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Markets

M&A insurance – a review of the year 2021

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Insurance in M&A Transactions 2022 – finally getting back together

Dear M&A REVIEW EUROPE reader,

this issue is a very special one. In the summer of 2020, Marina Guerassimova from the French Mergers & Acquisitions, and I from the German-language M&A REVIEW got to publish the first issue of M&A REVIEW EUROPE on the topic of "Insurance in M&A Transactions".

Due to the Covid-19 pandemic prevalent at the time, we had to hold our subsequent meetings virtually in webinars. This year, the time had finally come. On 23 June 2022, we were able to re-start exchange in in-person meetings. People who only knew each other from the phone, from virtual meetings or even only from email had the opportunity to finally meet in person, discuss and network.

With a camera team we arrived at the venue, which was kindly provided by Dr Philipp Giessen from Marsh at short notice, as the originally planned venue was unfortunately no longer possible due to various reasons. Gennadiy Kharif from Howden M&A was also immediately willing to provide a location.

And it was fantastic. After a short opening by Dr Philipp Giessen and Laurent Alexis Müller from Bregal Unternehmerkapital, the top experts exchanged ideas in an informal atmosphere. In sometimes controversial discussions, the perspectives of the policyholders represented by their lawyers, the insurance brokers as well as the insurers and their legal representatives were discussed. In the end, it was clear to all participants that this event should be given its annual place in the calendar.

We would like to thank all participants whose contributions made the event and this magazine possible. By name, we would like to thank AIG, ARQIS, Clyde & Co., Dentons, DUAL, Howden M&A, Latham & Watkins, Liberty Global Transaction Solutions, Marsh, McDermott Will & Emery, Norton Rose Fulbright, Oppenhoff, PwC Germany, Tokio Marine HCC, VALE IP and Willkie Farr Gallagher. We would also like to thank the colleagues from BREGAL Unternehmerkapital, Freshfields Bruckhaus Deringer and Hengeler Mueller for their participation in the panel discussion.

You can find impressions of the event as well as statements by individual participants on our website.

Enjoy reading!

Stefan Schneider
M&A REVIEW

REPORTS

Insurance

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M&A insurance – a review of the year 2021

Dr Dino Schönwälder, Marsh

General review

Already in the first quarter of 2021, an increased number of transactions was seen in the M&A market in Germany, Austria and Switzerland (the DACH region), as well as a greater demand for M&A insurance products, mainly Warranty and Indemnity (W&I) policies.

This trend continued seamlessly throughout 2021. Due to capacity constraints, some insurers had to repeatedly turn down requests for W&I insurance, as the increased demand temporarily left them without underwriting staff resources. However, this bottleneck did not persist and could be compensated by a strong increase in the number of insurers and underwriting agencies in the market who wanted to expand their offering to the DACH region. The increase on the part of insurers and underwriting agencies was also responsible for the fact that the required coverage amounts for W&I policies could be made available, although some insurers had already almost completely used up their available liability capital for the entire year by the beginning or in the middle of the fourth quarter of 2021.

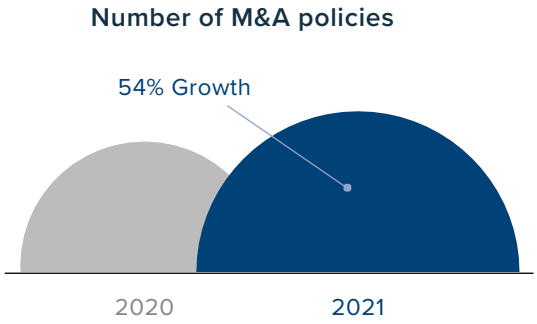
As before, W&I insurance is more common among financial investors than among strategic investors, although the latter group of investors is also using the product more frequently than in previous years. In 2021, for example, strategic investors opted to prepare W&I insurance already on the sell-side in a large number of sales processes in order to facilitate and accelerate the access to W&I insurance for bidders.

M&A insurance solutions placed by Marsh (Germany)

Marsh Germany placed well over 100 M&A policies in 2021, representing a 54% increase year-over-year

Fig. 1 • Growth of M&A policies

Source: Marsh



Coverage amounts and deal size

Marsh placed a total of approximately EUR 18 billion in coverage outside of Germany in 2021, with an average deal value of approximately EUR 210 million.

Premiums

There was a slight increase in premiums for W&I insurance in 2021 in the third quarter and particularly in the fourth

quarter. This was due to a temporary tightening of supply as a result of high demand in the market and significant staff capacity bottlenecks at insurers. However, the higher premiums were still within bounds and typically ranged from 1.5% to 2.9% of the insured sums, while in other jurisdictions such as the USA premiums at the time were between 4% and 6% of the insured sums.

In the case of insurance solutions for known risks (contingent risk insurance), premiums remained stable and even fell slightly in the area of tax insurance, as more and more insurers entered into competition with each other in this area. However, the risk to be insured, its probability of occurrence and the likelihood of it being discovered, for example by a tax auditor, will always play the most important role in determining premiums.

Coverage

Coverage under W&I insurance remained stable and could be extended in some areas via enhancement options. In particular, knowledge scraping has become established in the market, while materiality scraping is now also increasingly requested. In addition, coverage of unknown tax risks is increasingly being provided synthetically under the W&I policy and thus outside the acquisition agreement. The same applies to the expansion of the loss definition. As in the years prior to 2021, acquisition agreements to be insured generally contained very seller-friendly definitions of damages. Buyers were able to compensate for this liability deficit via synthetically expanded loss terms in the policy.

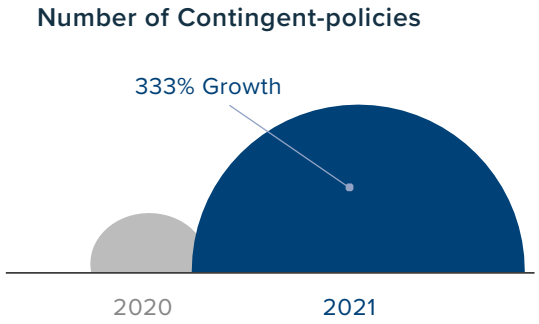
2021 also saw an increased request for full coverage of fundamental warranties (title warranties) up to the amount of the purchase price either by the W&I insurer in smaller transactions or through a title insurer in medium to larger transactions. This is mainly due to the fact that more and more sellers are applying the nil-seller-liability concept to the fundamental warranties in the acquisition agreement as well, and buyers or bidders are also referring to W&I or title insurers in this respect.

Strong increase in demand for insurance soltions for known risks

In addition to the strong demand for W&I insurance, Marsh also recorded growth of over 300% in 2021 compared to 2020, particularly in the area of insurance solutions for known risks (deal-breaks). The majority of these risks were insurance policies for known tax risks.

Fig. 2 • Growth of M&A policies 2021

Source: Marsh



Outlook for the remaining year 2022

M&A insurance solutions will continue to enjoy great popularity in 2022. New insurers have expanded their product offerings to the DACH region, making the market even more competitive. While the M&A market in the DACH region initially got off to a somewhat sluggish start and briefly stagnated due to the conflict in Ukraine, demand for insurance products in connection with transactions in the DACH region has now increased significantly, particularly in the second quarter.

Dr Dino Schönwälder joined the private equity and M&A department of Marsh in 2016 after more than nine years of practical experience as a commercial lawyer. He has advised customers on the placement of warranty and indemnity policies as well as on special risk insurance policies (e.g. contingent, tax, environmental) for transactions in a variety of industries and jurisdictions. Dr Schönwälder has placed and negotiated more than 150 M&A policies since 2017. He has also made arrangements for buyer-side warranty and indemnity insurance for sellers in more than 50 auctions.

W&I insurance for larger deals: practical considerations for tower structures and claims in syndicated insurance programmes

Dr Peter Ratz, Gennadiy Kharif & Anna Robinson, Howden M&A

W&I insurance continues to be particularly relevant on sizeable deals. According to several claims studies including our proprietary Howden M&A data,[1] large deals generate a higher number of notifications than smaller deals. In light of this, an increasing number of W&I insurers have a preference to deploy smaller policy limits on transactions to actively manage potential exposures, thereby triggering a need to involve several insurers. This means that syndicated insurance programmes (so-called "Insurance Towers" or "Towers") are becoming increasingly relevant in M&A practice. In this piece, we outline practical considerations for structuring towers and pursuing claims in syndicated insurance programmes.

1. What is a Tower?

Limited capacity of each insurer: The maximum amount W&I insurers can deploy on a single deal is limited.[2] Where the insured requires a higher policy limit, at least one other W&I insurance provider will have to be involved to supplement the limit under the so-called "primary policy". This is usually done by way of so-called "primary policy". The primary policy (issued by the primary insurer) and the excess policies (issued by the excess insurers) together form a layered syndicated insurance programme (the "Tower"), with each policy sitting excess of the underlying policies: the first layer is the primary policy (which will respond to loss once the retention is eroded), the second layer is the first excess policy (which will respond to loss once the retention and, subsequently, the limit under the primary policy has been eroded), the third layer is the second excess policy and so forth. There is, in principle, no limit to the number of excess policies that can be issued on a single deal.

The level of capacity that insurers can deploy on a single deal is, of course, particularly relevant on large transactions (on which W&I insurance is especially relevant).[3] In the current market environment, no W&I insurance provider could insure a transaction with a multi-billion euro transaction value on its own (assuming a policy limit of at least 10% of the transaction value).

Trends towards lower primary limits: W&I insurance providers increasingly prefer deploying smaller primary limits, while potentially offering additional capacity under an excess policy at the very top of the tower ("ventilated structure"). For example, the average limit of all policies issued in the DACH region by AIG has decreased from c. EUR 33m in 2019 to c. EUR 26m in 2021 (a decrease of c. 22%).[4] We are also seeing some insurance providers take a more conservative approach to standalone insurance structures (i.e. they increasingly prefer to insure deals in a syndicated insurance program rather than on a standalone basis).

The driver behind this trend is the fact that W&I insurance policies are intended to protect the insured against risks that have a low chance of materialisation but potentially imply a very significant loss. Only c. 20% of large deals attract notifications[5] and payments are made by the insurers in 57% of all notifications.[6] Only a fraction of the payments will exceed EUR for 10m a single claim but large claims occur regularly.[7] Given the premium levels in Europe and the US (and taking into consideration that a sizeable percentage of the premium charged by the insurer

1 Howden M&A Claims Report 2021.
2 The insurance providers' maximum limits are in a range between c. EUR 30m and c. EUR 100m. Some providers can deploy limits also in excess of EUR 100m on a stand alone basis, but this is increasingly rare in practice...
3 CMS, European M&A Study 2021, p. 3: W&I insurance has been used on almost half of CMS' large transactions (EUR 100m and more).
4 This includes primary policies and excess policies. Specific data for primary policies only is not available, but the decrease here can be expected to be even more pronounced.
5 Howden M&A, Claims Report 2021, p. 1: The notification rate for all deals is, on average, even significantly lower at roughly 12%.
6 Howden M&A, Claims Report 2021, p. 15: 57% result in a payment and 17% result in erosion of the retention when quantum is below the retention.
7 A prominent public example is the payment of EUR 50m to FSN Capital in 2019 for damages related to its acquisition of Gram Equipment from Procuritas..

will be spent on overhead costs), the premium corresponds to a minuscule fraction of the limit, which means that a single large claim can wipe out a substantial part of the revenues generated by a W&I insurer in more than a year. The impact will be greater for insurance providers with a lower number of policies issued in a year and less (geographical) risk diversification.

So, a single material claim can "make or break" an insurer's book. Considering this dynamic, W&I insurers in the US have already been implementing lower primary limits and fewer standalone policies for years. It is also common practice globally across other lines of insurance, such as directors and officers liability insurance.

2. What aspects should be considered when structuring a Tower?

Insurer Selection: When selecting insurers for the Tower, it should be ensured that the primary insurer is considered by other W&I insurers to be a reputable and experienced provider whose underwriting decisions they will have confidence following.

In selecting insurers for the Tower, brokers will prefer providers that understand the basic dynamic behind underwriting in a syndicated insurance programme (which is that the excess insurers rely heavily on the primary insurer's underwriting) and can be expected to follow the primary insurer. In any event, before selecting the excess insurers, key indications received from the primary insurer at non-binding indications stage (i.e. before its appointment as primary insurer) should be discussed with the excess insurers to ensure maximum consistency in the policies across the Tower (see below under 3. — Excess policies). Key considerations include that (i) the excess insurers can insure all relevant jurisdictions, and that (ii) they can follow the primary insurer's position with respect to key risk areas and key enhancements and policy terms.

Based on the nature of the provider, W&I insurance providers can be divided into two categories: They are either insurers or Managing General Agents (MGAs), i.e. non-insurers that have been authorized by insurers to write risks on their behalf (these insurers are called "carriers"). Some MGAs have also been delegated the authority to decide on claims on the carriers behalf. However, in case the insured does not agree with the decision of the MGA with respect to a claim and decides to initiate court or arbitration proceedings, the MGA's claims authority will no longer be relevant.

To minimize the number of parties involved in the claims process, it is prudent to select MGAs that hold claims authority. It can also make sense to use MGAs on the Tower that only have one capacity provider, thereby reducing the number of insurers that could be involved in court or arbitration proceedings.

Costs: The total cost of a syndicated insurance programme should, in most cases, correspond approximately to the cost of a single policy with the same limit. In practice, the cost of the individual layers of the Tower is calculated as follows:

- As discussed above under 1. – Limited capacity of each insurer, the excess policies sit excess of each other, which means that, the higher up in the Tower an excess insurance provider sits, the lower the likelihood that it will have to make payments to the insured (in other words: the higher up in the Tower they sit, the further "away from the fire" they are). Considering this dynamic,[8] "haircuts" can be agreed with the excess providers. This means that insurers will agree to a discount on the proportion of their premium relative to the limit of their layer ("rate-on-line") as compared to the rate-on-line of the underlying layer.[9]

- However, excess insurers providing excess capacity at the very top of the Tower will not accept a rate-on-line below a certain minimum percentage.[10] Also, excess insurers will expect that a reasonable pricing methodology has been applied consistently across the tower.[11]

- Alternatively, if the rate-on-line hits such a low level that it makes the risk unattractive to insurers, a "quota share" layer can be an option. A quota share policy is a policy jointly issued by two or more insurance providers. Loss insured under a quota share policy will be paid by the quota share insurers in the proportion agreed in the quota share policy.

For complex deals, the total cost of the Tower may prove to be lower than the cost of a standalone policy if a limited number of excess policies (two or three layers) is involved. This is due to the fact that insurers tend

8 By way of example, on a EUR 1bn deal, the chance of a €1m claim is significantly higher than the chance of a EUR 100m claim.
9 For instance, assuming that the rate-on-line of the primary limit is 1.5% (in other words, the cost of a EUR 20m primary limit would be EUR 300k), the first excess insurer would agree to a discount on the 1.5% rate-on-line for the primary layer. A reasonable haircut could be 17.5% so that the rate-on-line of the first excess layer would be c. 1.24%.
10 A rate-on-line below 0.7% is very rare even at the very top of a tower.
11 The insurers sitting on a Tower do not communicate directly with one another. Communication between the broker and the various insurers is kept separate. However, the insurers will usually ask the broker structuring the policy to confirm the pricing applied throughout the Tower.

to be more cautious on complex deals in case they insure the deal on a standalone basis rather than a portion of the total limit (see above under 1. — Trends towards lower primary limits). Such cautiousness usually translates into higher pricing.[12] By allocating risk to several insurers rather than one, each individual insurer's maximum exposure is limited, which should, in theory, lead to a more efficient allocation of the risk. If an insured party is not concerned about the implications of several insurers in the Tower being involved in claims decisions (discussed below under 4. – Insurer claims participation and Settlement of disputed claims), this aspect can be used proactively to reduce the cost of the insurance programme.

3. How are processes involving several insurers different from processes with only one insurer?

Process: The process for placing a syndicated insurance programme is generally more complex and time-consuming than for a single policy. However, the additional complexity will be relatively limited, and it is possible to put in place Towers with up to six layers within challenging timelines.

Involvement of excess providers in underwriting: In almost all processes, the excess insurers will rely heavily on the underwriting of the primary insurer provided that the primary insurer is a reputable provider. Whilst the excess insurers will expect to be involved in the process (i.e. receive all relevant documentation including due diligence reports and answers to underwriting questions and listen to the underwriting call), excess insurers rarely ask underwriting questions of their own or deviate from the coverage position offered by the primary insurer. Generally, the degree to which a primary insurer's underwriting is interrogated depends on how high the excess insurers sit in the Tower: The further an excess insurer is away from the primary risk, the less likely they will be to challenge or query the primary insurer.

In practice, the insured only must deal with the primary insurer in the underwriting process in most cases so that the underwriting process does not require more time or resources than in processes where only one policy is issued. In a process leading up to a tower structure, more administrative tasks will have to be done (non-reliance letters must be agreed with all excess insurers and access to the VDR provided to all), but this is something W&I brokers can handle.

Excess policies: The only part of a syndicate W&I insurance work stream that requires more attention from the insured's advisors is the discussion on the interlocking of the excess policies. The W&I broker's and the insured's legal advisor's objective is to limit any substantive differences between the primary policy and the excess policies, as well as between the excess policies to avoid gaps in cover and inconsistencies in policy terms between layers. Besides details specific to the layer (including the policy limit and the insurer's details), excess policies largely adopt the cover position provided by the primary policy. The only provisions that are, in practice, negotiated are the dispute settlement provisions (see below under 4. – Settlement of disputed claims). The primary policy and each excess policy remain a separate contract between the insured and each W&I insurer as excess insurers do not delegate their claims authority to the primary insurer or any insurer sitting below them on the Tower. This means that each policy has to be reviewed, discussed and agreed separately.

4. What aspects should be considered with respect to claims and dispute settlement?

Notification: Typically, excess policies adopt the notification clauses of the primary policy. Excess policies should be drafted so that losses can be notified to all layers at the same time as notifying the primary regardless of potential quantum (as opposed to only allowing notification once the quantum of the primary limit is exceeded). This enables the notification to attach to all layers, which protects the insured from losing the ability to claim under excess layers if the loss exceeds the primary after the policy period expires.

Insurer claims participation: Typically, the primary takes the lead on insurer claims participation, until it is apparent that there is a risk that the loss is large enough to attract cover from the excess layers. When an excess layer is notified of a loss that is well within the primary policy limit, the excess providers rarely take an active role in the claim. We recommend adopting the claims participation language of the primary policy in the excess layer policies to streamline insurers' involvement. Whilst each layer is a separate and distinct contract with the insured (with scope for disagreement), adopting consistent policy terms will limit inconsistencies in the policies with respect to obligations to which an insured must comply.

When a loss is larger than the primary limit triggering the excess layers, the excess insurers are likely to take an active role in the claim and usually conduct their

12 Howden M&A, Claims Report 2021, p. 7: "… large deals are more difficult to diligence and issues can be missed … Insurers have continued to price this into their models…"

own assessment of coverage, which is likely to involve instructing counsel and experts. This may lead to inconsistencies in interpretation of evidence submitted in support of the claim and the policy wording, and ultimately a difference in opinion as to policy response, or claim strategy, between the layers. Having a reputable lead insurer on the primary layer will assist in ensuring coverage restrictions and insurer participation starts off in the right direction. A strong primary should also reduce the risk of excess layers taking a different approach, as they should have confidence in following the primary's course of enquiry. This is important when the subject matter of the claim is a third-party demand, and insurers will need to agree on the defence. The broker will be consistent across each layer and can assist with navigating any disagreement between the layers. An effective claims broker should communicate with each layer to understand any key differences and identify how best these can be resolved.

Settlement of disputed claims: A coverage dispute for a claim under a Tower can be complicated for an insured party because (i) excess policies only provide cover after the primary and any other underlying policies have paid their limit and (ii) each policy is a separate contract with the insured and there is no contract between each layer. This can cause several practical problems for resolving a cover dispute, including:

(i) If a claimed loss exceeds the primary and exhausts the first excess layer, and the primary and first excess insurers take different views on cover, any settlement with the primary for less than the primary limit could leave the insured exposed as excess insurers are not usually liable until the entire underlying layer is exhausted. The policy wording and any settlement agreement should be worded with this situation in mind so that an insured can pursue the excess insurer for loss beyond more than the primary limit.

(ii) If a claimed loss exceeds the limit of the Tower and all insurers dispute cover but are prepared to settle at a discount, there may be disagreement between the insurers as to their contribution. The insurers higher up the Tower may refuse to contribute to the settlement until the layers at the start of the Tower are fully exhausted. The layers at the lower level of the Tower may not agree to this as cover is disputed and any settlement is outside the policy terms. They may prefer that all insurers contribute prorata to their limit. The lack of contract between the layers makes it difficult to negotiate but insurers often adopt a practical approach and settle pro rata. Active involvement from the claims broker will help facilitate discussions between the layers.

(iii) A coverage dispute that cannot be resolved between the parties may need to be resolved in litigation or arbitration. W&I insurers typically favour arbitration. The primary and each excess policy should be worded to allow any disputes to be resolved in a composite arbitration to avoid an insured having to pursue a separate arbitration against each layer. This will save on time and cost and prevent inconsistent decisions in each arbitration.

5. Conclusion

Towers are set to be more commonplace in W&I practice. As insurers seek to avoid full limit losses, they increasingly prefer to deploy smaller primary limits and be more cautious about insuring deals on a standalone basis. For large deals where the total policy limit exceeds the relevant insurance provider's maximum standalone limit, W&I insurance will in any case have to be structured as a Tower.

A Tower adds additional complexity to the W&I placement and claims processes. However, the additional complexity at the pre-inception stage is limited and, provided an accomplished broker is involved, can be dealt with under challenging timelines. Thinking of the claims process upfront, inserting appropriate language in the primary and excess policies (see above under 4. — (i) and (iii)) will reduce the additional complexities the insured faces in pursuing claims.



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The use of synthetic W&I insurance solutions in sell-side M&A

Dr Markus Rasner, Till Liebau & Dr Gunnar Knorr, Oppenhoff

The use of W&I insurance in the context of company acquisitions has become standard procedure. Through the targeted use of synthetic elements in the W&I policy, the parties can optimally cover the needs of both sides and create a coverage position that ensures maximum exclusion of liability for the sellers on the one hand and comprehensive coverage for the buyers on the other. From the seller's point of view, it is advisable to plan W&I insurance and especially the use of synthetic solutions into the process at an early stage.

1. Introduction

After the use of W&I insurances and other M&A insurance solutions has become a common, naturally used and frequently assumed tool in larger transactions in recent years, more recent developments show the increased use of synthetic solutions. In the following, "synthetic solutions" are understood to be all arrangements that provide for a liability in the relationship between the insurer and the policyholder with regard to guarantees or indemnities that is not inherent in the purchase contract - i.e. between the seller and the policyholder. This includes both certain so-called "enhancements" of agreed guarantees as well as the completely independent coverage of certain risks, for example through a purely synthetic tax indemnity. It can be seen that the targeted use of synthetic elements not only provides further liability relief for the seller, but also brings attractive advantages for the buyer in a transaction designed around the use of an M&A insurance policy. The following article presents the targeted use of synthetic elements in the context of a typical sales process and at the same time shows that such arrangements can also be used sensibly in mid-cap transactions.

2. Integration into the M&A process

The integration of a W&I insurance policy into the sales process should take place as early as possible in order to be able to approach a broad number of providers, to close any gaps in the due diligence that is fundamental to the W&I insurance policy and thus ultimately to achieve an optimal coverage position.

Depending on the details of the sales process, the procedure is somewhat different: In a 1:1 situation, it may well be expedient for the buyer or even the parties to jointly engage a broker to find a suitable provider. Here, the cover position is based on a pre-negotiated, possibly already signed purchase agreement and an attempt is made to achieve the greatest possible cover for this negotiated position.

However, the focus of this article will be on the sale of a company within the framework of a structured auction process. In such a process, too, a purchase agreement was traditionally negotiated first, which was then placed on the market via a broker. If it was not possible to obtain coverage for certain points, either the scope of the guarantees was adjusted or, under certain circumstances, the seller's liability was agreed.

Recently, however, a different procedure has become established, at least for larger transactions (upper mid-cap and large-cap), which among other things allows the targeted use of synthetic elements. Here, the seller first drafts a purchase agreement with a realistically expected final set of guarantees and has a broker conduct a market approach before negotiations begin. Instead of only presenting a draft of the purchase agreement to be negotiated in the bidding process, the seller then gives the bidders access to the broker's NBI report (Non-binding indications - an overview of the offers of the approached providers of W&I policies). The bidders then negotiate a W&I policy with the preferred provider before submitting their final offer and on the basis of their final, regularly

pre-negotiated mark-up. The cover position agreed there is used as a basis for the final offer, so that further discussions about cover are regularly no longer necessary – or no longer to any relevant extent – after the offer has been submitted and the policy can be concluded quickly. This then includes, in particular, agreeing on synthetic aspects with the selected insurer in order to arrive at a coverage of risks that is sufficient for the bidder.

3. Drafting the purchase contract

The same transaction structure is increasingly found in smaller mid-cap transactions. However, as some bidders in these structures regularly have less experience with W&I insurance, closer guidance from the investment bank managing the transaction and the advising lawyers is necessary in this respect. This should already be taken into account when drafting the first seller's agreement. In practice, it has become apparent that the use of synthetic structures is increasingly assumed and that the seller's drafts have once again become much more seller-friendly. In order to avoid frictions, especially in smaller transactions, it is not only advisable to make explicit references to the possibilities of synthetic cover to less experienced bidders, but it should also be clear from the draft SPA and the NBI report which synthetic elements are associated with which additional costs in order to avoid later discussions on the bearing of costs.

4. Warranties

When drafting the first seller's draft of the purchase agreement, different aspects have to be considered with regard to the catalogue of warranties in order to arrive at an optimal cover position for the bidder with minimal liability risks for the seller, also by using synthetic elements. In the following, some of the most important structures will be presented:

4.1. Categories: Fundamental Warranties vs. Business Warranties

Within the set of warranties, a distinction is regularly made between fundamental warranties on the one hand and business warranties on the other. In essence, the fundamental warranties deal with the existence of the target company and the unencumbered shares; whether the usual guarantee on the absence of insolvency grounds falls under this is handled inconsistently. The business warranties cover all other warranties, in particular all operational issues.

In the context of purchase agreements using W&I insurance, the sellers are regularly liable for the correctness of the fundamental warranties in addition to the insurance, but exclude liability for the business warranties completely (EUR 1). Anglo-Saxon financial investors in particular sometimes limit themselves entirely to issuing fundamental warranties and expect the management involved to grant the business warranties. Such arrangements can lead to quasi-synthetic arrangements if the managers do not have a stake in the company and therefore cannot issue warranties as sellers. In this case, a separate management deed can be used to agree on a catalogue of warranties that are declared by the managers, but for which the insurer is exclusively liable.

4.2. Time: Signing / Closing

Especially in constellations where a longer period between signing and closing is to be expected, the question arises whether the warranties given at the signing of the transaction are also given as of the time of closing and to what extent a W&I insurance provides cover in this respect. The ideal position for the parties to the purchase agreement would be that the seller only provides warranties at signing, but the buyer can also assert claims (under the insurance) in the event of breaches at closing.

The underlying problem is that W&I insurances generally only cover issues for which thorough due diligence has taken place. This is obviously not possible at the signing of the transaction with regard to the warranties given as of closing. The solution is for the policyholder to submit a bring-down declaration to the insurer at closing, stating whether and, if so, which breaches of warranties occurred in the period between signing and closing. For these, cover under the W&I policy is then excluded, unless something else has been expressly agreed at extra cost

(so-called "new breach cover"). The bring-down concept, on the other hand, is only meaningful if the policyholder receives corresponding information from the seller. Accordingly, purchase agreements regularly provide for the obligation to issue corresponding bring-down declarations by the seller to the buyer and policyholder. The seller has to ask his own management about this again immediately before closing. However, the seller's liability arising from the submission of the bring-down declaration is regularly expressly excluded.

4.3. Seller's knowledge

An essential element for limiting liability is for the seller not to give all or certain guarantees objectively, but only subject to its own knowledge. This is because in this case, in particular, it is much more difficult to substantiate the accusation that statements were made into the blue (Angaben ins Blaue), with the potential consequence of unlimited liability due to intentional misrepresentation, so that the seller can rely to a much greater extent on the exclusion of liability established by the purchase contract and the W&I policy.

Whether this is limited to positive knowledge - as is still predominantly the case - or whether the seller must also accept grossly negligent ignorance is a matter for the individual case. From the seller's point of view, however, a limitation to positive knowledge is the far superior means of limiting liability. The corresponding discussion is being conducted in parallel in the context of W&I insurance, because a different definition of knowledge is sometimes used for the purposes of W&I policies - in the German market it has so far been regularly rejected to extend liability to grossly negligent lack of knowledge, even though increased discussions on this issue have recently become apparent. This is relevant not only for those warranties that are already subject to knowledge in the purchase contract, but also for those for which it is assumed in the warranty spreadsheet within the scope of the W&I policy that they were given with qualified knowledge.

On the opposite, it is an essential element of synthetic cover to waive knowledge qualifications provided for in the purchase contract by means of so-called "knowledge scrapes". In these cases, it is assumed for the purposes of the W&I policy for certain – regularly numerous – guarantees that the knowledge qualification provided for is not applicable and that the guarantee is accordingly covered by the insurance as an objectively correct statement. As a result, the ideal result can be achieved for both parties, because for the seller the remaining risk of subjectively correct but objectively false statements is eliminated, but the buyer can rely on the objective correctness of the warranties backed by a corresponding liability. This form of bridging the gap ideally shows the possibilities of taking into account the wishes and requirements of both parties through synthetic arrangements.

For the advice to sellers and the drafting of the purchase contract, it remains to be noted that the possibility of a knowledge scrape must always be considered. By using knowledge qualifications, it should be possible for the seller to offer further guarantees and accordingly to obtain more attractive offers from the bidders. The draft should indicate that a waiver of the knowledge qualification is only acceptable in the context of the W&I policy and not in the context of the purchase contract.

4.4. Materiality scrape

In a very similar form, there are increasing requests in the market following the US model to agree on additional materiality scrapes in line with knowledge scrapes, i.e. to assume in the context of the W&I policy that materiality reservations contained in the guarantees are deemed to have been deleted. This form of synthetic extensions is now widespread in M&A insurance policies in the US M&A market, also against the background of the specific disclosure customary there, but is still the exception in Europe and especially Germany. Whether it will become more widespread is likely to be largely dependent on the link to due diligence: as long as the threshold used in the due diligence is reflected in the M&A policy, further materiality reservations are generally not necessary from the insurer's point of view and a materiality scrape is conceivable in principle. In practice, however, materiality reservations are regularly found in areas where a material (vendor) due diligence was not possible. This

will likely also make it difficult to obtain a corresponding cover position from the W&I insurance.

5. Legal consequences

When drafting the purchase contract, two further aspects in particular need to be considered in the context of the legal consequences of breaches of warranty. On the one hand, it is possible that the definition of damage in the purchase contract differs from that under the W&I policy. In particular, there is currently renewed discussion here as to whether and under what circumstances insurance companies are prepared to allow a damage calculation by multiple or at least not to expressly exclude it. The latter is now regularly agreed in W&I policies even if the purchase contract itself is silent on the matter. Furthermore, (very) short limitation periods for the warranties and indemnities covered by the W&I policy are increasingly found in the purchase contracts, as it is entirely common to synthetically agree to significantly longer periods in this respect than those provided for in the specific purchase contract and also generally common in the market in uninsured transactions. This aspect should also be explicitly pointed out in the first draft of the purchase agreement and the NBI report.

6. Tax

Especially in the context of insuring tax aspects, synthetic cover has become very common. Here, it has not only become common to extend existing guarantees and indemnities through the steps outlined above, but also to regularly agree on entirely synthetic tax indemnities without the actual purchase contract even providing for them. The basis for this is, in particular, a thorough due diligence, which the seller can prepare accordingly by means of a vendor due diligence report or at least a comprehensive tax fact book and thus create the conditions for completely excluding its own liability. The same applies to the tax warranties themselves, which are sometimes also agreed purely synthetically.

7. IP

A recent development in the field of synthetic cover is that – so far mainly in the London market – similar to insurance solutions for known tax problems, policies are also being offered that cover known, but in practice unlikely, risks with the IP rights of the target company. This development can offer highly interesting opportunities, especially for IP-heavy companies, e.g. in the tech or healthcare sector.

8. Conclusion

The synthetic extension of the scope of coverage of M&A insurances compared to the actual purchase contract is becoming increasingly important. For sellers, this offers the possibility of limiting or excluding their own liability with even greater legal certainty. For bidders in competitive processes, this results in more extensive coverage without having to limit the quality of their own bids. With the help of these instruments, they can submit a lean mark-up that focuses on purely commercial aspects and a reasonable extension of business warranties in order to stand out. In addition, bidders have the advantage that if the quality of claims under the W&I policy is better than under the purchase contract, there is no reason to assert claims against the seller at all, and thus a uniform and stringent pursuit of warranty claims is ensured.

Due to the increased effort involved both in the examination by the insurer and in the due diligence – a vendor due diligence is regularly offered – more extensive synthetic elements have so far been found mainly in the upper mid-cap and large-cap segment. However, identical arrangements are also possible for smaller transactions if the parties are willing to invest the effort involved and the additional premiums that regularly have to be paid for the synthetic elements.



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Industry-specific W&I Underwriting: trends and special features in the record year 2021

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Contrary to all expectations, last year was a record year for transactions in the M&A and real estate sectors. In total, M&A deals worth USD 5.9 trillion were completed worldwide.[1] This significantly exceeded 2007, the strongest year to date in this area (USD 4.55 trillion).[2] In the field of real estate investment, 2021 was also another record year in Germany. According to real estate investor CBRE, EUR 111 billion worth of real estate was purchased in Germany, which is 40% more than in 2020.[3] In a large number of these transactions, Warranty & Indemnity Insurance (W&I insurance) was purchased, showing the product is now an integral part of the acquisition process, especially in the context of bidding processes.

In this article, we highlight three sectors in M&A that have seen significant growth over the past year: (i) healthcare, (ii) utilities, and (iii) mail order. The reason for the increased demand in these sectors is likely to have been the Covid-19 pandemic. With this in mind, recent developments in the insured real estate transactions sector will be briefly explained against the backdrop of the Covid-19 pandemic.

1. Healthcare sector

Unsurprisingly, the Covid-19 pandemic was a strong driver for companies in the pharmaceutical sector (e.g. vaccine manufacturers and their suppliers) and medical devices/technology sector (e.g. test manufacturers, laboratory utensil manufacturers, medical software and laboratory diagnostics).

Within the context of these transactions, a particular focus of our review was on the sustainability of such investments. Clinical and biotechnological products that form the basis for novel mRNA vaccines are expected to remain in high demand due to advancing research in this area. On the other hand, demand for PCR and antigen testing is decreasing as new Covid-19 infections decline. The high demand for syringes, cooling facilities, etc., as part of the global Covid-19 vaccination campaign is also expected to level off in the foreseeable future.

As well as the importance of the quality of the clinical and biotechnological products, an increased focus in these transactions has been on the reliability of supplies. One of the lessons learned from early on in the Covid-19 pandemic was increased bottlenecks in what had previously been considered reliable supply chains. As a result, many companies broke this thus far prevailing trend and have, where possible, significantly ramped up their inventories. The problems that have occurred as a result of this, have highlighted that the historic reluctance of W&I insurers to insure losses arising out of inventory levels and quality, is appropriate.

2. Utilities sectors

The utility sector also continued to grow in 2021, with renewable energy dominating in particular. The ongoing shift to zero-carbon power generation helped wind and solar plant deals reach a new high last year. For example, investors and project developers of the largest wind farms in Europe focused the acquisition of onshore and offshore wind farms in Central Europe, which operate independently of raw material imports. Often, a so-called "sampling approach" is chosen in the review phase, whereby not all land permits of the wind farms have to be reviewed. As a result, a more efficient and cost-saving solution within the underwriting process could be found for the policyholder. To the extent that this approach indicates the systemic risks of the project, it can also be used to review the transaction from an insurance coverage aspect. In these circumstances, it may be

1 https://www.bain.com/about/media-center/press-releases/2022/global-ma-report-2022/
2 https://www.reuters.com/markets/us/global-ma-volumes-hit-record-high-2021-breach-5-trillion-first-time-2021-12-31/
3 https://news.cbre.de/deutschlands-immobilieninvestmentmarkt-mit-neuem-umsatzrekord--transaktionsvolumen-von-mehr-als-111-milliarden-euro--40-prozent-ueber-vorjahreswert/

necessary to raise the de minimis amount and/or the deductible accordingly.

In addition, the European "green deal" still aims to reduce net greenhouse gas emissions to 55% by 2030 and to invest a total of EUR 1.8 trillion in resource-efficient .[4] This development is further strengthened by the consequences of the Ukraine conflict (the European journey to independence from Russian-produced gas and oil). It is therefore expected that there will also be many transactions in the field of renewable energies in the coming years.

3. Container and packaging

Finally, the container and packaging sector represents one of the major economic beneficiaries of the Covid-19 pandemic. A large portion of these transactions involved packaging materials. Furthermore, demand to acquire transport and logistics companies as well as IT solutions increased sharply. In the transport and logistics sector alone, there was a record number of mergers and acquisitions last year (322 deals globally with a total value of USD 291 billion).[5] In addition, there was a boom in M&A activity involving food and beverage delivery services in the local sector.

The Covid-19 pandemic and its associated consequences largely restricted the lives of many people as well as the options companies had available to them to survive. Hence, online shopping and delivery services were particularly in demand. In addition, stable supply chains in the transportation sector became significantly more important for companies again for the aforementioned reasons. Strategic investors were very active in this area in particular.

Other than a risk of potential overvaluation of the target company, the main insurance risk focus is on the global structure that already exists. This requires a suitable comprehensive examination with the involvement of local consultants.

4. Real estate

Just under a third of the transactions we insured last year were in the real estate sector. Here too, the initial concern of a decline in transactions due to the Covid-19 pandemic has quickly dissipated. However, there is definitely a slight shift in the preferred real estate property types. Whereas shopping centres and retail parks previously enjoyed great popularity, demand in this area seems to have declined. Office properties also appear to have lost popularity. On the other hand, we saw a disproportionately large number of large residential portfolios and logistics portfolios (mainly as part of project developments) last year. In this respect, the growth in the mail-order sector, which has been boosted by the Covid-19 pandemic, is also making itself clearly felt in the real estate sector. Similar to the utilities sector, real estate portfolios often raise questions about how to structure the scope of the audit in a meaningful way, which insurers need to map.



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4 https://ec.europa.eu/info/strategy/priorities-2019-2024/european-green-deal_de
5 https://www.pwc.de/de/pressemitteilungen/2022/transport-und-logistikbranche-reagiert-mit-m-and-a-rekordjahr-auf-die-corona-krise.html

W&I insurance in carve-out transactions

Dr Michael Ilter, Willkie Farr & Gallagher

1. Introduction

Carve-out transactions remain very popular in Germany despite their high complexity. Over the last years, their number has increased significantly. One of the main reasons for this increase is the trend towards focusing on the core business that has emerged in recent years, as large listed industrial conglomerates are usually "punished" with a conglomerate discount on their share price. This trend is encouraged by activist investors who buy into listed companies to demand changes to the business model or company structure (often in the form of spin-offs or demergers) to boost the share price. Moreover, despite the economic fallout from the Covid-19 crisis, the war in Ukraine and the current stock market turmoil, valuations remain high, creating a good environment for a proposed sale. In addition, private equity investors are sitting on an all-time high of committed equity ("dry powder") and have long since shed their reservations about carve-out transactions. A similar development has taken place in the area of W&I insurance, the conclusion of which was the absolute exception in carve-out transactions just a few years ago. This development as well as the special features of W&I insurance in private carve-out transactions will be examined in more detail below from a legal perspective.

2. Carve-out transactions

A "carve-out" is the separation of legally dependent business divisions or parts of a company which are to be continued as an independent entity after completion of the carve-out. As a rule, a carve-out is followed by a capital market transaction (demerger and booking in the securities accounts of the parent company's shareholders or classic IPO), or the carve-out is combined with a private transaction (sale or contribution into a joint venture) being the norm today. A carve-out transaction should be differentiated from the sale of a business unit that is already operated in separate legal entities within a group with certain centralised overhead functions, the latter also requiring certain disentanglement measures for a successful completion.

Carve-out transactions are usually highly complex processes that can extend over a period of several years, not infrequently between three and five years. Milestones in the process are (i) the implementation decision as starting point, (ii) the development of the target operating model, carve-out plan as well as the draft purchase agreement including the transitional services agreement and other ancillary agreements, (iii) the conclusion of the purchase agreement with the acquirer, which usually marks the beginning of the implementation of the carve-out, and the (simultaneous) conclusion of the W&I Insurance, (iv) the achievement of the closing date under the purchase agreement as the starting point of the standalone operation of the carved-out business, and (v) the achievement of full independence of the business and thus the end of the transitional services provided by the parent. The W&I insurance work stream should be initiated by the seller in parallel with the preparation of the purchase agreement and be flipped over to the bidders as early as possible in the course of the sales process.

3. Preparations on the sell-side

Due to the high complexity, detailed and thorough planning and preparation are required at the operational level, but also from a financial, accounting, tax and legal perspective. This must extend not only to the carve-out but also to the subsequent divestment, which requires a huge effort and good coordination between the various parties involved and the internal experts and external advisors. Without a convincing business model and a detailed carve-out plan, the sale process will be slowed down, which could reduce the

interest of potential acquirers and thus minimize the achievable purchase price. Therefore, planning is not only key to a successful implementation of the carve-out, but also to a timely, cost-efficient and smooth completion of the sale process, which helps to avoid or at least minimise the uninsurable risk of business interruptions.

Legal and external lawyers and consultants (with the involvement of a W&I insurance broker) should be involved in the project as early as possible. The first task is usually to analyse the status quo of the target business unit and its interdependencies with the other business units of the group. Once the standalone operating and financial model has been worked out, the tax and legal structuring can be completed. A legal carve-out plan must then be drawn up to govern the various steps required for the operational and legal separation of the target business from the rest of the group. The carve-out plan is closely linked to the purchase agreement, which should provide a detailed legal framework for the implementation of the carve-out. It is also of great importance in the W&I insurance process and should also be coordinated with the insurance broker as early as possible in order to incorporate its experience with carve-out transactions and to anticipate potential pitfalls in the insurance process. The operating model and carve-out plan should also be submitted to the potential insurers so that they understand the scope and implementation of the carve-out and can assess any risks themselves. The various steps overlap to some extent and need to be carried out in parallel with the preparation of and assistance with the due diligence documentation.

4. Use of W&I insurance

The use of W&I insurance has been the absolute market standard in private equity transactions for many years and has now also established itself as market standard in strategic M&A. Even today, strategic M&A transactions in the small and lower mid-cap segment are still sometimes conducted without the conclusion of W&I insurance policies. Particularly in case of the sale of family businesses, the use of an insurance solution is often dispensed with. The main reasons therefore are, among other things, the fact that the business owner is usually active in the management, has a good overview of all aspects of the sold business and thus often qualifies the risk of warranty breaches as manageable.

Until a few years ago, the use of W&I insurance in carve-out transactions was a rare exception. This is in particular due to the greatly increased complexity compared to ordinary transactions as well as the specific risks of carve-out transactions. In addition, the liability regime in the sale and purchase agreement has developed significantly in recent years in favour of the sellers, who – like the W&I insurers – benefit from lower maximum liability limits, leaner warranty catalogues and far-reaching knowledge and materiality qualifiers in the warranty catalogue. Not least as a result of this development, the use of W&I insurance on the buy-side has now also become the market standard in carve-out transactions. In the context of auction processes, this means that bidders are regularly required to complete the underwriting process by the time the final bid is submitted.

The scope of protection in carve-out transactions usually falls somewhat short of the protection in ordinary transactions. In particular, the successful implementation of the carve-out and the independent functioning of the carved-out business after completion are regularly excluded from insurance protection. However, recent developments suggest that insurers have become more willing to insure certain carve-out risks for additional premiums. This trend towards a more carve-out friendly W&I insurance environment is likely to continue, although this will require the detailed conduct of due diligence with particular attention to the specific carve-out risks.

5. Specifics of W&I insurance in carve-out transactions

5.1. Specifics of due diligence

The key areas to be reviewed and documented during the due diligence in a carve-out transaction are the target operating model and carve-out plan, the pro forma consolidated carve-out financial statements, and the assets, contracts and employees that are the subject of the carve-out. While the target operating model and the financial statements are crucial for the valuation of the business to be carved out, the carve-out plan as well as the scope of the assets, contracts and employees to be transferred are essential for the assessment of the stand-alone functionality of the target company after the completion of the carve-out ("sufficiency of assets"). The latter regularly requires the provision of transitional and other services by the former parent company. It should also be noted that jurisdictions, entities or legal areas that have not been reviewed as part of the due diligence are usually excluded from insurance cover-

age. Therefore, in global transactions, local experts and advisors should be regularly consulted to avoid gaps. The more detailed the due diligence is carried out and documented in the reports, the greater the assurance provided to the insurer, which usually has a positive impact on the scope of insurance cover.

a) Target operating model, carve-out plan and carve-out financial statements

Since the target operating model as such has not yet proven itself on the market, it must be thoroughly examined. It forms the basis for the future cost base and business model of the target company and is thus a decisive factor for future earnings and profit potential. The target operating model established in the preparation phase has a significant impact on the carve-out financial statements. As it is an integrated business unit, separate historical financial data, especially on the cost side, will only be partially available and no financial statements will be available on a standalone basis for the business unit concerned. Therefore, pro forma consolidated financial statements must be prepared that adequately reflect the historical costs of the business unit in question and explain the underlying assumptions and accounting policies. This is where the target operating model comes into play, projecting the conception of the integrated business unit into that of a legally independent entity after the carve-out has been implemented. Ultimately, in order to prepare their business valuation, bidders need (pro forma consolidated) financial statements that provide a true and fair view of the historical situation and performance of the business to be carved out. Insofar as these are not certified by an auditor, the insurance cover is restricted to the effect that the insurance provider does not assume any liability for the presentation of a true and fair view of the assets, liabilities, financial position and profit or loss of the division. Instead, it merely assures that the financial statements do not materially misstate the assets, financial position and results of operations. This standard falls short of the protection afforded by the "true and fair view" standard.

b) Scope of the carve-out

From a legal due diligence perspective, reviewing information about the business unit's workforce (including employment contracts, compensation structure, benefits provided and retirement plans) and the assets and contracts to be transferred is essential.

Due to their outstanding importance for the business opportunities of the business to be carved out, the employees and the benefits granted to them as well as the underlying individual and collective contracts and regulations within the scope of the warranty catalogue of the purchase agreement are of great importance, which in turn has an impact on the due diligence to be performed. A carve-out generally leads to a transfer of undertaking pursuant to Section 613a German Civil Code (BGB) with the consequence that the employment relationships are transferred by operation of law with all associated rights and obligations, including all rights and claims under collective bargaining agreements, to the acquiring legal entity, unless the affected employees object to the transfer. Since the terms and conditions of employment remain unchanged and cannot be changed without the consent of each individual employee being transferred, a detailed analysis of the remuneration package and the terms and conditions of employment from a legal, financial and operational perspective is essential.

With regard to the assets and contracts to be transferred, the most important task is to ensure the independent functioning of the target business after the completion of the carve-out. Even after completion of the due diligence, a potential acquirer can hardly assess whether all assets required for a seamless continuation of the business after completion will be transferred in the course of the carve-out. Therefore, sufficient protection for the acquirer can only be achieved under the sale and purchase agreement. The seller has a better and more detailed knowledge of the necessary assets, but is often unwilling to accept catch-all clauses for their transfer. So-called "wrong pocket" clauses, which govern the transfer of assets that are inadvertently missing or the retransfer of assets that are inadvertently transferred, are important safeguards for both parties. However, they cannot be covered by W&I insurance. To the extent that the carve-out has not been completed at the time the purchase agreement is signed, which is the usual structuring of carve-out transactions today, there may be gaps in the scope of coverage provided by the W&I insurance. These can often be closed by addenda to the insurance policy if and to the extent that the insurer is notified in writing of the result of the further review and no risks were identified in the process. In carve-out transactions, insurers also regularly require a so-called "bring-down" of the warranties at consummation of the purchase agreement. This

obliges the seller to again provide information on the accuracy of the warranties and to disclose any breaches in writing, which are excluded from the insurance cover.

5.2. Carve-out plan and achievement of standalone functioning of the business unit

The completion of the carve-out measures required to achieve the independence of the carved-out business unit is usually a closing condition under the purchase agreement. Since the purchase price in carve-out transactions is usually determined on the basis of interim financial statements as of the closing date, the economic risk of the carved-out business transfers from the seller to the acquirer upon closing. Thus, the acquirer is protected against weak business performance and disruptions during the execution phase of the carve-out until closing, regardless of the W&I insurance and its scope of coverage.

The most critical point in the implementation phase is the closing. At this time, the transfer of the divested business unit to the acquirer takes place and the transitional services agreement is concluded. From this point onwards, the business unit is no longer part of the parent group. This final decisive carve-out step can hardly be simulated or tested and is therefore always associated with uncertainty. Any operational issues and problems that arise after closing must be negotiated and resolved between the seller and the acquirer on the basis of the provisions set out in the purchase agreement and the ancillary agreements and can no longer be resolved internally within the group – as was the case up to the time of closing. In this context, the "sufficiency of assets" warranty and the transitional services agreement are of key importance. While the former is – at least subject to seller's knowledge – insurable with sufficient due diligence, the scope and performance of the transitional services as well as disputes arising from the underlying contract are not covered by the protection of the W&I insurance.

5.3. Knowledge qualifiers in seller's warranties

Since German law is very strict with regard to the liability for intent and fraud, which eliminates all limitations of liability in favour of the seller under the purchase agreement, a seller regularly gives only few unqualified warranties. Liability for intent applies when a party makes a warranty without having verified or being able to verify the underlying facts and circumstances and thus makes statements into the blue. By making a warranty subject to the knowledge of the seller (or the natural persons acting on its behalf), this risk can be almost completely eliminated by careful examination of the warranties given. The risk of intentional liability has a particular impact on the "sufficiency of assets" guarantee. In complex carve-out transactions, it cannot regularly be given without knowledge qualification if the seller does not want to expose himself to potentially unlimited liability for intent. The same applies to numerous other guarantees if the business to be carved-out and its legal circumstances are quite complex which is regularly the case.

Under W&I insurance, knowledge qualifications can largely be declared inapplicable in the relationship between the acquirer and the insurer (so-called "knowledge scrape"). However, this requires a robust and comprehensive examination of the facts underlying the warranty in question. Where this is not possible, a "knowledge scrape" cannot be achieved. This is the case, for example, with the "sufficiency of assets" guarantee, so that the risk resulting from the knowledge qualifier must be borne by the acquirer. To the extent an asset belonging to the carved-out business was not transferred, the "wrong pocket" clause applies. However, if an asset necessary for the operation was missing even before the carve-out, the "wrong pocket" clause does not help and the acquirer must acquire or rent/lease the missing asset at its own expense.

6. Recent developments

6.1. Demand for and positive experiences with carve-outs

Unlike a few years ago, carve-out transactions are very popular with private equity investors today. On the one hand, the industry has a record volume of committed equity. On the other hand, the valuations of carve-out target companies are regularly much more attractive than those of secondary or tertiary exits. Moreover, the number of funds evaluating and executing highly complex carve-out acquisitions is still growing. At the same time, nearly all of the most complex carve-outs in recent years have been proven to have been successfully implemented without any major problems having become known in the market. This again increased the attractiveness

of carve-out transactions. On the insurer side, the increased demand had a positive effect on appetite and capacity.

6.2. Increasing competitive pressure from additional insurers

Just a few years ago, only the large and established insurers were prepared to insure carve-out transactions. Even then, they employed large teams of experienced underwriters who could execute underwriting of the significantly more complex carve-out transactions in a timely manner and without negatively impacting other transactions. While the number of insurers offering W&I insurance on the German market also increased as the popularity of the product grew, many providers also strengthened their teams by adding underwriters. This increased the number of insurers able to smoothly underwrite complex carve-out transactions. The combination of additional providers and the increasing professionalism of existing market participants led to increasing competition among insurers. This, in turn, had a positive effect on the product of W&I insurance in carve-out transactions in the form of increasing professionalisation. Today, and given the process is properly prepared, underwriting of a carve-out transaction can be completed in a similar timeframe to an ordinary M&A transaction (approximately seven to 14 days). At the same time, sellers and potential acquirers benefit from the increased number of experienced and reliable W&I insurers, especially in auction processes where several bidders need to work in parallel on W&I insurance for the same target.

6.3. Insurers' increased risk appetite and falling insurance costs

The increased competition among insurers in turn led to an increase in the risk appetite of many insurers. In addition to the established providers, comparatively smaller insurers are now also seeking to insure carve-out transactions with mostly large values. In terms of scope of insurance cover, they are often more flexible and acquirer-friendly than their established competitors. This has also had an impact on insurance premiums, which have been declining for a long time and are still very attractive despite slightly higher costs compared to the pre-Covid times.

7. Current market environment and outlook

With markets having recovered significantly from the Covid-19 shock during 2021 and the German DAX40 index reaching a new all-time high in early 2022, the outlook for 2022 was very promising. There were rumours that some major carve-outs of leading German companies, which had been put on hold during the Covid-19 crisis, would resume and the businesses concerned would come to market during 2022. With the outbreak of the Russian-Ukrainian war and the disruption of global supply chains as a consequence of the strict Covid lockdowns in China, both of which in themselves already entail serious adverse consequences for economies and stock markets, the general uncertainty has returned. It is still not fully foreseeable what impact both events will have on Western economies and stock markets. The German transaction market is currently divided. While the small and mid-cap segment appears to be largely unimpressed, some transactions in the upper large-cap segment have been paused or postponed for the time being. This is mainly due to differing views on valuation and difficulties in concluding large-volume financings, for which uncertainties in the capital markets are not very supportive.

8. Summary

The use of W&I insurance in carve-out transactions is today the market standard. Provided that the specifics of due diligence are taken into account, carve-out transactions can be insured adequately and without major gaps in insurance coverage. However, knowledge qualifications of certain warranties cannot be avoided in some cases due to the complexity of carve-outs, especially in the context of the "sufficiency of assets" warranty. Due to the professionalization of insurers, a policy can also be concluded in a carve-out transaction within a period of approximately seven to 14 days.

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Potential pitfalls in W&I claims: A finance perspective

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Introduction

Global M&A transactions reached a new all-time high in 2021. However, as a result of the war in Europe and Covid-19 disruptions, inflation and other market risks are increasing – as well as uncertainties in M&A transactions. Learn why an increasing number of companies are preparing for disputes following M&A deals, what advantages warranty & indemnity insurance can offer and what decision-makers should know.

A recent case

Sellers can face significant claims for damages if a financial statement warranty turns out to be false. A recent case in the aviation industry demonstrates how you can protect yourself against such claims. Shortly after signing the sale and purchase agreement (SPA), the buyer of an airline discovered lease agreements for two airplanes were accounted for incorrectly. The management of the airline had assumed that it was reasonably certain to exercise a renewal option on the lease. However, the lease agreement itself did not even contain such an option.

It was pretty obvious: the seller had breached a warranty. However, the buyer of the airline had entered into a warranty and indemnity (W&I) insurance policy, which covered the risk and protected the parties against the consequences. The buyer could claim the damages directly from the policy holder and – after negotiations behind closed doors – achieved a settlement of around EUR 8.5 million.[1]

W&I insurances in the current market environment

Recent market studies demonstrate a growing popularity of the involvement of W&I insurance in M&A deals last year. This development is not surprising since the global M&A activities in 2021 reached a new all-time high – both in the number of transactions and purchase prices[2] – with deal value totaling USD 5.1 trillion.[3] Based on our observations, this trend continued at least in the first half of the current year. As prices rise, so does the buyer's need for protection.

As a consequence, the W&I business recovered rapidly after a drop-off in 2020 during the Covid-19 pandemic. Insurers even reached personnel capacity limits temporarily.[4,5] The share of transactions involving such specialty insurance products rose to a record level of 19% in 2021 versus just 10% in 2010.

The bigger the deal, the higher the demand for M&A insurance. In almost half of transactions with a value of more than EUR 100 million, the parties made use of W&I policies.[6]

In our view, the portion of insured transactions will continue to rise. Despite the war in Ukraine and rising inflation and market risks, purchase prices remain high. In our experience, M&A disputes may become more frequent in the event of an economic downturn. If a downturn occurs between signing and closing, the negotiated price may appear subsequently inflated and a buyer may try to identify opportunities to reduce the purchase price or obtain compensation based on the SPA.

Significant advantages of W&I policies

W&I insurance facilitates the sale and purchase process and provides high strategic value to both sellers and buyers. Sell-side first: by means of an insurance, sellers can limit their liability and transfer the risk relating to breaches of warranties in a SPA to insurance companies, as shown in the case at the beginning of this article. The

1 Howden M&A (2022): Claims Report 2021. In: https://howdenmergers.com/documents/downloads/6296%20M&A%20Claims%20report%202021%20v14.pdf (abgerufen am 20.05.2022), p. 19.

2 PwC(2022: Global M&A Industry Trends 2022. In: https://www.pwc.com/gx/en/services/deals/trends.html (abgerufen 20.05.2021), p.1.

3 Referring to publicly disclosed deal values.

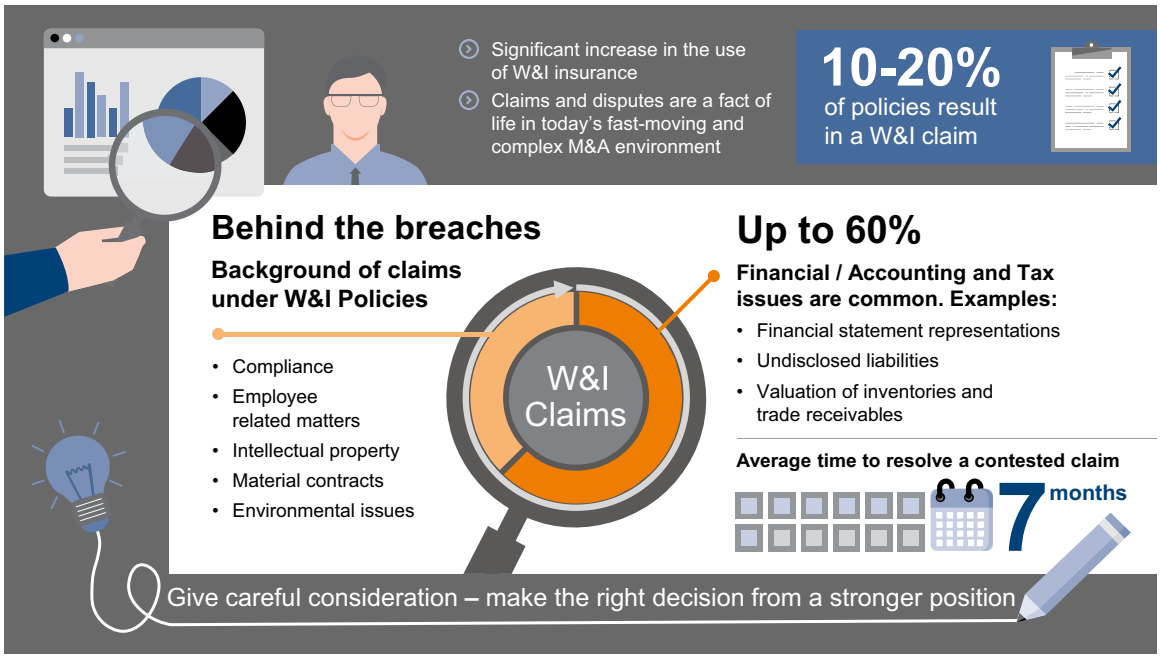
4 AIG (2022): M&A Claims Intelligence report. In: https://www.aig.com/business/insurance/mergers-and-acquisitions/mergers-and-acquisitions-claims-reports (abgerufen am 20.05.2022), p. 2.

5 Zusammenhang mit M&A Transaktionen. In: Der Betrieb, Beilage 03, Heft Nr. 51-52, p. 31.

6 CMS (2022): CMS European M&A Study 2022. In: https://cms.law/en/deu/publication/cms-european-m-a-study-2022 (abgerufen am 20.05.2022), p. 57.

Fig. 1 • Current market trends: W&I insurance claims

Source: PricewaterhouseCoopers GmbH Wirtschaftsprüfungsgesellschaft



insurers, not the sellers, are then liable if a representation or warranty turns out to be false.

In this context, the insurance provides a clean exit from the investment. Thus, sellers can determine and distribute sales proceeds much earlier. As a result, W&I policies are an effective tool to close gaps and overcome transaction hurdles between the positions of buyers and sellers: they offer additional leeway in negotiations and can significantly accelerate the closing of transactions.

But buyers also benefit from the insurance coverage, particularly in situations where no solvent debtor is available or the seller is a special purpose entity (SPE). Based on our experience, enforcing claims against such debtors arising from breaches of representations and warranties is difficult if no W&I insurance exists. However, well-known insurance companies may provide sufficient credit ratings. Other protection mechanisms such as escrow accounts which (partly) delay the payout of the purchase price become redundant.

Another advantage of W&I policies is the relatively low premium costs in recent years: today, insurance premiums often amount to approximately one percent or less of the risk to be insured.[7] At the same time, the insurable amounts have increased, and the insurance companies have invested in employees with a M&A background. Hence, the further professionalisation of both insurers and brokers enables them to provide tailored insurance solutions under challenging deadlines which offer a customer-oriented service approach.[8]

Typical types of W&I claims

Our observations and current market studies show that between 10 and 20% of M&A transactions result in a W&I claim. The bigger the deal, the more claim notifications. In deals with a value of more than one billion US dollars, the share of claim notifications amounts to 21% per an AIG study.[9]

Insiders assume that this rate will continue to rise. In times of high purchase prices and a volatile market environment, buyers often analyse whether purchase price adjustment mechanisms, warranties or indemnification clauses offer opportunities for subsequent purchase price adjustments.

Given the extraordinarily high level of uncertainty in the current market environment, there is a high risk that geopolitical conflicts, supply chain disruptions or implications due to the Covid-19 pandemic will throw the buyers' underlying valuations overboard – potentially even before closing of the transaction as several weeks or even months often pass between signing and closing. In those cases, special consideration is drawn to price adjustment clauses or comparable mechanisms – which are included in about half of all SPAs.

7 Haßler/Daghles (2016): Warranty & Indemnity-Insurances im M&A-Markt – ein Überblick. In: https://blog.handelsblatt.com/rechtsboard/2016/10/17/warranty-indemnity-insurances-im-ma-markt-ein-ueberblick/ (abgerufen am 20.05.2022), p. 4.

8 Haßler/Daghles (2016): Warranty & Indemnity-Insurances im M&A-Markt – ein Überblick. In: https://blog.handelsblatt.com/rechtsboard/2016/10/17/warranty-indemnity-insurances-im-ma-markt-ein-ueberblick/ (abgerufen am 20.05.2022), p. 4.

9 AIG (2021): M&A Claims Intelligence report. In: https://www.aig.com/content/dam/aig/america-canada/us/documents/business/management-liability/aig-manda-2021-w-and-i.pdf (abgerufen am 20.05.2022), p. 3.

Disappointed investors often intuitively put their spotlight on financial statements and other financial information, as well as tax-related issues. According to recent market studies, about half of all W&I claims relate to this category and are the key driver for W&I claim notifications.[10]

This is not surprising, as financial data are the basis for common valuation models and consequently for determining the purchase price. Accordingly, buyers usually request additional assurance from sellers that the financial information have been prepared in accordance with applicable generally accepted accounting principles and/or present a true and fair view on the assets, liabilities, operations and cash flows (financial statements warranty). Therefore, sellers may face significant recourse if they violate agreed accounting principles. If a buyer subsequently identifies material misstatements such as the erroneous lease accounting in the example described at the beginning, sellers should expect significant damage claims.

Other common drivers of W&I claims are breaches relating to material contracts, intellectual property, compliance issues, employee-related matters and environmental issues.[11]

Identification and enforcement of claims

In W&I claims, the parties usually argue about multi-million dollar issues. In order to identify and successfully enforce contractual claims, a systematic approach, comprehensive expertise regarding financial and legal related issues and in-depth experience in handling the claims are therefore essential.

The main challenge in identifying claims is that they are rarely unambiguous or indisputable. On the contrary, W&I claims are often based on financial information underlying complex accounting principles or contract-specific regulations.

These regulations often require significant management judgment for example in accounting estimates. Conflicts between sellers and buyers therefore regularly arise from subjectivity, which is unavoidable in applying recognition and measurement criteria in accounting.

Once buyers have identified claims, it isn't sufficient to simply report those damages to the insurance company. Instead, it is required to systematically analyse the legal and economic basis for a claim and to prepare financial data and other relevant facts in detail.

In-depth analysis and mindful communication

Buyers should intensively consider opportunities and risks. To do so, decision-makers must analyze the probabilities of success - taking into account the fact that it may cost time and money to enforce a W&I claim. With an average settlement period of seven months, which can also be significantly exceeded, no one should underestimate this aspect.

In case potential claims arise from breaches of representations and warranties, it is important to gather all relevant facts and circumstances, analyze the financial data, identify the relevant issues and work out the economic implications. Each SPA as well as the W&I policy is a customized solution tailored to meet the specific needs of a transaction. The underlying factors and intentions are necessary to assess whether an issue is covered by the insurance or not.

Involvement of dedicated experts is crucial for the outcome of a W&I claim. Based on their extensive transaction and claim experience they can estimate a reliable range of the potential settlement amount and respective success rates. This forms the basis to reach a favorable result during negotiations. However, they also support policyholders or insurers in investigating, processing and presenting potential claims.

Precise and proactive communication and reporting are extremely important in this context. Reports and statements must be clearly structured. In addition, convincing arguments must be drafted, supported by substantial evidence. This significantly increases the chances for a successful claim and at the same time builds the grounds for a trustful long-term business relationship between customer and insurance company.



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10 Liberty GTS (2021): 2021 claims briefing – Exclusive insights guiding global decision-making. In: https://www.libertygts.com/static/2021-09/GTS_ClaimsBriefing_2021FINAL+%281%29_0.pdf (abgerufen am 20.05.2022), p. 17.

11 AIG (2021): M&A Claims Intelligence report: In: https://www.aig.com/content/dam/aig/america-canada/us/documents/business/management-liability/aig-manda-2021-w-and-i.pdf (abgerufen am 20.05.2022), p. 3.

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Financial statement warranties in M&A insurance

Adriaan Louw, Clyde & Co Europe

Introduction

Between 13% to 23% of all claims made under warranty and indemnity (W&I) insurance policies relate to accounting and financial statement matters.[1] This is not surprising given that a loss of any kind will inevitably find its way to the accounts of a company in one way or another. However, in proportion to the number of claims, relatively little time is spent talking about financial statement warranties during M&A negotiations and W&I underwriting. This is owed, at least partially, to court judgments dealing with M&A being rare, given that the majority of disputes are dealt with by way of confidential arbitration.

This article reflects on some of the most relevant considerations, pitfalls and developments of financial statement warranties.

The financial statements warranty

One of the most important provisions in an M&A agreement, be it a share or asset purchase agreement (herein referred to as SPA), is the purchase price clause. Consequently, the financial statement warranty is one of the most important warranties that a buyer will request from the seller, given that the company's financial results and position are material to the buyer's decision on whether or not to proceed with the transaction, and on which terms.

As with any other warranty, there is a myriad of ways in which parties can draft a financial statement warranty. It is, for example, technically possible to draft a forward-looking warranty by which the warrantor guarantees that a certain future event may or may not occur. A warrantor (most often being the seller) could further also give warranties speaking to off-balance sheet items or single line items. All of this will depend on the negotiations between the buyer and the seller. However, W&I insurance has narrowed the playing field, at least to those who want to use the product, because no (conventional) W&I underwriter will cover such warranties. This brings, one could argue, a sense of "balance" to the warranty catalogue.

But what is a financial statement warranty and what does it mean?[2]

An example of a typical financial statement warranty would be:

> The audited financial statements of the target group company for the financial year ending 31 December 2021 (2021 Audited Financial Statements) have been prepared with the due care of a prudent businessman and in accordance with the applicable provisions of the German Commercial Code and generally accepted accounting principles in Germany. The 2021 Audited Financial Statements present, in accordance with such principles, a true and fair view of the net assets, financial position and results of operation of the target group company as of, and with respect to the financial year ending on 31 December 2021.

There are a few essential aspects to consider: firstly, such a financial statement warranty speaks to compliance with the relevant accounting standard (here, the German Commercial Code and generally accepted accounting principles in Germany) and should be distinguished from "correctness", "completeness" or reflecting the actual circumstances as perceived from an ex-post (or "after the fact") perspective.

For example, if the company provides services to a customer during the 2021 financial year and assuming that the customer has not yet paid for those services by the reporting date (31 December 2021), the com-

1 See, for example, AIG M&A Claims Intelligence report 2020, p. 3; Liberty GTS 2021 claims briefing p. 17; Marsh JLT Speciality Transactional Risk Insurance Claims Study, EMEA, p. 8.

2 For a more indepth analysis, see for example Hennrichs: Zur Haftung auf Schadenersatz wegen unrichtiger Bilanzgarantien bei M&A-Transaktionen NZG 2014, 1001

pany is required to record the receivables in its financial statements. Even if the company establishes at a later date in the 2022 financial year, i.e. after the fact, that the customer was already insolvent on 31 December 2021, unable to pay its debt and that the receivables should be written off, the financial statements may nevertheless be compliant with the German Commercial Code, because the warranty speaks to compliance with an accounting standard and not to the absolute collectability of receivables.

Secondly, there is a normative-subjective element to the warranty. To establish breach of such a financial warranty would require a party not only to show objective breach of a statutory provision, but also to show that a prudent businessman could have recognised this breach with the knowledge he had at the reference date. The second element may seem to be somewhat subjective, but the applicable standard is not the specific businessman associated with the company, but a prudent businessman more generally. The rationale behind such a normative-subjective element is to protect the businessman, the company, and its stakeholders alike. After all, if a businessman is too risk-adverse, he would not be able to properly fulfil his role and the company would not thrive. If the businessman acts prudently and can justify his decision under the circumstances, he has fulfilled his legal obligation.

Thirdly, one could argue that the second sentence in our warranty example is redundant. If the warranty states that the financial statements were prepared in accordance with the applicable provisions of the German Commercial Code, such compliance would inevitably include (to the extent applicable to the company) that the financial statements must give a true and fair view of the assets, liabilities, financial position and profit or loss. A party wishing not to include "true and fair view" wording in the warranty should thus be warned that a mere deletion of the second sentence (in our example) does not necessarily mean that the warranty is not given to that standard.

Fourthly, it is worth referring to the notion of a "hard" or "objective" balance sheet warranty (harte oder objektive Bilanzgarantie) when dealing with warranties under German law. Few buyers will expect a "hard" or "objective" balance sheet warranty from the seller and even if they did, an underwriter will not cover it. However, the line between a normative-subjective warranty and a hard, objective warranty is arguably thin.

Much has been written about the two, somewhat controversial decisions made by the OLG Munich[3] and the OLG Frankfurt[4] which need not be repeated here. It suffices to say that the warranty in question assessed by the OLG Frankfurt was not too different from our example above, and was found to be objective, despite the warranty expressly referring to "the due care of a prudent businessman".[5] And if a warranty were to be held as objective, the risk would be even higher in cases of longer look-back periods – it is not uncommon for warranties to refer to the financial statements of three financial years prior to signing.

Simply adding a knowledge qualifier in the SPA or the W&I policy is not the same adding a normative-subjective element to the warranty, as some parties may believe. Because a normative subjective element refers to the knowledge of the target group management as at the financial statements reference date. A knowledge qualifier in an SPA or a W&I policy usually refer to the knowledge of the sellers (depending on how it is defined) as at the signing or closing date of the SPA.

So how do parties draft a warranty and make it clear that a warranty is not objective? One option would be to draft the warranty in such a way that it includes specific reference to the knowledge of the company management as at the reporting date. A second solution, which is more common in practice, is for the parties to clarify in the warranty wording that it is not a "hard" or "objective" balance sheet warranty.

Lastly, warranties in an SPA are not limited to financial statement warranties, but often address management accounts, liabilities, assets, accounting procedures and controls, and a range of relate topics. In assessing whether the risk underlying the warranty has been addressed or mitigated, one could ask: does the scope of the relevant warranty match the scope of due diligence review performed by the buyer? Additionally, sellers (and underwriters alike) should be aware of warranties that go beyond the scope of what is required for financial statements or accounts by law or reporting standards, as it could easily enter the realm of an ex-ante perspective. Any ex-ante perspective would mean that a warranty is most likely breached from day one, because financial statements by their very nature, are not objective or prepared on an ex-ante approach.

Purchase price adjustments and earn-out clauses

Purchase price clauses can take a number of forms. For example, the parties may negotiate a fixed purchase price as at signing on the basis of locked-box accounts,

3 OLG München Urt. v. 30.3.2011 – 7 U 4226/10, BeckRS 2011, 7200

4 OLG Frankfurt a.M. NZG 2016, 435.

5 For an analysis of balance sheet warranties against the background of the OLG Munich and OLG Frankfurt judgments, see Widder/Koffka: Bilanzgarantien inUnternehmenskaufverträgen NZG 2020, 1284.

with a detailed leakage and "ordinary course of business" covenant dealing with the time between the locked-box date and signing or closing. This is the most common approach. Another approach is to agree on an initial purchase price which is then adjusted at closing on the basis of closing accounts or completion accounts. There are also a multitude of possibilities lying somewhere between these two approaches, and the ultimately favoured solution depends on the wishes of the parties and the nature of the target company. For example, an SPA for a start-up company being sold by its founders will often include an earn-out clause, especially when the founders remain with the company, in an attempt to align interests.

From a W&I insurance perspective, purchase price adjustment and earn-out clauses are relevant most prominently in two ways: firstly, a W&I policy would generally exclude losses which have been included in the purchase price calculation or adjustment. Secondly, the financial information on which purchase price adjustments or earn-outs are based, may be the same or overlap with the financial information warranted.

An earn-out clause is generally forward-looking insofar as it provides the sellers an opportunity to bear further fruit from the sale based on the future performance of the company. Given that warranties are backward-looking, these two rarely overlap, but it is not impossible. It could happen that the annual financial statements of a company will only be finalised and audited between signing and closing. The parties could agree to include in the SPA a warranty speaking to the audited financial statements, and that such a warranty is then given only at closing. A W&I insurer could similarly follow this approach. In practice, the policy is signed without the inclusion of the audited financial statements warranty, but the buyer and W&I insurer later sign an endorsement, effectively including the warranty in the policy as at closing, provided that the buyer undertakes a market-standard due diligence exercise, as would be the case during underwriting.

In a similar example, this time with a purchase price adjustment clause, the purchase price paid at signing is based on year-end management accounts, with the preparation and audit of the annual financial statements to be completed between signing and closing. The SPA provides for a possible purchase price adjustment or "true-up" for the differences between the year-end management accounts and the final audited financial statements. If the SPA contains a warranty for the year-end management accounts, differences between such management accounts and the audited financial statements could potentially fall within the scope of both the purchase price adjustment clause as well as the warranty.

Given that the SPA contains a purchase price adjustment clause (which no doubt has been negotiated vigorously), all parties involved may very well agree that differences between the management accounts and the audited financial statements should indeed be addressed via this clause – after all, that is its very purpose. It would also be fair to say that, depending on the wording in the SPA and the negotiations between the parties, such a clause's very existence indicates that it stands first in line in the hierarchy of avenues available to the buyer, at least in front on a breach of warranty claim from an insurer. Regardless, the parties may wish to crystalise this understanding in writing in the SPA.

Memorialising this understanding has a further benefit for both the buyer and the insurer: the sellers have some skin in the game.

Multi-national group companies

Over time, accounting standards and practices internationally have to some extent been aligned but are not standardised. In the case of group companies operating across multiple jurisdictions, management accounts for each entity are usually prepared in accordance with locally applicable general accepted accounting principles (or GAAP). On a consolidated level, financial statements are often presented in accordance with International Financial Reporting Standards (IFRS), and the (GAAP) accounts would require certain adjustments to be made to be compliant with IFRS.

It is not unheard of that a financial statement warranty speaks to an accounting standard (e.g. IFRS) while some individual entity level financial statements were prepared to a different standard (e.g. local GAAP). Here, in essence, a prudent seller should first assess the warranty wording, and ask whether this corresponds to the actual state of affairs. A further layer can complicate this: for example, where target management prepares management accounts according to local GAAP and then present it to a buyer adjusted to IFRS, ensuring that the GAAP to IFRS adjustments have similarly been reviewed could further mitigate any risk, especially where the warranty speaks to IFRS.

Discrepancies can also arise with different types of auditing standards across different countries. Every country has different auditing requirements for different

types of companies, but those requirements may also differ between different countries. This means that a single auditing standard set out in a warranty may not be relevant or correct for each financial statements set out across various jurisdictions. Financial statements that have been audited do not necessarily mean that they were audited to a "true and fair view" standard. For example, for smaller companies, Swiss law merely prescribes a minimum level of detail for the balance sheets and income statements and Swiss standards allow companies to reflect liabilities and assets below or above "true and fair" position. Financial reporting governed by the Swiss Code of Obligations (CO) is oriented primarily towards protecting creditors and forms the basis for taxation and, where applicable, dividend payments. Unlike IFRS, financial statements prepared in accordance with the CO are primarily driven by the principle of prudence and cannot be described as true and fair.[6] Consequently, a "true and fair view" warranty would warrant these Swiss audit reports to be something that they are not.

Furthermore, group companies usually have consolidated financial statements, which requires the group to make discretionary decisions and assumptions as well as estimates to a certain extent. This is further affected by, for example, the Covid pandemic, the war in Ukraine, and recent geopolitical risks and developments. While an underwriter may not necessarily be an expert in this field, it is prudent to ensure that these discretionary decisions and measures were reviewed as part of the buyer's due diligence, especially if a warranty speaks to such measures.

Carve-out

Financial statement warranties in a carve-out transaction present their own challenges. Risks are heightened when carving-out a business division from a larger group for which historically no standalone financial statements have been prepared.In these cases, the sellers most often prepare carve-out financial statements. While the buyer and his advisors can review and assess the carve-out financial statements, they are reliant on the disclosures of the seller, and have no way to ascertain whether costs were incurred in the running of the business, but perhaps not fully disclosed by the seller.

The principle may seem simple: the seller must disclose all costs that have been incurred in the running of the carve-out business. But in reality, these financial statements are teeming with complexities. More often than not, the exact scope of the carve-out is not as clear as the parties may believe, and a moving scope means that the financial statements are similarly a moving target. It may also be that costs were incurred in the running of the business on a different corporate level, which is not easily attributable to a specific division. For example, where an international conglomerate runs a global marketing campaign, undertakes business restructuring measures, or incurs global corporate function costs, it is not easy to split and assign these costs to a single business division (one of many), because costs most likely did not benefit each division equally. And when are costs incurred by a conglomerate to the benefit of its entire business simply too remote to say that at least part of it was incurred for a specific carved-out business division?

There are no easy answers to these questions, which ultimately means that it opens the door to disputes. And in a world where the parties are eager to sign and close a deal as quickly as possible, more often than not, these disputes arise after signing or closing.

Concluding remarks

Financial statements can be complex creatures and even standard warranties speaking to them should not be underestimated. Still waters run deep.

Each transaction is unique and a practical solution for one deal may be wholly inappropriate for the next. The best approach to mitigate risk is the age-old adage: to properly assess the warranty, consider whether it is a reflection of the actual state of affairs, and ensure that the scope of the warranty corresponds with the scope of the due diligence review undertaken by the buyer and its advisors.

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6 Deloitte, Accounting and Auditing: Investing in Switzerland (2018), p. 3.

The changing cyber landscape and M&A insurance

Nuala Read and Birgit Rummel, Tokio Marine HCC

The cyber landscape

The digitalisation of the global economy continues, and it is clearly an accelerating trend. This article focuses on how this growth has increased the risk and threats around cyber and the consequent impact this has had on the insurance market, M&A deals, and M&A insurance.

Surveys have shown that cyber perils were the biggest concern for companies globally in 2022. According to the Allianz Risk Barometer, "The threat of ransomware attacks, data breaches or major IT outages worries companies even more than business and supply chain disruption, natural disasters or the Covid-19 pandemic, all of which have heavily affected firms in the past year."[1]

The rising tide of cyber-crime is translating into costs for the global economy estimated at an incredible USD 6 trillion in 2021. Whilst industries like healthcare and e-commerce are seeing record levels of threats (according to RiskIQ's 2021 Evil Internet Minute Report[2]), this is an escalating menace regardless of industry, sector, country, or the size of the company.

Cyber security & cyber insurance

As cyber has evolved into a distinct new area of risk, the insurance market is naturally being asked to cover "new" types of losses including data breaches, data theft, systems outages, and failure, as well as ransomware attacks. Consequently, the insurance market has had to work out the best way to offer protection for clients.

In the last few years, insurers have started to move towards offering stand-alone cyber coverage with many insurance companies no longer including this within other policies: this removes the ambiguity that can occur with the so-called "silent cyber" coverage. In 2021, Lloyd's of London led the way with a requirement that all their policies be clear in their cyber coverage: full coverage, limited coverage or excluded.

As our understanding of these cyber risks increases, the insurance market is increasing their focus on clients' cyber security when coverage is requested. As businesses look to insurance for protection more and more, the growing expertise of cyber insurers is educating companies on what they need to do to manage and reduce these risks; this helps both business and insurers.

With cyber incidents, claims and losses augmenting exponentially each year, the insurance market is going through a period of flux as it looks to correctly assess and "price" cyber risks; cyber losses in 2020–2021 have deteriorated, mainly a surge of ransomware claims.

The insurance market recorded a 245% increase in global incidents since Q1 2019 (+390% ransomware, partially offset by a 70% reduction in data breach). In addition, there has been an 85% rise in remediation costs since 2019.

James Auden at Fitch Ratings observed that, "While cyber insurance premium rates are rising sharply, con-

1 Allianz Risk Barometer 2022: https://www.agcs.allianz.com/news-and-insights/news/allianz-risk-barometer-2022-press.html
2 Infosecurity Magazine: https://www.infosecurity-magazine.com/news/cybercrime-costs-orgs-per-minute/

cerns remain that underwriters can successfully price this business longer term, given constantly evolving risk exposures and sources of loss."[3]

Cyber security and M&A

In an M&A deal, cyber can be a problem for both parties. A breach discovered on the seller's side can reduce their asking price for their business and, equally, a buyer can be left counting the cost should a cyber issue come to light after the deal completes.

Many of the examples relating to cyber incidents and losses apply to trading companies or government bodies. As with many factors in M&A deals, there is not much public information available, but we highlight the following as public examples of cyber impacting on M&A:

- In 2013, a cyber attack in Yahoo's systems was discovered mid-acquisition. As a result, Verizon (the buyer) was able to shave USD 359 million off the final price – that is, 7% of the total deal value.
- In 2020, the ICO fined Marriott Hotels for a cyber breach in their 2016 acquisition of Starwood Hotels. The fine was applied because Marriot had not made investigations pre- or post-sale and allowed customer data to be exposed.

Cyber security & M&A insurance

Until recently and in line with most other insurance classes, M&A insurance covered cyber exposure, whether silently or explicitly, for most deals. However, as the cyber threat landscape has deteriorated, coverage offered under M&A policies has also changed. M&A insurers are not immune to the changes in the cyber landscape and the impact on other insurance classes; as a result, the M&A market position has become increasingly cautious.

There are still a range of coverage options available in the M&A insurance market; but generally, the cyber coverage offered will very much depend on the cyber risk exposure of the target. Some insurers will be more cautious than others, as is usual in other areas of this type of insurance.

It has been noted that with the rise of prominent cyber incidents, we are starting to see buyers look for an increasing number of warranties around cyber and IT, that they then ask insurers to cover. This is not surprising, as 80% of dealmakers said they have uncovered data security issues in at least 25% of their M&A targets in the previous two years.[4]

However, despite a heightened awareness of the potential impact of cyber and/or technology on the profitability of an M&A target, research shows that less than 10% of the deals undertake cyber due diligence.[5] Often cyber is not considered sufficiently "material" to investigate and cyber security is usually put into the post-transaction action list.

However, we note the increasing impact that cyber is likely to have in M&A deals:

- In the last year, we saw a significant rise in economic espionage, such as the theft of high-value intellectual property by nation-states.[6]
- Extended supply chain threats are challenging organisations' broader business ecosystem.
- New regulations aim to hold organisations and their executives more accountable in the protection of information assets and IT infrastructure.

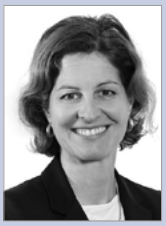
As awareness of cyber risks in M&A deals increases, and demand for cyber insurance grows, a collaborative Cyber-M&A coverage approach will help clients get their deals done effectively.

3 Reinsurance News: https://www.reinsurancene.ws/cyber-insurance-in-pc-industry-grew-by-22-in-2020-fitch-ratings/

4 PwC: https://www.pwc.com/us/en/deals/publications/assets/pwc-when-cyber--threatens-m-and-a.pdf

5 Aon Top Five Cyber Risks in M&A: https://www.aon.com/unitedkingdom/insights/top-5-cyber-risks-in-mergers-and-acquisitions.jsp

6 Accenture Cost of Cyber Crime 2019: https://www.accenture.com/_acnmedia/pdf-96/accenture-2019-cost-of-cybercrime-study-final.pdf



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Nuala Read, joined Tokio Marine HCC in 2017. She currently leads our UK team in their offering of tailored insurance coverages to clients involved in M&A deals. Nuala has worked in the insurance industry for over 25 years. Her career has focused predominantly on both the broking and the underwriting of M&A insurance products. Her vast experience in this field has seen her place a plethora of specialist M&A policies that often sit alongside complex deal structures and, thanks to this, Nuala is heavily consulted in the development of M&A insurance policies that bring value to both deal parties. Nuala is ACII qualified and holds a degree from Bristol University. nread@tmhcc.com

Insurability of IP Risks

Dr Mirjam Boche, Rolf Tichy, ARQIS & Robin Lawless, DUAL Europe

1. Introduction

The discussions around intellectual property risks have become increasingly important in the M&A context, in particular surrounding software issues. Whilst the challenges of the last two years have had a negative impact on M&A activities, companies with business models heavily focused on software, were amongst the winners of the crisis.[1]

The insurability of IP risks most commonly becomes practically relevant in the context of corporate transactions, especially in relation to the insurability of the warranties within a company purchase agreement. This raises the question of under which conditions and through which insurance products IP risks can be insured.

2. Differentiation of various IP Risks and insurance solutions

2.1 W&I Insurance

Warranty and Indemnity Insurances (W&I) only cover unidentified risks arising from a breach of warranties within company purchase agreements. In the first instance, warranties typically incorporated in company purchase agreements include warranties that certain intellectual property rights are owned by the target company and that there are no existing restrictions in this respect.

> **Schedule 1** contains a list of all registered and unregistered inventions, patents, utility models, trademarks, service marks, design rights, domain names, copyrights including rights in software developed or acquired by the company and its source code, rights in databases, know-how, in each case and as applicable including registrations and applications for registration, and similar forms of protection anywhere in the world, owned by the company or to which the company has exclusive, perpetual worldwide, unrestricted rights of use for any purpose (the "Owned IP Rights").
>
> The company owns all rights, title and interest in and to its Owned IP Rights free and clear of any third-party rights and of any and all encumbrances. Other than non-exclusive licences granted to customers in the ordinary course of business, no licences or other rights of use have been granted with respect to the Owned IP Rights and there are no obligations to encumber or grant licence or other right of use in and to the Owned IP Rights. The group companies are free to operate their business as currently conducted using the Owned IP Rights and to dispose of the Owned IP Rights at their own discretion without owing payment of any royalties or similar fees to any third party.

In the context of registered IP rights, it is often guaranteed that the required registration fees have been paid and that further measures to maintain rights have been taken. This warranty is flanked by the promise of confidential treatment of IP rights as a whole, which is of decisive importance for non-registered IP rights.

The typical warranties that IP rights of the company are not infringed by third parties and that the company will not infringe upon IP rights of third parties are of decisive importance for W&I insurance from a liability point of view. From the seller's perspective, it is usually not possible to make a final judgment on whether these declarations are true and therefore, almost without exception, these warranties can only be made to the best knowledge of the seller. Depending on the agreed standard of best knowledge, the buyer must therefore demonstrate and prove that the seller had a positive knowledge of or was grossly negligent regarding the incorrectness of this warranty in the case of a dispute.

Additionally, there are often further warranties with regard to licenced IP rights and the permission to use them. For companies heavily focused on software, particular importance is attached to the warranty for the use of open-source software ("OSS"). The seller guarantees that the relevant licence agreements have been complied with and that there is no disclosure obligation or obligation to provide rights of use free of charge.

1 Kengelbach et. al., Decoding the Competitive Software M&A Market, Exhibit 1, verfügbar: web-a sets.bcg.com/7e/6e/f07e502f46699dee6e9f4da78c55/bcg-decoding-the-competitive-software-m-a-market-feb-2021.pdf.

> The use of any software or other material that is distributed as "freeware", "free software", "open-source software" or under a similar licensing or distribution model in the development of or incorporated into or combined with the Owned IP Rights complies with the applicable licensing terms. The company's products or services do not use or incorporate any open-source software or materials that are subject to licence terms which provide for any obligation for the company (i) to disclose or distribute any of its intellectual property in source code form to third parties, (ii) to licence any of its intellectual property for the purpose of making derivative works or (iii) to distribute any of its intellectual property without a charge.

2.2 M&A Insurance for identified risks

Whilst identified risks are excluded from insurance cover in W&I insurance policies, under certain circumstances individual M&A insurance policies also offer coverage for identified risks.

An extremely low probability that the legal risk will occur is a prerequisite for the insurability of identified risks. This may for example be the case with pending IP litigation in which both the lawyers of the target company and the insurer's external advisors consider the prospects of legal success to far outweigh the prospects of failure. Purely factual issues such as the likelihood of a certain IP related claim stemming from an identified area of risk, cannot be covered by this type of insurance product. Of course, the interplay between legal and actual risk is complex and can ultimately only be evaluated by means of a concrete examination in each individual case.

2.3 Standalone IP Insurance solutions

The insurance industry is developing an increasing number of products for the insurance of IP risks independent of the field of corporate transactions. These are insurance policies that cover the costs of defence in the case of an alleged infringement of IP rights by third parties and also pay compensation in the case of justified claims, therefore ultimately offering a type of specialised legal protection policy. On the other hand, they also cover the area of IP ownership, for example in connection with cancellation or invalidity proceedings. This may be particularly relevant in connection with contractual obligations of the company towards third parties.

3. Verifiability of IP Risks in Due Diligence

The W&I insurance is the most practically relevant insurance solution for IP risks. The key prerequisite for the insurability of IP warranties in the company purchase agreement is the performance of a due diligence regarding IP by the buyer and thus potential policy holder.

3.1 Relevant IP Risks in the context of M&A

Several different IP risks are examined during M&A transactions. Arguably, the most important question is whether the company has all the necessary IP rights to carry out its business without infringing the IP rights of third parties. Should the company's products or services infringe upon IP rights of third parties, the third parties may be entitled to a number of claims, in particular for injunction and removal, information and damages. Especially companies in the technology and software industry can be severely affected by these claims, even rendering their business model completely impossible in the worst-case scenario.

Additionally, companies do not always have the necessary understanding of possible IP violations e.g., such as when using OSS.

To explain: according to the licensing conditions of some OSS components, the use, modification or distribution of the OSS component is only permitted under the condition that the software continues to be placed under the corresponding OSS licence (so-called copyleft). This can mean that in-house software developments

which are connected to or modify OSS components must be placed under the relevant OSS licence. In this context, it is spoken of a "viral effect" of OSS which can include an obligation to publish the source code of the software for some licences. However, for the determination of the point at which a viral effect occurs, a differentiated technical and legal examination in each individual case is required.

According to a study in 2021 conducted by Bitkom, 71% of all companies surveyed in Germany with over 100 employees stated that they use OSS in their company. For companies with 2,000 employees or more, this figure is even higher at 87%. Conversely, however, only 22% of all respondents stated that they had a policy regarding OSS in their company.[2] This shows that companies often still underestimate the risks that can arise from the use of OSS components.

3.2 Conducting the IP Risk analysis

In corporate transactions, the scope of a legal due diligence is regularly defined in advance between the client and the advisor. Due to financial reasons, so-called red flag reports are drawn up in most cases in today's practice, the aim of which is to show the potential buyer of a company the most important risks of the target company. A qualitative examination and in particular reporting only takes place within this limited scope.

(1) Registered IP Rights

In IP due diligence, this approach means that the examination of intellectual property rights of the company is limited to the information that can be derived from publicly accessible registers (such as the register of the German Patent and Trade Mark Office) or the documents provided by the seller. For these registered rights, it is possible that conflicting IP rights of third parties could be clarified within the scope of a "freedom-to-operate" search. In particular in the field of patent law, these are however usually associated with a considerable effort.

A comprehensive international patent research is only possible with the involvement of patent lawyers with scientific expertise from the respective technical disciplines. In addition to the examination for possible collisions with the patents of third parties, an extensive search by patent lawyers can also be used to verify whether the patent portfolio is qualitatively suitable for the adequate protection of the company's own inventions. A graduated approach is typically recommended with larger patent portfolios and numerous potential competitors in which the patent lawyer and the technical department of the company mapout and define the key innovative and commercially relevant features as well as the main competitors and then carry out a focussed and targeted research as part of the market comparison. However, such an extensive review requires considerable time and financial effort and can therefore only rarely take place within the often time-critical due diligence.

(2) Non-Registered IP

The most important intangible assets of a company are often those that are not recorded in a register and about which the company itself often does not have a complete overview. These include in particular works protected by copyright (especially software), technical know-how that has not yet been registered as a patent or industrial design, as well as trade secrets which derive their value precisely from their non-disclosure. Quite often there is a lack of knowledge on the part of the company about the existence and relevance of the submission of particular information. Naturally, this makes a due diligence more difficult, in particular with regard to possible conflicting rights of third parties.

In some cases, software tools can help to shed light on a situation for example when checking a software code for the presence of OSS components. Even without an OSS policy and continuously maintained OSS licence

2 Cf. Bitkom: Open Source Monitor 2021, abrufbar unter www.bitkom.org/sites/main/files/2021-12/211207-bitkom-studie-openmonitor-2021.pdf (Stand: 25.05.2022)

management some conclusions can thereby be drawn about the use of OSS in the software of a company. An example of such a tool is the "Black Duck" software, which reviews the code of a software to see which OSS licences have been used. Hereby, the vast majority of copyleft licences can be detected. However, neither a technical nor a legal evaluation of the concrete use of the OSS component in the individual case is covered by the report. It therefore often remains unclear whether the somewhat risky OSS has actually been modified in any way or whether the company's proprietary software has been linked thereto in such a way that it leads to the infection of the software development by the OSS-licence. Both the detailed technical knowledge of the software developers and the legal interpretation of a specialised lawyer is necessary for such an assessment in each individual case. Such an examination can be either more or less extensive depending on the size and complexity of the software. Moreover, the partly still very new, but in any case, vague rules of copyright law in this respect are not clearly defined by case law. Therefore, ultimately, even after such a detailed examination, residual risks that the company software infringes upon OSS licences may still exist.

If neither a black duck report nor a list of the OSS licences used in the software exists for the company, the due diligence is essentially limited to uncovering the most important risks within the Q&A process. It is advisable to talk directly to the technically responsible employees of the target company (e.g. the CTO or the senior software developers) in the technical Q&A call.

4. Risk assessment from a W&I Insurance perspective

From a W&I insurance perspective, it is particularly relevant to recognise the potential financial impact of the breach of an IP warranty in the worst-case scenario. For example, it is key to understand whether a particular patent is essential to the respective business model or in which products the OSS components are found and/or whether the software is only needed by the company to provide the externally offered service. The limited nature of "red flag" reporting means that the commercial relevance of IP (which is often assessed on the basis of due diligence reports submitted in the underwriting process) often does not become sufficiently clear. Such clarification only takes place via written queries to the buyer or during discussions in the underwriting call. The better the insurer can comprehend the concrete economic impact of a breach of warranty, the more differentiated and usually advantageous the coverage turns out to be for the policy holder.

5. Conclusion and prospects

In conclusion, the W&I insurance, which is now more or less established as a standardised insurance product in the M&A insurance market, offers solutions to various problems but does not provide conclusive coverage with regard to the relevant challenges from the buyer's perspective. However, under certain circumstances identified risks can be covered by special solutions. The insurance market already offers some solutions regarding IP risks that buyers may face in the future irrespective of concrete risk areas and independent of corporate transactions, which provide a value-added contribution to the management of IP risks.



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Impact of the Ukraine war on the coverage of liability risks in the context of M&A transactions by W&I insurances

Dr Daniel Barth & Philipp Becker, Dentons

A. Initial situation

Since 24 February 2022, Russia has been attacking targets throughout the territory of Ukraine without a formal declaration of war. After the Russian armed forces failed at the beginning of the war to permanently occupy the capital Kyiv and parts of Ukraine further west, the fighting is currently concentrated in eastern Ukraine. It is unclear what Russia's current war aims are based on the course of hostilities to date, as these have been associated with significant losses for the Russian armed forces and the original goals have not been achieved. In view of the course of negotiations to end the war so far, it is likely that hostilities will continue for some time.

In response to the war of aggression, which Russia continues to describe as a "special military operation", the Western community of states has initiated massive economic sanctions in addition to arms deliveries, and sanctions up to and including a far-reaching embargo on raw materials are in the offing.

The sanctions and public pressure in the West have led to a massive exodus of Western companies from Russia, which is not limited to sanctioned sectors. Production in Ukraine is currently substantially affected by the hostilities and a further collapse of production is to be feared. In addition, there has been a massive exodus from Ukraine, which also has an impact on local production capacities. At the same time, the war is causing restrictions on air and sea travel. As a result, global supply chains, which were already strained by the effects of the Covid-19 pandemic, have once again come under severe pressure.

The war in Ukraine is hitting a market environment that is increasingly characterised by inflationary tendencies and an associated turnaround in interest rates. At the same time, the market for corporate transactions is relatively stable and remains characterised by investment pressure on the buyer side and the resulting high company valuations and seller-friendly contractual arrangements. In this market environment, a far-reaching shift of liability risks from the warranty and indemnity regime of the transaction documentation from the seller to W&I insurers has been taking place for some time.

As a result, the extent to which the effects of the Ukraine war can be covered using W&I insurance solutions is relevant if these risks are assigned to the seller within the warranty catalogue and corresponding warranties are to be the subject of an insurance solution.

B. Impact of the Ukraine war on M&A transactions in general

The warranty regime of the transaction documentation leads to an allocation of risks to the seller to the extent of the seller's representations unless exclusions of liability under the respective warranty regime apply. The representations are made as of a specific date – usually the date of signing and the date of execution of the transaction documentation – and are subject to certain exclusions of liability.

The impact of the Ukraine war on individual M&A transactions is therefore first influenced by the progress of the transaction, i.e. whether signing and/or execution had already taken place at the start of the hostilities. In addition, the nature of the effects is of paramount importance for assessing whether the risks are generally covered by a standard market warranty regime and whether the seller can exempt itself from liability in this respect under the contractual warranty regime.

C. Transaction progress as a starting point for the analysis of warranty-related risks and response options

Insofar as transactions were signed and completed before the start of the Ukraine war, effects under the warranty promises are rather unlikely, as the time reference

points of the assurances are before the start of the hostilities.

If transactions had already been signed at the start of the hostilities but not yet completed, the situation is more complex. If, on the other hand, the parties want to stick to the transaction, the question for the seller is whether he is liable for the effects of the Ukraine war under the warranties relating to the date of completion and how he can exclude such liability as far as possible within the fixed contractual framework. Frequently, however, buyers will probably not want to stick to the transaction due to the changed environment and will try to get out of the transaction. In this respect, the circumstances of the individual case will be decisive, but it does not seem impossible – especially if a MAC / MAE mechanism is agreed as part of the transaction documentation – that the buyer will be able to terminate (or at least adjust) the transaction documentation.

The impact of the Ukraine war is fully felt if the transaction has neither been signed nor completed. In such a case, however, the parties have the option of addressing the relevant effects through the warranty regime and the due diligence process.

D. Differentiation into direct and indirect effects of the war in Ukraine

The manifold effects of the Ukraine war on the legal and factual circumstances of target entities are not always likely to be fully grasped and are, by their nature, rather dynamic. Nevertheless, a general distinction can be made between direct and indirect effects, whereby the boundaries are often likely to be blurred. However, the identification of specific effects of the Ukraine crisis within the warranty regime is likely to be easier the more directly the connection to the acts of war and the reactions to them is.

This distinction is relevant above all because a sufficiently clear description of the concrete effects and risks forms the basis for proper treatment within the framework of transaction documentation and the transaction process.

Diffuse general risks, for example, can by their nature only be covered to a limited extent by contractual provisions at the level of the warranty regime and the disclosure and due diligence process, while clearly defined risks are in principle amenable to regulation by the parties within the warranty regime (and potentially to an exemption for known risks). In addition, this concerns in particular the disclosure of warranty-relevant facts with a correlating disclaimer, which presupposes that the relevant circumstances of a disclosure are accessible in accordance with the disclosure standard of the transaction documentation, i.e. in any case not merely identifiable in a completely abstract manner.

E. Scope and limits of coverage for possible risks within the scope of W&I insurance

These statements are at the same time relevant to the scope of insurability, as the coverage exclusions of W&I insurance typically only cover the immediate effects of the Ukraine war.

I. Limits of insurability from general exclusions of cover

Limits to the insurability of risks related to Russia and Ukraine are regularly discussed if target companies have subsidiaries there or have substantial sales in these countries.

Even before the Ukraine war, W&I insurers were reluctant to underwrite risks in or related to Russia. This was mainly due to concerns about existing sanctions. Nevertheless, in individual cases it was possible to structure insurance solutions for transactions involving Russia.

With regard to Ukraine, there were also many concerns about insurance coverage, which, however, had their origin primarily in reservations about local business practices. However, insurance coverage was regularly possible in individual cases if certain requirements for the transaction were met.

Since the start of the Ukraine war, various coverage exclusions have now gained relevance, the content of which largely relates to the direct effects of the Ukraine war and excludes certain losses from insurance coverage.

1. Coverage exclusion for disclosed facts

The W&I insurance only covers unknown and undisclosed matters, which is reflected in the coverage exclusion for disclosed matters. However, this coverage exclusion is likely to be relevant mainly for direct impacts of the Ukraine war, as indirect impacts are not sufficiently ascertainable to be disclosed under current fair disclosure concepts. This

may change as developments progress and the concrete implications of the war in Ukraine are increasingly understood, but currently there is massive uncertainty in many respects combined with strong dynamics of the situation, which cannot (yet) be satisfactorily addressed by a disclosure process.

2. Territorial coverage exclusions

Ever since the annexation of Crimea by Russia in violation of international law, W&I insurance policies have contained exclusions of cover for circumstances relating to the annexed territories in Crimea and the areas in eastern Ukraine affected by fighting by pro-Russian separatists. These coverage exclusions have been applied in a modified and extended form since the beginning of the Ukraine war. As a result of this exclusion of cover, there is no insurance coverage for damage with a geographical reference to the areas covered. However, due to the requirement of a reference to the conflict area, the exclusion of liability is basically limited to direct (local) consequences of the Ukraine war.

3. Coverage exclusions for armed conflicts

Most W&I insurance policies provide for an exclusion of cover for losses in connection with war or armed conflict. This is certainly the case for Lloyds Syndicates. The wording and the scope of application of the coverage exclusions are currently being adjusted in many cases on the occasion of the Ukraine war, but essentially concern direct effects of hostilities.

4. Sanctions

All insurance policies contain provisions on compliance with existing sanctions, although the scope of possible insurance coverage varies. While some W&I insurers explicitly exclude sanction-related warranties from coverage, other W&I insurers are generally open to the insurance of sanction-related warranties but link the obligation to indemnify to the payment to a beneficiary not affected by sanctions. Compliance with existing sanctions on the part of a target company is thus not consistently excluded from possible insurance coverage.

5. State expropriations

The possibility of state expropriation of foreign assets within Russia has been raised in various contexts. The corresponding risks have led some insurers to include a general exclusion of cover for expropriation transactions. These partly go beyond Russia and also affect Belarus and Ukraine.

6. Special case: Insurance cover in case of theoretical possibility of contract termination

In previous insurance practice, the occurrence of a contractually defined Material Adverse Change / Material Adverse Event is not a reason for termination of the W&I insurance, but the obligation to indemnify is regularly excluded - with reference to obligations to mitigate loss. This means that the W&I insurance can be continued despite the occurrence of MAC / MAE, but the insured warranties cannot compensate for the effects of MAC / MAE. This must be taken into account when drafting the contract by suitably tailoring or waiving the corresponding mechanisms. For without a corresponding provision, a limitation of cover under the W&I insurance is hardly a possibility.

II. Hedging of relevant effects of the Ukraine war under a standard market warranty catalogue

As a general rule, effects of the Ukraine war are insurable under the warranty regime and the general coverage decisions of the W&I insurer.

In view of the dynamics described the insurance cover for indirect effects – especially under general clause-like warranties – can be quite extensive, while cover for direct effects will often be subject to one of the coverage exclusions described.

In the following, without claiming to be exhaustive, some of the risks that will usually be covered by the insurance coverage will be examined in more detail:

a) Fundamental warranties

The focus of the usual fundamental warranties is on the assurance of the seller's legal capacity and authority to enter into and complete the transaction, the enforceability of the transaction documentation, the absence of conflicts between the transaction documentation and the seller's legally binding obligations, and the seller's unencumbered ownership of the object of purchase.

With regard to the assurances regarding the seller, the enforceability of the transaction documentation and

the absence of a breach of legally binding obligations of the seller, a breach of warranty in transactions related to Ukraine and/or Russia seems conceivable in particular as a consequence of new sanctions that directly prohibit the intended transaction or at least indirectly make it impossible (in particular also with regard to the settlement at the level of the purchase price payment, which may become impossible due to sanctions). In such a case, depending on the existence and design of a coverage exclusion for sanctions, claims against the W&I insurance are likely to be possible.

If the subject of the transaction are shares in Ukrainian and/or Russian companies (and no sanctions intervene), there is a risk of expropriation. Unless this risk is addressed by an explicit exclusion from cover, a formal expropriation (including a forced sale below market value) may result in an insured loss. This is particularly true if relevant facts arise after the signing date and the transaction documentation does not include a bring-down to the closing date and a MAC clause.

In these cases, the buyer will regularly be able to claim the positive interest, or at least the costs of the failed transaction.

b) Real estate

The liability of the W&I insurance for property-related warranties is generally excluded if the properties are located in Ukraine or Russia, as area-related coverage exclusions are likely to apply in this respect. In contrast, in the case of direct and indirect acquisition of domestic real estate from a Russian or Ukrainian seller outside the scope of sanctions, a customary warranty regime should be insurable without restriction, so that the risk of enforcement of warranty claims in Russia or Ukraine can be avoided here using W&I insurance.

c) Financial statements

The material accuracy of financial statements as of 31 December 2021 will not be affected by the Ukraine war in principle, as it did not begin until after the balance sheet date. In contrast, the development in the 2022 financial year will certainly lead to challenges in the preparation and audit of the annual financial statements, depending on the sector, especially in areas of accounting that require prognostic assessments and estimates based on preliminary information. Overall, the uncertainties are not likely to be limited to the currently predominantly affected areas of the energy sector and the food industry but are also likely to affect other sectors due to the manifold effects of the war. In particular, the aforementioned uncertainty factors condense within the framework of the management report, whereby this (to the extent that it exists) is in many cases not likely to be part of the definition of the insured financial statements because of these very risks. In contrast, a coverage exclusion for forward-looking statements and forecasts (if any) will regularly not intervene due to its design, as the forecast elements are not explicitly part of the wording of the warranty itself.

d) Material contracts

The most probable effects of the Ukraine war in the context of customary warranty regimes are likely to concern the warranties on material contracts of the target entities, especially since these do not presuppose a direct context to the war. At the same time, the indirect effects of the Ukraine war – especially price increases and disruptions of supply chains – tend not to be covered by the exclusions of cover provided so far. Thus, in addition to the direct effects of sanctions on the existence and enforceability of material contracts, which – depending on the insurer – may well qualify as an insured loss, there is above all insurance coverage for (undisclosed) indirect effects. This concerns statements on the absence of disruptions in the supply chain, the availability of alternative suppliers for input products at comparable conditions, termination rights due to a significant change in the market environment, as well as statements on the absence of circumstances that are likely to cause a breach of contract or otherwise give rise to disputes between the parties.

Whether and to what extent disruptions of performance are used by the contracting parties to withdraw from essential contracts or to enforce claims for damages is questionable due to the general effects. In this respect, the effects of force majeure clauses in the respective contracts must also be considered in individual cases, which are currently the subject of extensive discussions. In general, it can be assumed that force majeure clauses only take effect if an unexpected event occurs. Particularly in the case of material contracts that were only concluded after the start of the war, recourse to such clauses is questionable.

e) Ordinary Course of Business

With regard to the statements on an orderly course of business since the last balance sheet date, which are

common especially for transactions with locked-box purchase price models, the situation is also complex. Business models are likely to be affected differently by the Ukraine war, while indirect effects influence a large number of business models. In this respect, insured breaches of warranty come into consideration if the corresponding risks have affected the course of business. Thus, disclosure and examination in the course of legal and financial due diligence are likely to capture relevant risks rather difficultly due to the only preliminary information basis and the very diffuse effects. In this respect, the situation is comparable to the dynamics in the early stage of the Covid-19 pandemic. Here, relevant risks were often generally excluded from the scope of the warranties because proper disclosure was not possible. It remains to be seen whether this will also happen in a similar way with regard to the Ukraine war.

f) Litigation

The risk of legal disputes is substantially increased, in particular, by possible performance disruptions in the area of material contracts. In addition, the predictability of possible disputed circumstances is greatly impaired by the complexity of the effects of the Ukraine war. Insurers will therefore be increasingly reluctant to insure warranties on the absence of circumstances that may give rise to litigation without appropriate restrictions.

g) Compliance

In the area of compliance, the unpredictable introduction of sanctions and compliance with sanctions by the target entities are particularly relevant. Depending on the approach of the insurance, a breach of sanctions by the target company can lead to an insured event if cover has been obtained for the relevant compliance warranties and only prohibits a payout to subjects affected by sanctions, but cover is not excluded entirely.

h) IT / Cyber

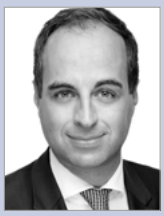
The Ukraine war is increasingly also being fought in cyberspace through hacker attacks. Insofar as the target companies have taken out cyber insurance prior to the Ukraine war, it may therefore make sense to use W&I insurance as a top-up to cyber insurance. However, at least sector- and jurisdiction-specific restrictions on insurance coverage must be assumed, since warranties on the adequacy of IT infrastructure and IT security, as well as the absence of incidents in the area of IT security, involve massive risks that make insurance claims likely within the scope of the hitherto customary coverage as an extension of existing cyber risk policies.

i) Insurances

As a rule, the existence of insurance policies is not directly affected by the war in Ukraine. It should be noted, however, that property insurance policies of the target companies contain extensive exclusions for wars and armed conflicts. This may well lead to insured events under the W&I insurance if the warranty regime contains statements on the coverage of corresponding losses. At the same time, the possibility for the W&I insurer to refer the buyer to the existing property insurances within the framework of the basic subsidiarity of the W&I insurance is severely limited as a result of this state of affairs.

F. Summary

The effects of the war in Ukraine are complex and affect various aspects of standard market warranty regimes. Many of the direct effects are excluded from possible insurance coverage under W&I insurance by specific exclusions. However, there remains a wide range of risks resulting from indirect effects of the Ukraine war that remain accessible to insurance coverage and are of high practical relevance. The W&I insurance is thus a suitable tool to cover unknown risks and intangible effects of the Ukraine war – this, incidentally, corresponds to its essence.



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W&I Insurance in M&A Transactions: Stapled Insurance

Dr Nikolaus von Jacobs, McDermott Will & Emery

Forward-looking risk management is particularly important in uncertain times. While the transaction market has reached new heights in recent years, players have also increasingly hedged their risks (not least because of global crises). While warranty & indemnity (W&I) insurance was not widely used in the past, it is now found in most transactions. Stapled insurance, which is brought into the process by the seller, is another structure that is becoming more established.

W&I Insurance in transaction practice

Warranty & indemnity (W&I) insurance protects buyers and sellers against the liability risks that can arise from corporate transactions. In many cases, their purpose is to protect the buyer in the event that the risks covered by the warranties and indemnities provided by the seller in the purchase agreement materialise. The insurance then fully or partially covers the materialised risk. W&I insurance is often combined with tax liability insurance, which considers the tax risks of mergers and acquisitions (M&A) or private equity transactions.

W&I insurance is not new, it has been used in M&A transaction practice for many years. However, the Covid-19 pandemic and the accompanying economic uncertainties have once again significantly increased the demand for W&I insurance. According to a market survey, some insurers even had to close their books for the current year starting with the fourth quarter of 2021.[1]

Additionally, the shift from a buyer's to a seller's market has also helped W&I insurance reach new heights. The more difficult it is for investors to win the bid for an attractive target company, the less eager they are to possibly diminish their chances even further by demanding liability from the seller. This is particularly true in auction processes.

Sellers are taking advantage of this and have increasingly decided to exclude their own liability for guarantees from their initial drafts of the sale and purchase agreement (SPA) and instead refer to coverage via an insurance policy. The insurance is generally structured as a buyer's policy in which the insurer undertakes vis-à-vis the buyer to assume responsibility for the seller's warranties and indemnities under the SPA.

A special case of Stapled Insurance

Since it is not only in the interest of the seller that the buyer takes out the W&I insurance, but given that the buyer is also interested in a process that is as quick and efficient as possible, the seller often already prepares the W&I insurance solution as part of the auction process. This form of transaction insurance is often referred to as stapled insurance and distinguishes between soft stapling and hard stapling.

Soft Stapling overview

In soft stapling, the seller – with the help of an insurance broker – takes charge of obtaining quotes and selecting a group of attractive indications, which they present to the buyer for selection. The buyer then has the choice of going with one of the insurers proposed by the seller or with another one that the buyer favors.

Soft stapled insurance is characterised by the seller submitting non-binding offers to conclude an W&I insurance policy to the potential buyers in coordination with a broker. The broker first checks the seller's sample SPA and obtains offers from insurers on this basis. For the offers received, the broker prepares a summary (a so-called Non-Binding Indications (NBI) Report), which the relevant bidder(s) can view in the data room.

1 https://www2.deloitte.com/de/de/pages/mergers-and-acquisitions/articles/w-und-i-versicherungen.html

The NBI Report sets out (for the early stage and given limited information), in relatively granular terms, the following for the various insurers:

- Policy amount (coverage amount)
- De minimis
- Entry threshold (first loss piece)
- Premium
- Legal expenses
- Buyer due diligence requirements
- Accepted liability regime
- A concrete statement as to which guarantees of the seller's draft can probably be insured (depending on subsequent buyer due diligence, etc.) and with which qualifications, if any, or which insurance exclusions there will be.

Over the past few years, premiums have settled at between 0.7% and 1.5% of the sum insured, with a minimum of approximately EUR 60,000 to 75,000.

With this approach, the buyer cannot claim that there are problems with an insurance solution. At the appropriate time in the process, they take over communication with the broker and select one of the insurances (or another one favored by the buyer) with which they then take up the usual underwriting process.

The underwriting process

The underwriting process is about the insurer being able to understand the deal and the negotiations between the buyer and seller. To that end, they will specifically ask to see:

- The SPA, including all attachments, namely disclosures, etc.
- Access to data rooms, including the index
- Any due diligence reports on the part of the buyer and, if available, the seller
- The latest audited financial statements of the target company
- The Information Memorandum, the Management Presentation and other documents and information prepared by the seller as part of the sale process.

The climax of this process is the underwriting call between the buyer, the insurer and the involved consultants, which is primarily about:

- How the sales process played out
- The type and quality of information disclosure by the seller
- The buyer's approach to due diligence; also relating to the different advisors and the scope of their mandate
- The relative strength of the negotiating positions of the two parties and how that affects the final SPA
- Any remaining known concerns or identified issues that are outstanding on the insurer's side as part of the underwriting process.

This process usually takes at least three to five days, although to be on the safe side, seven days should be allowed to clarify any outstanding issues and provide comfort to the insurer concerning clarifications and information where necessary.

Development of Stapled Insurance over the years

Stapled insurance has become increasingly common in recent years. In auction processes, when selling to financial investors in particular, as well as appropriately well-advised small-to-medium enterprises (SMEs) on the sell side, expect to take out W&I insurance. Conversely, such a request does not surprise a buying private equity investor. The instrument ensures transaction security and accelerates the speed of the process, making it favored.

Effects on the purchase contract

As is common in the sales process, the draft SPA is typically provided at the end of the due diligence process.

The parties negotiate the SPA and the buyer policy in parallel with the underwriting process. If something changes with regard to the guarantees in the SPA, the insurance policy is also adjusted accordingly (if possible) as part of the underwriting process with the insurer.

For stapled insurance, changes are made to the SPA by inserting a "W&I insurance clause". Under this clause, the buyer undertakes to acquire a standard W&I policy, with the policy itself typically being provided as an annex. The clause provides, insofar as the insurance solution is to take effect, for a limitation of the seller's liability to an amount 1 EUR for the warranties

and indemnities, irrespective of whether the policy has been validly concluded or whether the insurer pays in the event of risk realisation. Recourse claims are excluded.

Another fundamental issue that plays a more important role in practice than before because of the rise of W&I insurance solutions is the question of the seller's liability for "statements made in the dark" (*Angaben ins Blaue hinein*) in the case of guarantees that are provided without further verification. The case law has established an intentional liability of the seller in case of nonfulfillment of such guarantees, which leads to the fact that a limitation of liability does not apply. This is relevant in the case of W&I insurance because the agreed liability cap would not apply and the seller cannot escape liability, (i.e. they are liable despite the insurance provided). In practice, this leads to the fact that the warranty catalogs, despite the insurance solution, are to be evaluated very finely by the seller as to whether he can provide them consciously and with due diligence.

Overall, the insurance solution shifts any risk realizations to the insurance company, which is why, on the one hand, deadlocks can be avoided when negotiating the liability regime and the SPA can be negotiated more quickly overall. On the other hand, the need for collateral (escrows) is also eliminated.

Hard Stapling overview

Unlike soft stapling, in hard stapling the seller specifies one insurer.

This variant may be used if a highly competitive process is expected, and the seller has a strong negotiating position. In this case, the insurer starts the underwriting process on the sell side based on sufficiently thorough vendor due diligence reports, access to the data room, underwriting calls on the sell side and negotiation of the policy with the seller.

The purpose of the underwriting call is to provide the insurer with an understanding of:

- The way of compilation of the information deposited in the data room
- The placement of the data room
- The approach to the disclosure of information
- The approach and scope of vendor due diligence reports
- The sales process.

In the underwriting process, the seller also negotiates the fees and premium with the insurer. Hard stapling results in the insurer ideally being able to attach a finalised draft policy to the draft SPA already.

With the involvement of the buyer in the sales process, the underwriting process on the buy side then proceeds parallel to the buyer's due diligence and the SPA negotiations, as described above in the soft stapling section. This can naturally lead to policy adjustments.

Time-wise, hard stapling should allow at least 48 hours for the underwriting process on the buy side.

Conclusion and outlook

W&I insurance has become an integral part of the transaction practice. Its importance for the involved parties is likely to increase even further in times of economic and geopolitical uncertainty. For providers in the insurance market, while it is a sector that is expanding further with a tendency towards increasing demand, it also represents a highly efficient instrument that can significantly increase transaction speed and transaction security.

It is recommended to consider the option of W&I insurance in the early stages of any transaction in order to be able to act quickly if its usefulness or necessity is confirmed. Doing this in close cooperation with a broker and considering stapled insurance at the same time can add a completely different dynamic to a sales process, to the benefit of both parties.

Dr. Nikolaus von Jacobs at McDermott Will & Emery advises private equity funds and German industrial stakeholders on private equity, risk capital, and public andprivate M&A transactions. He is a member of the corporate law practice group and heads the German private equity activities.

Full synthetic W&I insurance coverage – fiction or shortcut to a policy 2.0?

Dr Marco Niehaus, Norton Rose Fulbright LLP*

The market as it stands

The immediate impact of the Covid-19 pandemic on the M&A market appears to have passed its negative peak for the moment. Markets experienced a record year in 2021 both in terms of number of transactions as well as of transaction volume. A total of more than 63,000 transactions moved a volume of more than USD 5.9 trillion – an increase of 64%.[1] It comes as no surprise at all that such increase has led to yet another boom in the transactional insurance industry and affected the way policies are or can be placed into the market also on a synthetic basis for policy purposes.

While certain policy discussion items such as unknown tax risks, adjustments or enhancements of loss definitions and of course knowledge scrapes remain the go-to topics when it comes to synthetic coverage elements, full synthetic cover is not yet something the market seriously wants to transfer from mere discussions into reality. While recent articles and social media posts still do suggest differently and won't stop doing so (and there is reason behind it, namely flexibility), it is worth the check to see where the market in fact currently stands – whether it is in need for yet another level of synthetic elements or whether this is and remains a theoretical discussion that is likely to pass the bore-out barrier for the moment.

Motives and motivation

Of course parties' interests under a standard transaction matrix are quite different, no surprise at all so far. While there is natural limitation in place (the SPA) when it comes to bridging the gaps between seller and purchaser, it is of course tempting to regard synthetic coverage as the golden share and quite an elegant alternative to facilitate transactional flexibility and a positive outcome for the transaction itself. We do count at least twelve scenarios from the past two years where synthetic elements along with dedicated contingent risk policies which in fact facilitated that potential show stopper were put out of the competition. But still, it remains highly in doubt whether a full synthetic coverage can honestly be regarded as desirable from an entirely motivational perspective. Of course, problems remain and they won't go away simply because an insurer is now stepping into the shoes of a seller or purchaser that would need to be convinced. Underwriters have recently shown great market perception when it comes to commercial decisions where synthetic elements can potentially be justified or where this would not be possible at all due to lack of information? Not only does it normally add additional complexity to the policy structure and negotiation but also it should not be regarded as an exit for any kind of due diligence gaps that were not capable of being overcome for purposes of the SPA warranty catalogue in the first place. So why would an insurer go for a risk derived from a synthetic warranty that has not made it into a "real" SPA provision?

Motivation of course is to match market demands. When brokers do see potential and the relevant portion of risk appetite to obtain a synthetic coverage for a certain risk or risk area that may well be within the limits of commercial reason for certain insurers then it is unquestionably on the agenda of the underwriters as well. Let's take synthetic tax indemnities: They have been in the market for quite some time now but only the last two years or so really showed huge demand for providing such element as an integral part of the policy. Challenges from market competition do contribute to the development of innovative market drivers anyways.

So when there is room in the market for bridging gaps via synthetic coverage it is just and fair to discuss how

1 Marsh, Transactional risk insurance 2021: Year in review, page 2.

*Sincere thanks to legal trainee David Nieendick for the background researches and discussions.

this could work. While formal restrictions (if at all in place) as to the degree of synthetic coverage available do not create significant hurdles and also would be counterproductive for the entire business, there is no such thing in regard to legal limitations under most jurisdictions either. Therefore, the window seems wide open and the market motivation would need to meet reality under the current market conditions. So where do we stand?

Frequently asked synthetic coverage for dedicated areas

As everyone knows, synthetic coverage is not only used for tax indemnities. There is a broad range of examples where synthetic elements are frequently placed into the policy to mitigate certain risk levels. Obvious examples are seller's knowledge scrapes, i.e. to add objective elements to an existing, knowledge qualified SPA warranty and a corresponding shift in the major risk from the seller to the insurer for the objective breach of the relevant warranty without referring to a subjective element of knowledge at all. The systematic approach therefore would be to skip the qualification element of the SPA warranty for the purpose of the policy. This is usually asked right at the beginning of negotiations with the insurer, and the nonbinding indication will require a dedicated pre-assessment and indication where the insurer would be willing to grant a knowledge scrape subject to further review of the due diligence information available. It is also common to then grant a knowledge scrape for various warranties, in particular the business warranties, when the insurer should have the impression of a well pursued due diligence exercise with reasonable deal specific risks to be taken into account. The transaction parties can still retain the SPA warranties in a qualified manner but the purchaser has all the upsides from the insurer to rely on their objective accuracy. Of course the insurer will hold dedicated discussions with his deal adviser whether he sees any particular risks in granting such objective elements. It is a fantastic example though of how synthetic elements have practically already become daily business. While there is significant market pressure in place to grant such enhancements, it is still a review process that would lead to such reliefs from a commercial and risk standpoint. Competition within the market, however, would make the lives of insurers difficult in case they would see factual difficulties in doing so by general principle.

Same applies to materiality scrapes. Any materiality limitations as set out in the SPA would not apply or apply on another materiality level for the purpose of the policy. The same can be applied for an extension of the applicable limitation periods which is particularly popular in the field of private equity transactions. Clean exit strategies can be undermined by limitation periods. If, however, such limitations can be shifted to an insurer who would still be liable for breaches months or years following the expiry of the statutory limitation periods, a purchaser would still enjoy adequate coverage while a seller would be put in a position to disburse the proceeds promptly.

Bridging from part to full – is a full synthetic coverage entirely off market?

While certain synthetic elements of coverage are well established must-haves of any tailored policy, it remains in doubt whether this can ever be true for full synthetic policies. Why is that? A huge argument still is whether there is in fact need for having one. The SPA warranties still do carry the factual elements of the deal, and it would carry rather absurd consequences to renegotiate every single warranty for policy purposes. Timing is of the essence anyway so there is little room for any such extensive conversations. The term "enhancements" il-

lustrates quite well where synthetic elements do carry the extra benefits for the parties, namely to mitigate between party risks and to facilitate an efficient process, which is obviously hugely important for competitive auction processes. While magazines, podcasts and social media posts argue differently are all over the place, market reality still fails to provide for different arguments. Of course everyone can tell that there is a smart element in discussing an entirely synthetic policy: it would introduce a maximum of flexibility that, from a theoretical standpoint, could help to bring deals over the finish line that would be off market in the first place. Spiced up with dedicated contingent risk policies for known risk areas such as title, environmental and cyber, this would lift things policy-wise on another level along with maximum freedom to shift deals into an even stricter market environment as we currently see it.

So while timing would be a huge barrier to overcome, transaction complexity for sure is another. Putting the relevant parties into a situation where they formally agree on a certain set of warranties and then doing the heavy lifting with the insurers does lack a logical element of providing a deal that still is manageable if it breaks the barrier of being super straight forward, e.g. only involving one jurisdiction or only few subsidiaries with almost the same quality of due diligence information packages, while of course carrying few to no black boxes in any form.

Also distressed scenarios, most commonly referred to as the ideal field to introduce full synthetic policies, still fail to date to demonstrate a suitable market environment for broader synthetic coverage. Insolvency administrators are often told that they do not have the relevant knowledge of the target to facilitate swift provision (timing is again key!) of the required due diligence information. The same applies to the intention to limit their liability from the entire process. Things might be changing in the future in case the long anticipated insolvency waves related to Covid-19 would appear on the horizon but it should be extremely difficult to argue that, of all things, it would be in fact such potential bulk of distressed deals that would finally overcome the hurdles described above.

Conclusion

Full synthetic coverage remains an interesting playground dealing with artificial scenarios to gain the obviously always welcomed increase of flexibility within the market. From the current perspective though, there is little need for a full synthetic coverage. The given set of warranties still can be supplemented and beefed-up with well-established synthetic enhancements. This also increases deal efficiency when the insurers need to look into things closely, most often pre-signing. It would come as a surprise if things would change in the nearer future in such regard. What will happen though is an increase of dedicated, specified synthetic elements to supplement the standard policies as we do currently see them.

Dr Marco Niehaus, LL.M. (Cambridge), LL.M. Eur, is a corporate partner at Norton Rose Fulbright LLP. He advises on cross-border M&A transactions, corporate law and reorganization matters. A special focus area is the advice of underwriters as deal counsel in particular at W&I insurance products.

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Event Impressions: Insurance in M&A Transactions

Laurent Alexis Müller, Bregal Unternehmerkapital (left) and Dr. Philipp Giessen, Marsh, on stage.

Stefan Schneider, M&A Media Services GmbH, during his speech.

Left to right: Dr. Dominik Waldvogel, Latham & Watkins, Gunnar Harlacher, AIG, Dr. Daniel Barth, Dentons, Birgit Rummel, Tokio Marine HCC, Dr. Philipp Giessen, Marsh

Left to right: Alexander Qvennerstedt, Marsh, Jonas Bauer, PwC, Dr. Sven Förster, Clyde & Co, Dimitri Schaff, AIG, Gennadiy Kharif, Howden M&A

Left to right: Dr. Philipp Giessen, Marsh, Dr. Michael Ilter, Willkie Farr & Gallagher, Dr. Marco Niehaus, Norton Rose Fulbright, Dr. Sebastian Schmitt, Liberty GTS

Great discussions during the panels (left to right): Gaia Pattyn, Freshfields Bruckhaus Deringer, Dr. Markus Rasner, Oppenhoff, Gennadiy Kharif, Howden M&A, Mathias Beyer, VALE IP.

Birgit Rummel, Tokio Marine HCC and Stefan Schneider, M&A Media Services GmbH.

Dr. Philipp Giessen, Marsh, and Boris Dürr, Heuking Kühn Lüer Wojtek (right).

Dr. Sebastian Schmitt, Liberty GTS, and Dr. Philipp Giessen, Marsh

Gennadiy Kharif, Howden M&A

Dr. Michael Ilter, Willkie Farr & Gallagher.

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