

Synthetic W&I Insurance Concepts in M&A

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► 1. Introduction

The current M&A market in Germany is characterised by a strong seller's market in many segments, notwithstanding the COVID 19 pandemic, resulting not only in high purchase prices. Sellers are also taking advantage of the positive environment to (contractually) optimise their liability risk in the transaction.

The popularity and significance of warranty and indemnity (W&I) insurances in M&A deals have grown in recent years, particularly in the private equity sector. Due to the market environment, synthetic elements in W&I insurances, which enable the seller to reduce liabilities or even to implement a "nil recourse concept", are trending. In particular in distressed M&A transactions where the sellers and the management are willing or able to provide only a very limited liability, if any, there is a need for (fully) synthetic insurances. Whether insurers can meet these needs with suitable products, remains to be seen.

2. Traditional and Synthetic W&I Insurance Concepts

The traditional W&I insurance concept is based on the share purchase agreement (SPA) and the respective liability package embedded. The insurer relies on the buyer and the seller to negotiate the SPA, as if there is no W&I insurance covering potential damages and losses. Besides, as part of the underwriting process the insurer and the insured buyer (assuming a market standard buy-side policy) negotiate amendments and exclusions with regard to the insurance coverage. However, the underwriting process may not only result in limitation of the warranty scope for the buyer. W&I insurers also provide additional protection by "synthetically" extending coverage under the W&I policy beyond the wording of the SPA (for details with regard to so called "enhancements" please refer to Section 3).

Fully synthetic coverage is a gradually evolving alternative to the traditional W&I insurance concept described above.

In particular synthetic tax indemnities are already very common on the market. Provided such synthetic tax deeds (negotiated directly between the buyer and the insurer) are implemented, the SPA does not contain a tax indemnity. The buyer's protection is thereby structured on a deemed basis as if the tax indemnity was given by the seller, although the seller will have in this regard no liability under the SPA. In case of a claim, the buyer pursues it directly against the insurer with reference to the W&I policy only. In particular where the seller is unable (e.g. in distressed M&A transactions) or unwilling to provide a tax indemnity (e.g. private equity firms approaching a "clean exit"), a synthetic tax deed can ensure appropriate protection for the buyer.

Such purely synthetic concepts could also be a suitable tool when it comes to warranties under the SPA and thereby help to increase the number of successful deals. However, such concepts bear (massive) uncertainties for the insurers. Even if the insurers should be prepared to accept the risks accompanied, such synthetic warranties may result in wide coverage limitations and increased costs for the insured buyer (for details please refer to Section 4).

3. Synthetic Policy Enhancements

Synthetic elements in W&I insurance policies are no novelty to the market, but a proven tool for the parties to the SPA in order to bridge gaps between expectations on seller's and buyer's side in an M&A deal. W&I insurers are offering many different (individually tailored) enhancements through a range of "scrapes" and extensions (in exchange for additional premiums). A few typical examples are described in the following.

3.1 Knowledge Scrape

Sellers seek to limit their liability under the SPA through warranties being qualified on a subjective basis (awareness) rather than on an objective basis. Since awareness with regard to the respective breach is quite hard to prove in case of a dispute, a knowledge qualifier has

a massive impact on the quality of the warranty and can, from the buyer's point of view, devalue it. Knowledge scraping under the W&I insurance effectively removes the knowledge qualifiers from the SPA for purposes of the insured warranty. This allows the buyer to claim against the insurer under the policy on an unqualified (objective) basis, while the seller provides a qualified warranty only. Taking into account that knowledge qualifiers are often highly contested issues in the SPA negotiations, a knowledge scrape can fasten the process by adding further layers of comfort for both the seller and the buyer.

3.2 Materiality Scrape

Materiality qualifiers are a further option for the seller to reduce his liability under the SPA. The seller attempts to avoid "immaterial" breaches by limiting the scope of an individual warranty (e.g. compliance with law in all "material" aspects) or the scope of the respective disclosure (e.g. disclosure of all "material" agreements). In particular without precise definitions, such qualifiers may cause post-closing disputes as to what is and what is not "material". Besides, materiality is used to determine the losses resulting from a warranty breach, e.g. by including de minimis, baskets and further thresholds. The materiality qualifiers can affect the buyer's position materially, either by precluding a warranty breach in general or by preventing the enforcement due to thresholds. Materiality scraping offered by W&I insurers can effectively remove both the materiality qualifiers in individual warranties and the thresholds agreed in the SPA. This allows the buyer to agree to materiality qualifiers, while having the option to claim for respective losses against the insurer under the W&I policy.

3.3 Definition of Losses and Extension of Limitation Period

The definition of losses agreed to in the SPA can be very decisive in the post-M&A disputes, when determining whether the buyer has a claim against the seller. In particular the limitation to direct losses may significantly

reduce the buyer's chances of recovering damages. Therefore, a synthetic coverage of indirect losses and lost profits can significantly enhance the buyer's protection.

Limitation periods in the SPA ensure that the seller's liability under the SPA is limited in time. The duration of the limitation period also depends on the type of warranty. Fundamental warranties (including title) are commonly subject to longer limitation periods than operative warranties. W&I policies enable to effectively extend these limitation periods to the buyer's benefit. The seller reaches the envisaged limitations, while the buyer can seek prolonged protection under the W&I policy.

4. Fully Synthetic Warranties

Fully synthetic warranties may protect the buyer, where the seller and the management are unable or unwilling to offer warranties. In particular in case of a sale as part of formal insolvency proceedings, the insolvency practitioner usually does not offer warranties to the buyer. For such conditions, a fully synthetic concept may be an attractive option to both the buyer and the seller in order to get the deal across the line. Besides distressed M&A, such a fully synthetic W&I policy may also be suitable for a bidder, who wants to provide a competitive bid by avoiding the negotiations with the seller over warranties and thereby fastening the process. The experiences with fully synthetic tax indemnities show that such a shift in the levels of negotiations can speed up the SPA negotiations and thereby reduce transaction costs for legal advice on the seller's side.

So far, there is only very limited experience in the market with synthetic warranty insurances. However, the fact that the respective warranties are negotiated exclusively between the insurer and the insured buyer, causes uncertainties and risks for the insurer, in particular, since there is no disclosure process with the seller involved. It can be expected that these uncertainties may lead to higher premiums, de and retention amounts. The insurer needs to invest more time and capacity in order to understand the

business of the target. Given the absence of disclosure schedules, a comprehensive due diligence process (e.g. financial, legal, tax, including a Q&A process in order to substitute the disclosures and to enable a recourse of the insurer in case of fraud/intent) is very important for the insurer in order to assess the respective risks. However, such a comprehensive due diligence review is often not conducted in distressed M&A transactions for reasons of cost and time. This could lead to non-insurability of such transactions in many cases.

An alternative with comparable effects for the seller, but easier to insure, are management warranty deeds. Notably UK and US sellers are often not prepared to give operative warranties due to a lack of knowledge with regard to the company's business. Instead, the seller offers the management to provide operative warranties through management warranty deeds insured under a W&I policy. Although not included in the SPA, but in a separate agreement between the buyer and the management, technically this concept is not synthetic, since there are third parties providing warranties. However, from a seller's position, management warranties have the benefit of implementing a zero liability concept. And since there is a third party providing warranties (including liability e.g. in case of fraud) and respective disclosures, W&I insurers are rather prepared to insure such concepts. However, the seller has to convince the management to take the respective (limited) liability, which will require some form of incentive.

5. Summary

Over the past few years the W&I insurance market has professionalised and become more competitive. Insurers are offering a wide range of products, including various synthetic enhancements. As a result of the product diversity and the competition among insurers, the prices for W&I insurances have decreased and such policies are no longer exclusive to high-volume

transactions. Therefore, synthetic enhancements will remain an important tool to bridge gaps and facilitate transactions within the continuing seller's market.

Except for synthetic tax indemnities, the fully synthetic insurance concept is still quite new on the W&I insurance market. Particularly in distressed M&A transactions, fully synthetic policies could open the market to many new investors, which are otherwise unable to invest without any appropriate warranty protection. Besides distressed M&A, such concepts could generally fasten and facilitate M&A deals. But in order to get respective insurance protection, the M&A teams should involve W&I providers at an early stage in the transaction to enable them to dive deeper into the business, including participation in the due diligence and the Q&A process. However, synthetic warranties are far from being the market standard. It remains to be seen in the future whether and to what extent insurance companies will be willing to bear the associated risks and at what price. ■



Dr. Tim Kaufhold is a partner in M&A and private equity. His focus is on advising private equity investors on M&A transactions and corporate law. Furthermore, he advises management teams within the context of private equity transactions. Tim has been listed several times in relevant rankings for his expertise in the M&A and private equity sector. Clients appreciate his comprehensive economic understanding, as well as his pragmatic approach to finding solutions.

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