

Reporting Corporate Finance

Boost your M&A Deals with Warranties & Indemnities Insurance

One of the most important steps in the sales and purchase process is the risk allocation between the contracting parties, i.e. purchaser and vendor. M&A advisors offer a number of tools to support the parties in this process (e.g. design of contractual warranties & indemnities, purchase price mechanisms, risk transfer). Sometimes, however, the distinct assessment of identified or potential risks becomes a deal breaker between the parties. To match the needs of the M&A market with regard to risk allocation, the insurance industry provides innovative solutions. The warranties & indemnities insurance (W&I or warranty insurance) is a ground-breaking tool and has been widely used by the private equity industry in the past years not only in the U.S.A. and U.K., but also in Asia and increasingly on the European continent.¹⁹

Transaction Risks

The turmoil of the financial crisis increased the risk awareness of buyers and sellers alike. Even if the parties are already familiar with each other and have decided to engage in an M&A transaction, extensive use of due diligence will be considered. An increasing number of aspects come into play that used to be less important during the inspection of target companies, such as environmental issues or the target company's commitment to corporate governance or to codes of conduct.²⁰ The growth in cross-border transactions reinforced this development. In a nutshell, the "quick deal" definitely has become a thing of the past.

A number of financial, legal, economic, and also ecological risks are associated with each transaction. In addition to risks related to the negotiation, closing, and valuation of the acquired shares or assets, a number of risks can be identified with respect to enforcement, integration and business continuity after the sales and purchase agreement (hereinafter: "SPA") has been signed, completed and executed. The buyer obtains the necessary information for its purchasing decision²¹ primarily through the results and findings of the due diligence, but also through its knowledge of

the usual business practices within the industry of the target company.

The seller's and buyer's interest regarding the allocation of transaction risks are, generally, diametrically opposed, hence conflicting: from the buyer's point of view transaction risks should as far as possible be borne by the seller. Conversely, the seller wants to minimize its contingent liability after completion of the transaction.²² What at first may have appeared to be an ideal purchase from a strategic or financial point of view, upon a closer look often turns out to be a *Pandora's box* with known risks that carry both quantified and non-quantified costs, as well as unknown risks. Typical challenges are:

- Insufficient or inadequate agreement as to the extent of certain warranties and indemnities.
- Specific tax matters: current, future and past fiscal positions of the target including taxes payable following post-purchase restructuring.
- Environmental exposures: The assessment of known environmental exposures with (quantified or non-quantified) disposal and clean-up costs as well as potential (unknown) environmental and pollution risks.
- Pending litigation and other known contingent liabilities (e.g. in relation to employment, pension, product liability or intellectual property exposures).

Once the risks are identified and each party has evaluated their impact on the transaction value, the parties need to agree on the allocation of such risks between them. The risk allocation is mostly done by means of price adjustment mechanisms as well as through an array of structural and contractual instruments available in relation to a transaction.

At this point, the parties should consider a well-established approach to risk management (see figure 1). Between the two extreme positions "risk avoidance" and "self-financing of risks" there are other means, such as "risk reduction" or "risk transfer" to effectively deal with risks. Risks can be transferred to either of the parties involved in the transaction, or - usually at a lower cost - to a third party that eventually can deal with a specific risk more efficiently.

¹⁹ This contribution is an abridged English version of a series of two articles in German language that were published in the M&A Review, issue no. 3 (part I), respectively no. 4 (part II), 2012 (www.ma-review.de). The authors would like to thank Ms ANNETTE HAYM and Mrs CHLOE ORSON, ANV, Barcelona, for their useful advice and thorough proofreading.

²⁰ BINDER PETER M., Globaler und komplexer, Merger Special, Handelszeitung, No. 3, 2012, p. 65.

²¹ LEMANSKI WALD, Risk allocation - driving force behind the M&A process, Financier 2008 (www.financierworldwide.com).

²² SHERMAN ANDREW J., Mergers & acquisitions, from A to Z, 3rd ed., New York, 2010, p. 212.

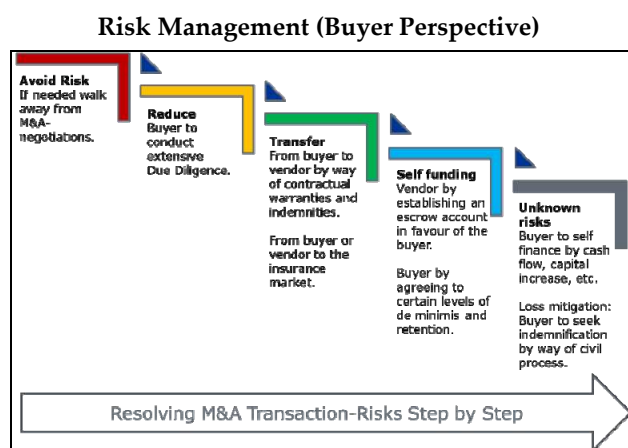


Figure 1: Risk Management (Buyer Perspective)

Source: Walker Risk Solution Ltd.

Risk Allocation by Price Adjustment

In most cases the purchase price is the key component of an offer. In an ideal situation the agreed price includes all transaction-related risks. Unquantifiable risks can be allocated by using a price adjustment mechanism in which part of the price is payable only after the fulfilment of certain conditions precedent, or after certain events. Contingent price adjustment is suited for business and financial risks. Another effective mechanism is the post-closing price adjustment. Thus financial issues can still be considered after the execution of the SPA.

In theory, price adjustment mechanisms therefore seem to be the ideal solution.²³ In practice, however, there are many factors which affect the viability of such tools. The purchase price for example is often communicated at an early stage of the negotiations, at times already in the memorandum of understanding (MoU). At such an early stage the information required to identify and assess the transaction risks may not yet have been made available by the seller or the latter may not even have been aware of which information is actually relevant. Also, many risks may not be known or sufficiently quantified at completion of the deal in order to effectively apply a price adjustment mechanism to it and even if they were, the seller is often unwilling to accept a later adjustment of the initially communicated sales price.

Risk Allocation

Besides price adjustment mechanisms, any M&A-advisor will consider further tools for the allocation of transaction risks and potential liability associated to such risks. Such tools are contractual warranties, as well as specific indemnities for contingent, identified risks. Warranties provide the purchaser with a remedy in case assurances or representations regarding the target company made by the vendor (or warrantor)

prove to be incorrect and the value of it is reduced.²⁴ Therefore, the purchaser would want the warranties to be as broad and extensive as possible. On the other hand, the vendor is interested in restricting contractual warranties and indemnities stipulated in the SPA as much as possible in order to limit his potential liability and receive all or a major portion of the sales proceeds promptly (reducing or avoiding the constitution and cost related to an escrow, or other suitable collateral).

During transaction negotiations, both the vendor and the purchaser must evaluate which risks can be minimized before closing (e.g. by carefully assessing the target company followed by adequate risk management measures) and how they intend dealing with remaining, known or identified liability risks. At the level of the SPA, this is mainly done by the assurance of warranties, as well as specific indemnities. From a time perspective, warranties and indemnities tend to incept when the SPA is signed, i.e. the deal is sealed²⁵, and are, as a general principle, repeated at completion of such agreement.²⁶ This may, however, not always be the case or may not apply to all warranties, in particular if there is a longer gap between signing and completion or regarding forward-looking statements, the parties may not agree on repeating all warranties at completion.

Result of Contractual Negotiations

Which warranties, indemnities, and covenants (conditions precedents) are finally included in the SPA depend on the negotiations between the parties. The results of such negotiations are not only influenced by the outcome of the due diligence (thorough assessment of the target company, in particular by the purchaser and its advisers) and of the respective positions of the parties, including their bargaining power and negotiating skills, but also, by the amount of concessions the purchaser is willing to make regarding the stipulation of certain warranties, indemnities, and covenants in exchange for a discount on the purchase price. At the end of sometimes cumbersome negotiations regarding the type, number, and nature of each relevant transaction risk that needs to be addressed in the SPA, the parties usually reach a detailed agreement including a balanced set of warranties, representations, indemnities, and covenants (assurances regarding the non-existence, respectively limited extent of potential liabilities).

²⁴ THOMSON ROBERT, *Sinclair on Warranties and Indemnities on Share and Asset Sales*, 8th ed., London, 2011, p. 2.

²⁵ KÄSTLE FLORIAN/OBERBRACHT DIRK, *Unternehmenskauf: Share Purchase Agreement*, 2nd ed., Beck'sche Musterverträge, vol. 49, Munich, 2010, p. 154.

²⁶ STILTON ANDREW, *Sale of Shares and Businesses, Law, Practice and Agreement*, 3rd ed., London, 2011, p. 198.

²³ LEMANSKI, op. cit., 1.

Customary Collateral

The possible liability arising from warranties and indemnities, and thus potential remedy for the purchaser, needs to be secured by collateral. Across the globe, the most customary and frequently used collateral to secure possible indemnification claims by the purchaser (or sometimes by a third party) seems to be the escrow account: a proportion of the purchase price that is equal to or a substantial fraction of the seller's cap is put into such an account for a specified period of time, generally a multi-year period matching the duration of the warranties and indemnities stipulated in the SPA.

If during that period any warranty is breached, or any claim under an indemnity successfully made, escrow funds can be turned over to the purchaser in order to compensate its financial loss. The escrow account is managed by a neutral person known as the escrow agent (often a lawyer, fiduciary, or the investment bank). The escrow agent is not allowed to follow any unilateral instructions by either the purchaser or the vendor. The escrow agent must deposit the funds (money, or negotiable instruments) in a bank account and is not authorized to pay out any amount until the agreed period has expired and the purchaser has not declared to have any warranty or indemnity claim, or until purchaser and vendor mutually agree on an earlier reimbursement, or until a final adjudication by the competent ordinary or arbitral court has been rendered. The expenses for an escrow account can be significant. They generally consist of a single transaction fee as well as of an annual escrow agent fee.²⁷

Further means of securitization include a holdback (retention) of a portion of the purchase price by the purchaser, a bank guarantee, or the freezing of a bank account held by the seller.²⁸ In addition, a vendor loan can also serve to secure a potential warranty or indemnity claim. The vendor's right of loan repayment would be set-off against the claim.

Problems with Traditional Risk Transfer

Even if a buyer-friendly SPA contains extensive warranties and indemnities that are, moreover, sufficiently collateralized by the seller, some uncertainties may persist:

- For the seller, contractual warranties can affect price certainty. Furthermore, the existence of (broad) warranties may reduce the IRR (internal

rate of return) for the investors that stand behind the seller (e.g. investment funds, private equity). It is finally not uncommon that the purchaser tries to reduce and respectively re-negotiate the purchase price post-closing by raising a warranty or indemnity claim.

- In the case of an investment fund being the vendor and looking for a "clean exit", contractual warranties may reduce or delay the distribution of sales proceeds to investors. The limited lifetime of a fund does not necessarily match the possible long duration of warranties and indemnities stipulated in the SPA. In addition, investment funds usually prefer not to give any representations or warranties in relation to the on-going and future business of the target company (so-called "business warranties").
- For the buyer, the counterparty risk grows proportionally to the rising number and increasing extent of the seller's commitments. In case of a loss the buyer must assert his warranty and indemnity claims against the seller. If the seller does not honour the buyer's claims, the buyer must enforce them before court. The buyer thus bears the risk of legal enforcement against the seller. Furthermore, he also bears the risk of insolvency of the seller.
- Asymmetry of the parties: depending on the bargaining power, it is almost always easier for either one of the parties to defend its specific interests during negotiations and to obtain a more favourable result regarding the warranties and indemnities that are going to be stipulated in the SPA. Generally, the same party that has a better bargaining power will have a better outlook to potentially enforce its position in court or out-of-court settlement negotiations.

Hence, there are practical limits to fully transfer transaction risks by traditional means.

A new, innovative tool to transfer transaction risks in relation to contractual warranties and indemnities is known in the UK as warranty and indemnity insurance (W&I) and in the US as representations and warranty insurance (R&W). W&I Insurance may be used as an alternative, a substitute, or as an addition to customary collateral. From a risk manager's perspective, risks that have a low probability but high severity are preferably transferred to the insurance market.²⁹

²⁷ MEYDING THOMAS/GRAU TOBIAS, Earn-out-Klauseln und Absicherung von Garantiesprüchen – „tickende Zeitbomben“ bei Distressed M&A?, NZG (Neue Zeitschrift für Gesellschaftsrecht) 2/2011, pp. 41-46, p. 44 et seq.

²⁸ In case the garnishment of an account is stipulated as collateral, the part of the sales price determined as holdback (retention) will have to be deposited on a separate bank account upon completion of the deal. Subsequently, the bank deposits on this separate account will be pledged as collateral for future warranty or indemnity claims of the buyer (MEYDING/GREY, op. cit., p. 44 et seq.).

²⁹ The M&A transaction poses a unique problem to both, seller and buyer, since the relatively low probability of a claim stands against the considerable severity of potential losses. Sellers are directly exposed to a range of escrow-

W&I Insurance

W&I Insurance - initially an insurance policy for the seller - was introduced roughly 20 years ago, originally sold by the London market and somewhat later also in New York for US clients. Only about five years ago specialized brokers started to proactively market W&I Insurance outside English-speaking Common Law jurisdictions, mainly in Continental Europe and in Asia. Today, W&I Insurance, as well as other transaction risk insurance products (e.g. tax opinion, contingent risk transfer, POSI³⁰, or EIL³¹) are more commonly known and used.

In particular the private equity industry has recognised W&I Insurance as a cost-effective tool that helps facilitate M&A transactions and often improves the results of deal negotiations. In this context it is certainly noteworthy that the European Venture Capital Association (EVCA) affirms that "the manager may also take out insurance that affects the fund's ability to give warranties and indemnities."³²

From a financial perspective, W&I Insurance is particularly effective, if the insurance premium is significantly lower than the purchase price discount requested by the buyer for the reduction of waiver or certain warranties and/or indemnities.

As supply follows demand, the competition amongst existing insurance carriers offering transaction risk insurance solutions grew and new entrants joined the market in recent years.³³ As a result, the average insurance premium strongly decreased, standard coverage improved, and underwriting proceedings have been streamlined. Notwithstanding such positive international development, W&I Insurance is not yet widely known or used in Switzerland.³⁴

Instead of securitizing possible warranty or indemnity claims by using customary collateral (as described above), a seller- or buyer-side W&I Insurance may be purchased (see Figure 2).³⁵ Such insurance protects the insured (the seller or the buyer) from liability (seller-side policy) or from loss (buyer-side policy) related to risks or value-reducing factors that were, generally speaking, unknown at signing and/or closing³⁶ of a

deal,³⁷ always provided that the vendor granted corresponding warranties or indemnities in the underlying SPA.

The scope of coverage of any W&I policy is negotiated individually between the insurer and the applicant, i.e. the vendor or purchaser seeking insurance protection. In most cases the applicant seeks coverage for all warranties stipulated in the underlying SPA, and, ideally, also for contingent risks (indemnities, indemnifications). Even if it may sometimes be difficult (or more expensive) to obtain from insurers, only a complete *back-to-back coverage*³⁸ creates the sort of parallel protection that may serve as a full alternative or a substitute to customary collateral.

Seller- and Buyer-side W&I Insurance

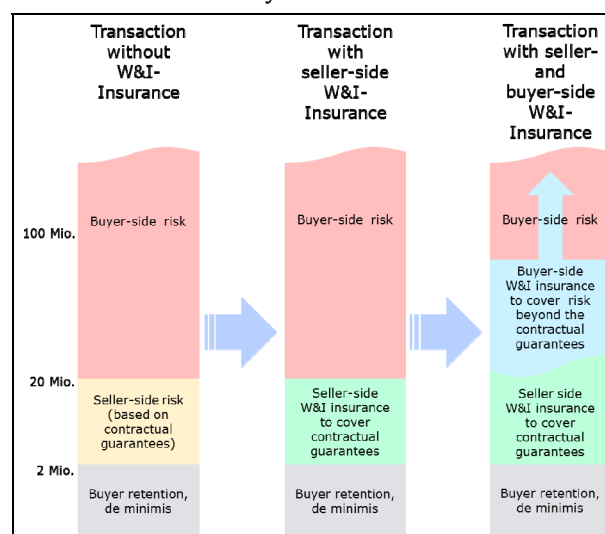


Figure 2: Seller- and Buyer-side W&I Insurance

Source: Walker Risk Solution Ltd.

Seller-side W&I Insurance

The seller-side W&I policy has to be qualified as a liability insurance, granting cover for sums that the insured is contractually or legally obligated to pay because of a warranty or indemnity claim by the buyer or any other third party entitled to claim under the applicable SPA. The "claims-made principle" is applied, whereas only claims made during the policy period (and duly reported before the end of such period) are covered.

Such liability insurance coverage is composed of two main aspects: First, the insurer pays loss on behalf of any insured arising from a claim first made against the insured during the policy period for any breach of warranty, or in certain cases under an indemnity (right to compensation). Second, the insurance generally also includes coverage for all reasonable and necessary

release 'triggers' and buyers may encounter issues with short indemnity periods or an indemnity cap resulting from a bidding war. Since the spread of exposures for any buyer or seller is limited to the number of transactions they undertake, it becomes far more economical to let the insurance market manage the risk.

³⁰ Public offering of securities liability insurance.

³¹ Environmental impairment liability insurance.

³² EVCA, The Professional Standards for Private Equity and Venture Capital, EVCA Handbook 2011, p. 28 (www.evca.eu).

³³ DEMIRBILEK NIKI, M&A Insurance, *GoingPublic*, No. 12, 2009, p. 64.

³⁴ DIEM HANS-JAKOB, Lenz & Staehelin, SECA evening event on 26 August 2010, on "Secondary Buy-Outs - Legal Aspects".

³⁵ Mannsdorfer Thomas M., W&I-Versicherung, *Versicherung von im Unternehmenskaufvertrag gewährten Zusicherungen und Garantien*, HAVE (Haftung und Versicherung), 3/2011, pp. 213-234.

³⁶ WATCHORN ALENA/WINBORN RICHARD, *Covering the risks, warranty and indemnity insurance*, PLC magazine, July 2008, pp. 43-51, p. 49.

³⁷ METZ FLORIAN, *Grundzüge der W&I-Insurance beim Unternehmenskauf*, NJW (Neue Juristische Wochenschrift) 63, 12/2010, pp. 813-815, p. 814; WALKER GREGORY, *Swiss M&A, Corporate INTL*, May 2011, pp. 34-40, p. 39; WATCHORN/WINBORN, op. cit., p. 44.

³⁸ WATCHORN/WINBORN, op. cit., p. 44.

costs related to the prevention, mitigation, investigation, defence, or settlement of any covered warranty or indemnity claim against the insured (right to legal defence).³⁹

A vendor (or warrantor) may in particular want to buy W&I Insurance for the following reasons:

- Cost-effective substitute of or addition to customary collateral.
- Full and immediate availability of sales proceeds.
- Financial investors and private equity companies are able to liquidate and close their funds right after completion of the transaction (clean exit).
- In an auction the seller can improve its offer by opting for an insurance solution (*dress up your bride*). A solvent insurance company can often grant a better security to interested bidders than the seller.
- Prevention of delays or break-down of negotiations between seller and buyer.⁴⁰

Buyer-side W&I Insurance

The buyer-side W&I Insurance is an insurance for first party loss, in which the purchaser (the first party) is paid by his insurer (the second party) for all loss arising from a breach of warranty, or in certain cases under an indemnity. The insurance benefit is thus intended to wholly or partly compensate the insured for its own financial loss, which occurs as a result of the insured event, i.e. a breach of warranty, or claim under an indemnity. Unlike the seller-side policy, generally, no final adjudication is needed under a buyer-side policy before loss suffered by the insured is compensated. It is enough that the purchaser proves loss arising from a breach of warranty, or under an indemnity. Depending on the scope of coverage of the insurance contract, the insured must claim first against the vendor (or warrantor), or he may instead directly demand compensation for the loss incurred from the insurer.⁴¹ This second, more client-friendly approach seems to prevail today. However, most insurance policies do stipulate subrogation and recourse rights of the insurer, in particular against the seller.

A purchaser may specifically want to buy W&I Insurance for the following reasons:

- Ability to directly claim for compensation of loss against the insurer, if such loss is arising from a breach of warranty or under an indemnity.
- Protection of the buyer's investments in the target company.
- Prevention of delays or break-down of negotiations between seller and buyer.⁴²

The latter applies in particular to situations in which claims against the vendor cannot be brought or if they are, only under certain conditions:

- The vendor is a fund or a company which is wound-down and liquidated after the transaction.
- There are doubts regarding the long-term solvency of the seller as a debtor or about the on-going existence of the seller as a legal entity.
- The seller is subject to insolvency proceedings or there are reasons that such insolvency proceedings are likely to start.
- The seller is a private individual, or consists of a majority of natural persons, which may belong to the same family (e.g. in the context of a sale of a family-owned company).
- The seller is owned by a multitude of shareholders with small individual participations that are not jointly and severally liable.
- The seller is a mere holding or shell company with its headquarters in a tax haven or jurisdiction where it may be difficult for the purchaser to have his potential rights asserted.
- In an auction the addition of W&I Insurance improves the offering of the bidder (*sugar your bid*).

An important difference between the seller- and buyer-side W&I Insurance is that the seller-side insurance does contain an intentional act exclusion (as is common for any third party liability insurance), whereas the buyer-side insurance generally does provide coverage for intentionally (and even fraudulently) wrongfully stipulated warranties or indemnities by the vendor.

Duration

The policy period is negotiated for each contract individually. A W&I Insurance contract is designed to be a multi-year stand-alone policy for risks arising from a single transaction that cover specific liability expo-

³⁹ THOMSON, op. cit., p. 390.

⁴⁰ SEGOVIA LORENA/MANNSDORFER THOMAS M., HCC Global Launch of New M&A Transaction Risk Insurance Team, Corporate INTL, November 2010, pp. 12-13, p. 13.

⁴¹ Hasselbach Kai/Reichel Georg, Die Gewährleistungsversicherung als Risikominimierungsmodell bei Private-Equity-Transaktionen und sonstigen Unternehmenskäufen, ZIP (Zeitschrift für Wirtschaftsrecht) 2005, pp. 377-384, p. 378.

⁴² Segovia/Mannsdorfer, op. cit., p. 13.

tures in relation to such a transaction. The duration of the policy should match (or sometimes to slightly exceed) the time limitations stipulated in the underlying SPA and will thus typically be 12, 18, 24, or 36 months, however, sometimes up to seven years.⁴³ Regardless of the stipulated policy period, the single premium is due at inception of the policy.

Sum Insured and Retention

The risks assumed by the insurer through risk transfer are always limited by a certain sum insured. The amount of the sum insured is individually negotiated for every W&I Insurance policy and often reflects the maximum liability amount stipulated in the SPA, the seller's cap.⁴⁴

The retention (sometimes also referred to as *excess* or *deductible*), a fixed amount that the insured has to bear, should - at least from the insurer's perspective - be commensurate to the overall risk transferred. From the perspective of the insured, it is often important that the threshold amount stipulated in the SPA is taken into account, and if possible mirrored, in the insurance policy. As a rule of thumb that amount should not be less than 1% of the sales price (i.e. the transaction value).⁴⁵ Some insurers will be offering cover for a lower retention or for a so-called tipping retention (US: disappearing basket), generally, against additional premium.⁴⁶

Exclusions

W&I policies are individually negotiated and tailor-made in order to best respond to the risks covered. This is particularly true in the case of exclusions of coverage. The subsequent catalogue of typical market exclusions⁴⁷ is therefore neither final nor exhaustive. Generally excluded from coverage are:

- Known facts and circumstances: facts and circumstances regarding an actual or potential breach of warranty, or claim under an indemnity, of which

one or more members of the deal team had (positive) knowledge at inception of the policy.⁴⁸

- Forward-looking statements: warranties or indemnities which relate to future performance or a future state of affairs.
- Failure to fund (pension underfunding): financial loss in relation to insufficient funding of pension funds or other employee benefit plans.
- Product liability: claims arising from defective products.
- Environmental liability: the actual liability for contaminated or polluted (production) sites.⁴⁹

As mentioned above, the insurance market for transaction risks provides other products, which might cover some of the above-mentioned, generally excluded risks. This is, for example, the case for contingent tax exposures, environmental risks, as well as for pending or threatening litigation. In the latter case, specific loss mitigation, litigation buyout and legal protection or expenses insurance solutions may be available.

Markets and Capacity

In the past few years there seems to be a noticeable boom for transaction risk insurance, in particular W&I Insurance.⁵⁰ In London ACE, Ambridge, AWAC, Beazley, Chartis, Chubb, HCC, Pembroke, and Zurich are - according to their own marketing information - present in this ever-growing niche market. Furthermore, the market launch is imminent for a new competitor, ANV.

In Continental Europe there are at least three carriers that are currently offering locally compliant solutions in local language. These insurers have specialized M&A underwriters and support staff on the ground. The capacity of each of these insurers is between €15 - €45 million per transaction and at least €100 million on a syndicated basis (or the amounts equivalent in Swiss Francs). Furthermore, there is a possibility to buy additional capacity from the London market (as described above). For large programs, it is possible to put

⁴³ The maximum period of seven years mirrors the applicable UK statute of limitations. In a few European jurisdictions or regarding certain exposures (e.g. environmental) policy periods of up to 10 years would be welcome by the market.

⁴⁴ STILTON, op. cit., p. 224.

⁴⁵ THOMPSON, op. cit., p. 391; WATCHORN/WINBORN, op. cit., p. 47.

⁴⁶ The distinction has to be made between a *normal retention*, *deductible* or *true basket*, on the one hand, and a *tipping retention*, *threshold* or *disappearing basket* on the other hand. In the latter case, once the threshold of claims is reached, damages are to be reimbursed beginning at the first euro, pound, franc, or dollar. In the former, only the damages above the threshold are reimbursable (MILLER EDWIN L. JR., *Mergers and Acquisitions, A Step-by-Step Legal and Practical Guide*, Hoboken, New Jersey, 2008, p. 235).

⁴⁷ BECKMANN ROLAND MICHAEL/MATUSCHE-BECKMANN ANNEMARIE (Hrsg.), *Versicherungsrechts-Handbuch*, 2nd ed., Munich, 2009, 39 N 155, p. 2396; GROSSMANN KLAUS/MÖNNICH ÜLRIKE, *Warranty & Indemnity Insurance, Die Versicherbarkeit von Garantierisiken aus Unternehmenskaufverträgen*, VW (Versicherungswirtschaft) 2003, pp. 652-654, p. 653; STILTON, op. cit., p. 223.

⁴⁸ The insured is generally requested to sign a no-claims declaration (NCD) in relation to a seller-side or a no-loss declaration (NLD) in relation to a buyer-side policy at inception. If the policy incepts at signing but there is a considerable time period between signing and completion, the insured may be asked to sign a second declaration at completion. In either case, with such declaration the insured is confirming in writing that he (in his own capacity and as a deal team member) does not have any actual knowledge of any breach of warranty, or claim neither under an indemnity nor of any circumstance that may lead to such a breach or claim.

⁴⁹ It has to be specified, however, that market-standard environmental warranties (e.g. regarding the validity of permissions, or the execution of regular inspections) are generally covered by a standard W&I product.

⁵⁰ WALKER GREGORY, *Unglückliche Kompromisse*, *Merger Special*, *Handelszeitung*, no. 3, 2012, p. 49.

together a layered structure (tower) with a total capacity of up to €400 million.⁵¹

Buyer beware: the Swiss domiciled buyer of a foreign insurance policy (i.e. a policy issued on paper of an insurer that is not admitted by the Swiss regulator FINMA) may need to know, that such policies are in violation of Swiss regulatory requirements. In any case, the Swiss Federal Act on Stamp Duties states that the Swiss domiciled insured is responsible for paying 5% IPT (insurance premium tax). Provided the foreign-based insurer is capable of having its policy issued in a compliant way, e.g. by its Swiss subsidiary or branch office, further issues need to be considered:

- Whether the ordinary⁵² or arbitral court shall have jurisdiction over possible litigation, the insured should insist on contractually stipulating a venue in Switzerland (e.g. Zurich, Geneva, Basle, or Zug).
- Swiss law should apply to the insurance contract and the interpretation thereof.
- While the policy may contain foreign, in particular U.K. terms and conditions, local (i.e. Swiss) legal terms should prevail over foreign terms and conditions in case of a contradiction. This may help to increase the clarity for a Swiss insured. Many foreign terms and conditions are not known in Swiss insurance law and offer room for interpretation.

Premium and Placement Costs

Thanks to increasing competition, the average premium has dropped significantly over the past few years and is now generally between 1 and 2% of the sum insured. In other words, for a transaction volume of, for example, €100 million and (at best) with a seller's cap of approximately €20 million, the premium may be fixed in a range between €200,000 and €400,000, plus the applicable insurance tax (e.g. Switzerland: 5%; Germany: 19%; Austria: 11%).

Factors which affect the level of premium include⁵³:

- Nature and level of SPA and policy retentions (deductible, *de minimis*).
- "First loss" scenario namely, the limit of liability compared to purchase price (transaction value).
- Definition of "loss" (in particular inclusion or exclusion of consequential damages).

- Policy duration.
- Share vs. asset deal.
- Whether or not cover is required for specific indemnities or contingencies.
- The language used in the warranties (e.g. if and to what extent warranties are qualified by awareness, or if they are subject to materiality).
- The law and venue of the SPA.
- The industry sector and the geographical location of the risk.
- The identity of the deal parties and their financial stability.
- The qualification of the professional advisers selected by the deal parties (e.g. for the conduct of the vendor and buyer due diligence). The insurers will generally take greater comfort in the performance of a thorough and professional external due diligence exercise and, likewise, the disclosure of more liabilities.

Taking into account the quite labour-intensive underwriting process, most providers will have an (internal) minimum premium that currently seems to float around €25,000. Such a minimum premium implies that the sum insured will generally not be below €1 million. It further implies that W&I Insurance for smaller deals with a transaction value inferior to about €7 million is - comparatively speaking - rather expensive.

Additional costs to consider include the underwriters' fees for external legal (and sometimes tax) review. Insurers who have expressed a willingness to underwrite the risk will generally (but not always)⁵⁴ require the insured to enter into an expense agreement, in which the insured commits itself to bear fees incurred by the insurance carrier in engaging external advisers. However, such external advisers typically work on a fixed or capped fee-basis.⁵⁵ Further, it has to be considered that the template expense agreements used by most carriers stipulate that the client will not be charged any external review cost in the case W&I Insurance is actually purchased.

Additionally, the prospective insured may consider compensating the broker on a fee basis (similar to a lawyer) and deducting the insurance commission of the offered premium (*net of brokerage*). Especially in the

⁵¹ €400 million as at the date of writing. Furthermore, additional excess capacity may be available from other insurers providing such capacity on a case-by-case basis, or via a facultative reinsurance solution.

⁵² In Zurich the Commercial Court (*Handelsgericht*) has, for instance, a perfect reputation to deal with corporate, M&A, as well as with insurance matters.

⁵³ WATCHORN/WINBORN, op. cit., p. 48

⁵⁴ Whether or not an insurer needs external advice depends on the complexity of the deal, the jurisdiction, the underwriter's own experience, the carrier's internal policy and the reinsurer's restrictions.

⁵⁵ WATCHORN/WINBORN, op. cit., p. 48.

case of large premium amounts, insurer's commission based on a percentage of premiums can be significant.

Use of an Insurance Broker

The procurement of W&I Insurance is mostly done by insurance brokers, who specialize in the field of transaction risk insurance and can thus provide in-depth experience and expertise to their clients concerning the placement of such insurance.

The broker advises the involved parties on the features and benefits and can explain the mechanics of suitable insurance solutions. If an insurance solution is considered, he advises on the selection of insurance markets and prepares the submission to insurers. He evaluates the offers on behalf of the prospective insured and provides professional advice with regards to the insurance program. Once the prospective insured has taken the placement decision, the broker ensures effective implementation and documentation of the insurance program. In the event of a claim, the broker assists and guides the insured in reporting the claim in a timely manner to the insurer.⁵⁶

Underwriting Process

In our experience the request for W&I Insurance often appears relatively late on the agenda of the negotiating parties, usually not before the end of the various due diligences. An initial insurance offer stating the expected premium and the standard terms & conditions will come in the form of a non-binding indication (NBI), and is usually available within two to three working days. However, until a binding offer is on the table, it can take up to fourteen days (depending on the insurance carrier, language and complexity of the deal and underlying legal questions). Generally, the underwriting of W&I Insurance can be separated into five different, consecutive steps:

1. Conceptual review by the broker (1 day): Following the signing of a confidentiality agreement, a broker can make an initial assessment and provide guidance to the applicant. Typically, at this stage, there are limited or no documents, although if heads of terms or a draft SPA are available, such documents can be provided to give a greater insight so that the broker can offer more specific guidance as to the programme's insurability and advise on the most adequate structure, as well as on the likely pricing.
2. Submission to insurers (1 day): Documents required to obtain a NBI from potential insurers include a draft SPA, information regarding the target and its operations, such as the latest set of audited accounts and/or the information memoran-

dum (if one has been prepared) as well as final or draft due diligence reports, to the extent available. After receipt of this information, a broker, looking at each deal on its merits, approaches the most appropriate insurance market(s) for a solution and will make a formal submission to potential insurers.

3. Receipt and evaluation of the NBIs (2 to 3 days): Following a review of the information, the interested insurers will provide a NBI including policy terms, approximate premium cost, and retention (excess) levels within 1 to 2 days. The broker will then compile the different NBIs into a report and provide an evaluation and/or a recommendation on the preferred insurer considering various factors like underwriting approach, service quality, accessibility of underwriting and claims personnel. The broker will collaborate with the client's transaction teams to discuss the options. Any indication is normally subject to the insurer's underwriting due diligence review.
4. Underwriting by the insurer (3 to 5 days): following the client's decision, the broker will engage the insurer of choice, to provide a binding quote. This process normally has several phases which may run concurrently, summarised as follows:
 - Detailed review of documents by underwriters and, as necessary, their external advisers.
 - Request for further information to be provided. It is critical that the client's submission of information to the insurer is coordinated throughout the process by the broker.
 - Meetings or discussions with relevant members of the prospective insured's deal team. If desired, specific comments on the warranties and indemnities (and their insurability) may be assessed and considered by the deal parties to improve the language of one of two selected clauses in the SPA.
 - 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. The customer (and potential insured) then receives a binding offer (quote, quote letter) that is valid for a certain period of time, sometimes up to 90 days before completion date and some days beyond.

5. Completion and binding of cover (2 to 3 days). If the terms offered are acceptable, instructions

⁵⁶ The role of the broker is described in more detail in the following section entitled "Underwriting Process".

will be given to conclude the placement. The broker will continue to work closely with the acquisition teams to update the offer and ensure its validity throughout the negotiation process. If covenants are drawn up between signing and completion, the insurance solution is again updated at the time of completion, ensuring seamless cover throughout the process. Finally, the policy is signed, stamped, and issued. The policy is generally issued at signing of the SPA, even if only an electronic copy may be available at this moment.⁵⁷

While a draft policy wording is likely to have been issued at stage 3, detailed negotiations will take place during stages 3 and 4 to finalise the wording and tailor it to the transaction. Together with the insurance broker, the lawyer advises its client on the legal characteristics of the insurance contract.⁵⁸

Timing

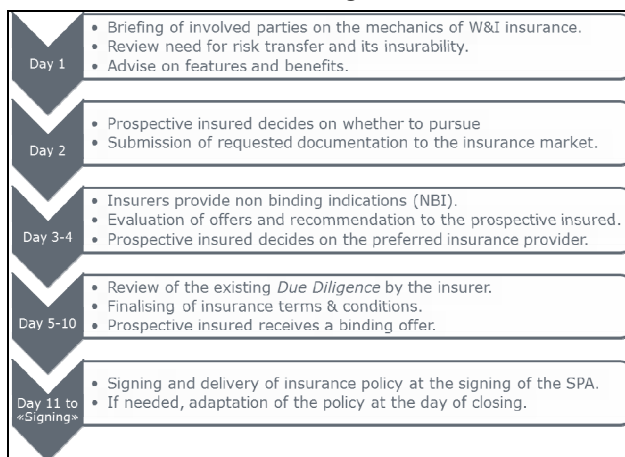


Figure 3: Timing

Source: Walker Risk Solution Ltd.

Special Considerations for the Bidding Process

In an auction several bidders are in competition for one target company. W&I Insurance helps the seller on the one hand to optimize the purchase price. On the other hand, W&I Insurance supports the buyer in its strategic positioning, to improve his offer versus the bids of his competitors by requiring a lower seller's cap. Especially in challenging auctions, W&I Insurance can serve to bridge contradicting positions of the seller and a certain bidder. W&I Insurance may thus help to enable transactions that would otherwise be unacceptable for the seller from a risk perspective.

Claims Handling

Experience shows that most claims are derived from third party liability claims that are directed against the target company or arise from circumstances that both parties have not anticipated. From a time perspective, warranty or indemnity claims are frequently raised once the first audit has taken place or after a change in the management of the target company has been effectuated. Particularly claims arising in relation to tax and environmental exposures can, however, also occur at a much later stage, even after several months or years. The main reasons for notifications resulting in non-payment under the policies are the amounts for which the retention is applicable, a settlement of the dispute by the parties, or the underlying warranty being excluded under the policy.⁵⁹

Summary and Conclusion

Corporate buyers often encounter difficulties due to the lack of enforceability of seller warranties and a low credit rating of the vendor, which cannot be compensated by a lower purchase price.

Transaction risk insurance offers special solutions for corporate transactions that provide a high strategic value and competitive advantages for the buyer and the seller. Using these cost-efficient insurance solutions, deal breakers can be overcome thus ultimately leading to a win-win-situation for all parties involved. In the current times of financial crisis and a volatile market environment, both parties' need for security has drastically increased. M&A insurance can be used strategically to gain a competitive edge in a transaction process.

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⁵⁷ The exchange of physical documents (policy and attachments) generally happens on the first business day after inception of the policy (e.g. by messenger, courier, or express mail).

⁵⁸ STEINKÜHLER STEFAN/SCHNICHOLS RENÉ, Warranty & Indemnity Insurance, Versicherungspraxis 6/2010.

⁵⁹ An analysis of non-US jurisdiction claims against W&I Insurance by one of the insurers from July 2000 to September 2010, found a rise in claims from below 5% in the first half of the last decade to around 13% last year. One reason for the increased claims frequency may be that a number of buyers had overpaid for assets before the crisis hit, so 2009 saw a number of buyers trying to offset the impact of underperforming business by making a claim under a W&I Insurance policy.