Navigating transactional Risks with W&I Insurance

Warranties & Indemnity insurance ("W&I insurance") has become a well-known tool to mitigate certain transactional risks and provide deal certainty in M&A and Real Estate M&A transactions. However, W&I insurance policies have inherited limitations which may seemingly conflict with the initial aim of taking out a transactional insurance.

This article delves into the pros and cons related to taking out W&I insurance and describes other insurance products used in recent transactions which Moalem Weitemeyer has advised on.

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Although W&I insurance is more frequently used in larger transactions because of the associated costs, it remains applicable in smaller transactions where the premiums for W&I insurance can be relatively moderate. The increasing competitiveness on the insurance markets has led to insurance companies offering appealing premiums and terms, making W&I insurance more feasible for mid-size and small transactions.

The cost of the W&I insurance is often in a range between 0.4%-2% of the policy limit depending on the choice of insurance coverage and the risks related to the target company or properties. Additionally, there will be costs to the W&I underwriter's advisors and taxes. Most often, the costs of the W&I insurance are paid by the buyer. In some cases, however, the costs may be split between the seller and buyer due to negotiations or covered by the seller entirely.

Warranties & Indemnity Insurance

W&I insurance covers losses or costs resulting from **unexpected issues** causing a breach of the seller's warranties. A claim resulting from such breach will be covered by the insurance company as party to the policy, rather than the buyer having to handle a claims process against the seller.

Further, W&I insurance only covers **historic matters** and not future matters. This means that insurance companies are reluctant to provide cover in relation to a warranty to the extent it relates to future matters.

Provided that the seller has not acted with **fraud or wilful misconduct** when giving its warranties, the seller is "off the hook" in terms of its liability related to the warranties and cannot be met with any claims by the buyer or the insurance company, irrespective of the monetary limitations and exclusions of the policy – thus providing the seller a "clean exit".

Deal specific exclusions

In general, W&I insurance coverage of the seller's warranties presupposes robust disclosures from the seller and thorough due diligence by the buyer. Lack of disclosures and gaps in buyer's due diligence may therefore result in a **transaction-specific exclusion** in the W&I insurance policy.

From time to time, actual material issues may be identified during a buyer's due diligence which conflict with the correctness of seller's warranties. Such **known issues** will as a general rule not be covered by W&I insurance and also constitutes a transaction-specific exclusion. If the identified risk is however considered low, we have experienced that insurance companies are increasingly willing to offer cover (*affirmative cover*).

General exclusions

In addition to lack of disclosure against warranties and coverage of known material issues, some of the typical exclusions under W&I insurance policies are coverage of warranties related to transfer pricing, state of property, tax asset and secondary tax claims as well as warranties related to contingent environmental risks.

If a risk identified by the buyer is considered material, the buyer must consider whether the risk should be handled between the seller and the buyer via a price reduction, retention of part of the purchase price (e.g. an escrow or equity lock) or the seller providing a specific indemnity to the buyer. With a specific indemnity, the seller will indemnify the buyer for any losses and costs incurred by the buyer related to such known issues, typically subject to time and monetary limitations.

Especially in a competitive auction process, a buyer must carefully consider introducing a specific indemnity, as it will dilute the "clean exit" which is one of the main advantages for the W&I insurance. Consequently, specific indemnities will by default always be a deal specific exclusion in the W&I insurance.

When taking out W&I insurance, it is worth noting that policy limits will typically be offered equivalent to 20%-30% of the enterprise value in M&A deals and 30%-40% of the agreed property value in Real Estate M&A deals, i.e. creating a coverage gap up to the full enterprise value or the agreed property value. As a consequence, most often the buyer's loss exceeding such policy limit will be borne by the buyer, save if the buyer and the seller have agreed otherwise in the SPA.

It is possible for the buyer to determine a higher limit of liability for certain warranties, e.g. the seller's warranties relating to authority and capacity, title to shares, title to property and taxes (fundamental warranties). Likewise, a separate cover for unknown risks relating to title to shares and/or real estate (title insurance) can be purchased with the enterprise value or the agreed property value as policy limit. Such coverage is not offered in a standard W&I insurance policy but will have to be taken out as a separate insurance.

Contingent Liability Insurance (known Risk)

In the case of a “known risk", there are an increasing number of opportunities to take out a separate insurance policy that covers the risk exposure related to such known risk whereby the liability associated with such known risk is transferred from the seller to the insurance company. Such insurance product is referred to as a “contingent liability insurance” or a known risk insurance.

A contingent liability insurance may, for example, cover identified legal risks such as litigation risks, tax risks, IPR risks, contractual liability, injunctions, complex property risks regarding missing building permits, legal rent levels, tenants’ pre-emption right and environmental risks. Such insurance can be taken out in addition to W&I insurance or as a stand-alone insurance product. As such, a contingent liability insurance product is often tailor-made to address and cover an identified specific high-impact matter which constitutes an obstacle in a transaction.

By taking out such insurance, a known issue that could otherwise cause the buyer to request a purchase price reduction or a specific indemnity to compensate for such issues – or even cause the buyer to cease negotiations – is moved from the target company’s balance sheet to the insurance company.

Coverage of known risks often demands in-depth due diligence of the matter resulting in an assessment that the risk is low. The cost related to a contingent liability insurance policy is often in a range between 1%-10% of the policy limit depending on the risk.

Environmental Impairment Liability (EIL) Insurance

In recent transactions which Moalem Weitemeyer has advised on, material environmental risks were covered by an environmental impairment liability (EIL) insurance as a supplement to a W&I insurance to enhance environmental coverage. An environmental liability insurance can however also be taken out separately.

A target company leasing or owning real property may have taken out a general liability and property policy as part of its ordinary cause of business which covers sudden and accidental pollution; however, liability arising from e.g. historic contamination, gradual pollution, emergency costs and statutory on-site clean-up orders will typically not be covered by such insurance, but will as a general rule be covered by an EIL insurance.

Additionally, as opposed to a general liability and property policy, EIL insurance will cover costs related to pollution no matter whether the pollution is caused by the insured (not fault-based) or a third party as long as the pollution is coming from the insured location. Coverage for costs will also relate to soil or groundwater and not only buildings, machinery, and stock.

EIL insurance covers contingent as well as identified pollution and contamination from past and/or current activities and includes e.g. coverage for costs arising from investigation- and/or clean-up orders related to soil and groundwater from public authorities, both on-site and off-site, and associated legal defence expenses, third-party claims for nuisance, claims related to bodily injury and damage to property. An open and ongoing claim with the relevant authorities or a third party.

General exclusions under EIL insurance policies comprise contaminants like PFAS, asbestos and lead paint. Costs related to fines and penalties and damage resulting from illegal acts or omissions are also excluded from cover. Further, EIL insurance excludes development cost-overruns due to remediation of a site after discovery of historic soil pollution.

Advantages and Disadvantages related to W&I Insurance

Advantages

- The seller avoids having to provide financial security to back its warranties by way of e.g. tolerating a retention of a part of the purchase price.

- The seller gains peace of mind, as the seller can achieve a “clean exit” and thus not be faced with warranty claims after the completion of the transaction.

- If the seller is a private equity fund, the W&I insurance makes it possible for the buyer to distribute proceeds to the limited partners immediately after completion of the transaction and avoid having to await that time limitations for the seller’s warranties in the SPA expire.

- For sellers, W&I insurance can help ease the sales process by providing an extra safety net for the buyer. This can increase the buyer’s confidence and potentially lead to a smoother transaction.

- For buyers, W&I insurance eliminates any worry relating to seller’s financial ability to fulfil warranty claims, as the claim is made against the insurance company.

- Buyers will often get broader coverage (and fewer knowledge qualifiers) in terms of number, scope, and phrasing of the warranties than if negotiated with the seller.

- The buyer benefits from the extension of the 'security' provided by the warranties, which is particularly significant if the seller is an investment fund or a development company that will be liquidated after completion of the transaction for the purpose of distributing dividends to investors/owners.

- In commercial terms, W&I insurance can help maintain the cooperative relationship between the buyer and the seller and create a better collaboration process as the parties do not have to negotiate warranty wording and security/collateral. If the seller and the buyer are not aligned on the terms of the seller’s Warranties, the W&I insurance is a good instrument to the bridge the gap between the seller’s and the buyer’s expectation, as the buyer can negotiate directly with the W&I underwriter and choose the specific terms of the W&I insurance with regard to coverage, retention, enhancements to the W&I insurance policy, etc.

- The W&I insurance prevents “awkward” situations where a buyer must make claims against management members or key employees which will be part of a MIP/reinvestment.

Disadvantages

- There is a risk that insurance coverage might make the seller less attentive in disclosing information that could be of relevance to the buyer, which could lead to the buyer not having the necessary insight into the transaction.

- The addition of W&I insurance increases the cost and formal complexity of the transaction.

- Insurers may deny claims if they determine that the loss falls outside the policy's coverage or if the insured party fails to comply with the policy's terms and conditions. However, claim denials are very rare and even fewer claims result in arbitration or litigation.

Our Remarks

W&I insurance policies contain various exclusions and limitations, which restricts the scope of coverage. In recent transactions where clients (or counterparties) have taken out W&I insurance and additional insurance products to address coverage gaps (e.g. environmental liability) we have experienced that while such products may seem costly, they help bridge what may seem like insurmountable worst-case scenarios and thereby mitigate obstacles otherwise potentially hindering completion of a transaction.

Contacts

Andreas Hvid Clement
Partner
andreas.clement@moalemweitemeyer.com

Simon Winther Bjerregaard
Senior Associate
simon.bjerregaard@moalemweitemeyer.com

Emil Lund Lauritzen
Senior Associate
emil.lauritzen@moalemweitemeyer.com

Hadil El-Jamal
Associate
hadil.el-jamal@moalemweitemeyer.com

If you have any questions or require further information regarding any of the above, please do not hesitate to contact us.