ADDLESHAW GODDARD

FUNDS AND INDIRECT REAL ESTATE
BRIEFING NOTE

# WARRANTY AND INDEMNITY INSURANCE

## The unknown unknown

## Overview

- In recent years, there has been a noticeable rise in popularity of using a W&I insurance policy on "corporate wrapped" real estate transactions. Providing a perceived "security net" for both sellers (wanting a clean exit with limited ongoing liabilities and enhanced investment returns) and buyers (faced with sellers unwilling to provide a substantial or sufficient level of cover), the W&I policy has become a standard feature of the market. As a result, many auction sales require purchasers to detail its proposals on W&I insurance as part of their bids.
- While both sell-side and buy-side policies are available, the buy-side policy has become the market norm as sellers seek to achieve a "clean break". However, in experience, the scope of coverage under buy-side policies is commonly misunderstood; perhaps too often we have seen the concept of a buy-side W&I insurance policy and £1 cap on seller liability agreed at heads of terms without a full understanding of the holes in the security net, particularly in relation to tax exposures.
- In some circumstances (for example, where the seller has agreed to pick up all or part of the cost of the insurance), the seller may have already started the ball rolling with insurance brokers and agreed a price based on a particular scope of cover. In such circumstances, it is unlikely that the terms of the policy agreed by the seller will match the requirements of the buyer, meaning that further (often lengthy) negotiations with the seller in relation to the gap are common.
- This short briefing note seeks to clarify the typical features of a buy-side W&I insurance policy; the advantages and disadvantages of using buy-side W&I insurance in the context of real estate investment; and highlights the current market position on the key terms of the policy.

## Why use buy-side W&I insurance?

- For the seller, it reduces its exposure to risk – often capping its liability under the sale agreement to a nominal amount (save in respect of fraud or wilful concealment). The seller also benefits from having immediate access to all of the sale proceeds, often with no requirement to leave funds in escrow. This can be very attractive to funds seeking to return sale proceeds to investors / wind-up following completion.
- For the buyer, it can provide a more substantial level of cover under the sale agreement, with recourse to a entity of financial substance (the insurer) rather than a property owning SPV or real estate fund seeking to wind-up shortly after completion.
- The terms of the W&I insurance policy are designed to operate back-to-back with the terms of the sale agreement. However, this does not mean that the protection for the buyer under the policy will necessarily be the same as available under a negotiated sale agreement with the seller – in fact, the buyer is often in a worse position by taking out the W&I insurance. The reasons for this are explained further below.

## The challenges

- As with any other form of insurance, the principal challenge for those wanting to take out a policy is to obtain a level of, and scope of, cover which will protect the insured against a particular risk or liability.
- In a standard M&A transaction, the buyer and its advisers are concerned with three categories of risks / liabilities which underpin the diligence they undertake:
  - **Known risks / liabilities**: these should be disclosed to the buyer and its advisers during the diligence phase and will usually be covered off in the sale agreement by way of (a) an appropriate warranty (subject to, and qualified by, disclosure by the seller); or (b) a specific indemnity (providing the buyer with the ability to recover on a £ for £ basis); or (c) by way of a retention from the purchase price (with or without escrow arrangements) or other form of deferred consideration. A simple reduction in the purchase price may also be considered.
  - **The known unknown risks / liabilities**: these fall under two categories:

    (i) a risk / liability which is known but cannot be precisely quantified at the time of entry into the sale agreement (e.g. a tax liability, the quantum of which is dependent on the finalisation of the accounts and tax returns for the relevant period); and

    (ii) a potential liability which can be quantified but cannot be determined at completion (e.g. whether there will be a tax charge in connection with the tax residency of the property holding vehicle).

    These liabilities are typically covered off in the sale agreement by way of a specific indemnity or, less frequently, by way of a retention or other form of deferred payment.
  - **The unknown unknown liabilities**: the liabilities that cannot be foreseen. These will be covered by the warranties under the sale agreement and/or by a tax covenant.
- Of the three types of liability set out above, a standard W&I insurance policy will only provide cover for the **unknown unknown**. The buyer will not typically be able to rely on the W&I insurance policy for anything which is known at the time of the entry into the sale agreement – although specific risks can sometimes be insured (often with an additional premium being payable) if the insurers are provided with sufficient details (such as the nature and quantum of the risk) which will allow the insurer to get comfortable with the risk.
- The level and scope of cover is also affected by a suite of market exclusions which act to reduce the scope of cover afforded by the W&I policy. This typically includes pensions underfunding; secondary tax liabilities and transfer pricing; consequential loss; fines and penalties; forward-looking warranties; accuracy of unaudited accounts; product liability (including defects in design and construction on property transactions) and environmental issues such as pollution (although sometimes these can be covered by separate, specific policies at a cost); anything arising out of fraud or dishonesty; the validity and adequacy of existing insurance in the target vehicles and collectability of book debts.
- The period between exchange and completion also poses a challenge. A number of insurers may cover repeated warranties if disclosure is updated at completion (with the consequence that the buyer would be precluded from claiming for a breach of warranty) but issues occurring between exchange and completion are generally not covered. In this context, it is key that the buyer negotiates suitable termination rights which will operate during the period between exchange and completion should certain risks / liabilities / issues occur.
- Given the number of exclusions and limitations which apply under a standard W&I insurance policy, it is likely (particularly in the context of indirect real estate transactions) that many of the tax liabilities of the target vehicles / properties, which would, in usual circumstances, be covered by the seller under a tax covenant, are unlikely to be protected. In such circumstances, it is critical for protection to be sought by buyers through other means – either through retentions or a reduction in the purchase price; OR risk greater exposure to tax liabilities than would usually be accepted. This puts more emphasis than usual on the importance of a thorough and robust due diligence exercise ideally tailored to take account of the lack of protection from the seller.

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## The policy: market trends

- **Policy Limit**: this represents the insurer's maximum liability. Our experience is that this ranges from 10 - 50% of the transaction value – with insurance cover for title to shares and property up to 100% of the transaction value often covered under a separate policy attracting an additional premium. Recent market data from Howden showed their average limit for policies taken out in the real estate sector being 18.15%, ranging from an average of 10.20% on hotel deals, to 48.03% on student accommodation deals (*see: A year of Change: Mergers & Acquisitions Insurance: Howden 2015 Insights*).
- **Premium**: this represents the one-off premium payable to the insurer at completion. This is typically between 1% and 2% of the cover sought.
- **Insurance Premium Tax**: often a forgotten cost of taking out W&I insurance and calculated only once financial matrix of insurance policy has been determined.
- **Excess**: this represents the aggregate amount of loss before an insurer will be liable to pay out under the policy. In the real estate sector, the typical excess amount is between 0.2% and 0.4% of the transaction value and will often 'tip to nil', allowing the seller to cap its liability at £1.
- **Policy Period**: this will match the claims periods for breaches of warranty under the sale agreement, with 7 years for tax and fundamental warranties and 2 years for non-fundamental warranties being common.

## CONCLUSIONS

- W&I insurance will continue to be attractive to both sellers and buyers in the real estate sector – with the use of W&I insurance likely to rise as more sellers demand a "clean exit".
- However, more understanding of the limitations of a "buy-side" W&I policy is needed to ensure that the blend of protection afforded to the buyer (or, as the case may be, risks accepted by the buyer) reflects what has been agreed commercially.

## About our Funds and Indirect Real Estate practice

The Funds and Indirect Real Estate (**FIRE**) group at Addleshaw Goddard is one of the market leading practices in the UK. The team provides a fully integrated indirect real estate solution in conjunction with its fund, tax and regulatory offering, advising on all downstream aspects of corporate real estate transactions. The team can advise on UK and cross border acquisitions and disposals of real estate assets and holding structures as well as complex joint ventures. Made up of real estate sector specialists, the team has a comprehensive understanding of the deal process, from cradle to grave; and works across the structuring and financing of deals, throughout the operational phase, to the ultimate exit.

## Who to contact

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