

M&A warranty and indemnity insurance... a buyer's perspective

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What are the consequences of taking out buyer's warranty insurance, and how can a buyer maximise the benefit from using it?¹

Warranty and indemnity insurance has been sold in the Australian market for many years, but its function and effect on transactions are not universally well understood.

Importantly, taking out warranty and indemnity insurance doesn't simply mean that the insurer steps into the shoes of the seller. There are a number of specific issues that a buyer must consider before deciding whether to acquire insurance and how to put it in place.

How much warranty insurance does the market use?

Warranty insurance plays a significant role in the private M&A market in Australia – especially in exits by private equity funds. It is estimated that warranty insurance was used in Australia in more than 50 transactions in 2010, with an aggregate transaction value in excess of \$23bn.

More than 10 US and European insurers currently offer warranty insurance in the market. This large number of insurers has corresponded with a reduction in premiums. The average premium is currently around 1%-1.5% of the insured amount, down from 3%-5% pre-2007².

The additional fact that insurers have actually paid out on claims has increased market confidence in the product.

There is currently \$350-400m of insurance capital available for any individual transaction in the Australian market, without the need for further reinsurance. In other words, insurance cover of 35-40% would be available for a transaction size of up to \$1bn.

Should the seller or buyer take out the insurance?

This paper focuses on buyer's warranty insurance, which allows buyers to claim losses arising from a breach of contractual warranties by the seller. It enables the buyer to claim directly from the insurer, without having to pursue the seller.

Sellers can also take out policies to manage the risk of warranty claims by the buyer. However, these policies will not provide the buyer with the same level of protection because:

- they do not cover seller fraud; and
- they do not name the buyer as an insured (meaning the buyer cannot claim directly under the policy).

What are the commercial benefits?

The commercial benefits of buyer's warranty insurance for both buyers and sellers are compelling. Those benefits can be summarised as follows:

¹ Specific transaction insurance can also be obtained for identified tax liabilities, contingent risks, litigation risk and environmental risk. However, the focus of this paper is "warranty & indemnity insurance" or "warranty insurance", which is insurance designed to respond in the event of an unknown circumstances arising post-transaction which amount to a breach of a seller's warranty.

² Note - premiums can vary materially depending on the nature of the transaction and the structure of the cover.

- **Pricing of risk:** The common mantra of sellers who are unable or unwilling to provide the warranty protection demanded by buyers is to invite buyers to "price in the risk" (ie. adjust your proposed purchase price downward to reflect the cost to you of the increased risk). Unfortunately, unless the buyer has a very large portfolio of similar transactions, it is illogical to price the risk based on the probability of the risk arising – and to do so would be to misunderstand the relationship between statistics and risk³. Insurers, on the other hand, can "price the risk" based on the average losses arising from breach of warranties across a portfolio of transactions. In short, the insurance industry can put a price on the risk (ie. reflected in the insurance premium), which a single event buyer cannot. This ability to actually "price the risk" reduces the disagreement to simple dollar terms (and the impact of the premium on the purchase price) which is much more easily negotiated by the parties.
- **Impecunious seller:** Even if a seller is prepared to give a warranty, there is no guarantee that the seller will have enough cash to meet a warranty claim down the track. This concern can arise in almost any transaction, but particularly where the seller is in financial difficulty or in the midst of a corporate restructure. The risk is enhanced if the warranty and indemnity liability period is extended.

Buyers often seek to manage this risk by holding back part of the purchase price or requiring part of the purchase price to be held in an escrow account. The cost to the seller of this hold-back or escrow amount is broadly equivalent to its cost of capital (less any interest payable to the seller on the escrow account). The seller's cost of capital will usually be higher than an insurer's, so at a purely economic level it is more efficient for the insurer to take the risk and hold capital against that risk.

- **Private equity seller:** In the case of a private equity seller, the return on a fund's investment (which drives fund performance and remuneration of the principals) will be measured from the time that the investors' funds are committed to the transaction until the time when the proceeds of sale are returned to investors. Rather than using a traditional cost of capital to assess the consequences of a hold-back or escrow, it is therefore more relevant to apply the target rate of return on the investment in assessing the cost to the fund. Since these targets are very high, the economic arguments for using warranty and indemnity insurance rather than a hold-back or escrow are even more compelling.
- **Other scenarios:** Some of the other scenarios where warranty and indemnity insurance may provide a commercial solution include: *insolvency* – where the seller is an administrator and will not provide warranties; *seller exiting an industry or country and winding up operations* – with no appetite or ability to accept residual liability for warranties; *seller and buyer in different countries* – where the buyer may prefer to recover under an insurance policy rather than commence costly proceedings in a foreign jurisdiction; and where the *buyer, for commercial relationship reasons, would be reluctant to sue the sellers* (eg. the sellers are individuals working in the buyer's business after the purchase).

How can warranty insurance be structured?

As with other types of insurance, the risks covered, amount and period of warranty insurance can vary to suit the buyer's needs.

The amount of loss (or size of warranty claim) at which the insurance begins to respond (known as the "deductible" or "excess") can be as low as the first dollar of loss or as high as the buyer wishes.

The deductible could be set at the maximum liability of the seller. For example, if the purchase price was \$100m and the maximum liability of the seller was 20% of the purchase price, the deductible could be set at \$20m. In other words, below \$20m is seller's risk (and uninsured) and above \$20m is insured.

Likewise, the period of cover can be short or very long.

For example, the seller may be particularly resistant to giving warranties for a period beyond, say, 12 months after completion. Insurers on the other hand are generally more comfortable with insuring risks for an extended period. They will generally be prepared to offer cover for tax warranties up to 7 years and other warranties for up to 3 years. The insurance can therefore be structured to cover losses arising after the seller's liability period has expired.

³ As the professor who taught Decision and Risk Analysis class at university was fond of saying - "That's like the story of my friend the statistics professor who sadly drowned in a lake that was only 5 centimetres deep, on average."

How much contractual liability to leave with the seller?

If a buyer decides to take out warranty insurance, how much liability should remain with the seller? A seller would prefer the answer to be "none". However, a buyer needs to consider the implications of letting the seller completely off the hook for warranty breaches.

As we all know, warranties in sale agreements have two important purposes.

The first is to help ensure that the price paid reflects what the seller has told the buyer about the asset. If what the seller says (in the sale warranties or in information disclosed against those warranties) is not true, a damages claim against the seller will reduce the price ultimately received by the seller.

The second important purpose is to "keep the seller honest". If the seller is at risk of a warranty claim, it has a strong incentive to facilitate a comprehensive buyer due diligence, conduct comprehensive vendor due diligence itself and undertake a detailed warranty verification process (with corresponding detailed disclosures). This reduces the likelihood of a warranty claim arising at all.

A seller may insist on a regime where the buyer's **only** recourse is to make a claim on its warranty insurance. The warranty insurance will substitute for the first purpose of warranties – but leaves the second purpose unaddressed. Whether this is acceptable will depend on the buyer's assessment of the apparent rigour of the seller's due diligence process and warranty verification and disclosure regime.

The buyer should also assess what other incentives the seller may have to not breach warranties. For example, if the seller is a perennial seller of assets in a market (such as a private equity fund), it has a different set of incentives to that of a foreign seller (who may have no intention of conducting business in the market going forward). It is also worth considering what legal liability the seller may have beyond liability for breach of contract which cannot be contractually excluded (see "What liability does the seller still have?", below).

What if I don't have insurance in place on signing?

A buyer may sometimes need to execute the sale agreement before its warranty insurance policy is finalised.⁴ How does this lag period impact on the buyer's transaction risk profile?

The first important point is that warranty insurance only covers a buyer for circumstances that **are not known to the buyer at the time the policy is taken out**. It does not cover a loss that has become apparent before the policy is entered into.

Further, the terms of the policy itself (and the buyer's obligations under the laws governing insurance⁵) require the buyer to disclose to the insurer every matter that the buyer knows or could reasonably be expected to know to be relevant to the insurer's decision to provide the insurance.

So, if the buyer executes the sale agreement and then becomes aware of a breach of warranty before the policy is put in place, the policy will not cover the loss arising from that breach. In other words, there is a risk that the buyer will be "contaminated" by additional knowledge which limits its protection under the warranty insurance, but will still be obliged to complete the transaction on the original terms.

How long does it take to get insurance? The process of negotiating multiple layers of insurance

Before providing warranty insurance, insurers will want to conduct their own due diligence (See "How does insurance impact on the approach to due diligence?", below) which can take up to a week (depending on the urgency). In estimating how long it will take to put a warranty and indemnity insurance policy in place, the buyer should also remember that it may be dealing with a number of different insurers.

⁴ It is possible that the seller might accept such warranty insurance being obtained as a condition precedent to completion (generally only if the commercial terms of the policy have been obtained by a reputable broker, subject to final underwriting).

⁵Section 21, *Insurance Contracts Act 1984* (Cth),

The primary policy (being the first layer of insurance) may be provided by a local insurer, but higher amounts of insurance may require different layers of cover provided by multiple offshore (generally European or US) insurers. Even without the delays caused by dealing with insurers in other time zones, settling final terms with every insurer can be quite time consuming.

Another complicating factor is the possibility that different insurers may have "standard" exclusions that are inconsistent with the expected operation of the warranty and indemnity insurance.

For example, the seller may give a warranty that the assets being sold are free from any environmental contamination. If an insurer of one of the layers has a "standard" exclusion of liability for environmental contamination, the buyer may need to negotiate with the insurer or find a different insurer. This type of potential delay needs to be factored in by buyers.

An odd result - the right to terminate under the sale agreement

A buyer will often demand a right to terminate the sale agreement if, between signing and completion, it becomes aware of a breach of warranty where the losses are likely to be higher than an agreed threshold amount. The buyer's argument is that a warranty claim of this size constitutes a fundamental change in the value of the asset that is being purchased. In that situation, the appropriate remedy is to terminate the transaction and/or to renegotiate a reduction in the purchase price before any money is paid.

A seller will usually resist giving the buyer such a termination right. If that fails, the seller will negotiate over the appropriate threshold amount. The buyer will want it as low as possible, while the seller will argue the opposite.

However, if the buyer takes out warranty insurance, it may actually end up arguing for a **higher** threshold.

This odd result arises from the fact that, if a breach of warranty arises before completion, the amount claimable under the warranty may be difficult to quantify with any certainty.

A buyer without warranty insurance in that situation has two options. It can terminate - and run the risk of being sued by the seller for loss of contract (if its assessment of the potential loss is wrong and the loss turns out to be less than the threshold amount). Alternatively, it can elect to complete and sue the seller for breach of warranty. If the seller is a person of financial substance, a risk averse buyer would probably elect to complete.

A buyer with warranty insurance is faced with a quite different choice. If it elects to complete in circumstances where it could have terminated, its insurance may not respond to a claim for the pre-completion breach of warranty, because the loss is one which the buyer elected to incur⁶. Its other choice is to terminate - with the attendant risk of being sued for loss of contract damages. In short, the buyer could find itself "between a rock and a hard place".

The somewhat perverse outcome is that a buyer may prefer to increase the relevant threshold amount, simply to reduce the likelihood of ever being faced with such a decision.

How does insurance impact on the approach to due diligence?

Before providing warranty and indemnity insurance, an insurer will want to be satisfied that the buyer has undertaken sufficiently comprehensive due diligence on the target business.

To that end, the insurer's own advisers will usually review due diligence reports prepared by the buyer's advisers and (if available) the seller's advisers, and the primary due diligence materials made available by the sellers. The insurer will also question the buyer and the buyer's advisers about the due diligence process.

Importantly, if the insurer identifies any matter which has been flagged as a potential issue in due diligence but which it believes has not been adequately resolved (either by further inquiry or concrete steps having been taken to address the risk), the insurer may expressly exclude liability in respect of the "unresolved risk".

Insurers' reluctance to insure unresolved risks affects the way the buyer approaches due diligence.

⁶ Insurance policies provide coverage against losses that occur only on a chance basis (called a "fortuitous loss"), where the insured cannot control the loss.

Generally, due diligence is a balance between the costs of undertaking further inquiry (ie. time, money and resources) and the benefits (ie. reduced reliance on warranty claims and more accurate up-front pricing of the deal). To put it another way, a buyer may decide to save itself the costs of further due diligence and instead "rely on the warranties".

However, if the buyer is relying on warranty insurance (and the seller bears little or no liability under the warranties), the position of the buyer is quite different. If the buyer elects not to further investigate an issue in due diligence, the "unresolved risk" may be excluded from cover, and there will be no ability to rely on either a seller's warranty or warranty insurance if the "unresolved risk" crystallises as a loss.

In summary, if a buyer plans to rely on warranty insurance, rather than recourse against the seller:

it must be able to establish to the insurer that it has undertaken a comprehensive due diligence process; and

it must understand that matters which are left "unresolved" in due diligence are likely to become buyer risks (and not seller risks, as would be the case under a traditional warranty regime).

What effect does warranty insurance have on the negotiation of warranties?

Insurers will be reluctant to provide warranty insurance if they believe that the warranties have been provided without much thought or resistance by the seller. Therefore, part of the insurer's own due diligence will be to question the buyer as to the nature of the negotiation process.

In practice, the seller has three incentives for resisting giving a possibly inaccurate warranty:

- The risk of potential contractual liability under the warranty.
- Perennial sellers of companies (such as private equity funds) may want to minimise the likelihood of insurance claims for their breaches of warranty, to ensure that insurers will continue to offer warranty and indemnity insurance in respect of their deals.
- Potential extra-contractual liability for claims which are not (or cannot) be excluded under the sale agreement (eg. fraud or statutory liability for misleading or deceptive conduct) - which is discussed further below.

If, under the terms of a sale agreement, the buyer is obliged to take out warranty insurance and to claim on that insurance (and not claim against the seller for the breach) the first incentive is removed, but the other two often remain. In practice, prudent and well-advised sellers will still take a rigorous approach to negotiating the warranties that they are prepared to give.

What liability does the seller still have?

Often the objective of warranty insurance is to give the buyer protection against loss for breach of warranty, while at the same time enabling the seller to minimise its liability for breach of warranty.

In some transactions, the sale contract provides that the buyer's only recourse against the seller for breach of warranty is for a relatively small amount. This amount can be as low as \$1.

Of course, in Australia the ability of the seller to contractually limit or exclude liability is subject to the overriding liability for misleading and deceptive conduct under provisions such as section 18 of Schedule 2 of the Competition and Consumer Act 2010 (formerly section 52 of the Trade Practices Act). There are a number of contractual devices that might minimise or avoid this liability, but they are not completely effective.

The other potential avenue to seller liability – which insurers will insist is not excluded under the sale agreement – is fraud.

In either case (misleading or deceptive conduct, or fraud), a buyer that recovers its loss under its warranty insurance policy cannot then claim against the seller (whether for misleading or deceptive conduct, or fraud) unless it reimburses the insurer for any amount recovered. This reflects the common law principle that a person cannot recover twice for the same loss.

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The insurer, on the other hand, would be able to exercise its rights of subrogation and enforce any rights that the buyer might otherwise have had against the seller. We are not aware of any insurer exercising such a right in the context of warranty insurance in Australia. However, insurers will still insist that the sale contract does not seek to limit the seller's liability for fraud, to ensure that the possibility of such a claim remains.

A technical legal reason why the sellers still need to have some liability: the insuring clause

Apart from the potential commercial benefits, insurance law provides a very good legal reason for the seller retaining some liability.

The concept is simple: for there to be effective liability insurance, there must be a liability. If the sale contract is expressed so that the seller simply has no liability (or, say, liability of only \$1), and if the policy provides an indemnity for loss for which the buyer would have a claim against the seller under the sale contract, then in the event of breach of warranty the buyer wouldn't have cover under the policy because there would be no liability on the part of the seller for insurer to indemnify.

Therefore, to be certain that the limitations or exclusions of liability in the sale contract do not undermine the insurance cover, the limitation of seller liability needs to be carefully drafted. Essentially, it needs to be clear that the seller has liability under the warranties – and that the limitation of liability does not have effect to the extent that the liability is recoverable by the buyer under the insurance policy. This is a subtle but ultimately a very important difference.

Conclusion

Warranty and indemnity insurance is designed to make life easier for buyers (and sellers) in financial terms.

Like any major commercial insurance, however, it is not a one-size-fits-all product. As the party left with the risk of an unenforceable warranty, it is in the buyer's interests to ensure that the policy's coverage is, as much as possible, co-extensive with that risk. Because of the many variables noted in this paper, it behoves the buyer to think about such bespoke insurance and plan for it as an integral part of the sale process itself.

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