



Mergers and Acquisitions Warranty and Indemnity Insurance

Warranty & Indemnity (“W&I”) Insurance is a tailored insurance product from AIG’s Mergers & Acquisitions (M&A) Insurance team to cover breaches in representations and warranties given in the sale of a business. Sellers can cover themselves to prevent sale proceeds being tied up in escrow accounts. Buyers can ensure that warranties have real value even if the seller is unable to pay a warranty claim which arises some time in the future.

Cover

The policy, whether seller-side or buyer-side, will indemnify the insured for loss resulting from a breach of warranty or tax deed/covenant in a Sale and Purchase Agreement (SPA).

A seller-side policy covers the seller for its own innocent misrepresentations; a buyer-side policy covers the buyer against the seller’s misrepresentations (innocent or otherwise). The buyer claims directly against the insurance policy and does not have to seek recourse against the seller.

Policy Form

The policy will be tailored in each case to offer broad coverage that matches the representations and warranties in the SPA as closely as possible. Consequently there will be little difference between what could be claimed against the seller pursuant to the SPA and what the seller (or the buyer as the case may be) can claim against the W&I policy.

- **Policy Period** - The policy term will generally run from signing of the deal for the full survival periods of the warranties and indemnities in the SPA. The period for a buyer-side policy can extend the limitations prescribed in the SPA to meet the buyer’s needs.
- **Retention** - The insurer and insured will agree on the 'retention (also known as an excess), which is the uninsured amount of the loss to be borne by the insured. This is generally set at 1% of the value of the transaction, but may be higher depending on the deal or to reduce premium costs.
- **Exclusions** - Although cover is tailored in each case to match the warranties specific to the transaction, some issues will be excluded on all policies. These will include matters set out in the disclosure letter or due diligence, pension under-funding and, on a seller-side policy, fraud by the seller.

Underwriting Considerations

AIG will consider offering insurance in respect of most mergers and acquisitions (M&A). The limit of liability under the policy will be agreed by the insurer and insured and will be driven by the transaction value. The premium will take into account such factors as the complexity of the transaction, the industry sector and geographical spread of the business as well as the quality of the transaction process and advisers involved. The timescale for obtaining W&I insurance will depend on the stage reached in the transaction, but will usually be available within a week from first enquiry.

Limit

GBP3m to GBP65m, EUR4m to EUR90m or USD5m to USD100m aggregate.

Strategic Benefits

W&I Insurance enables buyers to:

- Supplement protection for breaches of warranties both in terms of value and certainty of payment
- Extend the duration of warranties, affording buyers additional time to detect and report problems that may exist with the acquired business
- Distinguish a bid in a competitive auction by negotiating more limited recourse from the sellers by supplementing the contractual recourse with insurance
- Protect relationships with sellers who may become the buyers’ key employees or commercial business partners after the transaction

W&I Insurance enables sellers to:

- Reduce the risk of contingent liabilities arising from future claims allowing sellers to exit a business cleanly
- Distribute all or most of the sale proceeds to investors or use proceeds to pay down existing debt: there is no need for an escrow account
- Protect passive sellers who have not controlled or been actively involved in the management of the target business from unintentional non-disclosure or breaches of the SPA
- Remove intractable issues from a negotiation by transferring the risk to AIG
- Sellers can enhance the value of exits by offering a fulsome warranty package without increasing their liability

Premium

Typically 1% to 3% of the cover purchased.

Case Studies

- **Distinguishing a bid** - A private equity institution was one of several bidders for a target in a competitive auction process. The institution took out a buyer-side insurance policy so that it could obtain a competitive advantage against the other bidders by offering an attractive purchase price but only requiring a low warranty cap from the seller. The policy provided the institution with a GBP30m limit policy above the seller's cap. This had the advantage of giving it sufficient recourse for breach of warranty and the seller greatly reduced exposure in relation to the warranties.
- **Clean exit** - A private equity firm wanted to exit its investment in a technology company at an enterprise value of GBP500m. The buyer required substantive warranties with an indemnification obligation of GBP50m, which the private equity owner was unable to give as it could not take on long-tail financial liabilities during the divestment phase of its fund's life-cycle. Management of the technology company were prepared to warrant up to GBP10m (representing 50% of their GBP20m stake in the technology business). Placing part of the purchase funds into escrow to cover potential warranty claims would prevent a clean exit for the private equity firm and they were not prepared to consider a reduction in the consideration.

The buyer was able to purchase an insurance policy with a limit of £40m to meet the total £50m indemnity requirement. The policy was structured so that the buyer had to first pursue management up to their £10m limit. The SPA therefore provided for a warranty cap of GBP10m, backed by management's escrow and the PE seller assumed no additional liability.

- **Protection of warrantors** - A consortium of private equity investors was exiting from their investment in a retail chain in a transaction for which the consideration was approximately GBP1.5bn.

The management team, which held a very small percentage of the shares, was required by the purchaser to give limited warranties under the SPA. In order to protect their personal assets, in particular the proceeds of the sale of the business, the management team purchased W&I insurance with a limit of liability of GBP7m.

One unusual aspect of the cover provided was that there was no retention or de minimis provision for defence costs; the individual team members could look to the policy for immediate cover for lawyers' fees to defend any claim for breach of warranty.
- **Protect relationships with sellers** - Private equity investors wanted to purchase the entire issued share capital of an Eastern European healthcare business for approximately EUR80m. In order to help the investors understand the business, the individual sellers, who were the founding shareholders, were required to give warranties and "Business Declarations" principally as to historical revenues and strength of the business. However, as the individual sellers would remain as management and staff after the change of ownership, the buyer did not want to have to claim directly against them and thereby lose their goodwill. The insurer provided a buyer-side policy for the entire value of the warranties so the buyer could obtain recovery without having to pursue and alienate the management and staff of the venture.

These scenarios show the potential applications and possible scope of W&I Insurance. Note that they are illustrative only and not to be relied on to justify coverage in any particular situation.

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