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Will Pearce and John Bick

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Contributing editors

Will Pearce and John Bick

Davis Polk & Wardwell LLP

Publisher
Gideon Roberton
gideon.roberton@lbresearch.com

Subscriptions
Sophie Pallier
subscriptions@gettingthedealthrough.com

Senior business development managers
Alan Lee
alan.lee@gettingthedealthrough.com

Adam Sargent
adam.sargent@gettingthedealthrough.com

Dan White
dan.white@gettingthedealthrough.com

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87 Lancaster Road
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Fax: +44 20 7229 6910

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The use of W&I insurance in private M&A transactions

Lorraine Lloyd-Thomas

Marsh Ltd

Insurance capital has been used in various guises for more than 20 years as a means of facilitating transactions by transferring liabilities arising out of breaches of warranties and indemnities (W&I) away from the parties involved and to the insurance market. The ways in which it has been used have, however, changed substantially over the past few years.

For the purposes of this chapter, we will assume that the party giving the warranties is the seller and that the relevant warranties are contained in a single share sale and purchase agreement (SPA), rather than in, inter alia, an SPA, warranty deed and tax deed. We will also focus solely on W&I insurance, rather than also considering contingent or specific risk policies that are sometimes put in place in relation to a transaction. Finally, we will only refer to warranties, despite the fact that many policies will also cover any tax indemnity given.

Scope

Broadly speaking, the scope of a W&I insurance policy has remained the same, from the first seller-side policies written in the 1990s to the 'stapled' buyer-side policies that we see today: W&I policies are trigged by and respond to a breach of the warranties given by the seller in the SPA (breach) and exist to mitigate financial loss arising out of unknown or unforeseen breaches (ie, breaches caused by the seller's innocent misrepresentation or innocent non-disclosure).

There are, however, some key limitations to this scope:

- they are not designed to respond to known or identified breaches, nor to breaches (or potential breaches) that have been disclosed (although other insurance solutions may be available to provide comfort for such matters); and
- they are not intended to replace proper disclosure or due diligence exercised by the seller or buyer respectively. Insurers will always want to see the deal being transacted by all parties as if insurance were not being used in order to get comfortable with providing cover.

First policies

The earliest W&I policies were mostly used as a last-minute problem-solving tool to bridge a gap between the requirements of the buyer (in terms of how much recourse it needed for breaches) and the seller (in terms of how much liability it was willing to accept) when other paths of negotiation had failed.

Most of these policies were structured with the seller as the insured entity, indemnifying the seller for loss arising out of a successful claim against it by the buyer for a breach of warranty. Following discovery of the breach, the buyer would claim the full amount of the loss from the seller under the SPA; and the seller, as the insured party, would subsequently claim under the policy for reimbursement.

While this is the simplest structure from an insurance perspective, its primary drawback is that the seller has to accept a high contractual cap on liability in the SPA (equal to the amount of warranty recourse that the buyer is seeking), and therefore there is no 'clean' exit.

There were also other limitations at this early point in the development of the product:

- there was a very small number of insurers who could provide such cover and limited competition between them;
- policies were underwritten by directors and officers (D&O) insurance underwriters, who had a limited knowledge of how M&A deals were done: the underwriting process was viewed very much through an insurance (rather than a corporate law) lens;
- policies were 'off-the-shelf' and unwieldy, with many broad exclusions, and generally not subject to negotiation or tailored to the transaction; and
- due to the small market and its very specialised nature, policies were expensive (with rates on line between 3 and 5 per cent being normal for UK deals) and therefore uneconomical.

For these reasons, W&I insurance was often reached for only as a last resort when other options had been exhausted.

Buyer-side insurance

The market for W&I insurance started to move following the financial crisis in 2008 and 2009, driven primarily by private equity and other financial sponsors seeking a cleaner exit from their divestments by avoiding long-tail overhanging liabilities. Certain leading insurers responded to this desire by recruiting M&A lawyers from private practice so as to better understand the way that M&A deals were done and how insurance could dovetail more effectively with the process.

Although buyer-side W&I insurance had been previously considered by some insurers before this point, this was the point at which buyer-side structures become increasingly acceptable to and popular with both insurers and institutional sellers (which was the key to unlocking the potential of the product).

A buyer-side policy allows the seller to cap its warranty liability at a much lower level than would otherwise have been the case and provides the buyer with direct recourse for breaches of warranties, which is either additional to, or a replacement for, that which the seller contractually provides (ie, the loss that the buyer would otherwise have claimed against the seller is recovered instead from the insurer).

As an example, if in a £100 million exit where the buyer requires warranty recourse of £20 million a seller-side policy was used, the SPA would contain a £20 million cap on the seller's warranty liability, potentially surviving for seven years. In the event of a breach causing £15 million of loss, the buyer would claim that £15 million from the seller; the seller would pay £15 million to the buyer and then seek to reclaim its loss under the sell-side policy from the insurer.

However, if a buyer-side structure is used, the policy would allow the seller to cap its SPA liability at £1 million and provide £19 million of 'top-up' recourse to the buyer above the seller's contractual liability cap. When the buyer discovers the breach, it will choose whether to claim the first £1 million against the seller (which may or may not be an attractive option – see below) and claim £14 million of loss directly against the insurer.

The main advantages of this structure are, therefore, that:

- the seller obtains a 'clean' exit, setting a much lower limit on its warranty exposure than would otherwise have been acceptable to the buyer;
- the buyer obtains its desired level of recourse (from a third-party corporate entity with a secure financial rating); and
- the buyer has the convenience and comfort of being able to claim directly against the insurer (thus alleviating concerns over covenant strength and recoverability).

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Further benefits have arisen as insurers have become more sophisticated in their provision of such polices, including the following:

- each policy is bespoke, and will be negotiated and tailored to the particular requirements of the parties and the transaction;
- policies can be used to facilitate management giving warranties in a situation where a financial sponsor is willing only to accept liability for title and capacity warranties by reducing the level of liability the managers (who may not be in the equity) are required to accept. This principle is now being taken further, with insurers accepting £1 caps on warranty liability and policies that provide coverage on an absolute basis where the warranties are given in the SPA with a general knowledge qualifier;
- if management warrantors are retained post-completion, the buyer may recover loss from an insurer without proceeding against members of the rolling-over management team; and
- cover is provided to the buyer for breaches of warranties arising out of the seller's fraud (note that this is the only situation where insurers retain their subrogation rights against the seller: in all other circumstances, insurers waive their subrogation rights in order to ensure the seller's clean exit).

While there is a cost involved in using such insurance, this must be measured against the cost to the seller of having a significant amount of capital tied up in escrow or retention accounts, or provided for as a contingent liability in its accounts. Returning to the example above, £19 million of buyer-side cover would typically cost circa £200,000 to £300,000. However, from the seller's perspective, this allows £19 million of capital either to be returned to investors or reinvested (as opposed to having that cash tied up in a bank account generating income at today's low interest rates).

This move towards buyer-side structures represented a paradigm shift in how W&I insurance is used to facilitate deals. From initially being a blunt instrument that provided partial comfort to the seller and little benefit to the buyer, sophisticated and economically viable solutions are now available that address the concerns of both parties.

Trends

Since the financial crisis of 2008 and 2009, we have seen the use of W&I insurance grow significantly. The table below plots growth over the past five years in terms of placements made by Marsh globally.

	Limits of insurance placed (by Marsh) globally	Number of transaction risk policies placed (by Marsh) globally
2012	US$4,058 million	196
2013	US$5,117 million	251
2014	US$7,720 million	341
2015	US$11,223 million	450
2016	US$14,722 million	556

Percentage change of limits placed (by Marsh) 2012–2016	Percentage change of policies placed (by Marsh) 2012–2016
263	183
Prior year (2015–2016) percentage change	**Prior year (2015–2016) percentage change**
31	24

Within the context of that growth, we can identify three overarching (and interconnected) trends:

The rise of buyer-side insurance

The use of sell-side insurance has been declining steadily for a number of years, to the extent that 96 per cent of the policies that were placed by Marsh in Europe, the Middle East and Africa (EMEA) in 2016 were buyer-side polices. This has overwhelmingly been driven by the cleaner exit that buyer-side structures allow.

In the current market, seller-side solutions are generally only used when the deal was signed or closed before insurance was contemplated, or on the rare occasions when a buyer is not willing to use a buyer-side structure.

There are three additional factors running within this wider trend that we should highlight (and that reflect the 'seller's market' that we have seen for the past few years):

- More seller-initiated polices: almost two-thirds of the buyer-side policies that Marsh placed in EMEA in 2016 were initiated by the seller. The key advantage of this to the seller is that it has initial oversight of what information is presented to insurers and what parameters the insurance is requested on, and it can review insurers' coverage positions and pricing (this is important because most policies are paid for, either directly or indirectly, by the seller, either as a direct contribution to the premium or by the cost of insurance being factored into a bidder's offer price).
- More auctions: a seller will typically desire the cleanest possible exit from a transaction and can use W&I insurance to facilitate that result. A seller that goes to market proposing a minimal liability cap might receive some resistance from buyers; however, a seller proposing the same low cap but that facilitates the process for the buyer by offering a near-fully formed W&I insurance policy to the successful bidder in order to bridge the gap is likely to receive a much warmer reception. For this reason, many auction processes now consider the use of W&I insurance from the outset (and there are few instances where a buyer can use the product to steal a march on the competition).
- As auctions have become commonplace, brokers and insurers have become commensurately more sophisticated in dovetailing the insurance underwriting and placement processes with the auction process, to the extent that policies are now an integral part of (or 'stapled' to) many auctions. The seller will initiate the W&I process and take the selection and underwriting process as far as possible, before releasing the broker and insurer engagements to the successful bidder shortly before signing.
- A growing willingness of insurers to support nil seller recourse and £1 cap structures. There was a perception among insurers for many years that sellers needed to have 'skin in the game' to avoid moral hazard and ensure that proper disclosure and negotiation took place. Nil seller recourse structures were first accepted by a small number of insurers on real estate deals around 2012, but as insurers have become more comfortable and as demand has grown (particularly with more auctions and sellers in a very strong position in many deals), we have seen this become accepted by insurers for many deals and jurisdictions across the market.

Increased capacity and competition in the marketplace

The increased willingness of insurers to develop the use and sophistication of their policies has been driven not just by growth in demand but also by increased supply, as more insurers have come into this market and those existing insurers have grown their teams and increased their line sizes. By way of illustration, in 2013 there were less than 10 insurers capable of providing primary W&I insurance terms in the European market. At present, there are more than 20.

This growth in the market has predictably led to greatly increased competition among insurers. Boundaries are consistently being pushed, with the result being that coverage is now broader, very few sectors and jurisdictions are off limits, pricing has come down and attachment points have fallen.

Increased claims

Understandably, the greatest concern that many clients have with using W&I insurance is whether the policy will actually pay out if called upon. Given the small size of the market for many years, by virtue of the number of policies being written there were very few claims made. However, as the market has grown insurers now have demonstrable track records, and we are able to look to our own sizeable claims dataset to give clients (many of whom now have experience of making a claim) comfort on the point.

Current market parameters

At present, the market is dominated by buyer-side policies that are initiated by a seller and stapled to an auction process, generally based on a nil seller recourse structure (thereby obtaining the most benefit from using a policy). For instance, in 2016, 59 per cent of the UK deals that

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the Marsh EMEA team placed had nil seller recourse, and the average attachment point for UK deals placed by the team was 0.67 per cent of the enterprise value. The attachment point (sometimes referred to as the retention or excess) is the amount of loss that remains uninsured before the W&I policy will respond to a claim.

In terms of pricing of a W&I policy in the current market, below is a snapshot based on Marsh EMEA's book in 2015 and 2016, which highlights the effect of increasing competition in the market:

- Average EMEA (including UK) target rate on line: full year 2015, 1.54 per cent; and full year 2016, 1.39 per cent; and
- Average UK target rate on line: full year 2015, 1.37 per cent; and full year 2016, 1.28 per cent.

The term 'rate on line' is the premium cost expressed as a percentage of the policy limit. By way of an example, a GBP £100 million policy limit for a UK target transaction with a rate on line of 1.28 per cent would equate to a premium cost of £1,280,000.

The future

Where will this market be in 10 years' time?

We know that W&I insurance is still seen as a profitable line of business by insurers, so we expect the influx of new carriers and additional capacity to continue.

We are starting to see a split in the market between certain larger, more established insurers (who are able to provide a primary layer of insurance as part of a large programme on leveraged buyout deals) and other smaller insurers who are more expressly targeting small and mid-market deals. There have been discussions for many years about whether W&I insurance could be commoditised at the lower end of the market; we expect to see further efforts towards this aim.

This expansion in the market will continue to drive competition, so we expect to see further pressure to drive down attachment points and broaden coverage. Recent examples of this include one insurer agreeing to provide limited coverage for leakage; another is now sometimes willing to provide cover for 'new breaches' (ie, breaches that both occur and are discovered or disclosed in the interim period between signing and closing – this has been a feature of the Australian market for some time but is new to European deals).

As a means of enhancing coverage (and allied with a growing number of US-based clients purchasing UK assets), we are seeing more requests for US-style coverage. Broadly speaking, the position adopted by US insurers has traditionally been more insured-friendly than that taken by European insurers, reflecting the different M&A practices between the regions. The major benefits of US-style coverage are:

- more insured-friendly policy wordings;
- pay-outs on an indemnity (rather than damages) basis;
- fewer general exclusions;
- no general exclusion for matters disclosed in the buyer's diligence reports; and
- no warranty spreadsheet.

The corollary to this is that US policies are generally much more expensive (typical rates on line are between 2.5 and 3.5 per cent). A number of insurers can now offer pricing based on US-style cover for European deals (or a 'menu' of enhancements, whereby the insured can choose which of the above features are most important to it and pay an increased premium accordingly).

Finally, to attempt to foresee where genuine innovation may lie in the longer term, rather than providing cover for SPA warranties and limitations that are given and negotiated by the seller (despite the fact that it has no liability for them), it is possible to envisage policies that are negotiated entirely between the buyer and the insurer and that contain the full recourse package (ie, the full set of insured warranties and the limitations or exclusions that apply to them). These packages could be based upon a due diligence exercise commissioned by the insurer to support their coverage.

Conclusion

In the past 20 years, we have seen a great deal of change in the way that W&I policies are structured and underwritten and in the coverage that they offer. The market has changed enormously, and the flexibility and sophistication of the products today would be almost unrecognisable to one of the original D&O underwriters who first looked at these risks. W&I policies have gone from being an imperfect tool of last resort to now being an integral part of many deal toolkits, and a vital enabler for many of the auctions in today's marketplace to be structured as they are.

MARSH

Lorraine Lloyd-Thomas | **lorraine.lloyd-thomas@marsh.com**

Tower Place
EC3R 5BU
London
United Kingdom

Tel: +44 20 7357 1748
www.uk.marsh.com

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