



## Warranty and Indemnity Insurance



Bring on tomorrow®



## W&I insurance : step by step



**Warranties given in an SPA play an important role in M&A transactions, by aiding information gathering and clarifying the scope of legal liability attributable to the warranting parties.**

Warranties serve as a vital risk allocation tool in virtually all share and asset sale transactions and the extent to which sellers agree to compensate buyers for breaches of warranties is one of the critical determinants of the target's purchase price. The warranties given in an SPA are often heavily negotiated and can form one of the most contentious aspects of the deal negotiations.

Even in transactions that involve sophisticated buyers and sellers supported by experienced professional advisers, there always remains the risk that factual matters are overlooked during the due diligence and disclosure process. Transacting parties seek an apportionment of these contingent risks and tend to heavily negotiate warranties with:

- Buyers seeking maximum protection from sellers in the event of a breach of warranty
- Sellers trying to minimise liability in order to retain as much of the deal proceeds as possible and not locking proceeds in escrow accounts

In this context, Warranty and Indemnity (W&I) Insurance serves as an additional and alternative tool for transferring the risk of losses to a third party (being the Insurer), thereby reducing or removing exposure to financial loss caused by a breach of the warranties agreed between the parties to the SPA.



# What is W&I?



Warranty and Indemnity insurance responds to cover financial losses arising from breaches of the warranties, and in certain jurisdictions tax indemnities, provided to facilitate a variety of corporate transactions, especially mergers and acquisitions.

In a transaction, either the buyer or the seller may be protected by W&I insurance. It aims to provide back-to-back cover for the seller's liability under the SPA. The W&I policy "steps into the shoes" of the seller by responding to claims brought by the buyer for a breach of warranty or claim under a tax indemnity.

A buyer policy indemnifies with the buyer for losses caused by breaches of warranties and tax indemnities given by the seller in the SPA. It enables the buyer to claim directly from the insurer without first having to pursue the seller.

A seller policy indemnifies the seller/s for losses resulting from claims made by the buyer for breaches of the warranties and tax indemnities given in the SPA.

## Some other Terms and Abbreviations used in this brochure

De minimis	The minimum quantum of an individual claim for it to be recognised as a valid claim under the policy
M&A	Mergers and Acquisitions transactions
PE	Private Equity
SPA	Sale and Purchase Agreement
W&I	Warranty and Indemnity Insurance



## W&I insurance can be applied to provide strategic solutions to a range of transaction hurdles

### Strategic positioning in an auction process

**FOR THE SELLER, CAREFUL PLANNING AND THE INTEGRATION OF W&I INSURANCE INTO THE AUCTION PROCESS** can result in higher bids for the target (the seller can offer a customary set of warranties PLUS a higher warranty cap from the beginning of the process); a larger group of bidders being interested in acquiring the target (e.g., strategic investors buying from financial investors), or a more competitive bidding environment (as all bidders are offered the option of warranty protection).

**A BUYER** can also strategically deploy W&I insurance to differentiate themselves from other bidders by requiring a lower warranty cap from the seller, buying additional insurance coverage to protect itself against financial losses for breaches of warranties and thereby offering the seller a "cleaner" exit.

### Seller unwilling or unable to provide warranties

**PRIVATE EQUITY FIRM EXITING INVESTMENT.** A seller is often able but unwilling to give warranties beyond capacity and title (e.g. often private equity firms need to distribute sale proceeds to its investors or reinvest proceeds immediately on completion and may distribute sale proceeds to its investors or reinvest proceeds immediately on completion and may, therefore, be unwilling to accept any contingent liability under the warranties). A buyer needs or seeks "customary" warranty protection and is willing to pay for such protection.

**CORPORATE SELLERS WITH SHORT OWNERSHIP HISTORY.** Seller may be "selling on" a company which it acquired perhaps as recently as 12 months ago and is unwilling to give any warranties for periods prior to its ownership.

**INSOLVENCY.** Insolvency administrator is selling key assets and is not able to give warranties (or is unwilling to financially back such warranties appropriately). Investor is seeking "customary" warranty protection which may increase the value of the asset significantly.



### Enforcement difficulties

#### SELLER IN FINANCIAL DIFFICULTY OR WITH A POOR TRADING HISTORY.

Although the seller may be prepared to stand behind substantial warranties, buyers may be concerned over the seller's ability to meet claims throughout the warranty period, particularly if alternative solutions (such as an escrow or a letter of credit) are not available.

#### SELLER AND BUYER IN DIFFERENT JURISDICTIONS.

The resources required to obtain a judgement and then enforce it against parties in foreign jurisdictions is usually economically and operationally onerous.

### Protecting key relationships/ Claims process

#### AVOIDING CONTENTIOUS NEGOTIATIONS AND ACTIONS.

The seller may have vital skills and relationships that the buyer wants to retain in the business post-closing, or the buyer may be depending on future business relationships with the seller after the transaction. By arranging a buyer side W&I policy, buyers can avoid actions against the sellers.

To bring claims against the insurer may be a less disruptive exercise than trying to enforce remedies for breaches of warranties against former owners of the business.

### Low cap or restricted warranty survival period

#### WHEN BUYER IS A CORPORATE OR PRIVATE EQUITY FIRM,

its internal investment guidelines or commercial prudence may require a higher cap under warranties than the sellers are prepared to offer.

#### SELLER WISHING TO EXIT AN INDUSTRY SECTOR OR GEOGRAPHIC LOCATION.

Typically a corporate seller exiting an industry sector or particular country may not wish to be exposed to liability for the warranty period, particularly if it wishes to announce that it no longer has any material liability in that particular sector or country.

#### SELLERS WHO DO NOT WANT ANY RESIDUAL LIABILITY.

Sellers may require a low cap on their liability under the warranties for various reasons. For instance, a seller not wishing to risk the sale proceeds through a warranty claim, or needing to repay third party debt and not having the proceeds available to pay a claim.





# The W&I Policy



Each W&I policy is a bespoke insurance solution tailored to meet the specific needs of a transaction.

Our aim is to make the coverage under the policy back-to-back with the recourse and risk allocation agreed between the buyer and the seller in the SPA and to mirror the minimum claim provision (de minimis) and other limitation language (or disregard certain limitation language where the Seller has agreed a suite of "customary" warranties but has not provided for any liability under such warranties).

The duration of the policy will match the warranty survival periods under the SPA (including any

extended period for tax) but may also be extended if required by the client.

Cover on a buyer policy will also respond to cover fraud by the seller.

The W&I policy will be subject to certain exclusions. Typical standard exclusions are:

- known issues e.g. matters set out in the disclosure letter
- pension underfunding
- seller fraud (seller policies only)

## How much will it cost?

Assuming that the W&I policy provides for an insured limit of liability corresponding to 10-20% of the enterprise value and a retention of 1-2% of the enterprise value, our typical premium range is

**1% - 3% of the W&I policy limit**

## Underwriting Considerations

The insurance premium is determined by an assessment of the following transaction specific variables:

### Complexity of the transaction

Limit of cover vs total purchase price or enterprise value

### Scope of cover (scope of warranties, limitation language, de minimis, etc.)

Duration of cover

### Financial stability of the parties

Industry sector

### Geographical spread of the business

Level of risk retained by the parties

### Quality of advisers involved

Quality of transaction process and information available to the underwriters



Some illustrations based on  
our experience of successfully  
deploying W&I insurance



### 1. Strategic use of W&I insurance in an auction (PE seller)

**SELLER:** Swedish PE seller seeks to divest one of its portfolio companies (enterprise value: SEK 850m). As potential bidders will generally price into their offers reluctance on the part of PE sellers to offer customary warranties (backed by the usual warranty cap), the seller offers bidders these warranties from the start, backed by W&I insurance. They also agree to pay the premium, up to an insured limit of SEK 150m above a SEK 15m retention. The seller's data room SPA provides for the following structure: buyer threshold (deductible): SEK 7,5m, seller's warranty cap: SEK 7,5m and a purchase price adjustment deducting the insurance premium. AIG offers the bidders an insurance programme to cover SEK 150m in breaches of warranties. The sellers therefore attain a higher exit value, while the buyer has full recourse under the warranties.

**BIDDER:** German strategic buyer is one of several bidders for a target being sold in an auction process (PE seller). Strategic suitability means the buyer is prepared to offer the relatively high purchase price of EUR 150m. Internal guidelines require them to obtain customary warranties and an appropriate warranty cap (e.g. 20% of purchase price), backed by escrow. The strategic buyer fears that these conditions may not be attractive to the PE seller despite the high offer price; resulting in a competitive disadvantage against bidders demanding fewer (or even none) warranty protections. W&I insurance can permit the buyer to offer to the PE seller the full EUR 150m purchase price, together with a small seller-retained EUR 1,5m warranty cap (following a EUR 2m buyer threshold deductible), with the insurer providing buyer a EUR 30m limit policy above the seller's cap to meet internal guidelines. This is a buyerside policy giving the buyer recourse to breach for warranty, and the seller greatly reduced exposure under the warranties. The buyer pays the full premium.

## 2. Investment exit by financial investor

French PE firm is exiting its investment in a technology company at an enterprise value of €500m. The buyer requires substantive warranties with indemnification obligation of €50m, which the PE owner is unable to give, as it cannot take on long-tailed financial liabilities during the divestment phase of its fund's life-cycle. Management is prepared to warrant up to €10m (reflecting 50% of their €20m stake in the business). Placing part of the purchase funds into escrow to cover potential warranty claims would prevent a clean exit for the private equity firm and the alternative of a price reduction is not attractive.

The buyer could purchase a €40m W&I policy to meet the total €50m indemnity requirement. This might be structured so that the buyer must first pursue management up to their €10m limit, or it could run pro rata with management's liability. The SPA would therefore provide for a warranty cap of €10m, backed by management's escrow; the PE seller assumes no additional liability.

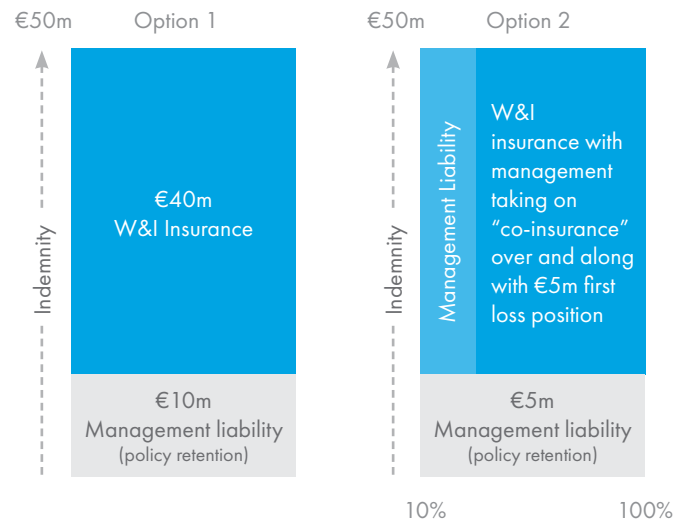


CHART 1: W&I policy sits above (option 1), or runs concurrent with (option 2) management indemnity, to allow PE firm a clean exit



### 3. Strategic use of W&I insurance in an auction

UK-based aviation firm has been adversely affected by a downturn in the sector and poor balance sheet management, creating pressure on its cash flows. It decides to divest a profitable subsidiary for £75m in order to pay down third party debt. The seller is prepared to stand behind the warranties in the SPA, but the buyer is concerned about the solvency of the parent and its ability to meet a breach of warranty claim in 12 months' time.

The buyer may be satisfied that the seller could meet a claim of £2m and could therefore purchase insurance to fill the shortfall in the total amount of indemnity being sought – at 30% of the transaction value. AIG structures an insurance solution that removes the credit risk for the buyer above the £2m threshold.

### Additional value created by W&I insurance

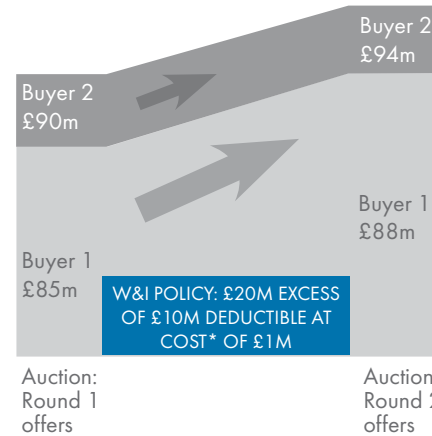


CHART 2: Increasing the warranty cap by using W&I to supplement seller's warranties can make target more attractive to bidders

\* Cost for illustration purposes only

### 4. Key Insurance Drivers

#### BUYER

#### SELLER

Protection when buying from a seller unwilling or unable to give recourse for warranties or indemnities

Cleaner exit, freeing up sale proceeds for distribution to investors

May replace breach of warranty actions against continuing management warrantors and retain their focus on the business

Bridges the warranty gap left by financial sellers

Extension of warranty period and warranty cap

Helps avoid long tail liabilities left outstanding

Reassure shareholders and other investors/lenders by reducing risk of deal and preserving value of transaction

Enables higher sale price by transferring risk to insurer

Concern over seller's financial status/enforceability of seller's indemnity

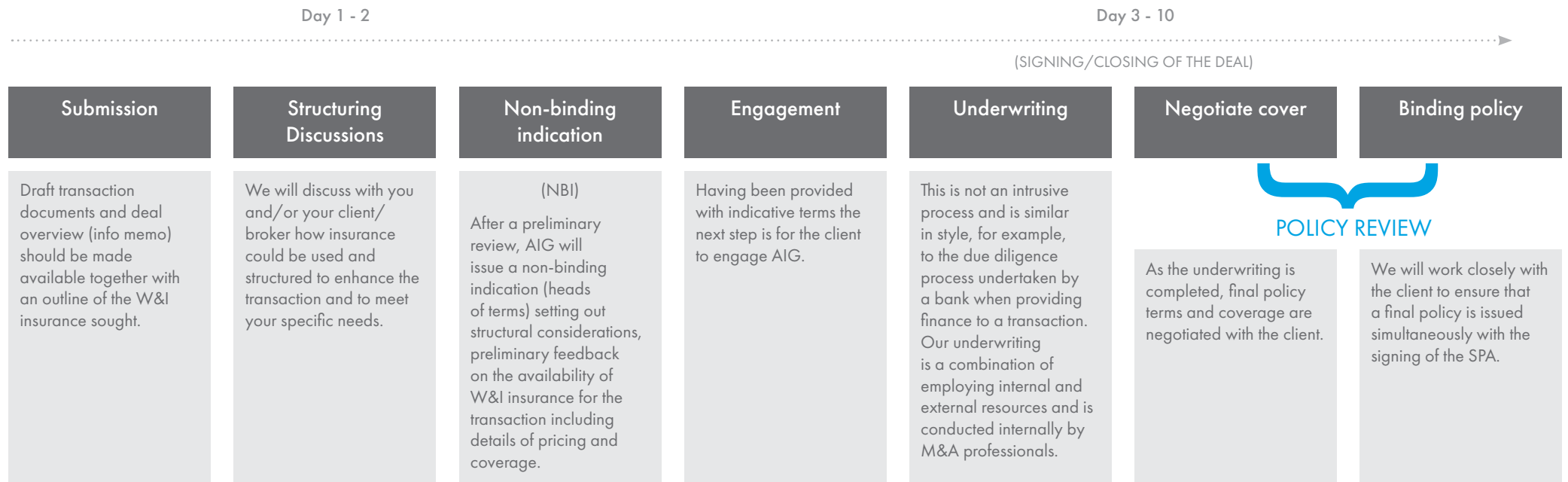
Prepares "cleaner" targets for auction process



# The W&I underwriting process: Seamless interaction with the deal team and the transaction process

With our experience and combination of legal, accounting and underwriting expertise, we structure W&I insurance solutions to meet transaction requirements and deal timetables. If W&I insurance is considered for one of your transactions, our M&A Insurance team or your insurance adviser should be contacted without delay.

## The underwriting process:






# Questions & Answers




**Q1. What size transactions can you insure?**

The economics of transactions with deal values in the range of €25 million up to €1.5 billion lend themselves well to our W&I policy cover. We have also supported transactions in the multi-billion € and £ range.

**Q2. What limits are available?**

Up to US\$ 100 million (€90 million, £65 million) cover is available from AIG for any one transaction.

Larger programs can be structured in co-operation with insurance brokers and co-insurance with other insurance markets.

**Q3. How much is the premium?**

The W&I policy premium is a one time charge, generally between 1% and 3% of the amount of cover purchased. The premium depends on several variables (see section titled Underwriting Considerations) unique to each transaction.

**Q4. What is the policy period?**

The term of each policy varies, but generally speaking the policy period matches the survival period for the warranties set forth in the SPA. Upon request, and in order to enhance a buyer's protection, we are able to offer a policy term for certain warranties that exceed the respective duration of the warranties in the SPA.

**Q5. How much is the insurance excess (retention) and how is it determined?**

The retention is usually around 1% or 0.5% (or lower where the underlying asset is real property) of the enterprise value of the transaction and is a function of several variables that impact our risk perception of the transaction. It may be shared by buyer and seller and usually includes the buyer's threshold.

**Q6. Protection for known or discovered risks**

Risks discovered or disclosed during the transaction process are not normally covered by the warranties (due to buyer's knowledge limitations) but are dealt with by way of specific indemnities. Such risks can be covered by means of other insurance products, such as cover (cost-cap) or true-risk transfer schemes for, e.g:

- ongoing, or threatened, litigation or dispute
- residual risks relating to known tax issues / tax structure of the acquisition
- known environmental risks contamination of sites, etc
- certain contingent risks identified in due diligence (i.e. potential legal liability for past acts).

Please contact your insurance advisor or our M&A Insurance team for further details.



## Why should I consider AIG for my warranty insurance requirements?

### Market leadership.

AIG is a market leader in W&I and M&A insurance solutions, with underwriters strategically located in financial hubs in North America, Europe, Asia Pacific and Australasia. This is evidenced by our market leading underwriting capacity (up to US\$100 million for a transaction).

Since it was established in late 2000, AIG's market-leading M&A team has reviewed and underwritten transactions in almost all European jurisdictions, Asia, Australia and Japan.

### Product innovation.

We are known for our commitment to new product development and innovation, evidenced by our comprehensive suite of offerings targeted to meet the risk management requirements of an M&A transaction with an emphasis on delivering customised solutions.

### M&A team credentials.

Our expertise in applying insurance capital to M&A transactions is evidenced by AIG's expert team, having in-depth experience in corporate law, commercial insurance, accounting and investment banking. Transaction solutions are developed by experienced M&A professionals, bringing hands-on experience in cross-border transactions to the table. We also employ a panel of leading law firms to provide additional local and sector knowledge and expertise and to facilitate the deployment of W&I and other insurance products within M&A transactions.

This brochure is a general overview. It is not to be construed as an offer of coverage; nor does it indicate our willingness to provide cover in relation to any of the specific issues discussed.



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