M&A REPRESENTATIONS AND WARRANTIES INSURANCE (W&I INSURANCE) – A GROWING RISK MANAGEMENT TREND IN THE DEAL MARKET

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1. INTRODUCTION

The last 2-4 years, an exciting “new” trend has emerged in the M&A market worldwide; a demand for mergers and acquisitions insurances (M&A Insurance in general), of which the most popular insurance type covers breach of representations & warranties (jointly warranties) and specific indemnities (if any, and only covered if specifically agreed) (W&I Insurance) given by the seller to a buyer in a sale document, typically in a Share Sale and Purchase Agreement (SPA)). Even if it is not that common in the Nordic market to insure specific indemnities, but rather the warranty catalogue in the SPA, the definition “W&I Insurance” will be used in the following. Since only a few years back these definitions were unknown to most M&A lawyers and parties on both the seller-side and buyer-side in M&A transactions.

The main purpose of taking out W&I Insurance is to provide coverage for either a seller or a buyer for financial loss as a result of a breach of a warranty or indemnity claim related to acquisition of either; (i) shares in a company (through a SPA), or (ii) business/assets (through an asset purchase agreement). This article will in particular focus on acquisition of shares in a company.

As a result of this trend, clients have new and high expectations to M&A lawyers’ legal and commercial advises, not only with respect to the specific deal, but also the unique aspects of W&I Insurance, as well as requirements from and process towards the insurance company in relation to such insurance. It is essential for M&A lawyers to handle complexities related to fulfilment of the insurance companies’ insurance terms in light of warranties and indemnities in the specific SPA, while negotiating the final SPA.

The purpose of this article is to give an introduction to the aspects of W&I Insurance as a “tool in the toolbox” to be aware of when negotiating deals, with specific focus on its increased significance in the Norwegian M&A, especially from 2013 onwards. Particular issues on the seller-side vs. the buyer-side to be conscious about taking out W&I Insurance will also be highlighted in this article. The overall message is that the need for W&I Insurance should be considered carefully by the seller and the buyer, especially in mid-size to large deals.

2. WHY A POPULAR “TOOL” IN M&A DEALS?

2.1 Reasons

There are undeniable several reasons for W&I Insurance becoming an important strategic tool when negotiating and closing M&A deals, the below mentioned being the most significant:

Seller reasons:

- More flexibility and smooth process towards closing a deal
- Minimizing risk under SPA
- Maximizing transaction value
- Avoiding joint and complex liability exposure when several sellers (pro rata liability)
- Achieving clean and efficient exit
- Elimination of need for escrow or other security mechanisms as (parent company) guarantees/indemnity letters etc. - The seller gets settlement of the purchase price at closing
• Enabling the sale proceeds to be distributed upwards to the owners directly after closing and to liquidate the holding company selling target
• Cleaner exit

Buyer reasons:
• Providing extended protection for breaches of warranties and/or indemnities, both with respect to duration and size
• Distinguishing a bid in a competitive bid auction process by supplementing contractual recourse with insurance
• Protection of relationship with the seller; of specific importance where the seller becomes the buyer's key employee (e.g. management roll-over) or business partner after closing the acquisition
• Mitigating enforcement risk against distressed sellers
• Providing protection in new/unfamiliar jurisdictions/industry

In general:
• Overall facilitating and adding value to transactions:
  o A tool for dealing with obstacles preventing the parties from reaching an agreement, e.g. financial (seller's credit risk), tax or environmental issues discovered in the DD, such obstacles normally being subject to significant price reductions or extensive warranties from the seller
  o Deal specific; tailor-made liability coverage and insurance language in each case
  o Closing of deals which otherwise would not have been completed
• Enabling wider range of overseas acquisitions, compensating for legal discrepancies between liability caps' and warranties in a new seller/buyer jurisdiction
• Applicable for all kinds of acquisitions, the most relevant being deals within the industry, real estate, infrastructure, private equity and energy (renewable as well as other power projects) sectors

2.2 Deal type and size
The size, type and complexity of the deal will influence on the parties’ choice to take out W&I Insurance. W&I Insurance is best suited for mid-range to large deals - where the risk exposure broadly speaking goes hand in hand with the deal size - typically in the range NOK 200 million to NOK 1,500 million, but might also be relevant for other deal-sizes of various reasons.

3. GEOGRAPHICAL “BIRD” PERSPECTIVE; THE NORDIC AND NORWEGIAN MARKET IN A GLOBAL PERSPECTIVE

The W&I Insurance trend in the Nordic countries has expanded from the European (London as “center” for M&A Insurance in Europe), to the Australian, Asian and US M&A markets, and has in the recent years become a well-known structuring and negotiating tool doing deals worldwide.

In UK, M&A Insurances are highly common to take out, and roughly 25-35% of all mid-size to large corporate deals are insured. In Australia as much as approx. 60% of such deals are insured, however, in US the numbers are much lower (approx. 10%) due to many reasons, as e.g. risk for lawsuits not being covered by the W&I Insurance.¹

¹ Based on unconfirmed figures for 2014 from M&A insurance brokers and companies in the Norwegian market.
Globally 2/3 of all claims under either a seller-side or buyer-side policy are put forward within a period of 12 months after closing the deal, and the rest within a period of 12-24 months or greater. In Europe the claims frequency so far has been quite low, but the claims activity seems to be increasing and this must be seen as a reflection of the increasing number of insured deals.

For the Nordic countries, there has been an increase in demand for W&I Insurance, being almost non-existing in these countries going a few years back. In the Swedish market approx. 8-10% of mid-size to larger deals are covered by W&I Insurance, of which a majority are real estate deals. 2014 is considered by insurance brokers as the “breakthrough” year for M&A Insurance in the Norwegian market, though in a much smaller scale compared to other European countries. Time will show how this tool will influence also the Norwegian M&A market.

There are about 12-14 insurance companies offering M&A Insurance coverage in the Norwegian market, some of the largest currently being AIG, Pembroke, Risk Point, AWAC and HCC, of which AIG and RiskPoint have local presence in Norway.

4. SELLER/BUYER INSURANCES, EXPECTATIONS AND EXAMPLES

4.1 General

A W&I Insurance policy insures either the seller or the buyer of the shares in the target company. Each W&I Insurance is unique as it is “tailor-made” for the specific transaction in question, including the warranties and indemnities given under the SPA. The insurance companies aim to provide full coverage back-to-back with the SPA, matching among others full coverage by breach of insured warranties and indemnities (if any), agreed de minimis and, in seller-side policies, also liability thresholds (cap), duration of warranties and period of indemnification.

The insurance companies presuppose that transactions are managed, diligenced and negotiated as if no W&I Insurance were put in place. The purpose of W&I Insurance is not to replace due diligence (DD), meaning that DD as a preliminary investigation prior to acquiring target will still be a crucial part of a normal deal process. Further, the insurance is not a substitute for proper disclosure in the deal. Neither will W&I Insurance cover issues already known to the insured party, nor will it protect the target against performing badly after closing of the transaction.

4.2 Seller-side W&I Insurance policy

A seller-side policy shall provide coverage for the seller in the event that the buyer sets forth a claim for a breach of warranty or indemnity set out in the SPA. The insurance companies usually provide an insurance limit under the policy which “mirrors” the warranty thresholds and limitations defined in the SPA. As such, any financial loss the buyer may be inflicted with exceeding the agreed limitations of liability for breach of warranties under the SPA, will be the buyer’s risk, unless the seller retains liability under the SPA which is not picked up by the insurance company, or the seller has acted with gross negligence or willful misconduct.

It is common that the seller-side is the process-initiator for taking out W&I Insurance. Despite this fact and since the buyer often desires a direct insurance process towards the insurance company without having to involve the seller first if claims arise, buyer-side W&I Insurance constitutes the majority of policies taken out, cf. clause 4.3 below.

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2 Based on unconfirmed figures for 2014 from M&A insurance brokers and companies in the Norwegian market.
3 Cf. Figure 1 attached: Illustration of insurance coverage limits under a seller-side policy.
4 Cf. Figure 2 attached: Illustration of the buyer’s claim procedure under a seller-side policy vs. buyer-side policy.
4.3 **Buyer-side W&I Insurance policy**

A buyer-side policy shall provide coverage for the buyer against financial loss the buyer may be inflicted with as a result of a breach of the seller’s warranties (or indemnities). The main reason for a buyer taking out W&I Insurance is that the seller’s warranties under the SPA are capped at a lower amount than the financial loss a buyer deem likely to suffer as a result of a breach against applicable warranties of the transaction. This results in a “gap” between the agreed limitation of liability for the seller for breach of warranties and indemnities and the total transaction value risk for the buyer in the SPA. The main purpose of a buyer-side W&I Insurance policy is to cover this “gap”. The buyer may in principal determine the scope of the insurance coverage in close co-operation with the insurance company, but the limits of coverage eventually depends on the buyer’s “risk appetite” and most importantly, whether or not the insurance company is willingly to insure the determined deal scope within Nordic market terms.

Bottom line is that a buyer-side policy is independent of the seller, allowing the buyer to make a claim directly against the insurance company under the policy without having to pursue its claim against the seller first. The buyer can, depending on the policy wording, claim under the policy also for matters the seller had knowledge about, even if the seller deliberately gave a false warranty or committed fraud (unless the buyer knew about these circumstances at the point in time of taking out the W&I Insurance). This results in the buyer getting comfort by the insurers standing behind the warranties and indemnities.

Approx. 90% of all W&I Insurances in the Nordic deal market are buyer-side policies, and often initiated by the seller in the transaction process, cf. clause 4.2 above. The main reasons for this practice are, among others, to minimize the seller’s total risk under the SPA, as well as to improve the negotiation climate between the parties, and the practice has generally been strongly driven by PE funds. Putting forward a claim under a seller-side policy is more “demanding” for both parties from a cost-efficiency perspective, and requires direct participation from the seller towards the insurance company.

If for instance a buyer-side policy is being purchased because a seller does not want to deal with putting up a certain warranty or indemnity, payment of the premium costs would generally be the seller’s responsibility. Usually, this is practically solved by the buyer’s deduction of the premium amount from the total purchase price, as a *quid pro quo* for the seller’s limitation under the warranties.

4.4 **Typical exclusions from insurance coverage**

In principle, the insurance companies include standard *exclusions not being covered* by the policy, the below mentioned being typical exclusions:

- “Actual knowledge” by the insured party and deal team, meaning e.g. known issues/risks discovered in the DD process, described in disclosure documents or in the SPA with schedules
- The agreed Purchase Price (including adjustment mechanisms)
- specific indemnities (unless insurance coverage has been agreed for such specific indemnities)
- Fraud and deliberate non-disclosure (seller-side policy)
- Amendments of the SPA without approval form the insurance company
- Civil and criminal fines

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5 Cf. **Figure 3** attached: illustration of insurance coverage limits under a buyer-side policy.
• Forward-looking warranties and indemnities (risks)
• Pension underfunding
• Transfer pricing

5. SCOPE OF INSURED WARRANTIES; TAX WARRANTIES VS. NON-TAX WARRANTIES

5.1 General
In principle, W&I Insurance covers the whole “blanket” of reasonably balanced warranties and indemnities (if any) back-to-back with the SPA (cf. clause 4.1). The SPA typically contains standard warranties and indemnities comprising among others; the company’s title to shares (Power and Authority), the seller’s ownership of the shares (the Shares), the company’s financials and accounts (the Accounts), tax and VAT matters (Tax), material contracts (Contracts), ownership to assets (Assets) and real estate (Real Estate), environmental matters (Environmental), intellectual property rights (IPR), disputes and litigation (Litigation), no pledge or encumbrances (Encumbrances) etc.

The insurance companies will as a main rule require that the SPA warranties and/or indemnities to be insured meet market standard terms for such warranties and indemnities. If for instance the parties do not meet the insurer’s conditions on adjustments of the warranties/indemnities, due to an unbalanced SPA which is not in line with Norwegian/Nordic market practice for sale and purchase agreements, the consequence may be that the insurance company refuses to insure the deal or parts of it through a specific exclusion for relevant parts/warranties.

If desired by the insured party, the W&I Insurance may be tailored to comprise only a few or specific warranties under the SPA.

5.2 Tax/VAT warranties
Tax warranties shall protect the insured party (usually the buyer) against the liability to pay additional and/or unknown tax, VAT, fines and penalties whether relating to a contingent tax issue identified in the DD or not. The W&I Insurance policy matches the agreed warranty/indemnification period, and this period is normally 5-7 years from closing date. By the buyer’s request and against an additional premium, some insurance companies may offer an extended coverage beyond the agreed thresholds in the SPA.

5.3 Non-tax warranties
For non-tax warranties, the average coverage period is 12-24 months, but this period can be extended against an additional premium, cf. clause 5.2 above.

5.4 Specific and additional insurance coverage
Specific contingent insurances may be taken out by the insured party related to for instance IPR, environmental, litigation or tax issues identified in the DD, the occurrence of which are often yet to crystallize out. Such specific insurance policies should be considered as an asset in future sales of target, the most popular being separate contingent tax or environmental insurance. Even if it is an average medium to high risk for tax claims put forward by a buyer under the SPA, it is rather unusual in the Nordic practice that the insured party signs up for additional tax coverage under a separate tax contingency insurance policy.

6. TIMING OF INSURANCE PROCESS
When the parties consider insuring a deal, important questions arising are; (i) at what point in time the insurance broker/company shall be contacted during negotiations of the SPA, and (ii) will the insurance process delay the agreed deal timetable?
Statistics show that in a majority of cases the process of putting W&I Insurance in place is initiated by the insured party (the seller or the buyer, as the case may be) 2-4 weeks before signing the SPA, in order to ensure that the W&I Insurance is valid at signing (or closing as required by the insured party)⁶.

Depending on deal specific reasons, W&I Insurance will typically be taken out: (i) at an earlier stage prior to signing and at latest on signing date (“main rule”), (ii) at closing (as a condition to closing), (iii) post closing (more unusual, but happens, and often if in a “rush” to complete the transaction), or (iv) for seller-side policies when a liquidation situation becomes clear.

Since the W&I Insurance is tailored to each SPA’s warranty catalogue, it is of high importance to involve the insurance broker/company as soon as the parties agree on a draft framework SPA, setting out the most important warranties and indemnities. In most cases the parties prefer to do so before the SPA is finally negotiated.

It usually takes between 5-15 business days to underwrite and bind the insurance company in question, from the point in time of contact by the insured party, depending on the specific deal complexity. The insurance companies are used to providing W&I Insurance on a fast track.

An experienced insurance broker/company will provide the parties with a non-binding indication letter including price and coverage quote (NBI) within a couple of days after the first conversation, and in connection with receipt of the NBI, the insurance company will send the party to be insured a list comprising among others disclosure of all DD reports, scope of DD, as well as requests regarding access to the data room. This, to ensure that the M&A lawyer (either external or employed in the insurance company) as soon as possible will be able to identify potential risks associated with the deal.

Normally, and within 1-2 weeks from receipt of the NBI, the insurance company, its counsel (if external), the insured, its deal members and its lawyer, will typically discuss the DD (status of finalized process and top up DD if relevant) and questions from the insurance company to ensure absence of any risk that might impact the transaction and scope of discovered risks, and how to handle this under the W&I Insurance. Based on such call (Underwriting Call) and possible follow-up Underwriting Calls to clarify issues, the insurance company will issue a draft W&I Insurance policy. The policy will be subject to further negotiations between the parties, in order to scope the loss included/excluded (e.g. to comprise only direct loss or also indirect/consequential loss), the impact of knowledge qualifiers or other qualifiers like “material” etc., term of coverage, operational restrictions, subrogation provisions and additional issues. Finally, if the insurance company and the seller or the buyer - as the case may be - agree on the insurance terms in light of the SPA and the DD carried out, the insurance company will underwrite the deal.

7. POLICY PRICING
The premium to be paid for W&I Insurance is case-specific and depends on a number of deal factors, including, among others, deal value, the nature and risk of the business involved (complexity and business sector), the quality of the DD’s carried out by the parties, geographical location, structure and scope of the deal, warranties/indemnities under the SPA, thresholds and limits of liability for the seller compared to deal value and if there is a gap between signing and closing.

⁶ Cf. Figure 4 attached: illustration of a typical time-frame for the W&I Insurance process.
As a main rule, the insurance premium for a W&I Insurance within the Nordic countries, being a one-off payment, is in general priced in the range of 0.9-2% of the policy limit depending on relevant factors. The policy limit will normally be in the range of 10-50% of the deal value of target.

The insurance companies often operate with a minimum premium amount in the interval of € 50-80,000, and a maximum insurance coverage amount. Provided the parties engage an insurance broker (e.g. AON, Willis, Lockton, Marsh or JLT), a broker fee will also be added, normally in the range of 0.1-0.25 of the policy limit. Further, a policy retention of approximately 0.5-1.0% of the deal value, being the amount of losses to be borne by the insured before the insurance policy can be called on, must be eroded before covered under the policy. Once fully eroded, the retention will not apply to subsequent claims.

8. SPECIFIC FOR PRIVATE EQUITY COMPANIES – “CLEAN BREAK”

There has been an increase in demand for W&I Insurance particularly among private equity (PE) or venture capital seller companies, also taken into consideration the reasons behind the W&I Insurance concept have been strongly PE driven from the “first beginning”. As a consequence of an operating life cycle of in average between 3-7 years for PE funds, it is desirable to limit post-closing liabilities of the PE seller company in question, created by mechanisms such as warranties in the SPA, indemnity letters, parent company guarantees (with a good financial covenant) or escrow arrangements.

Accomplishment of a clean and efficient exit from an investment is of high importance for PE portfolio companies, also in order to realize and distribute sale proceeds upstream for re-investment and return to their owners shortly after completion of the sale. Such seller companies would not want to retain a portion of the sale proceeds in an escrow account to satisfy potential warranty or indemnity claims from the buyer. For various reasons other standard “safeguard” mechanisms may not be available or desirable to use by the PE seller company. On the other side, the buyer generally expects a higher degree of protection, including among others long survival period for the warranties and indemnities under the SPA and a high cap on potential liabilities/indemnities from the seller.

To bridge this gap between the parties’ expectations, putting W&I Insurance in place enables PE seller companies to complete the transaction with a more limited risk exposure (or could serve to remove such risk in its entirety), and the seller can retire with the proceeds from the deal. Further, the need for establishing an escrow in these situations can be eliminated and replaced by a tailored W&I Insurance.

9. RISK OF LIABILITY RELATED TO LIQUIDATION

In a number of deals, and not unusual within the PE segment, the seller company will be wound-up shortly after completion of the disposal of the target. Provided the seller company is a Norwegian private limited liability company, the liquidation process must be carried out in accordance with the rules set out in the Norwegian Private Limited Liability Companies Act (the “Companies Act”), chapter 16. A specific issue in this respect is that the buyer will normally not be able to put forward claims under the SPA directly towards the seller after the seller company has been finally liquidated.

Pursuant to the Companies Act section 16-12, the shareholders of the liquidated company are jointly and severally liable towards creditors for unpaid obligations (not paid nor adequately secured in accordance with section 16-9 (2)) up to the value of the distribution each shareholder has received, cf. section 16-9. Further all members of the liquidation board are jointly and severally liable without any limitations if they fail to prove they have acted diligently. Consequently, the shareholders and the liquidation board must be cautious about settling any and all outstanding obligations of the company in liquidation prior to distributing liquidation proceeds to the shareholders and completing the liquidation
process. With respect to the sale of the target, the liquidation board should ensure that an amount sufficient to cover uncertain and/or disputed obligations for the seller related to buyer claims under the SPA is placed on an escrow account. Alternatively, the shareholders, another seller group company or the bank may issue a guarantee or indemnity letter covering the potential liability towards the buyer.

However, a W&I Insurance policy may prove to be a more adequate solution, enabling the liquidation board and the shareholders to liquidate the selling company without making any reserves or obtaining guarantees, provided that the coverage under the insurance is deemed sufficient. It should be noted that in these circumstances the parties should normally opt for a buyer-side policy, as the insured party under a seller-side policy will be liquidated.

10. FUTURE LANDSCAPE
We have yet to see a high rate of utilization of W&I insurance in Norway, but with increased awareness around this insurance type, it is becoming more common also up north. The overall impression is that an increase in demand for M&A Insurance in general reflects that this product has undergone material changes the recent years and become a more known tool in the M&A market with enormous potential for making deals happen and also as a catalyst to unlock “deadlock” situations.

The present landscape reflects broader insurance coverage than before, and prices have gone down due to a more competitive market within the W&I Insurance segment. However, it is of high importance to team up with a well-experienced insurance broker and company, in order to fulfil the purpose of sufficient coverage. The key to securing an efficient insurance process is a tailor-made policy language. In addition, it is crucial for the insured party to seek legal assistance on the terms of the policy.

If claims arise under the SPA, both parties will benefit from W&I Insurance as the claims process is directly handled by the insurance company (buyer-side policy), avoiding that the parties use endless of time and costs on negotiations and possible dispute resolution.

Bottom line is that W&I Insurance is narrowing the gap between the seller and the buyer expectations, provides the buyer with protection for unknown risks (and in some cases increased entitlement to compensation beyond the agreed limits in the SPA), and at the same time giving the seller a “clean break” and deal certainty in the future, avoiding security measures such as escrow arrangements, bank- or parent company guarantees, deferred consideration arrangements etc. At present all arrows seem to point upwards with regards to future growth and utilization of W&I Insurance.
Appendices:

**Figure 1:**
Sell-Side Policy

- Transaction value
- Limitation of liability for breach of warranty under the SPA
- Buyer’s risk
- Seller's risk
- Policy of indemnity
- Insurance policy
- Policy limit
- Sale & Purchase Agreement
- Limitation of liability for breach of warranty under the SPA
- Buyer's risk
- Seller's risk
- Policy of indemnity
- Insurance policy
- Policy limit
- Sale & Purchase Agreement

**Figure 2:**

Example 1: Seller-side insurance (third party)

- Buyer
- SPA
- Seller(s)
- Policy

Example 2: Buyer-side insurance (first party)

- Buyer
- SPA warranties
- Seller(s)
- Policy
Figure 3: Buy-Side Policy

Transaction value

Sale & Purchase Agreement

Buyer’s risk

Policy to protect against financial loss

Insurance policy

Seller’s risk

Policy limit (buyer’s risk appetite to determine limit)

Limitation of liability for breach of warranty under the SPA

Figure 4:

Deal status

Info required

Insurance stage

Time required

Phase 1
- Indicative offers
- Bidding
- Heads of agreement

Phase 2
- DD
- Second round bids
- IM
- Accounts
- Data room index
- Draft SPA

Phase 3
- Exclusivity
- Negotiation of transaction documents
- Updated SPA
- Disclosure letter
- DD reports
- Data room acc.

Phase 4
- Signing
- Completion
- Final SPA, DD and disclosure
- Underwriting call
- No claims decl.

- Broker feasibility study
- Insurer signs NDA
- Submission to insurers
- Non-binding Indicative bids
- Insurer review
- Policy created
- Commitment to insurer fees
- Formal insurer quotation
- Finalization of policy
- Binding policy
- Premium payment

1-2 days
1-2 days
7-10 days
1-2 days