Client Alert

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Warranty & Indemnity Insurance

What is it?

It is an insurance designed to protect the buyer or the seller from financial loss that would arise from a breach of warranty or indemnity. In summary, warranty and indemnity insurance policies (known as "W&I Insurance") remove the risk in whole or in part because it will be the insurance underwriter (not the seller), which covers the cost of the relevant warranty damages or indemnity.

This type of insurance is gaining in popularity amongst Japanese buyers. In the future we expect that many more knowledgeable Japanese buyers will use this insurance product on cross-border M&A due to its many benefits and its cost efficiency.

There are two main types of W&I Insurance policies:

- **Buy-side policy.** The buyer is insured for any losses it suffers as a result of a breach of a warranty given in the transaction documents (subject to the agreed limitations in the policy and the policy limit), plus any associated defense costs.

- **Sell-side policy.** The party providing the warranties is insured for any losses it suffers as a result of the buyer bringing a valid claim against it for a breach of warranty under the transaction documents (subject to the agreed limitations in the policy and the policy limit), plus any associated defense costs.

Nowadays buy-side policies are more popular than sell-side policies.

Is it important?

Yes. It can provide material advantage to a knowledgeable buyer or seller (at a cost-efficient price). Some of the key reasons to use W&I Insurance in an M&A transaction are set out below:

- **'Clean exit'.** The policy can be structured so that it provides the seller with a virtual 'clean exit' from the transaction (other than in limited specified circumstances).

- **Assists bidders in competitive auctions.** In a competitive auction a bidder can enhance its bid by proactively structuring W&I Insurance into the bid. Offering W&I Insurance can be an attractive proposition for a seller (i.e. reducing the seller's risk profile), particularly if other competing bidders do not offer such advantages.

- **Shortens negotiations by managing risk transfer.** Sellers and buyers often have very different expectations around liability and risk sharing. This can lead to lengthy and difficult negotiations. Cautious buyers are at a particular disadvantage in competitive auctions. However, the use of W&I Insurance can efficiently and usefully ‘bridge the gap’ between the seller's and buyer's expectations (by paying the insurer to bear the risk).

- **Helps to retain the seller's goodwill.** W&I Insurance can assist a buyer to maintain a good relationship with the seller. This can be particularly important where the ongoing participation of the seller is important to the buyer, for example when the seller is a joint venture partner or is a key member of the target's management. This is because W&I Insurance can be structured so that claims for breach of warranty are made directly against the insurer (and not again the seller personally).

- **Limited seller creditworthiness.** If the creditworthiness of the seller or the available security is limited or uncertain, W&I Insurance enables a buyer to pay the insurer to underwrite the financial risk, thus swapping the seller for a highly creditworthy insurer. This way the need to stagger purchase payments or hold funds in escrow can be limited or avoided.

- **Protection of family assets.** W&I Insurance can be particularly appealing to individuals who are sellers. In such a case it is used as an asset protection strategy, ensuring that proceeds of a sale to an individual are not able to be clawed-back in a warranty claim, enabling the individual to freely and fully spend or invest the sale proceeds.

What are the recent trends?

Popularity. W&I Insurance is rapidly gaining in international popularity. The number of new policies is increasing, on average by about 20 percent year-on-year globally. We estimate that more than 1,000 W&I insurance policies will be placed this year globally.

Global Reach. The key markets remain the UK, US and Australia, but we are seeing a recent strong increase in the number of policies bought in Asia (including by Japanese parties) and across continental Europe.

More Corporates. Traditionally W&I Insurance has been embraced by the private equity community. But recently it is becoming increasingly popular with corporates. One insurer that we collaborate with reports that nowadays over 50 percent of its new insured parties are corporates.

The Future? Australia is arguably the most developed of the W&I Insurance markets. The trend in the Australian market favors a "tipping retention" (which means that if the claim exceeds the amount of the retention, the W&I insurance will cover some or the entire amount of the retention). We expect that this concept may become more popular in other markets as risk-averse sellers in other countries start to demand equivalent terms (albeit the concept may be resisted by certain insurers).

How expensive is it?

The pricing for every deal is different and the scope of the insurance cover and the policy exclusions will affect the premium on any deal. That said, cost has dropped significantly in recent years. These days, **around 1 percent to 2 percent** of the covered amount is not uncommon. To give you additional background:

- **London market premiums.** The London market is currently seeing premiums within a range of 0.9 percent to 2 percent of the insured amount (where the retention was 1 percent of the deal enterprise value).

- **Australian market premiums.** Australian market premiums are around 1 percent to 1.4 percent of the policy limit insured for retentions of 1 percent of the deal enterprise value.

- **New York market premiums.** We tend to see US market premiums of around 2 percent to 3 percent of the policy limit insured for retentions of between 1.5 percent and 2.5 percent of deal enterprise value. However, premium prices are dropping and we expect to see cheaper policies.

Does W&I Insurance cover all claims?

Percentage of coverage. The average level of warranty protection coverage secured over the last few years has ranged between 10 percent and 30 percent of the total deal value of the target purchased. That said, the total amount of cover can vary significantly from the average, depending on individual deal terms.

Amount of coverage. In recent years, the global market has expanded; it can now provide cover of between around $5 million to $400 million for any single transaction.

Scope of coverage. A standard policy generally covers the following:

- Loss incurred by the insured arising from a breach of the warranties

- A claim under the general indemnity for tax

- Reasonable costs incurred in the investigation or settlement of a third party claim

Will W&I Insurance delay the deal?

The insurance process typically runs simultaneous to the deal process. The table below is an example of the timing on a typical auction and how the insurance process would work within the time frame of an auction.

W&I Insurance Process				
	Phase 1	**Phase 2**	**Phase 3**	**Phase 4**
Deal status	✓ Indicative offers/ bidding or heads of agreement	✓ Due diligence ✓ Second round bids	✓ Exclusivity/ negotiation of transaction documents	✓ Signing/ completion
Information required by broker / insurer	✓ Deal size, industry sector, jurisdiction ✓ No documentation required by broker	✓ Information memorandum ✓ (Audited) accounts ✓ Data room index ✓ Draft share purchase agreement (SPA)	✓ Updated SPA ✓ Disclosure letter ✓ Due diligence reports: tax, environmental, legal and any specialist reports (non-reliance basis) ✓ Access to data room.	✓ Final SPA and disclosure letter ✓ Final due diligence reports ✓ Underwriting call (insurer holds this with legal advisers and insured's deal team: approximately one hour) ✓ No claims

W&I Insurance Process				
	Phase 1	**Phase 2**	**Phase 3**	**Phase 4**
				declaration signed
Insurance stage	✓ Broker provides feasibility/ conceptual study giving opinion based pricing and guidance.	✓ Broker makes submission to insurer and will obtain indicative report (costs and terms). ✓ Insurer will sign confidentiality agreements.	✓ Insurers review documents. ✓ Commitment to insurer fees ✓ Insurer offers quotation on formal terms.	✓ Finalisation of policy ✓ Binding policy ✓ Payment of premium
Time required	✓ 1 - 3 days	✓ 5 - 8 days	✓ 7 - 10 days	✓ 3 - 5 days
Total time required	✓ 1 - 3 days	✓ 6 - 11 days	✓ 13 - 21 days	✓ 16 - 26 days

What else should I know?

Pricing Factors

There are a number of elements which an insurer will consider when placing and pricing the W&I insurance, including the following:

- **Veracity of disclosure process.** The use of reputable legal and accounting advisers will be considered by the insurer. The insurer will typically refer to the advisers' due diligence reports - a poor quality report will impact on the insurer's risk weighting for the deal.
- **Governing law of the transaction documents.** This will be considered as part of the insurer's risk weighting.
- **Industry sector, geographical location of the target, deal specifics.** This will be considered as part of the insurer's risk weighting.
- **Premium.** This is the amount payable to the insurer for the policy, generally calculated as a percentage of the amount insured.
- **Retention.** Sometimes called the "excess" or "deductible," the retention is the amount for which the insured is on risk before the policy will respond to cover a liability.
- **Insurer due diligence costs.** The insurer may waive these fees if the policy is successfully purchased and placed.
- **Broker income.**
- **Insurance premium tax.** Insurance premiums are not subject to imposition of consumption tax in Japan (but insurance brokerage and agency fees are subject to Japanese consumption tax). The situation in other countries differs case-by-case, for example for a UK insured there is a 6 percent tax on premiums and for a Dutch insured it is 21 percent; for other jurisdictions, tax may apply to the premium but it may be known by another name.

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Known Risks

The insurer's intention under a standard policy is to cover unknown matters that have not been identified by the insured. Therefore, a standard policy will not cover loss arising out of a known risk (e.g., a matter that has been identified during due diligence or has been disclosed in the 'disclosure letter').

Tax

Claims paid to a Japanese corporation under an insurance policy are treated as taxeable income under Japanese law and can therefore be subject to corporate tax (currently 35.64% for a company headquartered in Tokyo, reducing to 33.10% from 1 April 2015) unless sheltered by other deductible expenses or losses.

Depending on the underlying cause of the warranty breach (e.g. damage to a fixed asset), in Japan the income from the insurance could be netted off against the replacement value of the underlying loss (i.e. replacement of the damaged asset). However this concept would not apply to a typical situation where the loss is deemed to be a reduction in the value of the target company's shares. Insurers may agree to include a tax gross-up in the insurance coverage (in return for payment of an increased premium) but professional tax advice should be sought to ensure that there is no "tax-on-tax" effect (as the gross-up itself may also be taxeable).

Procedure for obtaining W&I Insurance

The process for arranging W&I Insurance has significantly improved in recent years. Specialist insurers now often employ internal M&A specialists (often ex-lawyers and bankers) who understand the deal environment and documentation. Recently several specialist W&I insurers established branches in Japan and are now licensed to provide W&I insurance from Japan. It may also be possible to access overseas W&I insurance policies, depending on the specifics of the cross-border transaction and the identity of the parties.