Risk issues for buyers and sellers in Mergers and Acquisitions (M&A)

Mergers and acquisitions can be complex, taking time and expertise to maximise financial returns and mitigate as far as possible the risks arising from the transaction.

The acquisition of a target business can make sound financial sense but buyers often have a concern as to the level, and route of recourse, available via the warranties and indemnities given in the Share Purchase Agreement (SPA). Sellers also increasingly want to reduce their residual liabilities under the SPA to maximise their return and facilitate as clean an exit as possible.

The due diligence process may identify certain specific issues such as a potential tax liability, or environmental impairment concerns, which create additional uncertainty.

Sellers face a different set of risks where they might inadvertently breach a warranty given in the SPA and then face a call on monies held aside or in escrow, which are intended to be returned to shareholders/investors. This can quickly escalate into a dispute between shareholders/investors and management.

Annual statistics published by insurers, and supported by our own, show that the most common incidents reported are breach of the Financial Statements, Tax, Compliance with Laws and Material Contracts. They also highlight an increasing severity of loss trend.

Warranty & Indemnity insurance (W&I) use in real estate transactions

W&I insurance is a strategic tool that has become common place in the context of M&A deals (typically involving private equity or institutional investors) in the real estate sector.

In addition to “pure” real estate deals – such as office blocks and large property portfolios – W&I insurance can also be used in transactions where there is an operating business associated with a valuable underlying real estate asset such as:

- Hotels and resorts (including franchises, portfolios, chains or landmark acquisitions)
- Retail parks and shopping centres
- Student accommodation
- Bar and restaurant chains
- Leisure centres, and gym chains
- Theme parks
- Golf courses

Who we work with:

Corporate Clients, Funds & Institutional Investors, Law Firms, Corporate Finance and members of the International deal advisory community.

What do you get:

- Insight, experience and engagement from a Global team of highly qualified Transactional Risk (TR) practitioners.
- Advice, selection and negotiation on the most suitable insurance solutions, (including detailed negotiation of the Warranty schedule to be insured).
- Support throughout the deal process.
Recent trends in W&I use on real estate transactions

- Most competitive pricing in W&I market offered by insurers for real estate transactions.
- W&I insurers offering historically £nil retentions for pure real estate transactions, or low or "tipping to £nil" retentions for operating businesses.
- Short form policy wordings with fewer general exclusions.
- "Bolt on" environmental (or removal of pollution exclusion) and tenancy credit insurance cover available for some assets.
- Affirmative cover for key tax structure coverage position points including trading versus investment risk and tax residence.
- Affirmative cover for loss of rental income (to the extent reasonably foreseeable).

Environmental

Environmental cover (including pollution) together with matters relating to the condition of real estate are generally excluded from standard W&I policies. You may therefore wish to consider a separate environmental policy.

Environmental insurance is a mechanism to transfer environmental risk and provides cover against losses incurred as a result of third party or regulatory action arising from pollution or physical impairment to the environment.

Legal Indemnities insurance

Our legal indemnities insurance can cover a variety of different challenges typically faced during real estate transactions:

- Rights of light insurance
- Portfolio insurance for title defects in a large volume property transaction
- Defective leases
- Judicial review/legal challenge

Identified property/title risks

These can encompass a wide range of title defects and vary from deal to deal. Examples include violation of planning/zoning; inadequate easements or servitudes; violation of legal restrictions; missing deeds and mortgage certificates; breach of public procurement or tender rules; infringements of rights of light or air; restitution and expropriation of land; and breach of inheritance laws, including Italian donation risk.

Title insurance

- Title insurance can be used in parallel with W&I insurance on a real estate transaction to either:
  - "Top-up" cover in respect of title to shares/property and assets to the full consideration value; or
  - Cover identified property/title risks.

Climate risks

We have extensive expertise and capabilities to analyse exposure to physical and transitional climate risks and to identify and quantify these risks for strategically relevant future time horizons. This enables smarter, more cost effective and analytically informed choices about risk financing, risk mitigation and investment strategies.

By leveraging proprietary climate risk analytics, in combination with proven re/insurance mechanisms and/or alternative risk transfer solutions, we allow our clients to manage risk in the most cost-efficient way.

We can assist our clients in identifying hidden opportunities in risk financing, risk management and/or investment.

End of Fund Life insurance

A tailor-made sell side W&I policy to indemnify the fund or general partner for residual liabilities relating to the assets and financial losses arising from warranties provided during different sell-side transactions during the divestment phase.

End of Fund Life insurance is a useful and strategic tool for fund managers to maximise return, ensuring cleaner exists, more efficient final distribution and promoting faster payments.

Warranty & Indemnity insurance (W&I)

- Indemnifies the insured for financial loss for a breach of warranty or the tax covenant in an M&A transaction.
- Covers loss or liability arising from unknown or undisclosed matters only.
- Can be purchased by either a buyer or a seller.

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Insurable risks in Real Estate transactions to be aware of by region

<table>
<thead>
<tr>
<th>United Kingdom</th>
<th>France</th>
<th>DACH</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Rights of light;</td>
<td>- Challenge to building permit;</td>
<td>- Missing Land Charge certificates;</td>
</tr>
<tr>
<td>- Planning breaches;</td>
<td>- Lack of conformity certificate; and</td>
<td>- Voidable lease (breach of written</td>
</tr>
<tr>
<td>- Use restrictions; and</td>
<td>- Encroachments.</td>
<td>form requirements); and</td>
</tr>
<tr>
<td>- Easements/servitudes for access and services</td>
<td></td>
<td>- Zoning breaches.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Italy</th>
<th>CEE</th>
<th>Spain</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Donation insurance;</td>
<td>- Missing spousal consent; and</td>
<td>- Building permit, planning and zoning</td>
</tr>
<tr>
<td>- Lack of habitation certificate;</td>
<td>- Restitution claims.</td>
<td>issues;</td>
</tr>
<tr>
<td>- Lack/breach of building permit;</td>
<td></td>
<td>- Historic ownership issues;</td>
</tr>
<tr>
<td>- Heritage buildings; and</td>
<td></td>
<td>- Missing title deeds; and</td>
</tr>
<tr>
<td>- Solar farm permits.</td>
<td></td>
<td>- Lack of first occupational certificate.</td>
</tr>
</tbody>
</table>

Focus on Warranty and Indemnity insurance

**Buyer-Side**
- Covers the buyer against the seller’s misrepresentations (both innocent and fraudulent).
- Two key advantages over a seller-side policy:
  - The insured can claim directly against the insurer (i.e. without having to pursue recourse against the seller or warrantor(s)); and
  - Provides indemnification in respect of the seller’s fraud.

**Example of recourse utilising W&I**

Pre-signing

- Enterprise Value EUR 500,000,000
- Seller’s Liability EUR 50,000,000

Post-signing

- Buyer’s Liability
- W&I Insurance EUR 100,000,000
- Policy Excess EUR 2,500,000 (uninsured)

**Seller-Side**
- Offers liability protection to the seller for innocent misrepresentations in M&A transaction documents.
- Designed to respond in the event that the buyer brings a claim for a breach of warranty or a claim under the tax covenant against the seller.
- Enables a seller to ring-fence the risks associated with the disposal.
- Typically used for End of Fund Life.

**Stapled insurance**
- Buyer-side policies are often instigated by a seller who insists that the buyer enters into a W&I buyer-side policy.
- This process is often referred to as “stapling” W&I insurance.
- WTW often works with the seller to ensure a smoother process by commencing the underwriting process on the sell side and then a WTW ‘non conflicted’ team works with the exclusive bidder, or each bidder ‘tree’, to finalise the insurance.

99% of the W&I policies WTW placed in 2021 were buyer-side policies.
A transaction tool that adds value

W&I insurance supplements and extends protection from breaches of the warranties. It can be used to increase the amount of financial protection and the scope of agreed indemnification and extend the time period during which a claim can be bought.

For sellers it can be used to simply remove or minimise the need for an escrow or to protect and return the proceeds of a sale to investors earlier than would otherwise be possible.

<table>
<thead>
<tr>
<th>Sellers reasons to use W&amp;I</th>
<th>Buyers reasons to use W&amp;I</th>
</tr>
</thead>
<tbody>
<tr>
<td>Achieve a “cleaner and enhanced exit”</td>
<td>Enhance/distinguish a bid/bridging a warranty gap</td>
</tr>
<tr>
<td>Use as part of an intra-group or pre-IPO reorganisation</td>
<td>Protect relationships with sellers or warrantors</td>
</tr>
<tr>
<td>Mitigate, ring-fence or remove general or specific liabilities</td>
<td>Risk management where investing in unfamiliar industries or territories</td>
</tr>
<tr>
<td>Protect passive, individual or family sellers</td>
<td>Give extra comfort for lenders</td>
</tr>
<tr>
<td>Risk management tool where a seller is exiting a non-core business division</td>
<td>Mitigate enforcement difficulties where the seller and buyer are in different jurisdictions</td>
</tr>
</tbody>
</table>

Why WTW?

The WTW Global TR team advised on more than 1,500 transactional risks policies in 2021.

We often work for buyers and sellers or indeed multiple bidders on a single transaction. We are able to provide segregated teams for each client to give complete confidentiality/compliance and bespoke advice for each bidder.

WTW’s TR team is a highly qualified global team of insurance advisers, many of whom are ex lawyers and accountants, experienced in advising on and negotiating the optimum insurance solutions for each transaction.

W&I insurance is more than a placement process, our expert team assimilate all of the relevant data, anticipate underwriters’ requests on key areas, advising on and creating the best available solutions and working closely with the client’s other advisers throughout the deal process and beyond in the event of a claim.

The WTW team are experts in cross border deals where we provide W&I, Tax and Contingent insurance solutions globally; providing local knowledge on each transaction.

We work closely with our insurance Due Diligence team, who give clients a clearer picture on target risk and insurance matters, to help enable better investment decisions, negotiations with sellers and successful post-closing integration.
WTW global M&A practice

A market leading team of 150+ M&A practitioners, many of whom are qualified in either Corporate Law, Tax and Accountancy principles or insurance, working together to help our clients navigate M&A transactions safely. We draw on the full resources of WTW to bring Sector expertise, analytics, risk evaluation and insurance placement (where required) to each transaction, in other words delivering the firm and focusing on our client’s strategic objectives on a deal-by-deal basis.

We help solve complex risk issues, regularly working to tight deal timeframes. Our transaction related advice and insurance knowledge is valued by our clients, who often use this tactically buy-side and sell-side to enable a successful outcome to an acquisition or divestment.

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