Q&A with Rod Brown

The Rise of Warranty and Indemnity Policies in M&A Deals

September 17, 2014

The use of warranty and indemnity (W&I) insurance policies in M&A deals has become increasingly popular in recent years. "This trend is becoming global," said Rod Brown, a partner in Latham & Watkins' Singapore office. "There has been a big uptick in the US and Europe during the last five years and increasingly we are seeing the same thing in Asia."

In this Q&A interview, Brown sheds light on the utility of these polices in M&A deals and shares his thoughts on the changes in the market that led to the recent growth.

What purpose does W&I insurance serve in M&A deals?

Brown: It is designed to protect either the buyer or the seller from the financial loss that would arise from a breach of the warranties and indemnities given by the seller. It essentially removes the risk in whole or in part from either the seller or the buyer in the sense that the underwriters will be standing behind the warranty claim. So, if you are worried about the credit worthiness of the seller, or the seller is not prepared to offer much in the way of contractual protection, then you may be able to access some coverage in the insurance market.

How do buyer-side polices differ from seller-side polices? Is one preferred over the other?

Brown: With a seller-side policy, the seller gives warranties and indemnities, as is customary, but then insures its own risk of a claim. So, when a claim comes along, the buyer would claim against the seller for breach of warranty as is usual, but the seller then looks to the insurers to write a check for all or at least part of the damages being sought. This contrasts with a buy-side policy in that the seller is not involved at all, so if the buyer finds that there has been a breach of a W&I post-closing, the buyer will deal directly with the brokers or underwriters to seek recovery.

The other really critical difference between buyer-side and seller-side policies is that with a buyer policy, if the seller commits fraud, (for example, if the seller has been fraudulent in giving a representation), then the policy would still payout. This is because the buyer is the insured party and it has not been fraudulent nor has it fallen foul of the obligation to make full disclosure to the insurers. This provides an extra layer of protection for buyers that they wouldn't otherwise have.

If I was a buyer, I think I would much prefer to just deal directly with the underwriters rather than having to go through the rigmarole of having the seller make a claim first and waiting for that process to exhaust itself before getting paid. And, on the seller-side, why would you want to incur the management time and hassle of dealing with a claim when you could step out of the process? Hence, the majority of the policies that are now being written are buyer-side policies.

What accounts for the recent uptick in the use of W&I policies in M&A deals?

Brown: I think the reason for the uptick is that the W&I insurance market is a lot more flexible than it used to be; they are being more pragmatic about the types of risks that they are insuring. For example, if you were giving an environmental warranty five years ago you might have really struggled to squeeze that into your general W&I insurance policy. They might have forced you to take out a separate and very expensive environmental policy. The same could be said with tax — that was always the real risk for the underwriters — environmental, tax and accounting warranties. Today, those will almost always be covered as part of the general policy. So, I think the first reason for the growing popularity is the flexibility being shown by the underwriters.

The second reason is perhaps much simpler: price. It was a very expensive product in 2000-2001 when I first came across it. The pricing has dropped significantly. The first deal I saw it on the pricing was about five percent of the limit of liability. So, let's say you are buying a policy for $US30 million worth of coverage, then the policy would have cost you 5 percent of the $US30 million. Nowadays that has come down to 1.5 to 3 percent depending on which market you are in and the level of risk being absorbed by the underwriters. For sellers or buyers, if you look at it in the mix along with their transaction costs, it may no longer be prohibitively expensive.

Another development in the market in the past few years, which I think has also helped the uptick, is getting certain specific risks insured. Rather than just insuring the indemnities and warranties generally against unknown risk, nowadays you might get specific insurance for a known risk such as litigation. For example, if the seller is giving an indemnity saying “if this certain claim that we know is lurking around ever happens, then we the seller will indemnify you the buyer for any loss you suffer”, that specific indemnity would have been very hard to insure in the past because it is a known risk. But now, the underwriters will exclude the risk from the main policy, but will offer you separate insurance for the particular risk. This has been amazingly useful in getting deals done. It can actually lead to a deal closing that might otherwise just have broken down because of one major risk that no one was prepared to bear.

Do you recommended warranty and indemnity insurance in all M&A deals?

Brown: It is still very deal-specific. It might not be appropriate for every deal. I think large companies remain pretty confident in their internal risk mitigation and probably feel it is just an extra cost that they don't need to incur. If they have gone through a proper disclosure process, then they are likely comfortable on the seller-side that there aren't going to be any breach of warranty claims.

But, for other parties it can be a strategic decision more than a cost-based one, especially in the private equity market. Take a situation where a seller is running an auction and offering fairly scant protection, such as a very low cap on warranty and indemnity claims. Typically, the buyer, as part of the auction process, would have marked up the seller’s sale and purchase agreement to get the seller to come to a more reasonable position whilst balancing the fact that they are in an auction and not wanting to put their bid offside. Now, private equity buyers are accepting restricted warranties, and then turning to the insurance market to cover off the risk that would naturally have been borne by the seller. That can put you in a pretty powerful position if you are a buyer in an auction. You’re making life easier for the seller because one of the sellers' biggest concerns, aside from price, is what risk are they going to have to bear and for how long? If you are taking that away from them, then I think it makes your bid look pretty compelling.

The other place that we are seeing it increasingly is if sellers want a totally clean exit from the business. For example, you might have four individuals selling a company and they literally want to head to the beach – they want to take their check and clear out. It is difficult to do that because you are not giving the buyer much comfort if you say, here is my company and I am not giving you any warranties and indemnities and you will never see me again. So, instead the seller could consider giving a buyer full W&I buyer-side policy. The sellers could pay the cost of the premium. The sellers could then take the consideration for the sale on day one and not have to escrow any of the funds to deal with potential warranty claims.

How can Latham assist parties considering taking out an W&I policy for an M&A deal?

Brown: Latham is becoming a leader in the market in this area because we have actually gone out to the leading brokers and developed a standard set of policy documents with each of them. This saves a lot of time (especially towards the end of a deal when time is short) and gives our clients the comfort of knowing that this is an area of expertise for us. The brokers are comfortable dealing with us and they are familiar with the comments we are going to be providing to make the policies more balanced.

CONTACTS

Rod Brown
Singapore
T +65.6437.5306
rod.brown@lw.com

You Might Also Be Interested In

[Insurance Coverage Litigation]

[Mergers & Acquisitions]

[Private Equity]