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W&I Insurance Claims on the Rise

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1. Introduction

► A current case shows impressively: after M&A transactions, sellers can be confronted with significant claims for damages - especially in times where target values are high. W&I insurance policies cover this risk and protect the parties involved from the impact of warranty breaches and indemnification claims. What decision makers should know.

The announcement caused an uproar in the M&A scene recently: The private equity house, FSN Capital, announced that it had received EUR 50 million in compensation for damages under a warranty and indemnity liability insurance policy resulting from errors in the financial statements of a target company which they had acquired in an M&A transaction.

It was shortly after completion of the transaction, that material misstatements in the financial statements were discovered leading to a significant drop in the target company's EBITDA. According to the claim of FSN Capital, the seller had provided „false and misleading“ information in the due diligence process violating warranties included in the share purchase agreement.

FSN Capital reported that after detailed investigation the W&I consortium of twelve insurers had acknowledged insurance cover and paid EUR 50 million in full. FSN Capital partner Thomas Broe-Andersen was pleased, emphasizing: „The insurance consortium acted very professionally“.

This W&I claim is interesting not only due to the significant amount of money involved, but also because the information has been made public. In most cases, W&I claims and M&A disputes are settled behind closed doors.

2. High prices, disappointed investors

For several years we have seen an increasing frequency of W&I claims. No surprise given the growing use of W&I policies on M&A transactions. According to market studies and our own observations, between 10 and 20% of M&A transactions result in a W&I claim.

High prices paid in M&A transactions due to positive market conditions in recent years mean an increased risk that targets are perceived to perform below expectation post-transaction. Buyers are desperate to find ways of recouping damages. It is obvious that they look at warranty breaches as a basis for claims.

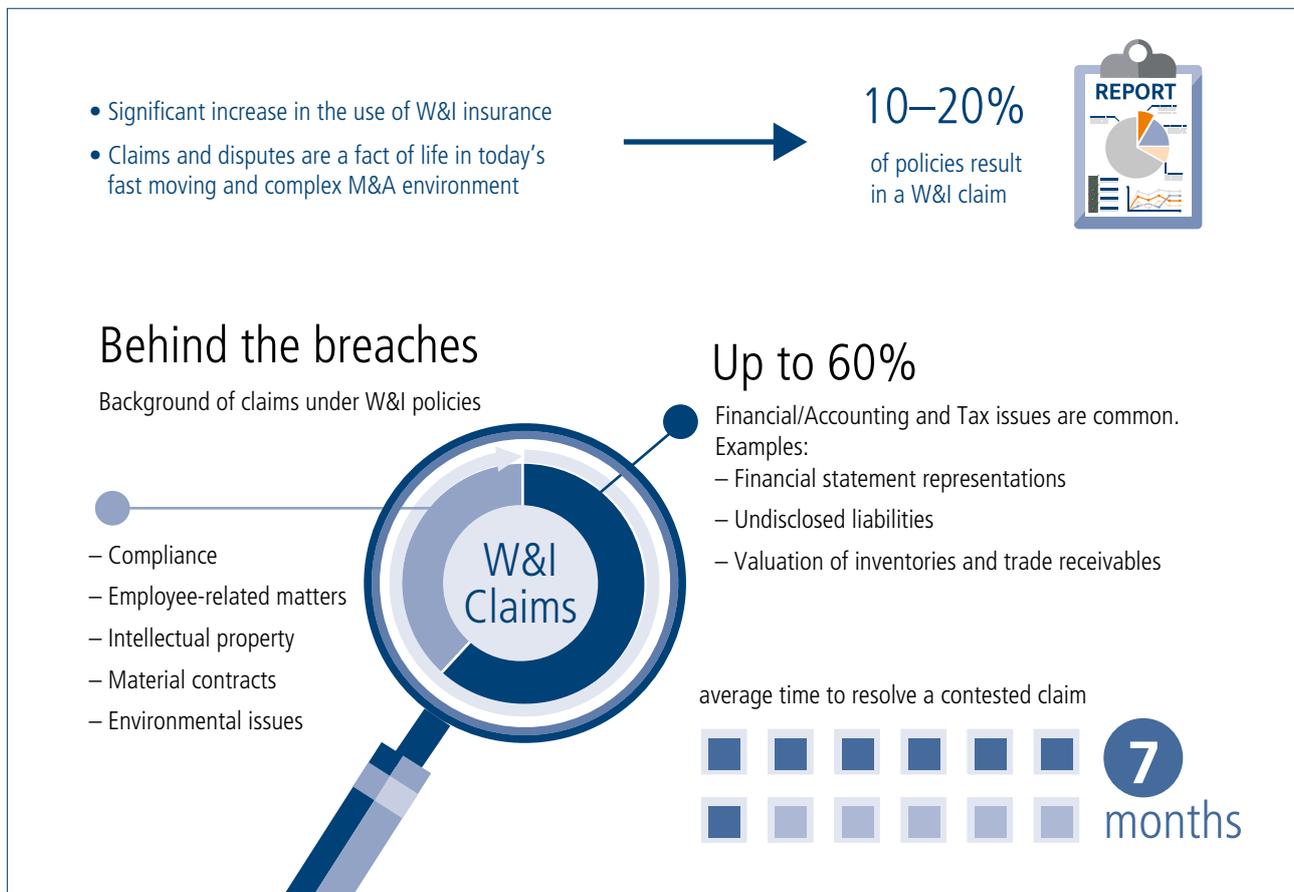
Financial statement and tax warranty breaches are the key drivers of W&I claim notifications. This comes as no surprise as financial data is of essential importance in valuing of a target company and is therefore reflected in contractual representations, warranty and indemnity provisions.

For instance, buyers generally request a „financial statement representation“ – i.e. the explicit assurance that the financial information has been prepared in line with underlying GAAP and is correct. Therefore, anyone who violates accounting regulations must expect serious consequences. For example, if a buyer discovers undisclosed liabilities even though the seller has provided a financial statement representation or a so-called „no undisclosed liabilities“ guarantee, this may lead to significant claims for damages.

Other typical breach types of W&I claims are material contracts, compliance issues, intellectual property, employment matters and environmental aspects.

Fig. 1 • M&A Market Trends – W&I Insurance Claims on the Rise

Source: KPMG AG



3. Claims often involve large sums of money reaching millions of Euros

Large sums, usually in the millions, are regularly at stake in W&I claim discussions. In view of rising M&A volumes in recent years and the high number of disputes, W&I insurance has increasingly been chosen as an effective and elegant solution to cover risks. In Europe, according to a study by the law firm CMS, W&I insurance is now used in more than one third of M&A transactions exceeding EUR 25 million in value.

The growing popularity is also a result of declining insurance premiums. In Europe, they are now around one percent of the risk to be insured, or even below. At the same time, insurable amounts have risen; cover exceeding EUR 500 million is now available. Therefore, policy premiums and retention levels remain very competitive.

Another driver of the growing interest in W&I policies is the fact that insurance companies have hired employees with excellent M&A expertise, able to provide tailor-made products even under the typically tight deadline of an M&A transaction.

So-called „buy-side policies“ are used in M&A transactions, in which the buyer is the beneficiary. Buy-side policies provide coverage against damages from warranty breaches or indemnity claims directly to buyer. This type of policy has achieved a market share of more than 90%.

4. W&I policies are useful for both sides

It is clear that buy-side policies protect buyers against breaches of warranty or indemnity claims and ensure a solvent debtor in the event of damages. But sellers also benefit from the fact that the risk of a breach of contract is covered and mitigated by an insurer. In this way, sellers can fully protect themselves and use the final proceeds from the transaction much earlier for new investment or return funds to investors. The need for an escrow can be avoided.

W&I policies ensure a prompt, clean and final deal exit, which is a vast advantage in many cases - such as the exit of a private equity company or a sale out of insolvency. ▶▶

But be careful: enforcing and handling W&I claims can be a challenging task. Because of the complexities, differing interpretations of accounting principles, and the lack of specificity around the financial provisions in many sale and purchase agreements, buyers and sellers often find themselves in dispute over these provisions.

5. How is Covid-19 affecting M&A claims?

The speed and breadth of the unfolding Covid-19 crisis is putting nearly every facet of business to the test. In many cases, the impact of Covid-19 is likely to lead to a disillusionment after the signing of an M&A transaction. The specific expectations regarding the performance of the target will likely be missed. This means that buyers are increasingly looking for ways to subsequently reduce the purchase price and generate urgently needed liquidity.

Companies having signed SPAs recently are under pressure to assess purchase price clauses, representations and warranties for maximizing the deal value.

6. W&I claims merit careful consideration

When W&I claims arise, it is important to gather the relevant facts, isolate and understand the key commercial and financial issues and identify the economic implications as soon as possible. W&I claims can involve complex economic, financial and technical issues as well as multiple languages, client locations and applicable laws and accounting standards.

M&A share purchase agreements are individually negotiated and reflect a multitude of factors and intentions. All of these are relevant in assessing what is covered by the W&I policy, and so the documentation and enforcement of claims is a challenging process for a buyer.

M&A share purchase agreements are individually negotiated with many different factors and aspects that come into play in the challenging situation of a claim notification which need to be considered against the background of the terms of a W&I policy.

The analysis of the legal and economic basis for claims as well as the subsequent damage assessment are anything but trivial. Support from dedicated experts who regularly deal with M&A claims is essential in successfully handling W&I claims. It is key that they can provide extensive experience of presenting well researched evidence and responding to challenging enquiries.

A realistic view of the reasonable settlement range allows both sides to negotiate from an informed position and settle the claim efficiently. At the same time, this forms the basis for developing trust and a long-term business relationship. ■



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