

Global mergers and acquisitions' activity in 2021 broke all prior records – with over 63,000 transactions recorded and a global M&A value of more than \$5.1 trillion. We expect 2022 to be another very strong year in terms of M&A deal volume. We have outlined five trends we predict to significantly frame M&A activity this year: (i) enhanced deal scrutiny; (ii) ESG's aspects significance; (iii) the continued growth in the use of W&I insurance; (iv) carving-out of assets increasing deal complexity; and (v) the introduction of a potential corporate re-domiciliation regime for the UK.

### TREND #3: CONTINUING GROWTH IN USE OF W&I INSURANCE



As 2021 has witnessed a significant increase in deal volume, so has the overall demand for Warranty and Indemnity (W&I) insurance, especially from corporate buyers. According to various reports, in the UK market W&I insurance is used in almost half of the deals, and is now a standard feature of private equity exits. As 2022 is expected to be another very strong year in M&A, we expect the advantages of W&I insurance to continue to contribute to its growth, especially in European markets where W&I insurance is currently less common but is becoming more popular.

#### WHAT IS W&I INSURANCE?

W&I insurance provides cover against financial loss that may arise from a breach of warranty and/or claims under certain tax indemnities given by a seller in a sale and purchase agreement (SPA). Historically perceived as expensive and inflexible, in the process of becoming a mature market, W&I insurance has become flexible, affordable, extremely available (specialist underwriters will provide coverage for deals as small as £5 million in enterprise value) and fully compatible with tight deal timeframes.

Warranties in corporate merger or acquisition transactions are an area of heavy negotiation. Depending on the parties' bargaining position, the seller of a company will want to limit the warranties as much as possible, whereas the buyer will want to be provided with an extensive and unqualified warranty package. A W&I policy effectively bridges this gap, by allowing the seller to retain less or no risk (i.e. if its liability is capped at £1) for breaches of warranties. The policy limit (the maximum amount that an insurer will pay out under the policy) varies on a deal basis, but typically is between 10% and 30% of the purchase price.

W&I insurance can be taken out by either the seller or the buyer. W&I policies were initially designed to provide sell-side coverage, giving sellers comfort in respect of the recourse that buyers could have against them. However, today most W&I insurance policies are taken out by buyers. This is because W&I insurance is frequently a requirement of sellers in the context of an auction process, and in any event a buyer can factor the cost of the W&I insurance (usually around 1-1.5% of the policy limit) into the price it pays. From a seller's perspective, W&I insurance paired with a locked box mechanism means that on completion of the transaction the entire purchase price is immediately available for distribution, with no retention or escrow mechanism required.

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## WHAT IS THE PROCESS?

The process of underwriting a buy-side W&I policy can be initiated by the buyer or by the seller. In the context of an auction process, the seller will often initiate the process by instructing a broker to obtain quotes to cover the warranty and tax indemnity package they are prepared to offer in the auction draft of the share purchase agreement. Underwriters will provide non-binding indications, including premiums and coverage positions, which the broker will summarise in a "non-binding indications" report (NBI Report), which the seller will make available in the data room in the second round of the auction process.

The seller can flip the underwriting process over to the bidders early in the auction process (in which case, this is referred as "soft staple"), or press ahead with a specific policy and then make the fully termed and negotiated policy available to the buyer late in the process (this is known as a "hard staple").

Once a policy has been selected by the seller (in the case of a hard staple) or a bidder (in the case of a soft staple) the underwriter(s) will initiate an in-depth review of the transaction, and specifically the disclosure and due diligence reports and findings, and the warranties and tax covenants agreed in the SPA.

While buyers will generally seek for the W&I insurance to provide back-to-back cover for the warranties in the SPA, insurers will exclude coverage for various issues. The key general exclusions are (i) known issues identified during due diligence; (ii) issues that in the insurer's view have not been diligenced sufficiently; and (iii) certain matters such as bribery and corruption, and environmental risks. A buy-side policy will typically contain a warranty spreadsheet confirming which provisions of the SPA are covered, partially covered or excluded under the policy.

Depending on the circumstances, it may be possible to agree that the seller is liable for matters that are not covered, or only partially covered, by the W&I policy.

Certain losses will not be recoverable under the W&I policy, including claims with a value below a *de minimis* threshold included in the policy (typically, between 0.05% and 0.1% of the enterprise value) and claims that do not meet the aggregate claims threshold or "retention" amount. These operate in the same way as the equivalent limitations of a seller's liability under a SPA.

A buy-side policy can also be taken out retrospectively, following signing or even following completion, with retroactive cover from signing or completion, providing cover for any matters not known at the time the policy comes into force.

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The policy period will either reflect the provisions included in the SPA or provide extended coverage, which currently can be up to a maximum of (i) three years for general warranties, (ii) five years for employment and environmental warranties, and (iii) seven years for fundamental warranties, tax warranties and tax covenants.

[Click here](#) for the four additional trends in our M&A Trends 2022 series.

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