The Role of W&I Insurance Summary

AIJA M&A and Real Estate Seminar (Panel #4)
Deals in leisure: The industries that bring enjoyment to your life – wine, food and hospitality
Speakers: Virigina List, Gülsüm Aslan, Fabio Schiavotiello
Moderator: Friederike Henke

Setting the stage

On the 6 October 2023, the International Association of Young Lawyers (AIJA) hosted the M&A and Real Estate Seminar in Piedmont, Italy. The purpose of the seminar was to provide the unique opportunity to look at M&A and real estate deals in the food, wine and hospitality industries. Panel 4 covered the topic of W&I insurance related due diligence aspects, and offered a com-prehensive overview of the international development of this new tool becoming increasingly popular in real estate and M&A transactions. The panel consisted of Virigina List (Howden), Gülsüm Aslan (Risk Capital Advisors) and Fabio Schiavotiello (Ryan Transactional Risk) and was moderated by Friederike Henke (BUREN). The below publication offers a summary of the panel discussion.

What is W&I insurance?

W&I insurance is an abbreviation of warranty and indemnity insurance. This consists of a policy that is meant to cover losses deriving from the incorrectness or untruthfulness of the representation and warranties given under any acquisition agreement. One major identifiable difference between W&I policies and other M&A policies is that W&I policies provide cover for unknown risks. It provides an alternative to usual liability safeguards such as escrow, bank guarantee. It has proven it's worth by providing a secure way to "de-risk" a transaction and thereby is expected to further develop and grow in popularity on the market in the coming years.

Impact of the Pandemic and jurisdictional Applicability

The pandemic had some unexpected effects on the market as a surge in M&A transactions occurred a few months into the pandemic. With this surge came an influx of M&A policies being taken out to safeguard the transactions. Since then the market has developed, which can be attributed to the level of competition in the field of W&I insurance. Therefore, one can currently observe more insurers on the market offering W&I insurance policies. Recent transactions led to more favorable terms for clients leading to balance the scale between the parties.

In the past, terms were more likely to favor the insurer, if one party was at an advantage, since terms tended to be more conservative and provide for itemized exclusions. In W&I insurance, these harsh conclusions are not usually applicable, partially attributable to the competitive market. Therefore, the trend leads to a highly developing market in favor of the client.

A large portion of the panel operated in the Italian jurisdiction, therefore it was affirmed that there had been a stagnation in M&A transactions but not in W&I insurance as a consequence of the pandemic. Due to this product only being polarized in recent years on the Italian market, it is difficult to draw a comparison and to identify long term trends. However, Italian private equity seemed to require this W&I insurance, to which brokers and insurers hired Italian qualified lawyers to develop the product. Thereby, with an understanding of the jurisdiction-specific risks, the Italian W&I market is still adjusting to match the more developed UK market, which is where W&I insurance originated. Therefore, it has been easier to achieve a more flexible approach, better terms, and broader coverage in the UK, than in Italy or other southern European countries. On the contrary, the Northern European Market (including The Netherlands) is more developed since W&I insurance has had a chance to prove itself and it is considered to have lower risk levels than the south. Whether that rings true remains to be seen.

Costs

Depending on the type and nature of the transaction, costs can vary. This is applicable to both M&A and real estate transaction and is usually expressed through a percentage value. This value is calculated with the enterprise value (EV) of the transaction. The EV of the transaction, or of the asset if it's a real estate, will influence the policy limit. The standard parameters of the policy limit are usually 10%, 20%, 30%. Further, the real estate market is perceived as less complex and lower in risk, which also affects these policy limits.

Across Europe, especially in the UK and the Netherlands, for instance, or the Benelux, it is apparent that the competition on the market has also translated into lower premiums compared to other jurisdictions. Within the scope of operational transactions, premium ranges are now between 0.6 to 1.5 percent of the policy limits that are taken out. In real estate transactions, premiums tend to be lower at around 0.4 to 0.8 percent of the policy limits that are taken out. Therefore, in real estate transactions, like the hotel sector, for instance, or other leisure business like golf resorts or any kind of operational real estate transactions, a premium range of 0.5, 0.4 to 0.8 percent of the policy limits is applied. In pure real estate transactions this will most often be quoted at the lower end of that range. Therefore, when discussing policy limits, it is relevant to note that they are usually taken out at 20 to 30 percent of the target's enterprise value. However, this is heavily dependent on the type of deal, as insurers on the market were willing to go much higher in terms of policy limits, and have also been known to offer limits equal to 50 percent of the enterprise value.

Synthetic W&I insurance

Synthetic W&I insurance is an alternative that is available on the market, which offers additional coverage to transactions. In a standard W&I policy the share purchase agreement stipulates that the seller is usually the party providing for warranties.

Synthetic W&I insurance can compensate for these scenarios. In the case of tax, for example, the tax warranty schedule can be separated from the SPA itself and treated as an autonomous agreement no longer only between the buyer and the seller, but the buyer and the insurer to apply to situations in which the seller is not willing to compensate. This can be treated entirely separately from the SPA, resulting in full coverage by the insurer, or as a partial scheme to fill any gaps that the seller decides to exclude in the original tax warranty coverage. Due to this additional coverage, synthetic policies tend to be more expensive than the standard W&I package.

Due Diligence

Due diligence has a significant influence on the coverage of W&I policies as it determines the scope of the coverage. Brokers therefore assist clients by exercising a gap analysis to determine whether the policy parameters are justified. By identifying any weak areas or matters that have not been covered early on, the broker can then address those early in the process. Without this analysis, the client runs the risk of certain aspects not being covered. In specialized areas it is also common to commission a specialized broker to complete specific insurance diligence.

No goes for Insurers

Insurers expect the conducted due diligence to match the scope of the material areas covered, however there are exceptions. There is an element of flexibility to provide cover for non-material areas or jurisdictions. In real estate transactions, the issue would most likely stem from compliance with planning and permits. Therefore, both technical and legal due diligence would be required to address those matters.
Further, there are some specific sectors that fall outside of the typical scope of W&I insurance since they are covered by other products.
As previously mentioned, conditional assets, the de facto conditions of the property, are usually covered by non-property insurances. To provide another example, pollution and other environmental factors are generally covered by

environmental policies developed specifically for that purpose. However, W&I schemes can also compensate for any gaps in these pre-existing policies. Therefore, the market is flexible to adapt to the needs of a transaction on a case-by-case basis and under certain conditions.

Key take-aways

Key take-aways from this panel are that W&I insurance is here to stay as it serves as an appropriate tool to cover risks that arise from M&A and Real Estate transactions. It is key for the process that the decision to take out the insurance is taken early on in the process so that due diligence can be aligned to the insurance scope and vice versa.

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