Proper protection

Thomas Schirmer and Markus Uitz of Binder Grösswang discuss the advantages of insurance coverage in Austrian private equity deals

The core of any share-purchase or asset-purchase agreement is the allocation of risks associated with the operation of the purchased business between sellers and purchasers. While sellers strive to pass all past and future risks to purchasers, purchasers try to ensure that sellers remain responsible for all risks connected with actions or omissions that took place before closing or even signing. Two contractual mechanisms, in particular, serve to allocate the risks between sellers and purchasers: representations and warranties (*Gewährleistungszusagen*), and indemnities (*Haftungsfreistellungen*).

While representations and warranties are used to describe the purchased object and to stipulate that it is free of defects within their scope, indemnities are designed to transfer certain liabilities that will (or whose occurrence is at least considered to be likely to) occur under certain circumstances. Needless to say, these provisions are therefore among the most controversial subjects in M&A negotiations. In particular the scope of the representations and warranties, their statute of limitation as well as any securities for payments to be made in case of a breach (by leaving part of the purchase price on an escrow account for a certain period of time, for example) usually require extensive discussions between the parties and their advisers.

Regarding these points, a conflict of interest exists between the justified interests of the purchaser to protect itself from unknown value-reducing risks connected to the transaction and the interests of the seller to consummate the transaction as quickly as possible and to invest the purchase price elsewhere. Private equity investors have a particularly strong need upon the exit from an investment to use the purchase price for new acquisitions or distribution to their investors.

To bridge these differences, warranty and indemnity insurance (W&I-insurance) seems to have become one of the standard solutions in Anglo-American M&A practice. While these insurance products have so far only be reluctantly used in continental Europe (with the exception of the construction and consumer sectors), recent deals have shown a slow but steady growth in the use of W&I-insurances.

By getting to know the main features of W&I-insurance, private equity practitioners should become able to consider W&I-insurance as an option for solving deadlocks in the negotiations of share-purchase or asset-purchase agreements.

Protection through W&I-insurance

Sellers intend to protect themselves to the extent possible from risks arising out of the granting of extensive warranties or guaranties. The primary risk for sellers in this respect obviously constitutes any claim raised by the purchaser on the basis of an (alleged) breach of contractual warranties or guaranties. One must not forget, however, that any claim almost automatically requires the seller to investigate whether the grounds for such claim are justified. This inquiry usually requires considerable time and effort from management, employees and outside counsel. Finally, the costs associated with challenging claims in court must also not be neglected.

Even though one could assume that sellers would only need to carefully revise the representations and warranties section of share-purchase or asset-purchase agreements to accommodate these concerns, it is important to remember that even a diligent seller may not possess detailed knowledge of the target company. It may therefore easily happen that sellers only grant bona fide representations and warranties that nevertheless prove to be wrong later on. In particular in the course of leveraged transactions, sellers may be required to grant numerous representations and warranties because of the financing banks insisting on a comprehensive representation and warranty catalogue. W&I-insurances are designed to help to protect a seller from these risks by insuring losses in connection with breach-

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es of the representations and warranties in an M&A transaction.

W&I insurances may help sellers to significantly improve their liquidity: in order to secure possible claims against sellers, purchasers often try to hold back at least a part of the purchase price until the end of the warranty period, for example by paying such amounts into an escrow account. Entering into a W&I-insurance enables both parties to reduce these monies to a minimum.

Thus, from a sellers perspective, W&I-insurance coverage is particularly suitable in situations in which the seller has only limited knowledge about the sold target company (such as where the target company constitutes a mere financial investment) as well as in situations in which the seller desires to use the purchase price immediately for new projects. Both reasons very often go hand-in-hand in private equity transactions.

From a purchaser's perspective the facilitated enforcement of a claim is paramount. After all, a purchaser can only obtain limited insight into the target company during the due diligence process before the acquisition but needs to assume the position of the plaintiff if a warranty claim is brought to court. A purchaser thus usually will case the litigation risk for warranty claims. Furthermore, purchasers bear the risk of the sellers becoming insolvent. This risk is especially virulent in distressed M&A transactions (the purchase of a company facing financial problems) as well as in transactions where the economic strength of the seller is questionable in the light of possible warranty claims. In this regard, purchasers should be even more careful in transactions involving natural persons (where claims might easily result in their financial ruin but not in the satisfaction of the purchaser's claim) or foreign sellers with no domestic assets.

Scope of policies

Both sellers and purchasers may purchase W&I-insurance policies in the course of a transaction. Although in both cases the purpose of the policy is to secure warranty claims, certain differences between sellers' and purchasers' insurance policies normally exist. (It should be stressed at this point that the scope of the W&I-insurance policy is of course dependent on any agreement between the insurance provider and the insured party and thus may be shaped differently in the individual case. This article therefore focuses on the material issues that are covered by W&I-insurance policies in general).

Sellers use W&I-insurance policies to protect themselves against the costs associated with potential warranty claims. However, there are of course certain limits to such protection:

- Most share-purchase or asset-purchase agreements stipulate that the seller is not liable for any facts which the purchaser has (or should have) been aware of at the time the agreement has been concluded. This exception usually applies to W&I-insurances as well. An indemnification for costs that have already been anticipated by the parties is thus usually not included in W&I-insurance policies.
- Furthermore, representations and warranties with a focus on the future, for example regarding the development or future profits of the target company, are normally not covered by W&I insurance policies.
- Damages arising out of the violation of laws or regulations and connected fines imposed on the target company as well as consequential damages and indirect damages arising out of breaches of representations and warranties also are usually not covered by W&I-insurances. In the light of the foregoing (and the connected risks) it is understandable, that normally environmental warranties and warranties regarding the adequacy of pension accruals are not included in the insurance coverage.
- Claims based on fraudulent concealment of certain facts before the entering into the agreement are regularly excluded from sellers' policies as well.

> "Insurance policies usually provide for a deductible requiring the insured party to bear parts of the damages suffered"

Purchasers also obtain insurance coverage for securing the sellers' payment obligations arising out of breaches of representations and warranties. Economically, however, their focus is to protect themselves against a default of payment. Thus, for purchasers it is important that the insurance also covers claims for damages arising out of reasons other than a breach of the contractual representations and warranties. In particular, it is essential for purchasers that claims that may arise due to fraudulent concealment of facts are covered by the W&I-insurance as well. In addition, purchasers' policies also encompass coverage for the costs connected to the legal defence against third-party claims that may lead to a warranty case. The higher standard of insurance coverage results in a higher premium for the respective policy.

In practice it is sometimes desired to combine the cheaper sellers' policies with a direct protection of the purchaser. This result may be achieved if the seller acquires the insurance policy but assigns his rights under the contract to the purchaser.

About the author

Thomas Schirmer joined Binder Grösswang in 1995 and has been a partner since 2000. He leads one of the firm's M&A teams with a specific focus on private equity and venture capital. He advises corporate clients, private equity houses and financial institutions on cross-border and domestic mergers and acquisitions, disposals and restructurings, and joint ventures as well as on Austrian and international investments. Schirmer has worked on transactions in many industry sectors throughout his career including the financial services, biotechnology/life sciences, retail, outsourcing, real estate, infrastructure, transportation, telecoms and energy sectors. He chairs the supervisory board of two Austrian venture capital funds and is vice-chair of the board of CPB Software. Important recent clients are Macquarie Funds Group, Capgemini, IPIC and Aabar, Danaher, DCC Energy, SIX, Husky Injection Molding, Austrian Federal Railways (ÖBB), Xerox and Merck. In addition, he is vice-chairman of the Banking Law Committee as well as a member of the Corporate and M&A Law Committee of the International Bar Association. He speaks English and German.

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Insurance premiums

The amount of the insurance premium and any deductible largely depend on the definite scope of the insurance policy, on the insured amount and on the contractual liability regime as provided under the representations and warranties section of the share-purchase or asset-purchase agreement (for example, the agreed *de minimis* amounts, liability caps and deductibles). The different insurance coverage under purchasers' and sellers' policies is noticeably reflected in the premium. As a rule of thumb, the premium for a sellers' insurance amounts to 1% to 5% of the insured amount; purchasers may have to pay an additional 1% to 2%.

Furthermore it should be noted that insurance policies usually provide for a deductible requiring the insured party to bear parts of the damages suffered. Usually the deductible has to be paid into an escrow account and remains there until the end of the insured period. The reason for this is plausible: the conclusion of a W&I-insurance should not cause the insured party not to conduct a proper due diligence of the target company in order to critically question the scope of the representations and warranties. Since the insurance coverage usually runs parallel to the contractually-agreed warranty period, this means that a certain amount of the purchase price will remain in an escrow account until the end of the warranty period.

Practical aspects

It is advisable to contact suitable insurance providers as early as possible in the transaction process, since insurance providers have to be involved in the transaction – at least to a certain extent – in order to assess possible risks and to identify the parameters for the insurance coverage. Most insurance providers are able to make a first indicative offer (that enables the parties to compare the prices of the different insurance policies) within only a few days. However, the insurance policy also needs to reflect the specifics of the transaction and thus (from experience) most insurance providers need at least an additional two weeks for the issuance of the final insurance policy. A separate due diligence of the target conducted by the insurance provider may consume additional time that may be missing at the final stage of the deal.

> "Insurance coverage is hard to obtain for higher deal values"

With regard to a due diligence of the insurance provider, it is important to clarify in advance who has to bear the costs thereof. If an insurance policy is acquired, the due diligence costs are in most cases included in the premium and are therefore part of the agreed cost-bearing provisions for the insurance policy. These costs have to be paid separately (or as a processing fee) in case the transaction does not close. Cost-bearing provisions regarding an insurance provider's due diligence should therefore be agreed at a preliminary stage of the transaction – they should be already in the letter of intent or the memorandum of understanding, as applicable.

To help minimise the costs of the insurance provider, purchasers and their advisers should furthermore be willing to disclose their due diligence reports to the provider. In addition, legal advisers should seek to be involved in the negotiations regarding the W&I-insurance policies, in order to explain the risks connected to the transaction to the insurance provider in detail.

Supplementary insurance products

As already mentioned, W&I-insurance policies generally only cover breaches of contractually-agreed representations and warranties. In almost every private equity transaction, however, further risk-allocating provisions in connection with legal uncertainties have to be tenaciously negotiated.

Also in these cases, the option to gain insurance coverage for such risks may facilitate the negotiation process and may lead to a faster consumption of the deal. The following insurance products are worth considering in this respect:

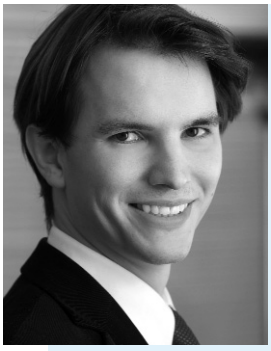
- *Liability buy-out*: This instrument serves to transfer the risks arising out of threatening claims (one time claims as well as long-term liabilities) to a third party through the payment of a lump sum. It is particularly suitable as a protective measure against liabilities that are normally covered via indemnification provisions.
- *Litigation buy-out* (also *Litigation transfer*): This instrument serves to transfer the risks arising out of litigation proceedings to a third party through the payment of a lump sum. It also serves as a protective measure against potential claims that are normally the subject of indemnification provisions.
- *IPO insurance*: Specialised IPO insurances policies offer certain protection against potential liabilities in connection with the preparation of the prospectus to those members of the management board who are responsible for an IPO.

Conclusion

In summary, it can be noted that the purchase of W&I-insurance policies constitutes a serious option which may help the parties to overcome deadlocks in negotiations and to bring transactions to a successful end.

From a practical viewpoint, these advantages are countered by several disadvantages, however. For example, insurance coverage is hard to obtain for higher deal values (based on our experience, the possible maximum coverage seems to amount to about €200 million(approximately $275 million)) and certain – albeit important – risks may not be covered in a satisfactory way by the use of W&I-insurance.

Although W&I-insurance policies could, therefore, seem unsuitable for bigger transactions at first glance, they may prove important in the context of private equity transactions in particular. For example, despite a high transaction volume, the use of W&I-insurance may be possible and useful if considerably restricted to certain risks. Furthermore an extension of the insurance coverage may be achieved by a skilful combination of sellers' policies and purchasers' policies within the same transaction.



About the author

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