Warranty and indemnity insurance in Spanish M&A transactions

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A rise in W&I insurance in Spain

In recent years the Spanish Mergers and Acquisitions (M&A) market has seen in an increase in warranty and indemnity (W&I) insurance as a means to cover certain transactional risks, namely those losses or liabilities arising from a breach of a warranty or a representation.

W&I insurance, known in the United States as representation and warranty insurance, is one of the three main types of transactional risk insurance, the others being tax insurance and contingent risk insurance. Tax insurance transfers a known or uncertain tax liability from the insured's balance sheet to an insurer; contingent risk insurance covers identified or known contingent risks that are typically the subject of a specific indemnity in an M&A transaction; and W&I insurance indemnifies against a loss deriving from unknown or undisclosed (even unfairly disclosed) matters only.

W&I policies have been offered since the 1980s mostly in jurisdictions such as the United Kingdom and the US. Their use had been relatively rare in Spanish M&A deals as a consequence of a lack of availability of products (by the insurers), lack of knowledge (by the operators), price and an underwriting process regarded as lengthy and complex - characteristics hardly fitting with an M&A transaction.

This has changed. Multiple insurers based in Spain are now offering W&I products, insurance brokers have developed a much needed expertise in the underwriting process and competition has led to lower premiums. As a result, more buyers and sellers are more often covering Spanish M&A transaction risks by W&I policies.

What is a W&I product?

W&I products are insurance policies that indemnify against loss resulting from a breach of a warranty or a representation (including tax covenants) given within a sale and purchase agreement (SPA).

In a typical transaction, a buyer will seek broad warranties and representations from a seller to get protection against losses that the target company (or the buyer itself) may suffers as a result of a breach of such warranties and representations. A seller, on the other hand, will try to limit the warranties and representations it gives to the buyer. A W&I policy would bridge this gap. It can be obtained by either the buyer (buyer-side) or the seller (seller-side) in a transaction.

While a seller-side policy would cover the seller for its own innocent misrepresentations, a buyer-side policy would cover the buyer against the seller's misrepresentations (both innocent and fraudulent). The latter presents two key advantages. First, the buyer can directly claim against the insurer so that it does not need to previously pursue recourse against the seller. Second, a buyer-side policy also provides indemnification against seller's fraud.

The majority of W&I policies undertaken in Spanish M&A deals are buyer-side. This is a consequence not only of the intrinsic advantages of the policies but also of the instigation of sellers who insist that the buyer enters into a W&I buyer-side policy, a process commonly known as 'stapling'.

Via stapling, a buy-side policy is instigated by the seller who insists on insurance to limit their exposure and provide alternative recourse. A W&I policy is thus stapled to the SPA. A seller may opt for:

- a hard staple, when the seller's W&I package is only available if a buy-side policy is undertaken; or
- a soft staple, when it is for the buyer to decide whether to undertake a W&I policy or assume a limited recourse for a potential breach of a warranty, as a seller's liability would be normally capped to a moderately low amount.

Full auction and limited competitive sales processes are the most favourable scenarios for hard stapling, as competition from multiple bidders leaves the seller in a stronger position to impose a take-it-or-leave-it approach. Soft stapling fits better with a negotiated one-to-one sales process.

When is it advisable to undertake a W&I policy?

From a buyer's perspective, a buyer-side policy will serve as direct recourse for breach of the representations and warranties given by a seller. From a seller's perspective, a seller-side policy will serve as a backstop for the seller's damage and indemnification obligations to the buyer.

Buyers and sellers may have different reasons to undertake a W&I policy. Buyers may seek to alleviate concerns over uncertainty of recourse, enhance or distinguish an auction bid (as it limits sell-side exposure), reassure shareholders, lenders or other investors or protect relationships with sellers, particularly if they remain minority shareholders or managers of the target company. Sellers will normally want to achieve a clean exit and fast distribution of sales proceeds, mitigate or ring-fence general or specific post-closing liabilities or protect passive sellers.

Whatever the reasons, W&I policies can be especially suitable in certain scenarios, such as:

- a divestment carried out by a private equity fund which either does not provide warranties and indemnities or, if it does, is not willing to place a portion of the sale proceeds in escrow or other type of retention;
- an actual or possible lack of financial solvency of sellers; or
- cases where a seller has the bargaining power to limit its financial exposure at a lower level than the buyer is willing to accept.

Key considerations when undertaking a W&I policy

Underwriting process and the importance of a proper due diligence exercise

From our experience, the party seeking to undertake a W&I policy will normally engage a broker to find insurers willing to present non-binding insurance proposals. To that effect it will provide the broker, after the signing of a non-disclosure agreement, with the main terms and conditions of the transaction (including a description of the business of the target, value of the deal and potential value of the policy), but there is no need to make available to the broker any transaction documents at this stage.

The broker will analyse the information provided by the eventual policyholder, contact insurers and then summarise all non-binding proposals received from potential insurers in a non-binding indication letter, which will usually give quotes, key policy terms and significant coverage items – including exclusions – of all potential offers. Alternatively, at this preliminary stage potential insurers may have already required access to certain documents – typically the information memorandum of the transaction, structure of the data room and annual accounts of the target company – which can be provided after entering into a non-disclosure agreement.

The policyholder will choose an insurer so that the underwriting process can commence. At that point, the insurer will normally conduct its own due diligence. It will get access to certain documents available in the data room, the buyer’s due diligence reports (legal, tax and financial, whether final or draft versions, as well as other more specific due diligence reports, eg, environmental) along with vendor reports (if available) and certain transaction documents (the SPA, with a particular attention to the liability regime and representations and warranties scheme, and disclosure letters).

After a satisfactory due diligence exercise, the insurer will propose a formal insurance offer which is expected to address proposed premium and coverage and include the draft W&I policy. The policyholder and the insurer will then advance in negotiations regarding the W&I policy, in parallel to the transaction due diligence works or even legal documents negotiation, so that before signing the deal the W&I policy is ready to be undertaken.

Coverage, limits and exclusions – should a W&I policy mirror the SPA?

W&I policies may cover most of the representations and warranties in the SPA on a blanket basis or be structured to cover only specific representations and warranties, either fully or subject to certain reserves. Whatever the case, insurers will normally refuse to insure those representations and warranties which relate to contingent liabilities, are forward-looking in nature or easily capable of breach.

Exclusions will usually refer to fraud on the part of the insured (but not on the part of the seller) and actual knowledge by the insured of a breach of a representation or warranty discovered during its due diligence exercise, disclosed by the seller or some other way known by the insured. Interim breaches, that is, those arising and discovered after the W&I policy has been put in place but before closing of the transaction, are also normally excluded. Representations and warranties regarding anti-bribery, anti-money laundering and corruption will be often excluded as well.

All in all, even if coverage may not fully comprise all the representations and warranties granted by the seller under the SPA, certain elements of the policy should definitely mirror the content of the SPA to avoid any potential conflicts with the insurer, including the concept of loss, qualifiers relating to the information disclosed during the due diligence exercise and the definition of a third-party claim.

Limits on the insurer's liability under the policy may also mirror the liability regime set out within the SPA (the most common approach) or provide a different scope. The period of coverage will normally then extend for the same duration as set out in the SPA for a claim of a loss arising out of a breach of a representation or warranty and monetary arrangements – whether caps, de minimis considerations or tipping to nil provisions – will be usually be that of the SPA.

It is also possible that a buyer seeks to supplement and extend protection for breaches of representations and warranties through the W&I policy by increasing either the scope, duration or amount of indemnity provided for in the SPA. This comes at a cost: an increase of the premium.

Claiming against the insurer

In case of a buyer-side policy, the insured (the buyer) will have to claim against the insurer according to the provisions set out in the policy and within a period normally ranging between three and six months from when the insured knew or could have known the loss had occurred. Notification to the insurer will normally be required to include a detailed description of facts,

circumstances and events leading to the loss, a reference to the specific representation or warranty breached and the amount of the loss. Once the claim has been assessed, the insurer should step into the shoes of the seller and directly indemnify the insured or reimburse the costs the insured may have incurred in relation to the breach.

In case of a seller-side policy, the insured (the seller) will notify the insurer that the buyer has claimed against for a breach of a representation or warranty. The insurer would then indemnify the seller directly or reimburse the payments it may have already made to the buyer.

An optimistic future

W&I policies are becoming common in Spanish M&A deals. They provide a useful tool for buyers and sellers to cover risks associated with transactions and may serve many purposes, from enhancing or distinguishing a potential buyer's auction bid to facilitating a clean exit in a private equity fund's divestments. Their use will continue to grow as products become more sophisticated, insurers and brokers keep specialising in this line of business and operators get more familiar with them. W&I insurance is here to stay.