Osborne Clarke

Paragon

W&I insurance:
an increasingly popular and often cost-effective tool to mitigate risks in corporate real estate acquisitions

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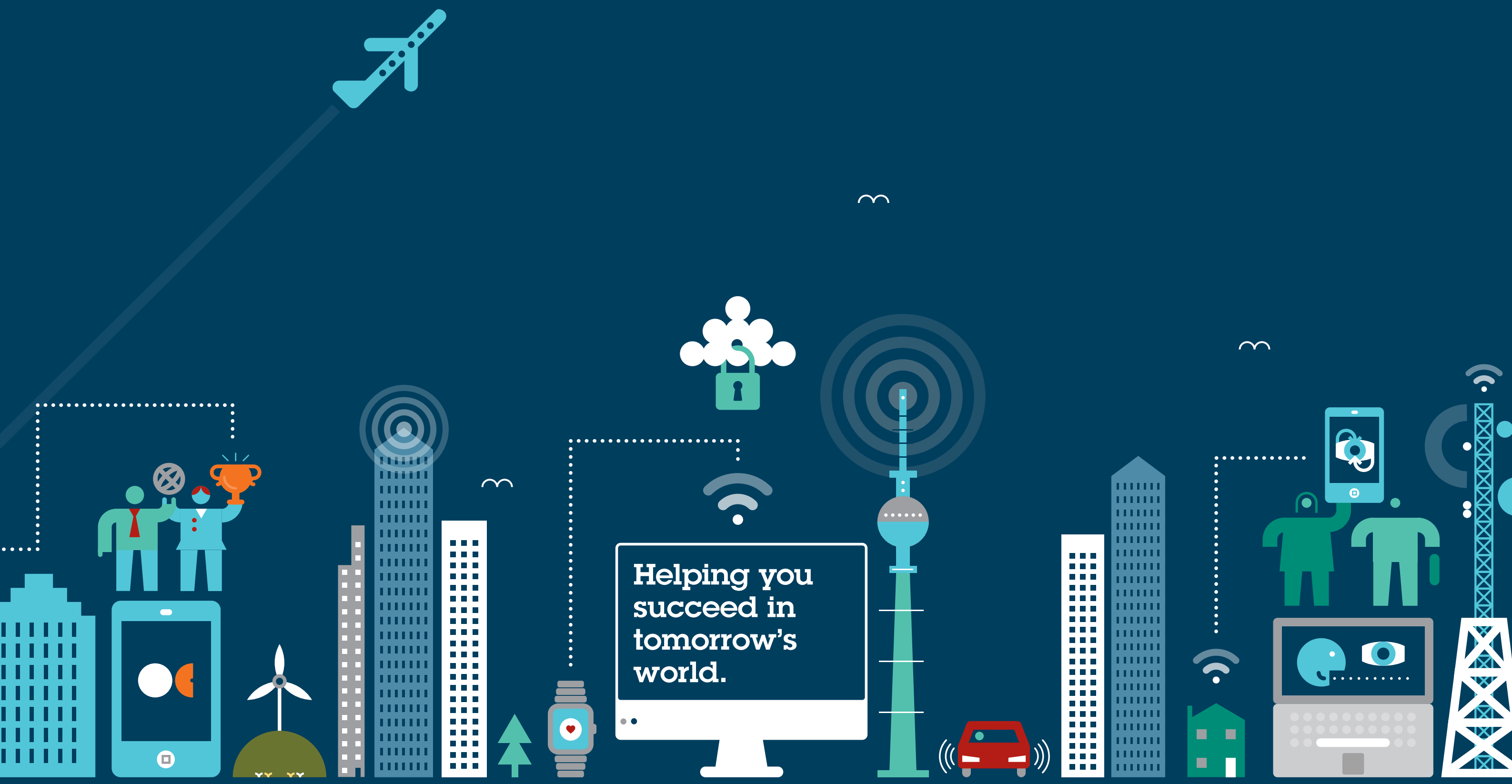


Introduction to W&I policies in corporate real estate acquisitions

Warranty and indemnity (W&I) insurance policies provide cover for losses arising from breaches of these terms under sale agreements for company acquisitions. They lend themselves well to various features of corporate real estate acquisitions and are becoming an increasingly popular tool, particularly during these uncertain times in which both buyers and sellers are looking to mitigate their risks on transactions through innovative and cost-effective solutions.

Why are W&I policies becoming popular on corporate real estate acquisitions?

Initially viewed as expensive, inflexible and not providing much in terms of insurance coverage, the W&I market has evolved significantly in the last 10 years to the extent that W&I policies are now seen as an important deal facilitator and, in particular, we see them being sought in the following situations (most often in the form of a buy-side policy).

- **Limited covenant strength:** Where the seller is a special purpose vehicle (SPV) with limited covenant strength (as is often the case in property-holding corporate structures), the buyer, by procuring a W&I policy, the buyer can take comfort from the W&I cover rather than recourse against the SPV. This avoids lengthy and potentially fraught negotiations around:
    - limitations of liability; and
    - security from parent companies or fund entities for claims if the seller limits their liability to an undesirable level (W&I avoids the disadvantages of obtaining and using parent guarantees, escrow accounts or deferred consideration mechanisms). It is often also a desirable solution for debt providers financing the acquisition.

Even if the seller is not an SPV and has provided a comfortable limit of liability under the sale and purchase agreement (SPA), a buyer may still harbour concerns regarding the seller's ability to stand behind a warranty or indemnity claim in the future if this unease is over the seller's creditworthiness or the recoverability of a claim in the jurisdiction where the seller is domiciled. In these scenarios, we often see buyers prefer the certainty of recourse against an A+ rated insurer's balance sheet as an alternative.

- **Best or controlled bid process:** Corporate real estate acquisitions sometimes take the form of an auction or best or controlled bid process. W&I cover is attractive for both buyers and sellers in such a process because:
    - sellers will often specify that they will only give limited recourse or a limited opportunity for further due diligence beyond the bid data room. Procuring W&I cover allows a buyer to differentiate themselves from other bidders as the seller is not required to assume extensive liabilities in relation to the warranties and indemnities provided;
    - a seller can sell its company with a "clean exit" by working with a competent broker to provide an auction draft SPA to all bidding parties with a fully insurable set of warranties so that the seller limits their liability to £1; and
    - W&I cover can help minimise buyer deliverability risk.

- **Split exchange and completion:** Another common feature of corporate real estate acquisitions is a split exchange and completion (for example, to accommodate the satisfaction of conditions such as planning, practical completion of a building or debt or capital drawdown requirements). Often, this can introduce additional complexity and negotiation issues between the parties – for example, the extent to which the warranties are repeated at completion and the consequences of a breach of warranty occurring in the period between exchange and completion. Underwriters are becoming increasingly flexible and innovative in terms of providing cover in these circumstances, with new and evolving products becoming available. An example of this is "new breach" cover, which specifically covers any new known breaches that occur between exchange and completion (although this may have its limitations in terms of the length of the gap that can be accommodated and the cost-effectiveness of procuring such additional cover). While "new breach" cover has been around for several years, only a few insurers will offer this product, and pricing and coverage is very much deal specific. It is only available as a specific policy sub-limit, in certain jurisdictions and cover will only be provided for short periods of time (normally a few weeks), although this timing can be extended with the consent of the insurer. In terms of pricing, this is very much dependent on the transaction risk but tends to vary from anywhere between 10% and 20% additional premium payable each time the cover period is extended.

- **Seller fraud:** While a thorough due diligence and disclosure process by a buyer should drive out all "known risks" in a transaction, there is always the risk of a fraudulent seller (or fraudulent advisors), with the time, energy and cost implications that arise when seeking recourse to recover the value lost. W&I policies provide sole recourse in these instances. Seller's fraud is currently the most common trigger for W&I claims that have been registered to date in the insurance market.

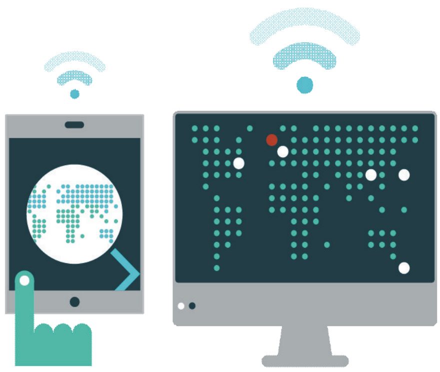
• **"Clean exit":** As mentioned, the commercial advantages for a seller being able to limit their liability at a £1 cap (which accounted for around 75% of all corporate real estate transactions that Paragon advised on in 2019, compared with 61% in 2018) are clearly advantageous. Receiving 100% of the sale proceeds on completion (rather than funds being held in escrow or retention accounts or otherwise subject to deferred payment) and having no residual liability going forward is hugely beneficial for private equity fund, corporate and individual sellers alike.

Compared with transactions in which the target is a trading company, the scope of the warranties and indemnities given and the risk associated with warranty and indemnity claims is generally considered to be lower in corporate real estate acquisitions. This is reflected in the pricing of W&I policies, which can be as low as 0.5% to 0.8% "rate on line" (that is the rate applied to the limit of liability required, for example, an aggregate policy limit of liability of £10m at a rate on line of 1.1% equals a premium of £110,000). This means that buyers can be comfortable with taking a lower level of W&I insurance coverage compared to a trading business, and will also benefit from a lower premium.

Common exclusions relevant to corporate real estate acquisitions

W&I policies are not always the perfect solution, as they often exclude any known risks relating to real estate assets, such as environmental issues and certain tax liabilities. It may be that further policies can be sought either alongside or as part of the W&I cover, such as title insurance for properties and contingent risk cover for otherwise excluded 'known' tax liabilities. For example, the policy cover could be around the intention to hold an asset in the City as an investment or a trading asset, or concerns around whether the central management and control really is in, say, Guernsey when several of the directors live in London).

An investment or a sale often brings such risks into focus and what may otherwise be an acceptable risk to have on balance sheet often becomes unpalatable when it cannot be quantified for the purpose of determining a purchase price or if a buyer is requesting an escrow or a price chip. By taking out a tax insurance policy, you can obtain cover for the amount of tax, interest, penalties and defence costs which may ultimately be payable by the insured party.



Current themes in the W&I market

As with most markets, the W&I insurance market has been affected by the Covid-19 pandemic – however, now that transactional activity is increasing and given the competition between underwriters, we are seeing the following trends emerge:

• **Sophistication of underwriters and brokers and the selection of policies:** Brokers and underwriters have seen a marked increase in the popularity of W&I policies in the mergers and acquisitions market in recent years, and brokers are becoming increasingly specialised; they become involved in transactions at an earlier stage and the best teams often contain ex-lawyers with 10 plus years' extensive experience of corporate transactions. Similarly, clients are taking a more sophisticated approach to W&I insurance. While the focus has historically been on obtaining the fastest and cheapest policies, clients are increasingly looking into the detail, including the ease of any potential claims process and the ability of the underlying insurer or managing general agent to pay out quickly.

• **Innovative solutions and full 'synthetic' cover:** While 'synthetic' enhancements in W&I policies are not uncommon (for example, extended warranty periods separate to that agreed between the parties in the sale agreement), there is an increasing appetite in the market for fully synthetic policies (that is, a policy based on a set of warranties agreed between the underwriter and the buyer with no involvement from the seller). Synthetic policies are very attractive to sellers as they enable them to have no residual liability going forward and the sale process naturally becomes a buyer-driven process. Also, the sellers can obtain a higher price for the asset as a buyer has warranty protection they otherwise would not have. That said, the team at Paragon are cautious on the applicability of synthetic policies to certain transactions and advise to speak to a competent broker as early as possible so that they can gain an understanding of the level of management and seller participation, data-room population and depth of due diligence process. Paragon can then use their experience to manage expectations on the likely depth and breadth of the coverage under a synthetic W&I policy and estimated pricing (synthetic policies tend to be around double the price of an ordinary W&I policy) so that the correct commercial decisions can be made at the outset.

• **Lower premiums:** Transactions across the real estate sector generally paused at the beginning of the Covid-19 lockdown, while buyers and sellers alike took stock of the impact on their businesses and assets. Now that transactions are starting to pick up again, we are seeing insurers lowering their prices to make up for lost premiums while deals were on hold.

Takeaways and actions

W&I insurance can be a cost-effective way to mitigate risks in corporate real estate acquisitions in a post-Covid-19 world and bridge the gap between buyers and sellers who are both looking to offload their risk in a transaction onto the balance sheet of an insurer.

Parties to the transactions, and particularly those procuring the W&I policy, should carefully consider the following practical points:

- be clear at the heads of terms stage how the W&I policy will operate, including who will procure the cover, who will pay for the cover, and how any excluded risks will be dealt with (for example, through procuring additional cover where possible or placing the risk onto the seller);
- involve a competent and experienced broker in real estate transactions as early as possible in the transaction, particularly if an acquisition has any complexities that may impact any W&I policy (such as a split exchange and completion). Early involvement of the broker and underwriter will also avoid delays and allow time for them to review the due diligence reports and transaction documents and make sure the transaction is not held up by insurance; and
- review the exclusions and scope of cover to ensure it meets the commercial requirements.

If you have any questions with regards to W&I policies in corporate real estate acquisitions, please contact a member of the team.

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1

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