M&A and the Role of Warranty and Indemnity Insurance in Asia

BOARD DISCUSSION

Spotlight on Buy-side W&I

No need for the buyer to inform the seller in the event of a claim.

No need for the seller to be exposed to future liabilities of the business.

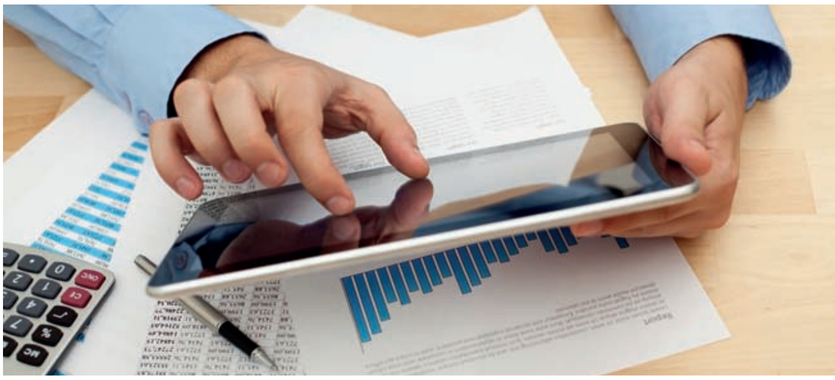
Claims are made against the insurance policy, allowing the seller to achieve a clean exit from the asset.

The use of Warranty and Indemnity (W&I) insurance in transactions is becoming much more commonplace across Asia as sellers, especially private equity firms, seek exits for their investments on a no- or limited-recourse basis. It's worth understanding how this type of insurance works and how policies respond in the event of a claim.

HOW W&I INSURANCE WORKS

In general, W&I insurance is used by buyers looking to give added protection to their investment and sellers looking to protect or reduce their liability after a transaction. Most commonly, it is introduced to deals by private equity firms that wish to exit an investment held in one of their funds. It takes the place of the traditional recourse mechanisms buyers use to ensure they are not exposed in the event unforeseen issues are discovered within the target business, potentially causing loss to the new owner.

Traditionally sellers have been required to hold a certain amount of money in escrow for a specified period should unknown issues be discovered in the target which give rise to a breach of the warranties in the sale and purchase agreement (SPA). Funds held in escrow are used to make good any damages incurred by the business that was acquired.



Recently however, we have seen parties to a transaction start to use the prospect of W&I insurance to fully replace the escrow mechanism. Rather than rely on funds in escrow, W&I insurance allows sellers to manage the transaction on a fully nil-recourse basis, allowing private equity funds to close the fund after the sale and return all proceeds to investors. This may not be possible if funds are held in escrow as the main recourse for buyers.

This recent trend is known as a "sell buy flip", whereby a seller will work with an insurance broker right from the start of the sale process and often, the SPA will establish that the insurance policy is the only recourse available to the buyer. At the start of the sale process the seller will usually approach the insurance market through a broker, indicating a policy is required. A note about the seller's requirement for the buyer to take out W&I insurance as part of the sale is uploaded to the data room with initial due diligence documents, so the bidder understands it is required to take out a policy.

Once a bidder is successful, the broker's relationship will "flip" to working with it to ensure the policy is fully underwritten and in place at the time the transaction signs.

So from the outset, it's essential for the buy-side to be upfront about the extent of due diligence it has done on the acquisition, to ensure the W&I policy meets its expectations.

THE ASIAN DIFFERENCE

The use of W&I insurance across Asian markets is relatively new compared to other markets where it has been a feature of transactions for some time. In addition, Asian jurisdictions have their own particular features that make the use of W&I insurance unique in these markets.

The way due diligence is conducted determines how W&I policies are structured and the more thorough the due diligence, the fewer exclusions the policy will have. For instance, a buyer may be comfortable not carrying out complete due diligence on an aspect of the business, for instance a small, non-core business unit. But the insurer may require due diligence to be performed on this part of the company to extend cover to it. The risk is that if due diligence is not performed on this part of the business, it will not be covered under the policy.

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HOW POLICIES RESPOND

W&I policies come into their own once a deal is complete. They are used when a buyer identifies issues with the target business that were not disclosed prior to the deal's signing or completion date, effectively breaching the warranties set out in the SPA. Traditionally in this situation, the buyer would make a claim for damages against the seller as a result of breach of contract or claim under an indemnity set out in the SPA.

W&I insurance provides an alternate form of recourse for buyers in the event warranties are breached. Buy side W&I policies differ from standard recourse mechanisms because there is no need for the buyer to inform the seller in the event of a claim. In addition, often there is no need for the seller to be exposed to any future liabilities of the business. Rather, the claim is made against the insurance policy, allowing the seller to achieve a clean exit from the asset.

MAKING THE MOST OF W&I INSURANCE

To ensure policies respond in the event of a claim, the first step is for buyers to ensure the due diligence they conduct meets the expectations of insurers and underwriters, as well as the M&A market.

To ensure it is as comfortable as possible with the transaction, it's essential for the buyer to commit to helping the insurer understand, its business and the business it is acquiring. This is especially the case in Asia, where insurers can perceive risks to be greater than in western markets.

In some cases, parties take on a small portion of the risk associated with the transaction to help insurers achieve the required level of comfort with it. A structure that is becoming favourable in Asia is for the seller to commit to an exposure equivalent to one per cent of the value of the transaction, which typically mirrors the value of the agreed excess on the policy. If the seller is prepared to take on even more risk, say two per cent of the transaction, the insurer may attain an even higher level of comfort when providing cover on Asian transactions. This may also be one way to lower the value of the premium.

From the insurer's perspective, it makes no difference as to which side of the transaction pays the premium, as long as it is covered. Generally, decisions around which side accepts liability for payment of the premium become a part of the commercial arrangements around the sale of the target.

The more collaborative all sides can be when putting in place a W&I policy and when dealing with claims the better the outcome.

MANAGING CLAIMS

When it comes to managing the claims process, the overarching rule is that it pays to over-notify the insurer about potential claims, rather than wait to notify or leave it too late.

The idea is to let the insurer know about a potential claim well inside the policy period, so that even if the costs related to the claim do not crystallize for some time, the claim should still be covered. This approach is quite different to the one taken when the acquisition does not have associated W&I insurance. In this event the claimant would normally not openly share information with the opposing party, as part of the process of preparing a legal case.

In contrast, the more collaborative all sides can be when putting in place a W&I policy and when dealing with claims the better the outcome will be. In the event of a claim, the policyholder should notify the insurer as soon as possible, even if initially it is on a high level basis only.

From this point, the insurer will likely commence a fact finding process, working alongside the broker to gather the requisite information to pay the claim.

Indeed, working alongside an insurance broker is the best way to properly structure a W&I policy and achieve a positive claim result. This is especially the case across Asia, where each market has its own nuances and where buyers are less likely to have experience of using this type of insurance.

In this situation a broker is best placed to navigate the insurance market and the intricate claims process so policyholders achieve their preferred outcome.

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