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W&I insurance

Upward trend

Since 2017, the use of R&W insurance policies in M&A transactions (known as R&W insurance or W&I insurance) is on the rise, in part because (i) the contracting process has been simplified in time and form; (ii) there is greater supply-side competitiveness, leading to lower premiums; and (iii) the trend has been driven by a seller's market.

Therefore, although they are not yet widespread, until 2020 the trend was clearly upward, especially in transactions involving private equity funds and in auction processes. However, owing to the COVID-19 pandemic, this upward trend seems to have slowed down somewhat.

Seller-side vs buyer-side policies

Although W&I policies are available for the seller (seller-side policy) and the buyer (buyer-side policy), most of them are buyer-side policies. In buyer-side policies, the buyer will claim directly against the insurer to recover the economic loss resulting from the contingency. In seller-side policies, the buyer will claim from the seller under the SPA R&W, and the seller will then claim from the insurer under the policy.

In both cases, the policy is intended to provide coverage for breach of the seller's R&W in the SPA, and the general principle is that the insured's situation cannot be better than it was before taking out the policy.

With and without recourse

Policies can be:

- without recourse to the seller, meaning that the seller has no liability to the buyer in case of untruthfulness of the R&W (with the exception, normally, of the fundamental warranties—i.e., those relating to the seller's capacity and title to the shares), and the buyer's only recourse is to the W&I insurance; or
- with recourse to the seller, meaning that the SPA sets liability limits and thresholds. The seller is liable above the threshold and up to the limit.

Types of coverage

The market basically offers four types of coverage choices, the first being the most common.

- **Unknown risks**. These policies cover breaches of the seller's R&W in the SPA.
- **Known and identified risks**. These tailor-made policies cover certain risks already identified (e.g., in the due diligence). They can often provide an additional solution to risks for which the parties did not reach an agreement in the SPA (e.g., through specific indemnity).
- **Tax insurance**. These are also tailor-made policies that cover certain previously identified tax risks.
- **Legal expenses insurance for ongoing disputes.** Also known as After the Event (ATE) Insurance.

Favorable scenarios for W&I insurance

W&I insurance can offer advantages in the following scenarios:

- **Seller's clean exit.** For example, in the case of private equity funds that disinvest to pay the agreed return to their stakeholders and plan to dissolve within a short period of time.
- **Beauty contest.** In auction processes, this can be a differentiating tool for the buyer, as it allows to offer more attractive contractual conditions.
- **Multiple sellers.** Particularly in the case of joint and several liability where the sellers are natural persons.
- **Extension.** This can serve as a complement to the buyer to extend the qualitative or quantitative limits set by the seller in the SPA in the absence of an agreement between the parties to establish broader limits or periods. It may also be useful in cases where the buyer has doubts about the seller's financial solvency.
- **Future relationships between the parties.** This allows them not to be directly involved in claim handling processes.

General exclusions

In general, R&W policies for unknown risks do not cover the following:

- **Known risks**
- **Matters not covered by the due diligence**
- **Anti-corruption, bribery, money laundering and tax evasion**
- **Fines and penalties**
- **Price adjustment or locked box mechanisms**

- **R&W as to future events**
- **Environmental liabilities**
- **Transfer pricing and joint and several tax liability for group membership**
- **Statement of assets**
- **Product liability**
- **Obligations and commitments of the seller on the management of the business during the interim period**
- **Offsetting tax loss carryforwards**
- **Legislative changes**

Contracting process

The contracting process has two phases:

- **Non-binding indications (NBI)**. In this phase, the confidentiality agreement is signed and the necessary documentation is provided. Following the relevant assessment, the broker contacts different insurance companies to send the NBIs. The broker then analyzes this information and sends a report to the client with a summary and recommendations so it can choose an insurance company. The first phase ends with the execution of an expense agreement.
- **Policy negotiation and underwriting.** The insurer and its external advisors review the documentation and the underwriting call is held with the insured to resolve any doubts. The draft policy is then negotiated and, if the negotiation is successful, the contract is executed. A no claim or no knowledge of loss declaration will be required.

  Policies are normally structured as follows: (i) particular conditions with a key-points summary; (ii) terms and conditions; (iii) warranty spreadsheet; and (iv) other attachments, which usually include a copy of the SPA and the no claim declaration.

Key-points checklist

The entire draft policy should be carefully reviewed before the execution of the SPA or the closing (as the case may be) to ensure consistency between the policy and the SPA. Special attention should be paid to the following points:

- The **definitions** included in the policy terms and conditions. Particularly relevant are the definitions of damage, seller's knowledge, team members or similar, disclosed or disclosure, documentation provided or similar, and tax definitions.
- The **warranty spreadsheet**, as it contains a list of all R&W, detailing those included, partially included, or excluded from coverage.

- Within the **terms and conditions of the policy**, it is generally important to analyze the seller's liability under the SPA and the policy to determine the seller's liability in the transaction not transferred to the insurer. For example, it would be important to analyze the caps and deductibles, the interim period, and the duration.

Bring-down mechanism

A **bring-down mechanism** can be agreed on so that the insurer covers the R&W at or very near the closing date. In this case, the seller can provide a bring-down certificate (bring-down disclosure) certifying the accuracy and truthfulness of the R&W on the date of the certificate. If any facts or circumstances known to the seller are identified or occur after the execution of the SPA and cause the R&W to be untrue or inaccurate at the closing date, it may be agreed that those facts or circumstances disclosed in the bring-down certificate will qualify the R&W.

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