

Warranties & Indemnities Insurance (Market Update 2012)

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. 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. The warranties & indemnities insurance (W&I or warranty insurance) is an innovative 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.

Following an introductory note on (1) the concept and the application of the W&I-insurance, this paper provides (2) a market update on its use in Switzerland as of 2012, and illustrates (3) the benefits achieved by presenting recent case studies¹.

1. Concept and Field of Application

M&A advisors offer a number of tools to support the parties in process of allocating the risks to a transaction. 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. For the buyer, the counterparty risk grows proportionally to the rising number and increasing extent of the seller's commitments. Sometimes, the distinct assessment of identified or potential risks becomes a deal breaker between the parties².

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, also known as representations and warranty insurance in the U.S.) is such a tool to transfer risks related to contractual warranties and indemnities to the insurance market³. W&I-insurance may be used as an alternative, a substitute, or as an addition to customary collateral.

The European private equity industry has recognised W&I-insurance as a tool to optimize their M&A-deal negotiations⁴. From a financial perspective, W&I-insurance is particularly effective, if the insurance premium is lower than the purchase price discount requested by the buyer for not insisting on certain warranties and/or indemnities⁵.

2. Market Update 2012

In 2012, approximately 350 M&A transactions were recorded in the Swiss M&A-market⁶. For the same year an estimated number of six to eight W&I-insurance contracts were concluded for policyholders based in Switzerland⁷. On average every 3rd request for an insurance offer resulted in a bound policy. This confirms that W&I-insurance is still very selectively used in Switzerland⁸.

Insured limits ranged generally between 10% and 50% of the transaction value. The average insured limit of the reported policies amounted to CHF 12 million, the smallest CHF 1 million and the largest CHF 50 million.

The average premium amounted to CHF 350,000. For the warranties & indemnities-type of coverage the premium ranged between 0.8% and 2.5% of the insurance limit depending on the complexity and size of the transaction. In case of the buy-out of known exposures (i.e. tax issues, pending claims and other contingent liabilities), the premium amounted up to 8%-10% of the sum insured as reflected in two of the reported insurance transactions.

3. Case studies

Five case studies based on recent M&A-transactions that involved parties in Switzerland, Austria and Germany were selected to illustrate the application of M&A-insurance and its benefits to buyers and sellers.

¹ The author would like to thank the contributors of case studies relating to recent M&A-transactions that involved parties in Switzerland, Austria and Germany.

² WALKER GREGORY, Unglückliche Kompromisse, Merger Special, Handelszeitung, Nr. 3, 2012, p. 49.

³ DEMIRBILEK NIKI, M&A Insurance, GoingPublic, No. 12, 2009, p. 64.

⁴ EVCA, Professional Standards for the Private Equity and Venture Capital Industry, EVCA Handbook 2013, Section 3, Art. 3.5.3. (www.evca.eu).

⁵ For a detailed description of the concept of W&I-insurance and its application the author refers the interested reader to a series of two articles in German language, co-authored by Dr. Thomas Mannsdorfer, that were published in the M&A Review, issue no. 3 (part I), respectively no. 4 (part II), 2012 (ma-review.de) as well as to an abridged version in English language that appeared in the SECA Yearbook 2012, p. 46, (www.seca.ch).

⁶ KPMG, M&A Yearbook 2013 Edition.

⁷ The estimate is based on information provided by the insurers Allied World Assurance Company, HCC, and Pembroke and cross-checked by the author with other relevant insurers.

⁸ DIEM HANS-JAKOB, Lenz & Staehelin, SECA evening event on 26 August 2010, on «Secondary Buy-Outs - Legal Aspects».

3.1 Swiss Sellers of Manufacturing Company⁹

Business sector	Food processing equipment
Deal size	€50,000,000
Insurance limit	€20,000,000
Policyholder	Swiss sellers
Insurer	Pembroke Syndicate at Lloyd's

Table 1: Swiss Sellers of Manufacturing Company

The sellers in the transaction were two individuals (domiciled in Switzerland), who were selling their manufacturing company, based in Europe. The buyer was a Scandinavian trade buyer.

The sellers planned to distribute some of the sale proceeds to family trusts, soon after the sale. The sellers were concerned that, once they had transferred sale proceeds into their family trusts, they would not be able to meet any claims under the Share Purchase Agreement (SPA). The sellers were also attracted to the defence costs cover provided by a sellers' W&I-insurance policy.

The insurer provided the sellers to transaction with €20m of insurance to protect a significant portion of their acquisition. The W&I-insurance facilitated the transaction and provided both the seller and the buyer with key benefits:

Benefits to the buyer – by taking out insurance, the sellers were willing to give the €20m of warranties & indemnities demanded by the buyer.

Benefits to the sellers – the sellers' insurance policy protected the sellers up to the full amount of warranties & indemnities. The policy included defence costs cover to protect the two sellers (who planned to retire). This meant that the two sellers felt comfortable distributing a significant portion of the sale proceeds into family trusts.

3.2 Secondary Transaction¹⁰

Business sector	Healthcare products
Deal size	€200,000,000
Insurance limit	€20,000,000
Policyholder	German PE firm, buyer
Insurer	Allied World Assurance Company

Table 2: Secondary Transaction

The insurer deployed W&I-insurance capital to facilitate an international secondary deal.

The target company sold is a leading global manufacturer of specialized healthcare products with production facilities in Europe, the United States and Mexico, and its products are sold in over 90 countries. The target has over 1,500 employees and annual revenues in excess of €250 million.

The target was formed in the 1980's and the exiting private equity (PE) seller was invested in the target early 2000. As the new investor (buyer) is a large German PE firm, this was a secondary PE deal

The value of the transaction was of approximately €200 million. A buyer-side W&I-insurance was placed with a policy attachment point of €2 million (i.e. 1% of transaction value) and a policy limit of €20 million. The insurer provided cover for the warranty clauses.

Key driver for the use of W&I-insurance was that the target being divested was the last investment in the fund to be sold and so the seller could not give any contractual liability beyond the €2 million cap set out in the SPA. The target's management was rolling over with the deal. The PE buyer required additional contractual recourse and so W&I-insurance was used to provide this cover.

Other macro-economic drivers:

- Auction process in a competitive environment, reflective of uptick in M&A activity in Q4 2012.
- SPA contained leakage provisions, reflective of strong competitive process as locked box-structures were less popular in 2012.

⁹ Source: Robert Brown, Director, Mergers & Acquisitions Insurance, Ironshore International / Pembroke Syndicate at Lloyd's, London, (www.pembrokeunderwriting.com)

¹⁰ Source: Tim Martin, Senior Vice President, Allied World Assurance Company (Europe) Limited, London, (www.awac.com)

- Continued strong focus by buyer on the due diligence – i.e. global review including legal, financial, tax and commercial due diligence.
- Alongside concentrated due diligence process there was a heavy focus on the negotiation of the warranty package – the due diligence and warranty package as a joint work-stream.

3.3 Private Equity Portfolio Company¹¹

Business sector	Private equity portfolio company, co-owned 15% by its management
Deal size	€25,000,000
Insurance limit	€8,750,000
Policyholder	Buyer
Insurer	HCC Global Financial Products

Table 3: Private Equity Portfolio Company

A target company, valued at €25 million, owned by a PE funds and managers was to be divested. The fund, which held the target, was to be closed in the coming months.

The PE fund did not want to give any warranties, managers agreed to give warranties up to their share percentage with the target company (15%).

Following an auction process the best offer required a limit of warranties up to 50% of the purchase price. The seller proposed to the buyer to take out a W&I-insurance policy. The insurer would indemnify in case of a breach of representations and warranties on a “quota-share basis” with management (additional limit up to 35% of the purchase price).

Benefits to the seller - The policy matched the deductible provided under the SPA (i.e. €250,000). The policy was structured on a non-recourse basis against the seller. There was no price adjustment linked to the limit of warranty. The seller did not retain any liability following completion and was able to close the fund and distribute the proceeds accordingly.

Benefits to the buyer - The buyer was satisfied by the insurer’s financial rating and did not require anymore an escrow account.

3.4 Acquisition of German Automotive Company¹²

Business sector	Automotive components
Deal size	€370,000,000
Insurance limit	€30,000,000
Policyholder	German trade buyer
Insurer	Pembroke Syndicate at Lloyd's

Table 4: Acquisition of German Automotive Company

The buyer in the transaction was a German incorporated trade buyer, which was acquiring a specialist automotive component manufacturing company. The target business had significant operations in several countries throughout Europe and in China. The seller was a major private equity fund. The transaction took place in the Germany.

The seller planned to distribute some of the sale proceeds to its private equity shareholder, soon after the sale. The buyer was concerned that it was unlikely to be able to make recoveries from the seller (the exiting private equity fund) and also wanted to avoid pursuing the selling management, who were staying with the business. The buyer carried out thorough due diligence but the target was large and diverse.

The insurer provided the buyer with €30m of insurance to protect a significant portion of their acquisition. The M&A-insurance facilitated the transaction and provided both the seller and the buyer with key benefits:

Benefits to the buyer – the insurance protected a significant portion of the purchase price, (including any seller fraud). This was more attractive to the buyer than the limited level of warranties and indemnities provided by the seller. Further the insurance contract represented a lower credit risk than the seller.

Benefits to the seller – by structuring the transaction to include insurance for the buyer, the Private Equity seller was able to avoid putting a significant amount of money into escrow. This meant that the private equity seller could quickly distribute the sale proceeds to its fund and investors.

¹¹ Source: Priscille Héroult, Senior Underwriter, HCC Global Financial Products - Barcelona, a subsidiary of HCC Insurance Holdings, Inc., (www.hcc-global.com)

¹² Source: Robert Brown, Director, Mergers & Acquisitions Insurance, Ironshore International / Pembroke Syndicate at Lloyd's, London, (www.pembrokeunderwriting.com)

3.5 Facilitation of a German Property Sale¹³

Business sector	Real estate
Deal size	\$650,000,000
Insurance limit	\$650,000,000
Policyholder	US private equity fund, seller
Insurer	Various, incl. Lloyds of London through Secure Legal Title

Table 5: Facilitation of a German Property Sale

A major US private equity fund wished to sell its \$650 million office project in Germany, held in a special purpose entity. The private equity fund expected that the buyer would require representations and warranties that the property was being sold with good title. To secure those representations and warranties, the special purpose entity would be required to escrow a portion of the sales proceeds. Alternatively, the private equity fund would be asked to guarantee the entity's representations and warranties, resulting in a contingent liability on the fund's balance sheet.

The private equity fund wanted to avoid both alternatives. The insurer underwrote the title risks on the property and issued a title insurance policy, which assured the buyer that there was good title to the property, free and clear of any liens, charges or encumbrances. In addition, the policy provided that, in the event of any claims against the title, the Insurer would assume the defense at its own expense. The total sum insured amounted to \$650 million of which 50% was co-insured by Lloyd's of London. This satisfied the buyer and eliminated the need for the representations and warranties escrow or guarantee in the sale and purchase agreement.

4. Summary

In a volatile market environment, both parties' need for security has increased. Corporate buyers often encounter difficulties due to the lack of enforceability of seller warranties or a low credit rating of the vendor, which cannot be compensated by a lower purchase price.

M&A-transaction risk insurance offers special solutions that provide a high strategic value and competi-

tive advantages for the buyer and the seller. From a financial perspective, W&I-insurance is particularly effective, if the premium is lower than the purchase price discount requested by the buyer for not insisting on certain warranties and/or indemnities.

Using M&A- insurance solutions, deal breakers can be overcome, eventually leading to a win-win-situation for all parties involved.

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¹³ Source: Jean-Bernard Wurm, Managing Director, Secure Legal Title Limited a representative of Lloyd's Cover-holder SSL Insurance Brokers Ltd., (www.securelegaltitle.com)