Avoiding the Pitfalls of W&I Insurance: A Lawyer's Perspective

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1. Introduction

Warranty & Indemnity (W&I) insurance policies are becoming increasingly popular in Europe.[1] However, such policies should be carefully aligned with the binding purchase agreement, the due diligence, and the disclosure exercises to achieve the desired insurance coverage — as the following examples illustrate.

2. Warranty spreadsheet versus general coverage exclusions

The scope of coverage under a W&I insurance is mainly determined by the so-called warranty spreadsheets attached to the policy. These warranty spreadsheets set forth the scope of coverage for each of the individual warranties provided for in the purchase agreement. A thorough assessment of the policy coverage requires examining not only the warranty spreadsheets, but also the policy itself in full — and in particular, the general coverage exclusions. Insurers commonly include certain exclusions in policies with respect to warranties which, in general, seem to be covered according to the warranty spreadsheets. In fact, the applicable exclusion may nearly eliminate the coverage for the respective warranty. This situation may arise, for instance, in the following cases:

Environment: With regard to environmental warranties, the spreadsheet will sometimes state that these are covered (even in full) while the catalogue of general exclusions excludes the coverage of any losses based on, resulting from, or in connection with environmental matters in general.

The general exclusion for environmental matters is, in principle, subject to discussions with the insurer. However, insured parties should know that, if a contamination is identified on single property out of various properties owned by the target group (i.e., no clean report) during the environmental due diligence, certain insurers are reluctant to provide even a limited W&I coverage for the unaffected properties.

In both cases, the final coverage is subject to the scope of due diligence, the disclosure, and the negotiations with the insurer or may only be obtained through a specific and/or top-up insurance (partly against payment of an additional premium).

Compliance / sanctions: Notably, with regard to (specific) compliance warranties, the buyer often requests coverage for anti-bribery and corruption, as well as sanctions; however, such coverage is regularly not given, as these areas often fall under general coverage exclusions. Thus, it is necessary to align and discuss with the broker and the insurer what is needed from a due diligence and disclosure point of view in order to obtain full coverage or a least partial coverage (e.g., limited to certain jurisdictions) for these topics.

Pensions: Many policies provide for limited coverage when it comes to pension underfunding matters. The general exclusions regularly exclude coverage with regard to the funding of pensions or the respective funding obligations. As a result thereof, for example, the financial statements warranties, irrespective of specific pension warranties, will lack coverage in this regard. Hence, if pensions are a material financial aspect of the transaction, it is important to focus the financial/HR/pensions due diligence on this matter and to discuss the potential coverage of pensions in general with the broker and insurer.

3. Scope of individual limitations of warranties in the spreadsheet

As a general rule, the warranty spreadsheet itself needs to be reviewed in detail. There is a risk that a limitation/exclusion applicable to a specific warranty under the spreadsheet (column – comments) may also (indirectly) be interpreted in a way to limit the coverage regarding another warranty. For example, if the spreadsheet specifically limits a warranty regarding intellectual property or pensions, it could be argued that this limitation also applies to the warranty regarding financial statements. Hence, discussions with the broker and insurer should ensure that each individual limitation only applies to the respective warranty (i.e., the policy contains a provision, according to which a limitation does not apply in general, but only to the respective warranty).

4. Coverage of closing warranties

Parties can receive coverage not only for warranties given at signing, but also for warranties given at

1 Source: Latham & Watkins Private Equity Market Study – Of the 240 deals surveyed between July 2017 and June 2019, 35% featured W&I insurance (up from 13% three years ago) and usage on PE seller deals reached 48%.

closing. The usual instrument to obtain such coverage is the so-called "*bring-down concept*",[2] which means that in respect of warranties given at closing (except for title warranties), the seller needs to disclose any facts occurred in the interim period between signing and closing that would constitute a breach of a closing warranty. By this means, all warranties given at closing in the purchase agreement will be covered for unknown risks whereas all facts disclosed by way of the bring-down disclosure are deemed known. Thus, related breaches are excused from cover. The parties of the transaction usually do not agree on any negative consequences for the seller in connection with such disclosure. However, the seller is often still reluctant to follow such concept as closing warranties – which are already granted in the purchase agreement (i.e., at the time of signing) – cover future matters. From a seller's point of view, this fact results in a higher exposure of a liability for willful misconduct based on the *statements into the blue-concept* (Aussagen ins Blaue hinein).

In order to provide the seller with more comfort, the seller may not be required to give the warranties at closing in the purchase agreement itself, but rather to grant the warranties again under a separate declaration on or shortly prior to closing (so-called "Closing Warranties Declaration"). The advantage of this concept is that (i) the seller is not required to make future statements, and (ii) even warranties being subject to a knowledge qualifier can then be given as at closing (subject to the respective disclosure by the seller).

5. Scope of Due Diligence / Disclosure

In light of the above, both the scope of the due diligence and the quality of disclosure should align with the intended coverage of the W&I insurance. In particular, an extensive due diligence allows the insurer to grant a broader coverage. Our experience shows that the coverage constantly develops as the insurers increase their understanding of deal dynamics and especially the risks in question. As a result thereof, exclusions can be negotiated to a certain extent in exchange for the provision of additional information through the due diligence exercise and the disclosure.

2 See also Giessen/Lüttges, BB 2018, 647 et seq.

6. Outlook

A number of other areas should always be assessed in detail when reviewing the policy, such as (i) the interplay of the liability regime in the purchase agreement with the provisions of the policy (including the definition of loss in light of the coverage for title warranties, de minimis and the disclosure concept) and (ii) the burden of proof concepts provided for under the policy.

As competition within the W&I insurance market continues to intensify, insurers will likely provide greater flexibility on terms and reduce coverage exclusions. Against this backdrop, each individual case should be discussed with the broker and the insurer in detail in order to achieve the best results. This recommendation not only applies with regard to the general coverage exclusions, but also with regard to synthetic coverage solutions as well as the coverage of known risk through contingent risk insurances (e.g., with respect to title defects, ongoing litigation, permits in dispute or specific tax risks). Hence, in our view, previously uninsurable risks are now viewed as increasingly insurable. This shift not only applies to unknown risks, but also to known risks – in particular, environmental and tax risks. Moreover, in light of an expected increase in distressed M&A activity, the insurance coverage and the tools facilitating this sector will likely develop faster.

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