

Article

CORPORATE & COMMERCIAL

Warranty Insurance For Sale Transactions

How Is It Used?

By Brett Thorneycroft

What is Warranty Insurance?

Warranty and indemnity insurance (often referred to simply as “warranty insurance”) has been available in South Australia through specialist insurance brokers for quite a few years in the context of a sale of either a business or shares in a company. The main issues in negotiation of documentation are usually the:

- scope of warranties to be provided by a seller;
- the minimum threshold for warranty claims to be made;
- the maximum liability cap for a breach of warranties; and
- the duration of those warranties

A seller is commonly asked by a purchaser to provide a guarantee of the seller’s obligations under the sale agreement including the warranties.

Warranty insurance can be very useful in “de risking” a transaction from both the seller and the purchaser’s perspective. The cost of this insurance, however, is not cheap.

It is usually only feasible if the transaction is reasonably significant in size, if there are very specific risks that a seller knows they simply cannot warrant (e.g. taxation or environmental risks) or a seller wants a perfectly clean exit post-sale.

Buy-side insurance

It is more common for a purchaser to take out the warranty insurance rather than the seller. Buy side warranty insurance allows a purchaser to claim losses arising from a breach of contractual warranties by the seller. It enables the purchaser to claim directly from the insurer, without having to pursue the seller. Whilst it is technically possible for a seller to take out warranty insurance, such a policy will not provide a purchaser with the same level of protection because the policy will not respond to matters of which the seller had prior knowledge (which would include knowledge of any of the officers or employees). Further such a policy does not usually name the purchaser as an insured, meaning the purchaser cannot claim directly under the policy.¹

1 Direct action by the purchaser would be possible if the purchaser were noted on a sellers warranty insurance policy. We have not observed the practice of “noting” on policies in the context of warranty insurance.

Why warranty insurance may be useful

The reasons for warranty insurance vary from transaction to transaction, but it is usually motivated by some or all of the following:

- Sellers will not provide warranties, such as in an insolvency context (e.g. a liquidator, receiver or administrator) or where the seller is a private equity seller closing down a fund;
- Some sellers have not been involved in the day-to-day running of the business, and suggest that the purchaser look to management for warranties;
- Even if a seller is prepared to give warranties, a purchaser will be concerned that the seller has sufficient resources to meet a warranty claim. In these circumstances, a purchaser will usually insist on a guarantee or part of the purchase price being held back to meet any warranty claim. A seller may not be willing to provide such security and an impasse may result.

continued overleaf...

- Sometimes there are numerous and disparate sellers or the sellers consist of trust entities which again are unwilling or unable to provide standard warranties;
- Perhaps critical/material issues exist or are discovered during the due diligence process, which a seller is simply unable to warrant, such as an environmental liability or a particular taxation liability. The inability to warrant such fundamental issues may be a deal breaker for a purchaser.

Buy-side warranty insurance assists the purchaser in the scenarios above for the reasons set out earlier and sellers can take comfort post-sale, that they can expend the sale proceeds knowing that the purchaser will not pursue them for any breaches of the warranties provided.

The sale contract requires careful drafting to provide as far as possible, that the purchaser is unable to bring a claim for breach of warranty against the seller, but rather is only able to directly bring the claim against the insurer under the terms of the warranty insurance policy. (Refer discussion in paragraph 1 under “Three Critical Issues”, below)

Terms of coverage

Scope – A purchaser will usually seek that the insurer cover the warranties “back to back”. The precise coverage results from negotiation with the insurer, who takes into account the results of the various due diligence reports. In recent times there are some warranties that an insurer is less willing to cover (see below).

Limit of liability – A purchaser will usually seek that the warranty insurance will at least cover the maximum cap on liability set out in the sale agreement. It is possible that higher limits, or for that matter, longer periods of coverage can be sought by

a purchaser from the warranty insurer than as set out in the sale agreement, for a higher premium.

Retention and de minimis – The W&I policy will be subject to a per claim threshold (de minimis) and a basket of claims threshold (“retention”), which will need to be satisfied before the warranty insurance will respond to a claim. Below these amounts, no claim can be made by a purchaser for breach of warranty. Note that these amounts usually mirror the individual and aggregate small claims thresholds set out in the underlying sale agreement.

Interaction with the due diligence process

The provision of warranty insurance does not negate the need for the usual due diligence process and rigorous negotiation of the warranties between seller and purchaser. In placing the insurance, the warranty insurer will want to assess the risk of a potential breach of warranty. Therefore, it will want to be satisfied that the purchaser has undertaken sufficiently comprehensive due diligence on the target business. The insurer's own advisers will review all relevant due diligence reports and question the purchaser and its advisers about the due diligence process. In our experience there is usually at least one conference call with members of the purchaser's deal team in order for the warranty insurer to address any outstanding underlying questions.

A warranty insurer will be very reluctant to provide warranty insurance if they believe the warranties have been provided without much thought or resistance by the seller.

Multiple layers of insurance

The relevant insurance broker usually deals with a number of insurers. The primary policy may be provided by a local insurer, but higher amounts of insurance may require different layers

of cover provided by multiple offshore insurers. Despite multiple insurers, in our experience, the insurer's confirmatory underwriting process does not take longer than a week or two if the primary insurer is provided the draft sale contract at an early stage.

Three critical issues

1. Does the seller still have any liability (despite the existence of buy-side warranty insurance and limitation of liability)

It is important to understand that warranties are also representations to the purchaser. Therefore if a seller breaches a warranty, in addition to a breach of warranty claim the purchaser may also be able to bring a misleading and deceptive conduct claim under the Competition & Consumer Act 2010 (formerly the Trade Practices Act) (or, in the case of a share sale, under the Corporations Act and/or ASIC Act.)

It is clear from common law that parties cannot exclude liability for misleading and deceptive conduct. Terms that purport to do so will be unenforceable. However recent cases have established that it is open to a contracting party to seek to limit their liability for misleading and deceptive conduct, at least in terms of fixing a shorter period in which to bring a claim or agreeing to a monetary limit.

Therefore a critical issue, for a seller who is looking for a “clean exit” is whether it may have some direct exposure from a purchaser for misleading and deceptive conduct, even though there exists a warranty insurance policy which clearly responds to a breach of warranty. If a seller is looking for absolute certainty that no claim can be made against it (only against the warranty insurer), then it will be nervous about any potential additional causes of action not covered by the policy.

continued overleaf...

As a consequence, it is critical to clarify with the warranty insurer early on, that the warranty insurance will cover a claim arising from the same factual circumstance, whether it is framed as a breach of warranty, misleading and deceptive conduct or otherwise. The objective from the perspective of a seller who is looking for a “clean exit” is to ensure that any claim made by a purchaser is against the warranty insurer under the warranty insurance policy and cannot be directly against the seller. In our experience some advisers and insurers do not fully grasp these issues. It is important to obtain experienced legal assistance to ensure the parties’ intentions are reflected in the relevant sale documents and warranty insurance policy.

2. The insurer’s right of subrogation

As with all insurance policies, the insurer has a right of subrogation. In short this means that after paying out any claim under the insurance policy, the insurer is able to “stand in the shoes” of the insured, namely the purchaser. From a seller’s perspective, it will not want to find itself in a position whereby the insurer pays out a purchaser under the warranty and indemnity policy and then, via its right of subrogation, attempts to sue the seller directly for its loss as a consequence of the breach of warranty.

The seller will need to negotiate a waiver of the right of subrogation or some modification to it so it does not find itself in this position. Bearing in mind that the seller is not a party to the buy-side insurance policy, it will need to insist on reviewing the insurance policy or seeking contractual comfort from the purchaser that the insurer’s standard right of subrogation has been waived.

3. Exclusions/carve outs from warranty insurance policy

In our experience, the extent of coverage offered by an insurer has changed over the last five years. Insurers are quicker to exclude certain specific matters from coverage under the warranty and indemnity policy. As with any insurance policy, a warranty and indemnity insurance policy will not respond to a matter that the insured (i.e. the purchaser) had a duty to disclose. Obviously the warranty insurer takes a very keen interest in the issues which have been noted in any due diligence report, in assessing the scope of cover, but we understand there may now be certain subject matter warranty insurers will no longer cover.

This is difficult for the seller, because ordinarily it is the purchaser who is negotiating the terms of the insurance policy with the insurer. If the seller desires a “clean” exit, it will want significant input into what exclusions there will be from the warranty insurance policy.

Conclusion

These policies are now common in relation to sale transactions and even if a broad policy is not sought by the parties, there may be specific risks which can be covered by an appropriate insurance policy. Experience in relation to this element of a transaction is limited in South Australia. However, our firm has previously advised on these types of policies in the context of sale or purchase transactions and is able to protect your interests.



MORE INFO

Brett Thorneycroft Consultant

p: +61 8 **8124 1944**

brett.thorneycroft@dwfoxtucker.com.au

DW Fox Tucker Lawyers

L14, 100 King William Street, Adelaide, SA 5000

p: +61 8 **8124 1811** e: info@dwfoxtucker.com.au dwfoxtucker.com.au