Warranty and indemnity insurance is a crucial consideration in an M&A transaction. Here's how you can mind the gap

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Warranty and indemnity insurance (W&I) is an insurance product that is tailored to protect either the buyer or a seller in an M&A transaction from the financial loss that arises from a breach of representations and warranties given by a seller in a sale and purchase agreement (SPA).

Whilst a W&I policy is usually tailored to be as back-to-back with the SPA as possible, the W&I policy is flexible and provides a buyer the ability to improve their recourse in respect of a SPA, for instance by extending claim time periods and/or simplifying recourse to one point (the insurer) when there are a number of sellers.

However, there are going to be some gaps in coverage between the W&I policy and the SPA terms. We see this on many deals and on a recent W&I policy that we negotiated for a hospitality asset, we were reminded of this again.

The existence of coverage gaps is problematic for all contracting parties and the utility of a W&I policy will be eroded. From the buyer's perspective, where the parties have agreed that the W&I policy is the buyer's sole recourse, any coverage gap will be a buyer cost. From a seller's perspective, a coverage gap compromises any clean exit they desired.

We set out below some of more common coverage gaps that we see.

Inherent differences

W&I insurers will not generally provide cover for the following:

• Known matters – Fundamental to any insurance contract is the insured's duty to disclose what they know that is relevant to the risks they seek coverage for.

• Specific indemnities (for known issues) – Specific insurance products are available to deal with such matters (For example, tax indemnity, litigation and environmental).

• Fraud and deliberate non-disclosure – Seller fraud will usually be covered in a buyer's W&I policy.

• Forecasts, forward-looking statements, projections and estimates – Warranties are factual statements around what has occurred. Insurers are unwilling to cover a warranty to the extent it relates to future matters.

• Warranties drafted too broadly – Each warranty must clearly articulate the subject matter, and insurers may apply an interpretation to narrow the warranty for policy purposes.

• Covenants, undertakings or performance obligations – An obligation in the SPA is not an insurable risk.

• Tax 'avoidance' – This is never insurable.

• Uninsurable fines and penalties – Some countries prohibit insurance for certain criminal and like conduct.

Some insurers will also not cover other specific matters including:

• Undiligenced transfer pricing risks – Where a party has not conducted sufficient or any due diligence on the target.

• Consequential loss (with some exceptions) – It is usual for SPAs to exclude these types of loss, and so a W&I policy will too.

• Collectability of accounts receivable – Treated like a future matter.

• Pension underfunding – Insurers will not underwrite the target's employee pension plans.

Specific differences

The specifics of the deal may also give rise to differences leading to coverage gaps. These arise in a number of ways, and we focus on a few common types below.

Tipping retentions

A typical SPA includes an aggregate claims threshold (or '*claims basket*') which must be reached before the seller is liable for loss. Usually the seller is only liable for loss in excess of that claims threshold, but SPAs can provide that once the aggregate claims threshold is reached, the seller is liable for the full amount of loss suffered and not just the amount in excess of the claims threshold.

A similar process can happen in the context of a W&I policy. For example, say a W&I policy has a fixed retention of $100 and the insured claims covered losses totalling $120, then the insurer will pay $20 (being the amount of loss in excess of the $100 retention) and the insured bears the first $100 (as a deductible). If in the same scenario the retention was a fully tipping retention, then the insurer will pay the full $120. If the W&I policy does not mirror the SPA this then will be an unrecoverable amount that an insured buyer must bear. Practice varies between insurers.

Coverage between signing and completion

A typical W&I policy provides coverage for a breach of signing warranties between signing and completion, a breach of completion warranties from completion, but will not provide coverage for a breach arising between signing and completion of completion warranties (*'new breaches'*).

Insurer practice around this type of coverage varies and will depend on a range of factors including the time frame between signing and completion (the shorter the better), a right of a seller to disclose against the completion warranties prior to completion (this is not usually a feature of Australian transactions), and the ability for an (insured) buyer to terminate the SPA prior to completion.

Closing the gap

There are actions that the parties can take that can address the coverage gaps and maximise the effectiveness of a W&I policy. These include:

• Proper quality due diligence and proper disclosure process – Insurers expect a reasonable level of due diligence and disclosure to have occurred in relation to the M&A transaction. This is technically required by the insured's duty of disclosure and is practically required for the insurer to conduct their underwriting. The better the quality of the due diligence and the disclosure process, the better the information for the insurer to analyse and more accurately price the risk.

• Arms length dealings and reputable professional advisers on each side – The more robust the general transaction negotiation methodology is between the parties, the more comfortable the insurer will be that the information provided is full and fair and that the warranties and indemnities the insurer is being asked to insure reflect a position that more clearly reflects the risks being assumed.

• Warranties being properly and thoughtfully drafted – It is important to phrase warranties clearly and concisely to correctly articulate the matter they relate to and ensure they are proper statements of fact or circumstance. The better the warranties are drafted, the less likely the insurer will include exclusions in the W&I policy and the better and clearer the coverage provided.

If the above matters are not handled well, then, in our experience, it costs the parties time and money and maybe even kill the deal. It is clear that when insureds are looking at their W&I insurance options, they should turn to their specialist W&I insurance broker, their lawyer and/or their financial adviser. They can minimise the coverage gap and this can mean valuable results for the client – a much higher quality W&I policy and likely for a lower premium.

So, get in touch with your W&I experts….and mind the gap.