A Practical Guide to Warranty & Indemnity Insurance

Transactional risk insurance, also known as warranty and indemnity (W&I) insurance, is a bespoke product developed by insurers to cover losses arising from breaches of warranties given by sellers in the context of mergers and acquisitions. Both buyers and sellers have come to recognise the benefits offered by the product, which include enabling sellers to have a clean exit, and protecting the relationship between buyers and sellers post-completion of the transaction by circumventing hostile legal disputes over warranty breaches.

Prior to 2012-3, W&I insurance was a foreign concept that few Asian investors were familiar with, and even averse to, given the perceived high cost. However, over time, private equity investors encountered the product in their overseas investments and began introducing it in their Asian transactions, prompting other market participants and their advisors to recognise that the product was something they needed to familiarise themselves with. In 2018, Marsh placed 73 deals across the region alone, representing a 22% increase over 2017.
Further, Marsh observed that premium rates across the Asian region hovered around 2% in the last 2 years with reductions in ASEAN and China, in large part due to increased competition amongst insurers - the number of insurers who have expressed interest in underwriting Asian risks has grown tremendously in recent times, putting downward pressure on pricing.

Some of the most common questions posed to Marsh are no longer the transactional risk “101” questions but rather relate to how to utilise W&I insurance and how the placement process works vis-à-vis active transaction timelines. Cheow Ai Ling and Gwendolyn Tan from Marsh’s Private Equity and M&A Services practice have worked together with Chan Sing Yee and Jason Chua, partners from WongPartnership LLP’s Corporate / Mergers & Acquisitions team, to share practical insights and tips on the implementation of W&I insurance from a broker’s and a transactional lawyer’s perspective.

**Strategising and Quote Solicitation**

1. What are your key considerations when contemplating whether to recommend W&I to a client in a transaction? (e.g. profile of client, potential bidders/deal participants, etc.)

WONGPARTNERSHIP LLP (WP):

M&A transactions are typically dynamic in nature and our starting point is to understand our client’s assessment on how post-transaction/”tail” liabilities (for which warranty claims is the most obvious category) should be dealt with. In general, we see W&I being favoured by private equity clients, more sophisticated strategic clients who are acquainted with the W&I process, and increasingly, sellers in auction process involving “high-quality” assets. In addition, we would typically introduce W&I for consideration when deal dynamics – for example, mismatched expectations on scope of warranties or limitations, or where sellers are staying behind as key management, etc. – call for it.

2. Typically, at the initial stages of a transaction where W&I is contemplated, do you engage with the client, lawyers, financial advisors, or other parties? Do you think it is important to engage with the lawyers early on?

MARSH:

It really depends – sophisticated clients tend to take charge of the insurance procurement process from the beginning and we engage with them primarily. On the other hand, for deals where the legal or financial advisors are the ones recommending the use of W&I, we typically interact more with the advisors and that continues throughout the procurement and placement process.

It definitely helps to have the client’s lawyers involved early on. In a seller-initiated process, Marsh can work with the seller’s lawyers to incorporate W&I-related provisions in the sale and purchase agreement (SPA), and we can also reach out to insurers to obtain their comments on the insurability of the seller’s draft warranties in the SPA. The lawyers can then take into account insurers’ comments before providing the draft SPA to potential buyers.

The first draft of the SPA tends to be more “balanced” and we expect to take less time in the negotiations of the representations and warranties and the seller’s limitations of liabilities.
3. When acting as sell-side lawyers, what is your view on informing bidders or potential buyers of the involvement of W&I insurance through a process note? Would you think more information is better than less, or less is more?

WP:
It is certainly useful to be upfront and set a seller’s expectation of W&I involvement. This is especially so if the W&I policy is intended to be a buy-side policy as that will have an impact on how a bidder approaches the auction process (in particular, on diligence and documentation). On the level of information required, a general note setting out such expectation and a note to get shortlisted bidders acquainted with the W&I process (if required) should suffice.

4. When acting as sell-side lawyers, would your approach towards the preparation of the SPA be different if W&I is involved?

WP:
Definitely – if W&I is involved, the SPA will be structured such that primary recourse is through claims under the W&I (and not the seller). In addition, the SPA will also need to be generally in line with the underwriters’ expectations on what the usual/market standards are to better manage bidders’ expectations on what is acceptable and to avoid extensive exclusions during the underwriting process. We will also walk through with clients on matters which are not typically covered by W&I to pre-empt significant deal-execution issues. The first draft of the SPA tends to be more “balanced” and we expect to take less time in the negotiations of the representations and warranties and the seller’s limitations of liabilities.

If W&I is not involved, the seller will be very focused on the scope of the representations and warranties and the limitations of liabilities as the seller is primarily liable for breach of such representations and warranties. The first draft of the SPA will then tend to be more seller friendly and we typically expect that the time required for negotiations of the SPA to be longer.

5. What do you think is the most important part of the process note for bidders?

MARSH:
For most bidders, it would be the cost of W&I insurance. Having clarity on the cost of insurance early on in the negotiation process enables bidders to take this into account in their approach to dealing with the cost.

Blind calls are especially useful when there are bidders who have not come across W&I before and/or are unfamiliar with the concept.
2. If you know the client is going to use W&I insurance, would your approach to due diligence and the preparation of due diligence reports be any different?

WP: Definitely – the overall buyer’s due diligence (i.e. commercial, legal, financial, and tax) would have to be coordinated to cover the usual scope/bases that an underwriter would expect to see to get comfort before incepting a W&I policy. As for the due diligence report, we find that the underwriting process favours succinct “red flag” reports. This is because the underwriting process typically runs in parallel to the main transaction and underwriters typically do not have the luxury of time to digest long reports containing summaries of documents in order to assess the OB markers. Succinct “red flag” reports highlight the key risks of the transaction which underwriters can assess quickly to form conclusions as to whether certain exclusions to the W&I coverage are necessary.

3. Would the client need to understand the typical/likely exclusions in the W&I policy when scoping due diligence? Would this affect the approach towards due diligence?

WP: Yes – generally, we would suggest that materiality thresholds for due diligence purposes dovetail the limitation thresholds typically acceptable to the underwriters, and for a buyer to conduct more extensive diligence into certain aspects of a target group depending on the sector concerned so as to be better prepared for the underwriting process.

M A R S H: It is key for clients to understand that insurers will only cover subject matters which have undergone due diligence, and that known issues identified in the course of due diligence are not covered by a general W&I policy. Insurers expect buyers to conduct customary due diligence which is market standard in terms of scope, for deals of a similar size and nature. If the scope of due diligence is reduced or carved back, insurers will not be able to provide coverage for those areas which have been excluded from the scope of review. For example, if a buyer chooses not to conduct any due diligence on stamp duty or goods and services tax, insurers would not be prepared to offer coverage for any stamp duty or goods and services tax liabilities.
Insurers expect buyers to conduct customary due diligence which is market standard in terms of scope, for deals of a similar size and nature.

Preparing answers to underwriting questions

1. We see varying roles of legal counsel during this stage of the deal. Some clients are reliant on their counsel, some clients are independent. What in your view is the ideal role of legal counsel when answering the underwriting questions? Do you think clients are reluctant to get counsel to assist due to cost considerations?

WP:
We would generally respond to the questions relating to the legal due diligence and coordinate with the client’s other advisers (e.g. financial and tax diligence etc.) in providing a consolidated response. Some clients are very well versed in the W&I process and require very little “handholding” from legal counsel. Others new to the W&I process may require a fair bit of guidance from legal counsel as to approach in answering underwriting questions. As a good legal counsel, we should tailor our role according to the needs of each client.

The additional costs for us to get involved in the W&I process is usually not significant when compared to the legal costs for the main transaction so costs will usually not be the determining factor when clients decide whether legal counsel should be involved in the W&I underwriting process.

2. How do you as the insurance broker work together with legal counsel, other advisors, and the client in preparing the responses to underwriting questions?

MARSH:
When the underwriting questions become available, Marsh sends these across to clients and their advisors to work on, together with a tip sheet on how to draft responses and address questions during the underwriting call. We place great emphasis on the quality of underwriting responses, and seek to optimise responses through the review of clients’ responses and the conduct of rehearsal calls ahead of the actual underwriting call.

It is important for clients to understand the insurer’s rationale for certain questions, and we take the time to explain how best to word or present the responses to achieve a positive outcome and what to expect as a result of the insurers’ line of questioning. Marsh will continue to help review subsequent revisions of the responses, until we are confident they are able to adequately address the points that the insurers will be looking out for.

3. Where counsels are involved, has their involvement always been beneficial? Have there been instances where their involvement could be improved, and in what way?

MARSH:
In most instances, having counsels involved in the underwriting process is beneficial as they can provide assistance in the drafting or wording of underwriting responses, in particular more legal due diligence-focused questions which can be rather technical.

Occasionally, we encounter legal counsels and other advisors who are reluctant to take into account Marsh’s advice during the rehearsal calls and refuse to revise their responses to the underwriting questions. This can have a detrimental impact on the client’s coverage position as the responses (as originally drafted) may not adequately address or explain away the insurer’s concern and may even heighten the insurer’s concerns on the subject matter. This is especially problematic where the client is one that defers to its advisors completely and does not take a stand on or take ownership over any such issues.

4. In a sale process where seller diligence reports are provided, can the buyer rely on such diligence reports when taking up W&I insurance?

WP:
Yes. However, there are inherent limitations to the seller’s diligence report (which are prepared on a single scope and does not take into account a specific buyer’s investment objectives). Therefore, we typically see underwriters requiring buyers to conduct top-up diligence to get comfort on the state of the target group. The seller’s diligence report and buyer’s top-up diligence will be used for W&I underwriting purposes.

MARSH:
Where vendor due diligence reports have been prepared, insurers can look at those reports during the underwriting process, but would still expect the buyer to conduct some additional due diligence of their own.

This includes extending the time period of review (as typically vendor due diligence is conducted several months before the deal is signed), expanding the scope of review to cover any areas not covered by the vendor due diligence which would customarily be covered by a buyer in due diligence looking at a similar target business, as well as a question and answer process between the buyer and seller regarding any issues identified in the vendor due diligence reports.
Policy Negotiations

1. Do you find that clients and/or their lawyers spend significant amounts of time marking up certain parts of the W&I policy? What are the sections which you view as most crucial and that clients should focus on?

MARSH:
In the past, when clients and their lawyers were less familiar with W&I, we found that they would mark up the main body of W&I policies relatively extensively, particularly with the input of insurance lawyers. However, as the product has become more mainstream and widely used, lawyers have come to realise that the main body of W&I policies is quite standardised across insurers and provisions relatively boilerplate. As a result, we find that mark-ups have reduced and are, in many instances, minimal.

The most crucial sections of a W&I policy are the list of exclusions in the main body of the policy and the warranty spreadsheet, which is a schedule to the policy setting out all of the warranties in the SPA and the insurer’s coverage position for each one. These sections define the parameters of coverage under the policy, and the client as well as their lawyers should take time to review these sections closely in tandem with SPA negotiations.

2. Are there any clauses in W&I policies which you think insurers can improve on, or exclusions that you wish could be removed?

WP:
The W&I policies are generally fine. However, most of them are drafted based on English and US laws and it would be helpful to bring them into greater alignment with concepts which are better suited in Singapore. For example, in some policies, the concepts of direct and indirect losses (as understood in the Singaporean law context) are conflated and may not necessarily work, as what is considered an indirect loss under Singaporean laws may be different from an indirect loss as understood under US laws and the carte blanche listing of the categories of indirect losses as understood under US laws then require negotiations with the underwriters to re-align with Singaporean laws.

We would also like to see certain market standard exclusions by underwriters further evolve to take into account the different risk assessments across different countries. For example, it is still usual for W&I policies to exclude liability for anti-corruption, money laundering, etc., across Asia, regardless of countries. This could be fine-tuned to reflect the different sentiments or realities on the ground as to the frequency of occurrences of such activities in the different countries.
The most crucial sections of a W&I policy are the list of exclusions in the main body of the policy and the warranty spreadsheet, which is a schedule to the policy setting out all of the warranties in the SPA and the insurer’s coverage position for each one.

**Claims**

1. What are the key steps to take when clients encounter a claim? What is Marsh’s involvement in the claims process?

**MARSH:**
Under W&I policies, the client / insured is required to submit a notification to the insurer within a specified period from the date of discovery of the breach of warranty/ies. Marsh’s claims advocacy team will work with the client on the claims process and advise the client on how to best present their position to the insurer.

The key step upon discovery of a breach of warranty/ies would be for clients to approach their legal advisors to prepare a notification of claim, which should include full particulars of the claim, quantification of the loss, parties involved, etc. In order to quantify losses arising from a claim, clients may also seek advice from forensic accountants and/or who can then work other external advisors, who then work together with the legal advisors to prepare the claim notification.

Once such notification has been prepared, Marsh’s claims advocates will assist the client to liaise with the insurer and follow up on any subsequent requests for information and insurer responses to the claim. With the client’s interests in mind, it is Marsh’s goal to achieve the best possible outcome for the client in a claims situation.

2. As a deal counsel, when a client comes to you on a potential claim, what are the key considerations when advising the client on whether to proceed? Would you (as deal counsel) be involved throughout the process?

**WP:**
Yes – we would be involved throughout the process. As a starting point, we will review and assess the strength of such claims (including a review of whether any facts required to establish a claim has previously been disclosed). If our assessment with the client is that there is merit to the claim, we will prepare a notification of claim for the client, which will include particulars of the claim, quantification of the loss, parties involved, etc. We may also be required to liaise with other advisers of the client such as forensic accountants (if their assistance is required, for example, in quantification of the losses arising from a claim) to prepare the claim notification. After submission of the notification of claim, we will generally assist clients in discussions/negotiations with the underwriters until full settlement of the claim.

3. Based on your experience, how do underwriters approach a claim notice and what is the process the underwriter will undertake in determining whether a claim should be approved?

**MARSH:**
Insurers’ claims teams take charge of any claims notified under W&I policies. However, due to the W&I underwriters’ heavy involvement during the deal and policy placement process, and because any potential breaches may arise quite some time after the transaction date, it is important for the W&I underwriters to be available once a claim is made to determine whether the claim fits within the intention of the policy.

As each W&I policy and claim notified is unique, it would be difficult for insurers to apply a “template” protocol to assess the validity of a claim. However, Marsh has developed the following general W&I claims checklist, which can be used to assist in the assessment of a claim:

- Which warranty (or warranties) does the potential breach relate to?
- Is the breach excluded under the W&I policy by general exclusions or the warranty spreadsheet in the policy?
- Have the policy conditions been satisfied?
- Has the amount of the potential claim crossed the de minimis threshold under the policy?
- Has the amount of the potential claim crossed the retention threshold under the policy?

The key step upon discovery of a breach of warranty/ies would be for clients to approach their legal advisors to prepare a notification of claim.
ABOUT MARSH’S PRIVATE EQUITY AND M&A SERVICES PRACTICE

Marsh’s Private Equity and M&A Services practice develops solutions that help create value for investors throughout the investment lifecycle. Clients include corporations, private equity firms, alternative asset managers, lenders, pension funds, infrastructure funds, and family office investors. Our global team of specialists, spanning every region, has deep expertise in all facets of M&A risk management.

ABOUT WONGPARTNERSHIP LLP

WongPartnership is a major provider of legal services in ASEAN, China and the Middle East. Headquartered in Singapore, we have lawyers and offices in Beijing, Shanghai and Yangon, as well as in Abu Dhabi, Dubai, Jakarta, Kuala Lumpur and Manila, through member firms of WPG, a regional law network. Offering a full suite of services, we have a twin focus on advisory/transactional work where we have been involved in landmark corporate transactions, as well as complex and high-profile litigation and arbitration matters. The collaborative nature of our practices ensures that clients receive the quality of service that is essential in today’s competitive and challenging environment.

DISCLAIMER

Marsh is one of the Marsh & McLennan Companies, together with Guy Carpenter, Mercer and Oliver Wyman. This document is not intended to be taken as advice regarding any individual situation and should not be relied upon as such. The information contained herein is based on sources we believe reliable, but we make no representation or warranty as to its accuracy. Marsh shall have no obligation to update this publication and shall have no liability to you or any other party arising out of this publication or any matter contained herein. Any statements concerning actuarial, tax, accounting or legal matters are based solely on our experience as insurance brokers and risk consultants and are not to be relied upon as actuarial, tax, accounting or legal advice, for which you should consult your own professional advisors. Any modeling, analytics, or projections are subject to inherent uncertainty, and the Marsh Analysis could be materially affected if any underlying assumptions, conditions, information, or factors are inaccurate or incomplete or should change. Marsh makes no representation or warranty concerning the application of policy wording or the financial condition or solvency of insurers or re-insurers. Marsh makes no assurances regarding the availability, cost, or terms of insurance coverage. Although Marsh may provide advice and recommendations, all decisions regarding the amount, type or terms of coverage are the sole responsibility of the insurance purchaser, who must decide on the specific coverage that is appropriate to its particular circumstances and financial position. Insurance coverage is subject to the terms, conditions, and exclusions of the applicable individual policies. Policy terms, conditions, limits, and exclusions (if any) are subject to individual underwriting review and are subject to change.

This article is for general information only and does not constitute legal advice. Please seek specific legal advice before acting on the contents set out herein.

Copyright © 2019 Marsh. All rights reserved. All rights reserved. www.marsh.com

PH18-1145