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WARRANTY AND INDEMNITY INSURANCE – THE PRACTICE BEHIND THE PROMISE

Global mergers and acquisitions transactions hit $3.5 trillion in 2018 making it the third-largest year on record for M&A by value[1]. Within the private equity and real estate investment worlds, the insatiable appetite for warranty & indemnity insurance ("W&I") to support transactions that has emerged in the last decade has persisted. This is not without good reason – sellers and buyers are now well aware of the deal-enabling benefits that laying off thorny transactional risk to a neutral, well-capitalised, third party can bring. Moreover, the W&I market continues to welcome a healthy torrent of new capital seeking underwriting return and market participants looking to build businesses; both of which have kept W&I premiums low and terms of cover on offer broad.

But, the true measure of any contract of indemnity is in whether or not it indemnifies. Since nearly one in five policies now results in a claim[2], understanding whether, and how, W&I policies are likely to respond to claims is critical for investors and a matter often overlooked in the fervour of deal-making[3]. The purpose of this article is to provide an insight into the anatomy of a successful W&I claim and highlight some of the issues we often see come up in them. A solid grounding in this area pays dividends both when claims arise and also in selecting and negotiating W&I terms.

The basic premise of W&I

A buy-side W&I provides cover against sums which the buyer would be able to claim from the seller in respect of breaches of insured warranties in the transaction documents (if the limitation provisions in those documents were to be ignored). This is subject to a range of provisions typically incorporated into a W&I policy, as well as more standard insurance constructs, such as deductibles/de minimis, retentions, limits, policy period, notification and co-operation provisions (to name but a few). Once cover has been established in principle for a warranty breach, the insured is then left with demonstrating the loss that it has suffered from it (which is not always as easy as it might seem). We examine some of these issues below.

Establishing a breach of an insured warranty

This will first require an understanding of whether or not the relevant warranty has been insured and if it has been subject to any deemed modifications in the W&I. Clearly, buyers will want to ensure that warranties insured are covered on the broadest basis possible as modification within the W&I leaves open gaps in cover.

Whether or not there has been a breach of a warranty will depend on the precise wording of the relevant warranties in light of the facts. Disagreements over interpretation will be resolved by usual contractual rules of interpretation. It is often the case that loss-causing circumstances implicate breaches of multiple warranties. Where this is the case, an insurer will expect to see precision in how the facts are analysed, breaches presented and loss allocated. It is also important to understand that what is relevant is whether or not the warranty was accurate as at the date it was given (and not at some later date, when issues emerge) – and the evidence will need to bear this out. Quite often, buyers assume their target only to find a different state of affairs than they understood to have been warranted. However, where matters have changed since signing (or completion), the consequences are not insured. Reconstructing a state of affairs within the target about facts pertaining to insured warranties as at the date they were given

[1] Since 2001; Mergermarket 2018 Global M&A report, 3 January 2019.

[2] AIG 2018 Claims Intelligence Report "*M&A Insurance – The new normal?*".

[3] Interestingly, when conducting a survey into why W&I has not penetrated corporate M&A in the same way as it has in the PE world, AIG found that a quarter of directors surveyed were sceptical that W&I would pay in the event of a claim. AIG "*M&A Insurance: A view from the Boardroom*" (2017).

is not always an easy forensic exercise. It is nonetheless important that this is hard-wired into an insured's investigation of its loss early on, so that the position is accurately analysed.

Warranties may be qualified by seller awareness. Where this is the case, it will need to be proven that the seller did know of the facts said to cause a warranty breach. For this purpose, the seller's knowledge may be limited to the VDD materials; alternatively, the transaction documents may state that the seller is deemed to have the knowledge it would possess had it made due and careful enquiries of directors or employees reporting to the seller on the matters being warranted. Assessment of this evidence may therefore be required and if necessary, steps will need to have been taken during the transaction to ensure that the parties retain access to this information to demonstrate seller awareness. Knowledge scrapes therefore provide a valuable extension to W&I cover and remove this evidentiary hurdle.

Depending on the issues, expert evidence may be required. Accounts warranty breaches will clearly require accounting expertise comparing the recorded position against the actual position at the relevant accounting reference date. Technical issues, such as the details of the target's manufacturing operations, will again need specialist technical evidence assessing the relevant conditions at the time against what was warranted. Early engagement with experts, briefed to analyse the facts specifically by reference to the warranties (as at the date they were given) is critical to establishing the evidence necessary to support a W&I claim.

Finally, W&I policies are what are known in the insurance world as "claims made" policies. What this means is that breaches need to be discovered and reported to insurers during the policy period – generally two or three years for general and fundamental warranties and seven years for tax warranties. Where potential issues arise, it makes sense to check at the outset that you are still within the relevant policy period of cover.

Do any exclusions apply?

Insurers may well seek to apply deal-specific exclusions, but it is standard to see exclusions for loss arising from:

- matters known to the buyer's transaction team prior to completion or fairly disclosed in due diligence materials;
- forward-looking statements;
- consequential loss;
- environmental pollution;
- secondary tax or transfer pricing liabilities;
- fines and penalties;
- post-completion adjustments; and
- matters that would ordinarily be covered under the target's operational insurance programme (eg, product liabilities).

When framing a claim, it is important that it is presented in a manner that makes clear that exclusions do not apply. To give an example, VDD materials often contain statements about the company's strategy and planning, which are forward-looking in nature – if the accuracy of these statements has been warranted, losses stemming from their inaccuracy are likely to be excluded. But it is possible that the similar information may be contained in other documents, which are not forward-looking in nature (eg, accounts) the accuracy of which has been warranted. If so, claims of that nature may be less exposed to the exclusion.

For similar reasons, care needs to be taken in reviewing and negotiating exclusions to ensure that they are properly focussed on circumscribing the insurers' liability and not too expansive. Language requiring there to be a direct link between the excluded cause and the loss for which indemnity is sought is therefore preferable. The current soft market allows W&I buyers some flexibility to negotiate away some of these exclusions (for example, in some cases insurers may be willing to provide cover for consequential loss, eg, loss of rent in a real estate transaction).

Has the insured suffered loss?

The general rule for damages for breaches of transactional contracts is to put the innocent party in the position it would have been in but for any breach. This will mean that the measure of loss in a W&I claim is calculated by reference to the difference between the value of the shares of the target as warranted and the true value of the shares. It is important that insureds understand this principle because they may view their loss very differently (for example, if an accounting warranty is breached, the insured may simply think their measure of loss is the shortfall in the accounts – this is generally not the case).

The starting point is that a Court is likely to take the actual price paid as evidence of the value of the shares as warranted. It will then compare this to the sale amount that would have agreed to in an arms-length transaction had the true position been known. Projecting this latter amount again requires expert evidence and will require consideration of the buyer's deal valuation methodology. What methodology or combination of methodologies was used (EBITDA multiples, PE ratios, discounted cash-flow, eg) and why? Is it objectively defensible – if not, it may be possible to argue that the paid price was inaccurate or that a different methodology should be used to calculate the true value. It often helps to keep records of internal analysis and presentations defending these methodologies because insurers will inevitably require justification for them (especially if multiples have been used as these can greatly increase insured loss).

Indeed, would an arms-length buyer have adjusted the price at all? Is the nature of the breach such that it would not have adjusted its offer (as may be the case if it falls below any materiality thresholds applied in buy-side due diligence). Again, this is an issue worth considering.

Another issue that can arise may be that the buyer cannot demonstrate that a company's market value has been affected at all by a warranty breach – if a profit or earnings-based methodology is used to calculate purchase price, will an understatement of assets in the accounts affect the target's ability to derive profit – potentially not, and so no loss may arise unless a net asset valuation is deployed. Similar principles apply in reverse.

Notifying the insurer

Normally, W&I policies require notification where the insured becomes aware of any fact or circumstance which has or could reasonably be expected to give rise to a loss (including third party claims). This is generally when the insured's management know of facts that are suggestive of a warranty breach and can be before the precise amount of its loss is known. In some cases, failing to comply with these terms can mean that the insurer is not liable for the claim – so it is important that insurers are notified as soon as reasonably practicable (and prior to a full investigation and claims submission). In those cases where a claim may sit below the insured's retention, it is still worth notifying the insurer (as required) to ensure that the relevant loss is treated as eroding the retention, should further claims arise.

W&I policies generally require insureds to take steps to mitigate their losses. So, where warranty breaches cause ongoing loss or concern third party claims, reasonable steps must be taken to ensure it is mitigated in order to preserve coverage.

Where a warranty breach arises from a claim made against the target by a third party, the insurer may well have rights to participate in the investigation, defence and settlement of that claim. Where this is the case, consideration will also need to be paid to rights of association granted to the seller to ensure those that should be involved in the defence of the claim are and that there is no clash of interests. Similarly, when defending those claims, insureds will need to be wary of "hammer" clauses (which state that where the insurer is willing to settle a third party claim at a certain value, but the insured declines and later becomes liable to pay more, the insurer only pays the lesser amount). Ideally, these should have been negotiated out of the policy when it was put in place, but where not, heed will need to be paid to the insurer's views on settlement.

Conclusion

W&I offers many benefits from a transactional perspective and, increasingly, investors understand how it will respond to their claims. This has prompted a higher frequency in claims across the market, as well as, on average, earlier submission rates of claims following completion. In turn, this builds on W&I's growing track record for the payment of claims. Nonetheless, to obtain the full benefit of their W&I, users should ensure they understand how it will operate when the chips are down and that they notify, investigate and present their claims in the most focussed manner to ensure maximum chances of a full recovery of their loss.

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