deal itself and the advantages that it can bring to the seller and buyer alike. If structured properly, a W & I insurance policy can result in:

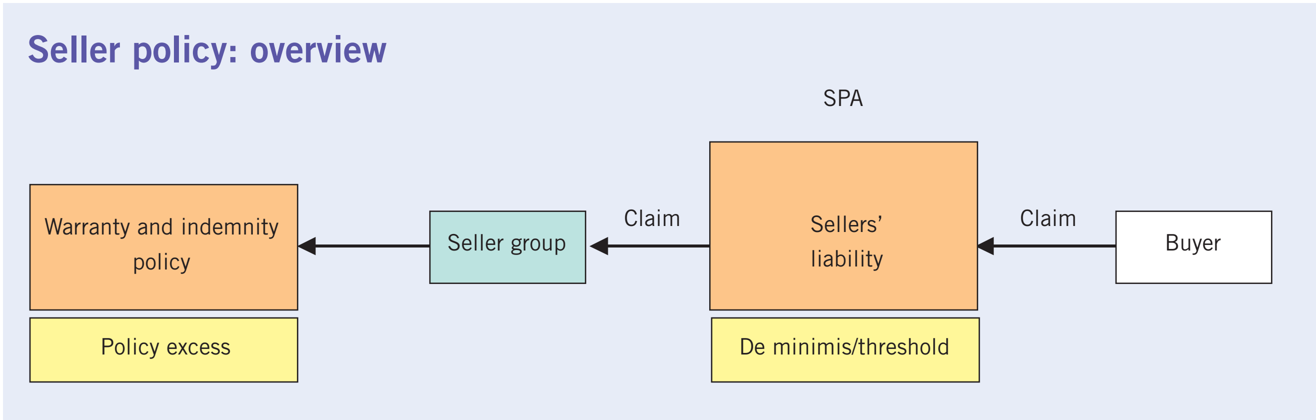
- The seller having immediate access to the sale proceeds, a reduced period of risk and, in many cases, no requirement to leave funds in escrow.
- The buyer having a satisfactory level of recourse (which may have otherwise been unavailable) through an insurance policy with financially rated insurers.

SELLERS' INSURANCE

A seller policy will indemnify the warrantors for any losses suffered as a result of the buyer bringing a valid claim against them for a breach of warranty or under a covered indemnity. The policy will also indemnify the warrantors for the defence and investigation costs incurred - this element of coverage should not be underestimated as these costs can be significant and can sometimes exceed any settlement or damages for warranty claims. Typically, the warrantors will negotiate their position with the buyer and provide thorough disclosure to limit their exposure to a claim, but may remain concerned about the potential financial risk of something coming out of the woodwork after completion.

A seller policy can be used where the warrantors are individuals, some of whom are leaving the business and are looking to use their proceeds or just want to protect their personal and/or families' position. Alternatively, the seller may be concerned that the residual liability may impinge on future plans or the seller may just be nervous of the proposed buyer's litigious nature. In these circumstances, while the warrantors will

Seller policy: overview



remain liable under the SPA for a warranty claim, a seller policy may offer some comfort to protect their position.

If the buyer makes a valid claim and the seller has a legal liability to indemnify the buyer for loss, the seller will then turn to the insurance policy for cover (*see box "Seller policy: overview"*).

If there is a claim, the warrantors cannot walk away and leave the claim to insurers, they will be required to co-operate with the insurers to benefit from the policy. In most claim cases there should be a close relationship between the insured and the insurer to consider the merits and strategy in handling the claim.

It is important that the SPA and policy coverage match so that any exclusions which result in gaps in the warrantor's protection are avoided. If the buyer makes a valid claim under the SPA but it is excluded by the policy, the seller remains liable to the buyer even though it will not be indemnified by the insurance policy.

In addition, other policy terms and conditions may be particularly important, such as:

Severability. Where there are a several warrantors, it is important that the knowledge of one warrantor does not impede the coverage for the other warrantors, particularly in relation to fraud or deliberate non-disclosure to the buyers or insurers.

Definition of knowledge. If the warrantor is a corporate entity, the policy should track the wording of the SPA and/or be limited to certain individuals' knowledge, particularly in relation to any warranty statement required by insurers on entering into the policy regarding the knowledge of any claims.

Claims co-operation and control. The policy should not impose on the warrantors a more onerous obligation of control over the management, defence and settlement of any claim than that negotiated in the SPA.

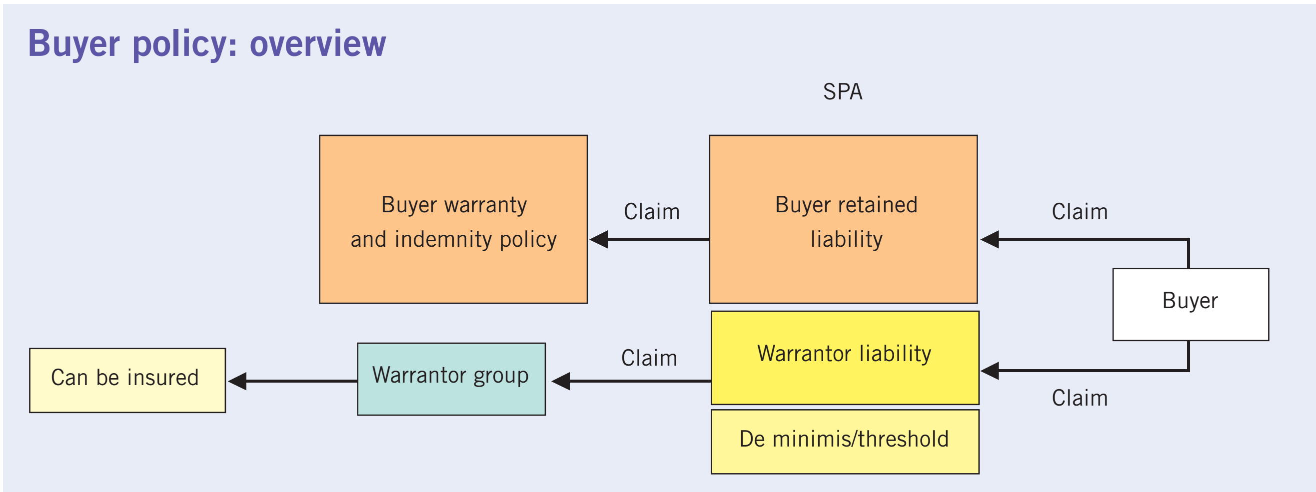
Excess. Insurers will typically want the sellers to bear the first portion of any warranty claim by way of an ***excess*** (*see "Excess" below*). This means that after the ***de minimis*** and ***threshold*** provisions in the SPA have been reached insurers will not typically cover the first amount of risk so that the warrantors will have to bear any excess before the policy responds.

BUYERS' INSURANCE

Buyers' insurance developed as a result of sellers either being unable or unwilling to provide the necessary level of warranty cover to the buyer (*see box "Buyer policy: overview"*). The buyer may be concerned about the seller's financial standing post-completion and whether it will have the resources one to two years after closing. Alternatively, the seller may seek to cap its exposure at a very low quantum so that it can make a clean "exit" with limited or no residual risk.

A buyer policy will indemnify the buyer for loss arising from a matter which

Buyer policy: overview



Buyer policy: sellers' limitation of liability

A buyer may take out an insurance policy where it cannot recover from the sellers because they have limited their liability in the sale and purchase agreement. For example:

- A group of selling shareholders consists of private equity funds, employee trusts and management (including the founder and his family). The founder is looking to retire and the private equity fund is looking to realise its investment through a sale and neither are willing to assume any liability to a buyer for general commercial warranties.
- The management are willing to provide warranties and conduct disclosure but only up to the level of their net proceeds which is less than 2% of the ***enterprise value*** (*see Glossary*) for twelve months.
- One of the bidders for the business has made an offer significantly more attractive than the others, but requires reasonably extensive warranties for a longer period and for a higher quantum (10%).

The buyer insurance policy can be structured to increase the level of the buyer's protection in excess of the management's warranty cap and extend the coverage to the levels the buyer requires. If the buyer suffers a loss, it may bring a claim against the management up to their warranty cap but would also, simultaneously, notify a claim against its insurance policy. If the claim is valid, the buyer would have recourse to the warrantors for the extent of their liability and also look to obtain settlement from the W & I insurer. However, if the W & I insurance does not respond due to its terms, conditions and exclusions, the buyer retains the loss having exhausted its recourse against the warrantors.

would be a breach of warranty (or a covered indemnity) but perhaps the buyer cannot recover from the warrantors because they have limited their liability in the SPA (*see box "Buyer policy: sellers' limitation of liability"*). It is therefore important to match the SPA and the policy coverage and identify any gaps before completion.

Other policy terms which are particularly important in considering buyer policies include:

Excess. This should erode at the same time as the warrantors' liability cap (*see "Excess" below"*). Traditionally, policy excesses are only eroded by matters insured under the policy, but this should be amended where a buyer policy is structured above the warrantors' liability cap so that it erodes for both covered or excluded matters and so sits seamlessly above the warrantors' cap in the SPA.

Control of claims. It is important to check that any policy provisions do not conflict with the position the buyer has negotiated in relation to claims control under the SPA.

Documents disclosed. The buyer will be deemed to have knowledge of those matters disclosed by the seller and/or those apparent as potential claims through its due diligence.

Knowledge of insured. Specific individuals of the corporate buyer involved in the process should be identified, particularly if the transaction is a ***secondary management buy-out*** or where the management are continuing in the business.

POLICY COVERAGE

Certain features are common to W & I insurance policy coverage for both sellers and buyers, including the following:

What is not covered?

In most current insurers' policies, each warranty will be specified in a table and a comment made if the insurers are unable or unwilling to provide cover for a part of or the entire warranty (or clause in a tax deed). This is an extremely helpful development in identifying the scope of coverage and any gaps which may then be negotiated through either further discussion or the provision of further information to insurers. However, most policies will also contain general exclusions which encompass the following:

Fraud and matters which the insured was aware of on inception of the policy. This exclusion can give insurers the opportunity to avoid claims and so should be carefully tailored to the knowledge provisions of the **SPA** and limited in scope.

Changes to underlying agreements without approval or consent of underwriters. Consideration needs to be given to any completion condition, waivers or alterations in relation to this exclusion.

Fines and penalties. This will impinge particularly on potential HM Revenue & Customs or environmental agency claims. As a matter of public policy, insurers feel that there is a moral duty not to provide cover for such fines and penalties, although this exclusion can sometimes be restricted to exclude criminal fines and penalties only.

Purchase price adjustments. These would normally be dealt with by completion account adjustments, instead of warranty claims.

Forward-looking warranties. This would affect, for example, coverage for a warranty relating to the ability to collect debts or accounts receivables after the date of the SPA.

Generally, when conducting their underwriting, insurers will look carefully at the scope of warranties which have been given in relation to:

- Accuracy of unaudited accounts.

- Funding of defined benefit schemes.
- Release of hazardous substances on sites.
- Environmental risks.

Each case will be considered on its own merits and coverage offered accordingly. In most cases, the more information the insurers can obtain on the various risk areas, the wider the coverage they can offer.

During due diligence on the acquisition, matters will be identified which will be managed through disclosure and so would not be covered by a standard W & I policy. However, the buyer will not be willing to accept certain identified contingent risks (such as ongoing litigation or a potential tax liability that could arise from a supposed tax efficient structure) and the buyer will seek specific protection through indemnities and/or escrows. If these contingent risks are identifiable and assessable in quantum and likelihood, insurance cover may be available either within the W & I insurance policy or, more typically, separately as a bespoke product dependent on the nature of the risk (*see "What other transactional products are available?" below*).

Amount insured

The limit of policy coverage will be dictated by the negotiations between the buyer and the seller, and their respective appetites for retention or transfer of risk. The minimum limit of insurance available is generally dictated by the minimum levels of premium, typically £15,000 to £25,000. As a result, if the limit of cover is less than £1 million, the premium level tends to be uneconomical.

A seller policy can insure up to the full limit of liability agreed in the SPA or a lesser amount (normally the first 10 to 30%) where the sellers are willing to bear the remainder of the risk, plus defence and investigation costs. It is worth bearing in mind that the seller's costs incurred in defending or investigating a claim which they recover under the insurance will diminish the limit available for potential damages.

With buyer policies, buyers can choose a level of cover which provides them with the appropriate level of comfort required. Often a buyer will look to obtain warranty protection through insurance from as low as 1% of the ***enterprise value*** of the transaction up to 30% of the enterprise value. If cover is required for the full consideration and there is sufficient ***capacity*** in the insurance market, there is no reason not to seek the full limit. Using the full global insurance market, current capacity is in excess of £200 million but this would involve creating a syndicated facility (not unlike a banking facility). In most of the London market, buyers seek an average limit of insurance of between £5 million and £10 million for deals up to £50 million, and £20 million (plus) for transactions in excess of this level.

Excess

Insurers typically require that the parties involved accept a certain portion of the risk, and this is often referred to as the "excess". In general, insurers will ask that parties bear at least 1% of the deal consideration at their own risk before the insurance policy attaches, although on smaller sell-side and larger buy-side transactions, policy excess levels of less than this have been negotiated. Typically, the policy excess operates after erosion of the minimum claims limitations negotiated under the SPA.

For example, a warrantor negotiates that the buyer cannot make a claim until each claim has exceeded £10,000 (the de minimis) and after each claim has exceeded that level, a claim cannot be brought until all claims have exceeded £100,000 (the threshold) and then the buyer can claim the whole amount, up to the warrantor's cap. The warrantor obtains W & I insurance for £1 million with a £100,000 policy excess. If the buyer has five claims for £25,000, they all satisfy the de minimis limitation and in aggregate exceed the £100,000 threshold. The buyer pursues its claim for £125,000 against the warrantor, who looks for recovery under its insurance. On the assumption that all the claims are insured, the warrantor would bear the first £100,000 and the insurer £25,000 (ignoring defence and investigation costs which will no doubt be incurred).

It is important to negotiate with insurers that the policy excess will be eroded by both uninsured and insured losses. This is particularly important for a buyer policy which has been structured to sit in excess of the warrantor's cap. For example, where a warrantor has negotiated a de minimis limitation of £10,000 and a maximum aggregate claim cap of £250,000 for all claims, the buyer may deem this insufficient and so takes out a buyer policy for a limit of £750,000 in excess of £250,000. However, the policy excludes liability arising out of a specific environmental indemnity. A £100,000 loss is recovered from the warrantor for the specific environmental indemnity and while the warrantor's aggregate cap has been reduced to £150,000, the policy still has a £250,000 excess as the insurance policy excess did not erode for excluded or uninsured matters.

Sometimes, a buyer policy may have an excess below the warrantor's cap and/or may drop down to a lower quantum after the expiry of the time limitations in the SPA, for example, after the time period given for the non-tax warranties (usually two years). It is extremely rare for insurers to provide a policy where there is no excess, although occasionally this has been offered (at a cost) where there is a need to ring-fence the entire liability, for example, in a voluntary liquidation where the receiver needs to provide for all risks.

Duration

The policy will generally reflect the duration of the warranties given in the SPA although, if the seller is successful in limiting the duration of the warranties, a buyer policy can be extended beyond the SPA time limits up to a maximum of six or seven years post-completion for tax warranties and typically up to two years post-completion for general warranties. This can be for either the whole schedule of warranties or specific areas where a buyer may seek a longer protection period (for example, environmental or tax). As most claims notifications appear to be made after the first audit (450

days from completion), most of the premium allocated falls within this period, and so there is relatively little cost associated with extending coverage (and also little premium benefit in seeking a reduced period).

A claim under the insurance policy must be notified within the policy period, although unlike some SPA limitations, there is no time limit on when proceedings must be commenced or the claim settled or withdrawn. Insurers generally rely on the SPA provisions in this regard and/or on general statutory time limitations.

PREMIUM AND COSTS

The premium is calculated as a percentage of the total limit of insurance. Depending on the specific risk factors relating to the transaction and assuming a typical limit to deal value ratio is required, the net premiums are currently between 1% to 2% of the insured limit for both a seller policy and a buyer policy. The premium is generally payable in full, for the entire period of the policy, when the policy is taken out or shortly thereafter.

In addition to the premium, UK insureds must pay insurance premium tax at 5% of the total premium. If the policy is underwritten in another jurisdiction, different rates are likely to apply and can be as much as 20% of the premium.

Other additional costs include the underwriters' due diligence fees and any brokers' fees (if the brokers are retained on a fee or commission basis). With the underwriters' due diligence review, insurers who have expressed a willingness to underwrite the risk will require the insured to enter into an expense agreement committing the insured to pay their due diligence fee (including fees incurred in engaging external advisers if appropriate), typically up to a pre-agreed cap. For most UK transactions, these due diligence fees often cost between £5,000 and £15,000 plus VAT. Depending on the insurer selected to underwrite the risk, these fees may be deducted from the premium when the policy is taken out.

Process for obtaining cover

The process for obtaining cover can be broken down into the following stages and timescales:

Stage 1: Broker's conceptual review (1 day). A broker can make an initial assessment and provide guidance with the benefit of a phone conversation. Typically, at this stage, there are limited or no documents, although if there are heads of agreement or a draft sale and purchase agreement (SPA) these can be provided to give a greater insight so that the broker can provide more specific guidance (in its opinion) on likely structure and pricing.

Stage 2: Submission to insurers (2 days). To obtain indications of interest and possible pricing from potential insurers, documents will be required including a draft SPA and information regarding the target and its operations, such as the latest set of audited accounts and/or the information memorandum (if one has been prepared). After receipt of this information, a broker will make a formal submission to potential insurers to obtain a non-binding indication.

Stage 3: Initial indication (1 day). Following a review of the information, the insurers will provide an indication of terms including premium cost and excess levels and the broker will compile these into a report and provide commentary and/or a recommendation on the preferred insurer considering various factors. Any indication is normally subject to the insurer's underwriting due diligence review and further information, which incurs a potential cost to the client.

Stage 4: Underwriting due diligence (3 to 5 days). This process normally has several phases which may run concurrently. They can be summarised as follows:

- Initial review of documents by underwriters and their advisers.
- Request for further information to be provided.
- Meetings or discussions with relevant members of the insured's deal team.
- Review of final documents.

Once this exercise has been completed, underwriters will usually be in a position to offer a quotation or formal terms of cover.

Stage 5: Completion and binding of cover (2 to 3 days). If the terms offered are acceptable, instructions will be given to conclude the placement. While a draft policy wording is likely to have been issued at stage 4, detailed negotiations will take place during stages 4 and 5 to finalise the wording of the policy and tailor it to the transaction.

Factors which can affect or determine the level of premium include:

- The level of excess or ***co-insurance***.
- Whether cover is required for specific indemnities.
- "First loss" scenario namely, the limit of liability compared to sale consideration.
- The language used in the warranties (for example, if warranties are limited by awareness, or if they are subject to materiality qualifications).
- The level of thresholds which must be exceeded for a buyer to make a claim.
- The law and jurisdiction of the SPA.
- The industry sector.

- The geographical location of the risk.
- The identity of the parties to the deal and their financial stability.
- The identity of the professional advisers to the parties to the deal. Where they are high calibre, the insurers will generally have greater comfort that a thorough due diligence exercise has been carried out and that, correspondingly, more liabilities will have been disclosed.

ARRANGING A POLICY

Before an insurer is prepared to "step into the shoes" of the warrantors, it will need to have a good appreciation of the transaction, the negotiation process of the warranties, appropriate disclosures and due diligence (*see box "Process for obtaining cover"*).

To reach the level of comfort required to offer a binding quotation, insurers will require:

- An opportunity to speak with the seller or buyer (as the case may be) and their advisers. The actual conversations are likely to be limited to no more than 30 minutes duration. The involvement of the legal and financial adviser teams may be greater depending on specifically identified issues.
- An explanation of the disclosure process which has been gone through on the sell-side.
- An appreciation of the buyer's due diligence process together with access to the due diligence reports for a buyer policy.
- A copy of the SPA and disclosure letter (and tax deed if separate) along with the various iterations as negotiations progress.
- On completion, a signed representation letter where the insured declares at inception of the policy that it is not aware of any claims (or circumstances) which may lead to a claim under the policy.

The underwriting process is typically an overview of the deal, the documents and if necessary, a review of specific issues. It should not replicate any due diligence or disclosure process undertaken and, if managed properly, it should not impinge on the seller's or buyer's resources. Within their M&A teams, most leading insurers and brokers employ corporate lawyers who are familiar with the negotiation process and timescales required.

However, it will be necessary to anticipate (and build into the timescales) that if there is a material change in the scope of the warranties, before confirming coverage, the insurers will need to review and understand the implications of that change and be kept abreast of developments. This can be seen as a hindrance to the deal completing but is necessary to ensure that the scope of policy cover matches that of the SPA. In most cases, the policy will be tailored to the transaction and this requires some discussion and negotiation over the policy wording. The time required negotiating and commenting on the policy should be built into the deal timetable. The parties to the deal should understand the point at which the insurance is put "on risk" (that is, it becomes effective) and how it operates.

W & I INSURANCE PROVIDERS

Most insurance placements in this specialist market are arranged through the specialist M&A departments of major insurance broking houses who have indepth experience and expertise in placing such cover. Brokers are engaged as insurance advisers to the potential insured and have a duty to act in their best interests in advising and placing the insurance policy. They assist in managing the process and documentation requirements and they should be able to provide valuable experience on an insurer's typical position on coverage, premium and terms. In general, brokers are either remunerated through a pre-agreed fee rate on an hourly basis, or through commission from insurers.

As the insurance market has matured and insurers gained experience, they have become more sophisticated and there are now variations in the capabilities and products offered globally by insurers. Insurers who are recognised lead insurers in the London markets include: AIG UK, ACE European Group (currently through facility arrangements with other underwriters), Ambridge (operating as an agent on behalf of certain Lloyds Underwriters and others), Allied World Assurance Company (AWAC), Chubb Insurance Company of Europe and Zurich. The US market also includes The Hartford and a number of other insurers, mainly underwriting US transactions.

FREQUENTLY ASKED QUESTIONS

The following issues are commonly raised in relation to W & I insurance:

Does the policy cover loss under a tax deed?

Most insurers' standard W & I policy wording will include coverage under the general tax indemnity in a tax deed but only for unknown and undisclosed matters. Depending on the nature of the sellers or target, insurers may look closely at specific tax areas such as secondary tax liabilities, Pay As You Earn (PAYE) exposure for consultants and transfer pricing. If there are specific tax indemnities relating to known contingent risks then these would typically be underwritten separately under a bespoke tax insurance policy (*see "What other transactional insurance products are available?" below*).

What happens when warranties are given at exchange and repeated at completion?

Typically in this scenario, the insurance policy is taken out at exchange and covers the warranties given at exchange, then when they are repeated at completion, coverage is extended to include those warranties given at completion. If a matter arises between exchange and completion which the sellers have disclosed to the buyer and/or it is a material change, the insurers will not normally provide cover. In such situations, they would expect the buyer to have negotiated the ability to rescind, or continue and accept the risk through disclosure or renegotiate the price. Sometimes, the

Glossary

Co-insurance. Where one insurer is in a direct contractual relationship with the insured for part of the same risk. Co-insurance can also mean self-insurance of some part of the risk by the insured.

Capacity. The maximum level of cover which can be bought from the insurance market at any one time.

De minimis. The specified minimum amount below which no individual claim for breach of warranty can be made.

Enterprise value. The market capitalisation of the target plus debt, minority interests and preferred shares, less total cash or cash equivalents. This is the theoretical takeover price.

Escrow. The process by which a third party holds documents, money or other property until certain pre-agreed conditions are satisfied.

Excess. Also known as retention or deductible. A fixed amount in the aggregate or per claim that the insured party agrees to pay in relation to each claim made under the insurance policy.

Loss payee. The party to whom the insured may require payments to be made. For example, where the seller is the insured party, the buyer can be named as the loss payee.

Secondary management buyout. Where the original private equity fund and the management team (who are the owners of the business) dispose of a group (including the old acquisition group and original target) to a team led by its existing management team with funding provided by a new private equity fund. In essence, a secondary management buyout is a buyout of a buyout.

Threshold. The aggregate monetary limit which must be exceeded before any claims can be brought.

Warrantor. A person who gives warranties in a sale and purchase agreement. Where the target company is a wholly-owned subsidiary, or where the transaction involves the transfer of business assets, the seller will normally be the warrantor.

reason that completion is delayed is simply due to regulatory approval reasons, in which case there may be a different approach to when the warranties are given. Insurers aim to fit around the deal dependent on how it is negotiated.

Are there any industries or jurisdictions where insurers are unable or unwilling to offer cover?

There are certain industries to which insurers may pay careful attention. These include industries where valuations may be based on a significant amount of goodwill, or where there is a high degree of regulation or litigation. These may include the pharmaceutical/biotechnology or financial services sectors but insurers' views are more heavily influenced by the target's individual risk factors, its reputation and historical financial and management performance.

In relation to jurisdictions of transactions, most underwriting skills and experience is focussed in London and New York. However, over the last five years insurers have expanded their appetite to underwrite transactions in Western Europe and Australia and are spreading their capabilities in Eastern Europe and Asia.

Insurers have recently written or considered risks in Poland, Czech Republic, Russia, Japan, India, Korea, Hong Kong and China and are looking closely at the Middle East and South Africa as potential future markets. In most cases, insurers' appetite for risks in new territories and the resulting growth is driven by transactions which have detailed and thorough due diligence processes and sale documents written in English.

Can the policy be assigned?

In general, W & I insurers will accept that the policy can be assigned within the insured's group of companies. This is important because if the insured has transferred the assets to another member of its group, it cannot prove loss for it to recover under the policy as the loss will be attributable to another group company. On leveraged acquisitions in particular, the financing banks or loan note holders may also seek to have their interest noted or the proceeds of the policy assigned to them.

If required, insurers will generally accept *loss payees* or the assignment of the proceeds to a third party with a financial interest, but as the policy coverage includes conditions in relation to the defence and settlement of claims on the insured, it is not often considered appropriate to assign the whole policy. A seller policy cannot be assigned to a buyer. Specific policies, such as environmental policies are often assigned and have multiple interested parties noted, as these tend to attach to the site and whoever could potentially suffer risk, so investors, financiers, property developers, landlords, tenants, buyers and sellers may all have a financial interest in the cover.

Do insurers offer policies where the sellers have no risk under the warranties or SPA?

In certain cases, sellers have sought to sell their interests with no exposure under the warranties and have instructed the buyer to rely on due diligence or a buyer insurance policy.

This would be the perfect scenario for a seller, but most buyers are naturally cynical that any warranties given where a warrantor has no risk would de-motivate the disclosure process. For this reason, while some insurers have offered structures based on this approach, in many cases they have been viewed with cynicism or have attached at such a high level or offered such limited cover, the parties have preferred a structure where the sellers are exposed to a small quantum of risk and can negotiate the warranties under the normal process.

In certain European transactions, insurers have, through the due diligence process, become so comfortable with the risk that they have agreed to this structure – often in secondary management buy-outs where the buyer has the additional comfort that the management has retained a significant level of interest in the business. The key factor in the insurer's willingness to provide insurance is that the principle of seeking warranties is to obtain disclosure, and the insurers

are keen not to undermine this position so that, if there is full due diligence and disclosure, they may be more willing to consider very low or no seller risk.

What claims experience has there been?

W & I insurance has been underwritten in the insurance market for over 25 years but it is really in the last five to ten years that it has become an established product used globally. Therefore, claims data is relatively new, particularly in certain territories and often shrouded in secrecy due to the sensitivities of such claims. Experience shows that most claims made under insurance policies have stemmed from third party claims or actions which neither party anticipated. The claims experience of the market shows that claims tend to occur either after the first audit or when there has been a significant change in management. Often, the first notification is made under the warranty relating to business since the accounts date or the management accounts warranties, but following investigation, more typically, will fall under the more specific areas of risk.

How do insurers handle claims?

Most warranty claims under SPAs, whether insured or otherwise, are settled out of court. In the majority of cases, the most significant proportion of the claim is the costs incurred by either party in investigating the claim. On the sell-side, insurers generally do not want to take over the conduct of handling a claim and the insured will engage their own advisers to investigate and/or defend the claim. Insurers will monitor the position as it develops and work with the insured to reach a settlement. On the buy-side however, insurers will require the buyer to specify the loss in detail and will review and consider its merits and deal with the insured's claim directly.

What other transactional insurance products are available?

Every deal has its own dynamics and during due diligence issues may arise which are contingent and the buyer or seller may look for risk solutions to allocate the risk. Bespoke products are frequently designed for these unique circumstances and issues which arise during transactions and due diligence. These often fall within the following areas:

Identified tax risks. During due diligence, the buyer's advisers may identify tax issues which the tax authorities could challenge. A seller may disagree, as during its tax planning and in general, it may have sought expert advice from professionals who consider the risk low. Typically, a buyer would seek an indemnity for such exposure but the seller may be unwilling to provide an indemnity or there may be no-one able to provide such security to the buyer. In these cases, insurers can offer "tax insurance" for these specific known contingent tax risks. Areas where insurers have offered solutions include tax liabilities arising from challenges in relation to de-grouping charges under section 179 of the Taxation of Chargeable Gains Act 1992, PAYE exposure arising from consultants and challenges to the target's domicile status.

Contingent or specific risks. Similar to tax issues identified in due diligence, there may be other one-off contingent exposures. While a buyer may seek an indemnity or escrow, these may not be available or capable of being provided. Specific policies can be arranged to provide protection for these issues. Insurers have considered and underwritten issues in relation to title of shares, product run-off exposures, historical planning issues, exposures under the Transfer of Undertakings (Protection of Employment) Regulations 2006 (*SI 2006/246*) alongside existing litigation risks. In most cases where insurance is considered, the risk is low in likelihood and high in quantum so even if the risk is small, the downside would potentially have a large impact on the target's value.

Environmental risks. Environmental insurance provides indemnity against liabilities arising from pollution or contamination from active or inactive industrial sites. Such liabilities may affect owners, developers, contractors or financiers and so environmental insurance can play a significant role not only in on-going business operations but also in any sale, purchase, maintenance or development of land. As the policies attach to specific site risks, cover can be arranged for one-off pre-identified sites which have some historical site exposure and to extend beyond and/or replace any warranties and indemnities under the SPA.

Alena Watchorn is an executive director and Richard Winborn is a project manager in the mergers & acquisitions practice at Willis Limited.

Related information

Links from www.practicallaw.com and the web
This article is at www.practicallaw.com/[to be inserted by PLC]

Topics

Acquisitions: private (shares)	www.practicallaw.com/1-103-1081
Acquisitions: private (assets)	www.practicallaw.com/ 5-103-1079
Insurance	www.practicallaw.com/2-103-1132
Legal risk management and compliance	www.practicallaw.com/8-103-1332

Practice notes

Warranties and indemnities: acquisitions	www.practicallaw.com/2-107-3754
Disclosure: acquisitions	www.practicallaw.com/5-107-4667

Previous articles

Warranty and indemnity insurance: Keeping a lid on risk	www.practicallaw.com/7-101-5064
Risk management and insurance: The in-house lawyer's perspective	www.practicallaw.com/4-101-7644

For subscription enquiries to PLC web materials please call +44 207 202 1200