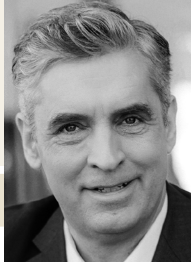

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Market Trends in Warranty & Indemnity Insurance and their Impact on M&A Contract Practice

Warranty and indemnity (W&I) insurance policies have been an integral part of M&A transaction practice for many years. In this context, risks of the target company that are the subject of warranties and indemnities of the sellers are covered by special transaction-related W&I insurance. The economic result is that the insurance company's liability fully or partially replaces the seller's own liability. However, from the buyer's point of view, the full exclusion of the seller's own liability is not unproblematic.

Today, W&I insurance is usually structured as a buyer's policy, i.e., the insurer undertakes vis-à-vis the buyer to vouch for the seller's warranties and indemnities under the sale and purchase agreement (SPA). It is therefore the responsibility of the buyer to take out the W&I insurance policy. However, within the context of the bidding process, the seller has usually already prepared the W&I insurance solution. An insurance broker commissioned by the seller (but usually paid for by the buyer when the insurance policy is concluded) obtains non-binding offers from insurers on the basis of the seller's model SPA and summarizes them in a non-binding indications (NBI) report, which is made available to the bidders in the data room.

Objective: Exclusion of the seller‘s own liability

The desired shielding of the seller's liability is achieved as follows: In the SPA, as in an uninsured company purchase, the seller provides warranties and indemnities vis-à-vis the buyer. However, the seller's liability is usually limited to a minimal cap (for the business warranties and usually also for the tax indemnity, but not for title defects and similar so-called fundamental warranties).

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As the number of competing insurers in the W&I insurance market has increased, the requirements for the sellers' own liability have decreased in recent years. Although the W&I insurance policies contain de minimis amounts in the relationship between the insurer and the buyer (usually currently around 0.1% of the transaction value) and deductibles (usually between 0.25% and 0.5% of the transaction value), the insurers (and in the current market environment also the buyers) no longer require the seller to be personally liable, so that the cap agreed in the SPA is usually EUR 1.00. Claims exceeding the cap can then only be asserted by the buyer against the insurer, not against the seller himself, so that the difference between the cap according to the SPA and the deductible under the W&I policy is thus borne by the buyer himself.

If an insurance company pays the injured party on account of damages caused by a third party, the insurer is in principle entitled to a statutory right of recourse (so-called subrogation) against the damaging party. In order to achieve the desired liability shield for the seller, it must therefore be ensured that the buyer agrees with the insurer on the exclusion of subrogation. A corresponding obligation of the buyer vis-à-vis the seller is part of the SPA; in practice, the exclusion of subrogation is unproblematic because it is already included in the standard terms and conditions of the W&I insurers.

From the buyer's point of view, the complete exclusion of the seller's own liability is not unproblematic, because the elimination of the liability risk may have a negative effect on the diligence of some sellers when giving warranties and compiling the disclosure exhibits to the SPA. However, the insurance solution is advantageous for the buyer in that he has (as a rule) a solvent debtor for his warranty and indemnity claims, and contentious negotiations on retentions of purchase price, bank guarantees and escrows can usually be avoided. In the current market environment, which can still be described as a "sellers' market", it has in any case become standard practice in bidding procedures for sellers to insist from the outset on full coverage of the transaction by W&I insurance to the exclusion of their own liability. Accordingly, insurance brokers are typically involved in the process from the outset (originally on the sell-side but the contracted relationship with the broker is subsequently being shifted to the buyer).

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Piercing of the liability shield in the case of intent

However, shielding the seller from any liability is not without loopholes. This is because the SPA's warranty catalog can neither effectively exclude nor effectively limit the seller's liability for intentionally incorrect information. Liability-limiting provisions of any kind (cap, reference to utilizing W&I insurance, shortening of the statutory limitation period, etc.) must always be provided in the SPA with an express exception for liability for intent, since otherwise there would be a risk that the liability-limiting provisions as a whole (i.e., also with regard to actions taken without intent) may be invalid. Similarly, the W&I policy cannot exclude subrogation for intentional or fraudulent acts on the part of the seller.

Despite the limitation of liability to intent, however, the seller and his advisors must be careful when formulating the representations and warranties: If the seller makes unfounded contentions without prior investigation of the facts, this can under certain circumstances be regarded by the courts as intentional action, i.e., in this respect neither liability under the SPA nor subrogation by the insurer can be effectively excluded. The risk of liability for intent for unfounded contentions can be reduced by expressly making guarantees in the SPA with the proviso of positive knowledge of the seller (with the express exclusion of duties to inquire); the corresponding clauses are referred to as knowledge qualifiers in Anglo-Saxon usage.

Naturally, warranties with knowledge qualifiers are of limited value for the buyer, because positive knowledge of the seller of the falsity of a warranty will often not be available or, in any case, cannot be proven in the event of a dispute. As of now, W&I insurers can also offer solutions for this in the context of a so-called enhancement agreement to the insurance policy: for many typical warranties (but not for all warranties), insurers can offer a so-called knowledge scrape, i.e., the warranty in question is insured as if it had been issued irrespective of knowledge, even if, in the SPA, it is only issued by sellers with knowledge qualifiers. Against this background, sellers are increasingly demanding in bidding procedures that warranties be restricted to positive knowledge, with the proviso that the buyer agree to a knowledge scrape with the insurer.

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The disadvantage of this is that knowledge scrapes lead to not inconsiderable increases in insurance premiums (in market practice up to 10%), because the knowledge-independent insurance of guarantees that the seller himself only issues on a knowledge-dependent basis naturally means a considerable additional risk for the insurer that is difficult to control.

Other enhancements

Controversial negotiation items in uninsured buy-out transactions include the definition of damages (in particular, the inclusion of indirect consequential damages and lost profits) and the statute of limitations. Given the limitation of the seller's own liability for guarantees on business operations (and usually also for tax indemnities) to a minimal cap, sellers are often willing to accept a broad definition of damages and generous limitation periods. After all, the economic relevance of these clauses is essentially limited to the so-called fundamental warranties (such as, e.g., the legal existence of the target company and unencumbered ownership of the shares sold), for which personal liability of up to 100% of the purchase price is usually agreed upon, as the policy limit is usually insufficient to fully cover these warranties. As a rule, the statutory scope of damages cannot be reduced for intentionally false warranties, nor can the statutory limitation periods be shortened.

Nevertheless, it has recently been observed that sellers sometimes specify narrow definitions of damages and very short limitation periods, as W&I insurers are now in a position to offer policy enhancements for this purpose as well. Here, the insurer is prepared to cover warranties even beyond the periods provided for in the SPA (until the expiry of a longer period agreed upon in the insurance policy) and also to pay for consequential damages and lost profits excluded in the SPA. However, these enhancements are also usually associated with considerable premium surcharges, so that the reasonableness of shortening the limitation periods and narrowing the definition of damages in the SPA must be weighed by the parties in each individual case. One of the key responsibilities of the insurance brokers is to check availability and pricing of enhancements.

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Dealing with identified risks, exclusion of liability and DD findings

Only a few years ago, W&I insurance solutions in M&A practice were associated with uncertainties and time delays, as the number of insurers was limited and insurers regularly insisted on an additional due diligence (DD) review (at least on selected topics) that took place after the buyer's DD review. In the meantime, the review on the insurance side is essentially limited to the insurer's legal advisors reviewing the DD reports of the buyer's advisors with regard to the risks identified therein. Insofar as specific risks, which are very likely to occur, are named in the DD reports, this usually leads to exclusions or limitations of liability in the insurance policy. This applies in particular to identified tax risks. In this respect, the insurer thus passes the ball back to the SPA contracting parties, so that they must either factor in the identified risk or cover it by means of an uninsured warranty or indemnification with the seller's own liability.

Insurance solutions are now also available on the market for identified risks, but on a case-by-case basis and after thorough risk assessment by the insurance company. Typical insurance premiums for covering known tax risks can, for example, be between 5% and 10% of the insured risk; however, if the probability of occurrence is classified as high in the tax DD report, a separate insurance policy is usually not available. Similar solutions are sometimes offered for risks arising from individual legal disputes, but at not inconsiderable cost (usually a low to medium double-digit percentage of the insured litigation risk). Other areas for which no coverage is available under standard W&I policies, but for which an extension of coverage can be negotiated in individual cases, are environmental and product liability in particular. Here, as in some cases with coverage for tax risks, it should be noted that the inclusion of foreign matters in certain jurisdictions can often be problematic. Leakage guarantees relating to cash outflows from the target company to the seller, as well as covenants of the seller between signing and closing are also not insurable; in this respect, the SPA usually provides for unlimited liability on the part of the seller.

As a general rule, W&I insurers only insure those risks that were the subject of the buyer's DD. The previously frequent practice of bidders to limit the scope of the DD for time or cost reasons and to rely exclusively on the warranties for

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the subject areas not covered thus only functions to a limited extent within the framework of a Warranty & Indemnity concept:

If the insurer finds the DD scope of review on individual topics to be too thin, or if areas are excluded from DD altogether, there is a risk that the policy will be restricted, with the result that the topics in question will either have to be factored in or covered by the seller's own liabilities. The same applies if the buyer agrees on materiality thresholds with its DD providers that are above the de minimis limit provided for in the policy.

The issue is also of practical relevance for the inclusion of smaller foreign subsidiaries in the legal and tax DD. Here, it must be clarified in advance with the insurers (i.e., the insurance broker must ask the insurers) to what extent risks of insignificant subsidiaries can also be insured without a DD check by local advisors. Recently, insurers have become more flexible in offering blind spot coverage for foreign subsidiaries with a small share of the group's total sales.

Price trends and separate supplemental insurance for fundamental warranties

Strong competition among insurers has led to a decline in insurance premiums over the years, which have currently stabilized at a favorable level. Typical insurance premiums are currently between 1% and 1.5% of the sum insured (policy limit), depending on the transaction volume. With a standard market policy limit of, for example, 30% of the transaction value (enterprise value), the premium is therefore between around 0.3% and 0.5% of the enterprise value. For smaller transactions, fixed minimum premiums apply in some cases. Various customary but separately remunerated enhancements trigger additional costs, which can be between 10% and 20% of the premium. In addition, there is a lump-sum reimbursement of the insurer's legal fees by the buyer (usually between 5% and 10% of the premium), which usually has to be paid even if the transaction does not materialize. In some cases, insurers also charge break-up fees to cover their own expenses if the transaction fails to materialize. A description of such surcharges is part of the NBI Report.

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Increasingly, insurers are offering separate supplemental insurance policies only for fundamental warranties up to the full purchase price (or sellers are requiring the buyer to take out such supplemental insurance). The costs of this can currently amount to up to 0.2% of the transaction value, so that if no legal defect risks are apparent, conclusion of such supplemental insurance is often waived for cost reasons.

Conclusion

In summary, in the current market environment, more than ever W&I insurance can be an inexpensive, highly standardized and quick solution that significantly shortens the previously customary lawyer negotiation battles on warranties and liabilities, minimizes the seller's risks and at the same time makes bank guarantees, escrows and security hold-backs superfluous, since the buyer has a (usually) financially strong debtor in the W&I insurer.

The strong competition among W&I providers has also led to creative solutions to many remaining problem areas. In some cases, however, these solutions are associated with higher costs (which can vary greatly depending on the insurer). Not only exclusions of liability by the insurer but also the individual enhancements offered for certain contract clauses differ considerably from insurer to insurer.

Therefore, more than ever, early involvement of an insurance broker by the seller and a detailed inquiry of the individual terms and conditions of different insurers based on concrete contract clauses from the seller's SPA draft is crucial for a successful W&I insurance solution.

The comprehensive preparation of the various non-binding offers of the insurers by the broker within the framework of an NBI report, which is made available to the prospective buyers in the data room, has therefore now become standard in bidding processes.

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Philipp von Braunschweig is a partner at Poellath (www.pplaw.com) and has specialized in buy-out transactions for private equity funds, entrepreneurs and investment companies for over 25 years. In the current JUVE Handbook, he is listed for the second successive year among the 28 "leading advisors" for private equity transactions in Germany. In addition to his legal practice, he is a practice lecturer and chairman of the executive board of the master's program in business law at the University of Münster.

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