

Warranty and indemnity insurance – “do”s and “don’t”s

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Warranty and indemnity insurance (W&I) in recent years has become a customary aspect of private equity and other M&A transactions, with investors well aware of the deal-enabling benefits (in particular, the transfer of risk onto third parties and the facilitation of “clean exits”). As a result of this increasing trend, there has also, as expected, been a sharp increase in the notification of claims by purchasers under such policies. Historically, there have been reports of a small number of full insurance limit claim payments, such as a €50 million to FSN Capital concerning its acquisition of Gram Equipment. As the number of claims made increases, insurers are scrutinising the terms of W&I policies ever more closely. It is therefore important that insureds consider how to increase the chances of recovery under a W&I policy in the event of potential claim.

In light of this, there are some simple “do”s and “don’t”s which insureds should bear in mind, both during negotiation of the policy, as well as at the claims stage. We have set out below several of these to give a flavour of what to watch out for. However, this is by no means an exhaustive list.

Negotiation of the policy

- **Insurance schedule:** Whilst it may sound obvious, it is crucial that correct details are included in the insurance schedule, for example: (i) the correct legal entity is listed as the insured (plus any other entities in the group structure, shareholders or investors which would suffer a loss as a result of a breach of warranty or failure to indemnify), and (ii) the schedule should identify all the relevant transaction documents containing representations and warranties to be insured.
- **Definitions:** The starting point in W&I policies is that the definitions should be consistent with those in the transaction documents. Certain amendments will, of course, need to be made. You should pay particular attention to the definitions (or equivalents) of “actual knowledge”, “breach”, “due diligence reports/transaction information”, “disclosed/fairly disclosed”, “loss” and “transaction team members”.

- **Exclusions:** There are certain exclusions which are standard in W&I policies. However, you should review all exclusions carefully to ensure that they will not cause issues in the context of a particular transaction and that they are not overly broad.
- **Limitations of Liability:** You should review carefully any terms that may qualify, or limit, the seller’s liability in the transactional documents, and identify which limitations will and will not be deemed to apply to the W&I policy. All terms that have the potential to limit the value of an insurance claim should be considered and, if appropriate, disregarded in the policy. Many W&I policies taken out in PE transactions are given in respect of warranties given by a management team, where the management team’s exposure to liability may be disproportionately low in comparison to the coverage provided by the W&I policies. It is therefore important to ensure that none of the limitations of liability in the transaction documents, such as a management warranty deed, cut across the insured’s ability to make a claim without undue interference.
- **Cover spreadsheet:** This lists out which warranties are covered under the W&I policy, and any deemed amendments by insurers. You should review this to ensure the scope of cover aligns with your expectations.

During the life of the policy

- Parties may want to amend the terms of a transaction, either between signing and closing or after closing. If they wish to do so, W&I policies typically require the insurer’s prior written consent to the amendments in order to preserve cover under the W&I policy, so the parties should take steps to ensure this is obtained.
- It is common for buyers to want to re-structure their investments post-close and where they do so, they need to be sure that the representations and warranties in the SPA remain aligned with the insurance to avoid uninsured losses. If necessary, appropriate provision should be made in the policy terms.

Key point for sellers

- **Subrogation:** Subrogation rights allow the insurer to pursue rights of recovery against a third party (such as a seller or a management team) in the event it makes a payment under the policy. Sellers should ensure that the policy includes a provision to the effect that the insurer is not entitled to exercise rights of subrogation against the seller, except in the case of fraud by the seller. This should mirror the limitations of liability adopted in transaction documents.

Claims stage

- **Notification:** It is crucial that a claim is notified as soon as possible and, in any event, in accordance with the specific terms of the policy. Failure to do so could compromise your claim.
- **Provision of information:** You will need to set out the relevant facts and evidence relating to your loss, the warranty that is breached, as well as a calculation of loss flowing from the breach. If all relevant information is not available when you make your notification, then you

will need to provide this information on a rolling basis until the relevant facts and loss are demonstrated.

- **Valuing loss:** Provide a reasonable, rather than an ambitious, assessment of loss. This may require an independent expert valuation of the target on comparative “as warranted” vs “as was” bases.
- **Exclusions:** As noted above, W&I policies will contain exclusions. You will need to demonstrate that none of the exclusions in the policy apply to your claim.
- **Mitigation:** W&I policies generally contain obligations in relation to mitigation so it is helpful to show how you have sought to mitigate your loss.
- **Third Party Claims:** should your claim arise from a third party claim against the target, the policy will likely require that insurers are made aware of, and involved, in the defence and settlement of that claim. You should ensure that they are and should not settle the claim without their prior consent.

Ensuring that you have the best possible chance at recovering for loss under your W&I policy through negotiating the policy at the placement stage and handling the claims process appropriately when a loss arises will increase the value of the product for your business. It will also move W&I from being simply seen as a “deal-enabler” to a useful risk mitigation tool.

We can help every step of the way. Get in touch if you have any questions or would like to discuss this further.

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