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Warranty and Indemnity Insurance

by **Lester Sosa-Villatoro**

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Nil Recourse in the UK and Ireland. Lester Sosa-Villatoro explains.

Introduction

Warranty and indemnity insurance in M&A transactions (W&I Insurance) has been used for many years to provide cover for losses suffered in connection with warranty or indemnity claims.

One of the most attractive benefits for sellers has been a reduction in the exposure to risk and having immediate access to all of the sale proceeds, often with no requirement to leave part of the proceeds in escrow.

For buyers, the most notable benefit is a more substantial level of cover under the purchase agreement with recourse to an entity with financial substance, i.e. the insurer.

Indeed, W&I Insurance can be a neat solution to some tricky situations such as:

1. A buyer's unwillingness to sue the sellers due to the dynamics of the deal.
2. A seller being unwilling (or unable as a matter of policy) to provide warranties and indemnities.
3. Parties that are unable to agree on the seller's liability cap.

W&I Insurance can be taken out by either the buyer or the seller , but it is usually taken out by the buyer. A buyer-side policy would indemnify the buyer whilst a seller-side policy would indemnify the warrantor/seller.

Insurers apply market standard exclusions to certain warranties, examples of which include forward-looking warranties and warranties which relate to: compliance with environmental legislation; the condition and title to real estate assets; medical or professional negligence; and criminal fines and penalties.

As certain trends continue to emerge and develop around the use of W&I Insurance in Irish M&A transactions, it is worth having a look at developments in the W&I Insurance market across the Irish sea and any related impacts on the structures of M&A transactions in the United Kingdom. One notable development is the use of nil recourse structures in private equity backed transactions.

The £1 cap

In a nil recourse structure, the liability of the sellers for warranty claims for an amount less than the excess under the W&I Insurance policy is capped at £1. As the excess under the W&I Insurance is unaffected in that structure, buyers effectively assume the risk of claims for an amount less than the excess under the policy.

The buyer's perspective

This somewhat aggressive approach to the sellers' liability is partly the result of buyers adopting a more commercial and pragmatic approach in relation to interests and how best to take care of them.

The reasoning goes that capping the sellers' liability at £1 goes a long way to giving some level of comfort to the sellers on their exposure to such claims. The sellers often remain as part of the target's management

team and this will boost their relationship with the buyers: a relationship which is seen by many as crucial to the success of private equity backed transactions post-acquisition.

The reductions in the average excess under W&I Insurance policies as a percentage of the deal, which have been seen in the last few years in the United Kingdom, have resulted in the gradual reduction of the level of cover provided by the sellers. And buyers in large transactions are unlikely to bring a claim against the sellers for amounts less than the excess. These factors have also contributed to an increasingly positive perception by both buyers and insurers to nil recourse structures.

That being said, nil recourse structures have encountered some turbulence in transactions involving targets operating in industries were the risk of warranty breaches for amounts which are less than the excess under the policy is greater than what may be considered prudent to assume.

The sellers' perspective

There is no need to comment on how appealing nil recourse structures may appear to sellers. But it is important to advise sellers that having obtained the buyers' agreement to such a structure does not mean that the sellers may be remiss in their approach to disclosure against the warranties -- indeed, the opposite is the case:

1. Insurers do insist of being provided with evidence that a thorough disclosure exercise has been carried out in order to provide cover.
2. A reckless or negligent approach to the disclosure exercise may result in the sellers stepping into the realm of fraud or misconduct.

In such scenarios, neither the W&I Insurance nor any limitations on liability provided for in the agreement will apply, leaving the sellers unprotected against any claim for breach of warranty.

Conclusion

We would recommend that the parties consider whether W&I Insurance is necessary or desirable at an early stage of the M&A process. If the parties are in favour of W&I Insurance, the insurers and their advisers should be engaged as soon as possible and address any issues the insurers may raise in order to understand the extent of what cover may be obtained and the feasibility of applying a nil structure to the W&I Insurance policy.

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