MARSH

Warranty and Indemnity Insurance

Globally Marsh is the market leader in securing transactional risk insurance for clients.

Warranty and Indemnity (W&I) insurance is one of a suite of insurance solutions secured by Marsh's Private Equity and M&A Practice to assist private equity and corporate clients to execute M&A transactions. There has been an increase in the uptake of W&I insurance in M&A transactions in Asia and globally. The number of policies placed in Asia has increased between 40% to 65% year on year since 2015.

Introduction

The warranty schedules in a Sale and Purchase Agreement (Agreement) form an important part of the negotiation process in any M&A transaction. It is typically used to ensure the seller discloses material information about the target's business. This allows the buyer to adequately and accurately assess the worth and associated liabilities of the potential acquisition. The buyer will also usually seek to protect its position by requiring the seller to retain liability in respect of the warranties and indemnities that the seller provides.

The Agreement will set out the process involved, by which the buyer can bring a breach of warranty claim against the seller (or warrantor).

The Agreement will also specify the warrantor's financial and time limitations in respect of a potential breach of warranty. Time limits can be up to seven years in respect of the fundamental and tax warranties.

Seller's Concerns

In most circumstances, if a breach of warranty occurs, the seller is liable to 'compensate' the buyer. This obligation will terminate in line with the time limitations negotiated in the Agreement. In some cases, a buyer may ask the seller to place a percentage of the purchase price in escrow as security, which will significantly affect the seller's immediate return on capital. Often, this is a concern for the seller, particularly for one who is looking either to retire or start up a different venture. It can also provide serious problems for a financial or private equity investor when looking to exit an investment without any contingent liabilities and return investor funds.

Buyer's Concerns

From the buyer's perspective, uninsured warranties or indemnities may give limited comfort and no guarantee of recovery for a breach. Often, a buyer will need an adequate set of warranties to obtain sufficient comfort about the target's operations and for the acquisition to be structured efficiently.

W&I insurance (or representation and warranty insurance as it is sometimes known) is increasingly being used by buyers and sellers in M&A transactions to insure liability for a breach of the warranties and tax indemnities in the Agreement. Using W&I insurance often allows parties to bridge otherwise considerable gaps between parties' perceptions of the amount of liability which the seller should remain responsible for, after the transaction has completed.

Common Scenarios

What are some of the most common applications for W&I insurance?

- Transactions involving a private equity exit where it is difficult for the private equity firm to 'retain' liability upon exit. This includes secondary buyouts.
- Transactions where the selling entity has, or is perceived to have, a weak balance sheet.
- Transactions where the buyer is unable to obtain sufficient recourse from the seller. This includes an insolvent sale situation where the sale is 'driven' by the banks.
- Transactions where the shareholding structure is complex and only some of the shareholders will give warranties.
- Cross border transactions where a comprehensive understanding of jurisdictional-specific risks may be of concern to the buyer.
- In an auction situation, where it is possible for a prospective buyer to use W&I insurance strategically to enhance its bid by reducing the seller's liability in respect of the warranties. We have placed policies for clients who have been successful in competitive auction processes, because they used W&I insurance.

Technical Specifics

What is W&I Insurance?

It insures the warranties and general indemnities given by a seller in the Agreement. The aim of the insurance policy is to mirror the risk in the Agreement, and make the policy as 'back to back' with the Agreement as is possible.

What does it cover?

The policy provides coverage to theinsured against losses/claims arising from breaches of warranties and general indemnities which are unknown. The insured party can be either the seller or the buyer.

Who can buy this product?

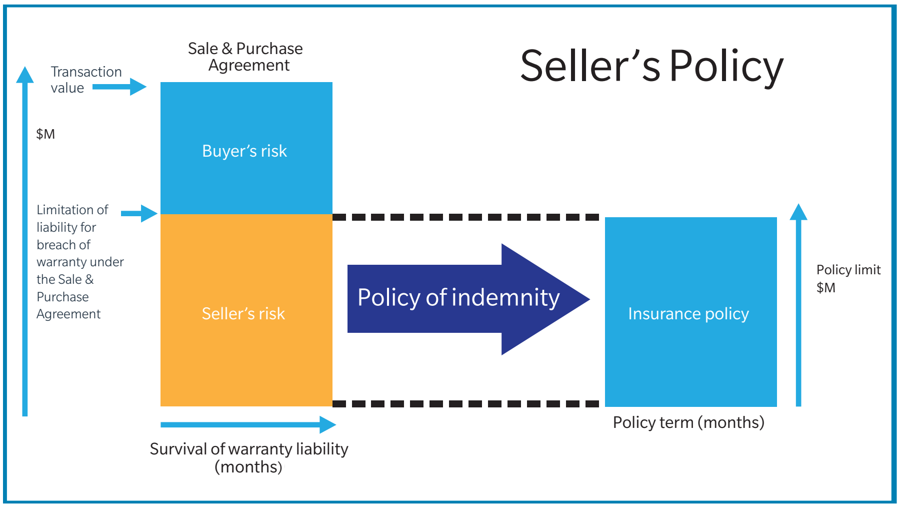
The two basic structures are 'seller' policies and 'buyer' policies (sometimes known as 'vendor' and 'purchaser' policies, respectively).

SELLER'S POLICY

A seller's policy is a liability policy for the seller, which provides coverage in the event the buyer sues the seller for a breach of warranty or indemnity. The policy provides coverage up to the limit of liability/ indemnification, provided and agreed to in the Agreement, plus defense costs. A seller's policy is structured 'back-to-back' with the Agreement.

Should a claim arise under this type of policy, the insurer will require the seller/warrantor to be available to assist in the defence of the claim. The policy is not designed to cover fraud by the seller/warrantor.

As this is a policy of indemnity, the seller will retain liability under the terms of the Agreement and remains liable for any breach that is not covered by the insurance policy.



BUYER'S POLICY

A buyer's policy is provided to protect the buyer against financial loss suffered as a result of a breach of the seller's warranties. The policy is entirely independent of the seller and, as the insured, the buyer would be entitled to make a claim directly against the insurer (i.e. it is a first party policy). Therefore, the coverage can extend beyond the limitations of liability provided in the Agreement. Coverage under a buyer's policy can extend to fraud of the seller.

Insurers need to ensure that neither the seller nor the buyer uses the insurance to replace the normal negotiation process and typically need to see some element of financial motivation to ensure that this is the case. This is usually achieved through a combination of the seller's retained liability and the buyer's insurance deductible.

A common example of this type of policy is found in situations where the buyer requires more comfort than the liability limit assumed by the seller – the buyer's policy would respond in excess of the seller's liability. In addition, such policy will allow the seller to reduce its liability cap under the Agreement.

Who are the main underwriters?

W&I insurance is underwritten from the UK, Singapore, Hong Kong, Australia, the USA and Bermuda, by recognised and highly rated insurers.

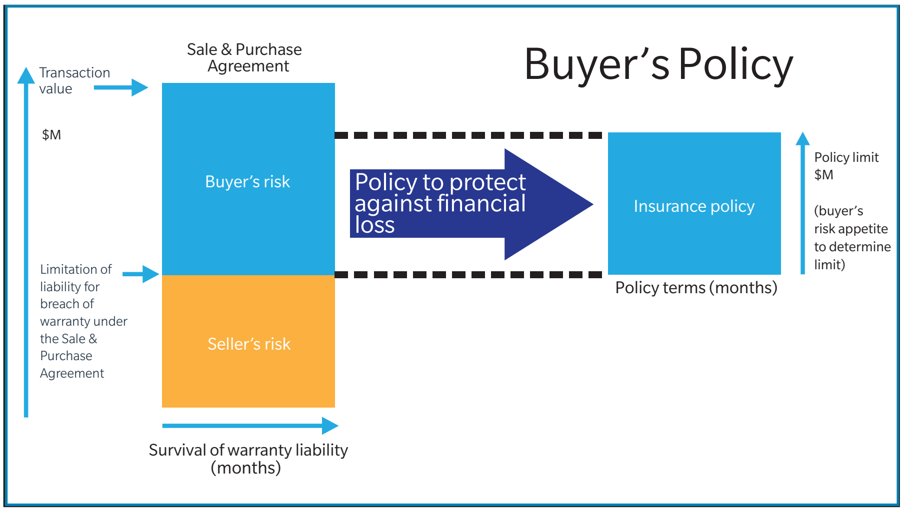
What are the main exclusions?

Exclusions vary from policy to policy and will always be subject to negotiation to ensure they are kept to an absolute minimum.

W&I insurance is designed to cover unknown risks. Breaches or potential breaches of warranties which the insured has knowledge of (i.e. known matters) are not covered by W&I insurance.

Other common general exclusions fall broadly into the following categories:

- Forward looking statements or projected warranties.
- Fines/penalties.
- Post-closing adjustments/ completion accounts mechanisms.
- Fraud/dishonesty of the seller for sell-side policies.
- FCPA and anti-bribery and corruption liabilities.
- Transfer pricing.
- Secondary tax liabilities.
- Deficiency in pension schemes.
- Certain categories of consequential losses.
- Environmental pollution – it is possible to obtain separate coverage with a specific environmental pollution policy, which can be integrated with the
- W&I insurance policy.
- In addition to the above, there may
- be circumstances where:
- Inadequate due diligence has been carried out.
- There is lack of disclosure.
- The responses to the insurer's underwriting questions are incomplete.



These situations could result in additional exclusions being imposed. These are transaction specific exclusions and, in most cases, can be identified and further work or due diligence can be undertaken to rectify them.

Frequently, the resulting work can enable the insurers to become comfortable with the risk.

What is the required excess or deductible?

As a broad indication, insurers will normally look for an aggregate uninsured amount of around 1% of the enterprise value (i.e. a fixed retention) to be exposed before any insurance layer attaches. This can vary from transaction to transaction.

A 'fixed' retention operates like a typical insurance deductible such that the insured can only recover amounts in excess of the retention.

In certain situations, insurers offer coverage on a 'tipping' basis. A 'tipping' retention option allows the insured to recover from a lower amount once the initial threshold is exhausted.

Can transactions be structured so there is no recourse to the seller?

'Nil recourse transactions' involving private equity sellers are on the rise. The typical market practice has been to require at least a 1% retention under a W&I policy, with the retention borne by the seller under the Agreement. This has shifted so insurers are increasingly comfortable about underwriting nil recourse transactions involving professional and experienced sellers. This is sometimes done at no additional costs. Of course, if a higher retention is preferred, the premium rate on line will be lower.

Importantly, there are four key matters which will still not be covered by W&I insurance: (i) known matters; (ii) general exclusions; (iii) transaction specific exclusions, and (iv) excess deductible. The allocation of liability for these matters should be taken into consideration between the parties at an early stage.

What is the period of cover?

The policy can be designed to follow the obligations under the Agreement (in the case of a seller's policy) or extend beyond the Agreement (in the case of a buyer's policy). The maximum time periods insurable under a policy are:

- 24 to 36 months for general/ business warranties.
- Up to seven years for fundamental and tax warranties.

What are the premiums?

Generally, W&I insurance is priced between 1% and 2.5% of the limit of insurance purchased. Premium is charged as a one-off amount.

The cost is largely dependent upon a number of transaction-related factors and may be outside this indicative range. Some of the factors most likely to affect pricing include:

- Excess/deductible (i.e. retention) requirements.
- Industry/sector.
- Jurisdiction.

Who pays the premiums?

The premium does not necessarily have to be funded by the insured. Allocation of premium is a commercial decision between the parties, and can be borne wholly by the seller or buyer, or split between the parties.

What are the policy Limits?

As with premium costs, the limits available depend largely upon the jurisdiction of incorporation of the target, industry in which the target operates and structure of the transaction. Limits of up to US$400 million are available, with further potential capacity available if required.

What information is required to obtain a quote/ non-binding indication?

The available information will depend upon how advanced the transaction is. The more information available, the more accurate the indication will be. It is usually helpful to have a meeting to discuss the basic parameters and motivations of the transaction. This allows the indication to be tailored to fit the specific risk areas or purpose more closely. Generally, a non-binding indication can be provided with a copy of the latest draft of the Agreement containing the proposed warranties and indemnities and the information memorandum/management presentation.

Provision of a list of advisors on the transaction would assist the indication process.

How long will it take to obtain an indication and when should marsh be approached?

With the information noted above, it takes three to five business days to obtain indications from insurers. Marsh then provides a report to the insured, summarizing the indications received and providing a recommendation on the preferred insurer, taking into account pricing, coverage and the experience of the insurers.

Marsh should be approached as early as possible, as soon as the Agreement and information memorandum/ management presentation is available. This ensures there is sufficient time to obtain the best coverage possible for the insured. The insured will also be able to factor the premium payable into valuation, and the coverage position of the insurers into its negotiations of the transaction at an early stage.

Must the due diligence reports be in english?

Insurers are increasingly willing to consider underwriting transactions with foreign language due diligence reports. The insurers will request for executive summaries (along with any other key sections of the reports) to be translated into English, but will not necessarily require the entire report to be translated.

How long will it take to complete underwriting

In order to move from a non-binding pricing indication to a binding offer of insurance, insurers need to review the key documents alongside discussions with the insured and their professional advisors. Insurers need to understand the target's

business in sufficient detail, as well as how the disclosure and due diligence processes were structured, and the negotiations between the parties in respect of the warranties provided, and any key businessrelated issues.

As part of their underwriting process, insurers will review the due diligence reports of the insured (if available) and the documents in the data room. Insurers will provide a list of underwriting questions to be addressed by the insured.

Upon receipt of the responses, an underwriting call will be scheduled between the insurer and the insured (and its advisors, including Marsh). Once the underwriting call has beencompleted, the insurer will issue itsW&I policy coverage position and the policy will be negotiated in parallel with this process.

Insurers may need to engage an external law firm to assist with their analysis of the risk depending on the size and complexity of the transaction. While the legal review is carried out for and on behalf of insurers, it is paid for by the insured. A cost estimate (which operates as a maximum cap) will be provided to the insured prior to commencement and in most cases these costs are waived if the policy is incepted.

This review can normally be carried out in a matter of days, depending upon the complexity of the transaction.

The total time required to effect an insurance policy usually varies between three to four weeks.

What costs are payable apart from premium, and when are these costs due?

At the stage of obtaining indications, no costs are charged by Marsh or the insurers. The costs are only payable when the underwriting commences.

If for any reason the underwriting is completed but the policy is not incepted, the insurer's underwriting costs are payable. If the underwriting has commenced but is aborted midway, the costs incurred as at that date will also be payable, depending on how advanced the underwriting process is. In addition, if the policy is incepted but not completed, a fee of about 5% to 10% of the premium is sometimes payable to the insurers, on a deal-by-deal basis.

How do underwriters deal with insuring the tax indemnities or the tax deed?

It is possible to cover the general tax deed or covenant in respect of pre-completion taxes under the Agreement, typically for little or no additional premium if there arerobust tax warranties under the Agreement. Specific known tax risks are excluded under such 'blanket' tax policies. However, it is possible to place specific contingent liability policies to insure known tax risks.

TIMING AND PROCESS

PHASE 1: INITIAL MARKET ACTIVITY WEEK	PHASE 2: UNDERWRITING PHASE	PHASE 3: IMPLEMENTATION
(Week 1)	**(Week 2/3)**	**(Week 3/4)**
• Marsh to prepare market submission and reach out to insurers who are best suited for headline terms. • Marsh to provide detailed non-binding indication report, setting forth the primary insurance options, including analysis of price, terms, coverage and execution risk, as well as a recommendation as to how to proceed. • The insured will, together with Marsh, select the primary insurer. • Once the primary insurer is selected, if needed, Marsh will work with you to structure a tower of excess insurance to accommodate your desired specifications.	• Marsh and the insured will engage the selected insurer to conduct its confirmatory due diligence. • The insurer will require access to (i) the virtual data room, including all its documents and the Q&A register; (ii) all revised drafts of the Agreement and the disclosure letter (if one is prepared); (iii) any information memorandum, management presentations, etc. prepared regarding the target; (iv) buyer due diligence reports (on a non-reliance basis) for a buyer's policy; and (v) copies of the warranted last audited financial statements and management accounts. • If required, the insurer will engage external legal counsel. This cost (a budget will be agreed at the outset) will be borne by the insured, if the insurance is not purchased. Such cost will usually be waived if cover is incepted • Insurers and their external counsel will prepare underwriting questions for the insured based on the information provided for due diligence. The insured is required to provide detailed written responses to the underwriting questions; which is followed by an underwriting call. Marsh will assist the insured in this regard, including reviewing and providing guidance on the written responses and the underwriting call approach. • Simultaneously Marsh will negotiate the terms of the policy on behalf of the insured	• Once the policy is fully negotiated, coverage will be put in place at a time of the parties' choosing. A dated 'no claims' declaration will be required to be signed by a deal team member on behalf of the insured in order to incept the policy on the signing/closing date.

CASE STUDIES

SELL-SIDE POLICY TO HELP REDUCE CONTINGENT LIABILITY	STRATEGIC USE - REPLACING ESCROW	STRATEGIC USE – BUYER ENHANCING A BID PROPOSAL IN AN AUCTION
Company	**Company**	**Company**
Sale of a significant minority stake in a leading ASEAN based construction service provider by an entrepreneur (seller).	Exit by a private equity firm along with the promoter from an information technology company in India.	Purchase by a private equity firm of a North Asia-based entity, focused on design and manufacturing.
Situation	**Situation**	**Situation**
The buyer was a large multi-national conglomerate with significant experience conducting M&A transactions. The seller was required to provide warranties and indemnities, but was not familiar with such concept.	The private equity firm (owning a majority stake in the target) was not able/willing to give appropriate warranties to the buyer (another private equity fund) and as such, the promoter was asked to provide the warranties and indemnities.	The buyer participated in an auction to bid for the target, against multiple bidders.
Challenge	**Challenge**	**Challenge**
The seller was seeking risk transfer avenues to protect the transaction proceeds from any future liabilities, because such proceeds would form part of his retirement fund.	The promoter was asked to provide escrow for 10% of the deal value in order to give comfort to the buyer.	The buyer wanted to provide the best bid possible to win the deal.
Action	**Action**	**Action**
The seller decided to take a sell-side policy and Marsh placed a USD10 million policy with very minimal transaction-specific exclusions, in order to better protect the seller's exposure.	The buyer offered the seller the option to reduce the escrow offered to 1% of the deal value and Marsh placed a USD43 million policy to cover the buyer's risk above that amount, making its offer highly attractive to the seller.	In order to maximise its opportunity to win the bid, the buyer approached Marsh to discuss the possibility of structuring a buy-side policy for the limit of liability amount they required, instead of requiring the seller to bear the residual liability post-completion. Marsh was able to put in place an insurance tower with three insurers for a total limit of liability of USD150 million.

For more information about managing risks in real estate transactions and other solutions from Marsh, visit www.marsh.com, or contact a Marsh Private Equity and M&A Practice representative.

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About Marsh

Marsh is the world's leading insurance broker and risk adviser. With over 35,000 colleagues operating in more than 130 countries, Marsh serves commercial and individual clients with data driven risk solutions and advisory services. Marsh is a business of Marsh & McLennan Companies (NYSE: MMC), the leading global professional services firm in the areas of risk, strategy and people. With annual revenue approaching US$17 billion and 76,000 colleagues worldwide, MMC helps clients navigate an increasingly dynamic and complex environment through four market-leading businesses: Marsh, Guy Carpenter, Mercer, and Oliver Wyman. Follow Marsh on Twitter @MarshGlobal; LinkedIn; Facebook; and YouTube, or subscribe to BRINK.

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