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CORPORATE & COMMERCIAL ALERT

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W&I insurance – A key consideration for M&A transactions

Warranty and indemnity (W&I) insurance has become increasingly familiar to the South African M&A market in recent years. This has been driven, in part, by transacting parties gaining a better understanding and appreciation of the process and benefits of an insured deal. At its heart, W&I insurance exists to support a seller's clean exit and to ease a buyer's concern as to a seller's ability to make good on a warranty or indemnity claim once a transaction has closed. With M&A activity expected to increase as we emerge from the pandemic, largely as a result of private equity fund activity and distressed disposals, W&I insurance could prove invaluable to support the key objectives of parties to a transaction.

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W&I insurance – A key consideration for M&A transactions

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Benefits of W&I insurance

Warranties and indemnities are usually heavily negotiated. W&I insurance can be a key tool in reducing execution risk of a transaction as it provides comfort to the parties, after having negotiated the warranties and indemnities, that claims under these provisions are to be brought against a third party insurer, instead of the parties themselves.

Either the buyer or the seller can take out W&I insurance, resulting in either a buy-side policy or a sell-side policy, respectively. Under a buy-side policy, a buyer can claim from the insurer for a valid warranty or indemnity claim under the sale agreement without having to first claim directly against the seller. Under a sell-side policy, a seller can claim from the insurer to recover its losses arising from a successful warranty or indemnity claim instituted by the buyer. Either policy has clear benefits to both the buyer and the seller.

As far as the seller is concerned, W&I insurance:

- (i) ensures a clean exit and promotes certainty that a buyer will have no recourse to the seller after closing. This is particularly important to, for example, private equity fund sellers who are winding down their fund or who have returned capital to their investors;
- (ii) frees up the total purchase price for onward distribution to shareholders or investors instead of having to retain funds to cover future claims; and
- (iii) can make a target a lot more attractive for buyers and reduce execution risk, especially where the seller has financial concerns.

As far as the buyer is concerned, W&I insurance:

- (i) significantly mitigates the risk of a seller being unable to settle a warranty or indemnity claim, should one arise;
- (ii) can protect the ongoing relationship between a buyer and a seller where the seller remains invested in or employed by the target after the deal has closed. In these circumstances, a buyer may not wish to sour its relationship with the seller by instituting a warranty or indemnity claim and can instead recover from the insurer; and
- (iii) may be a key factor in driving down the purchase price for the transaction, as a seller may be persuaded to accept lower proceeds that are immediately available, rather than accepting that a portion of the purchase price is retained in escrow or held back for the duration of a warranty period.

It is important that parties decide in the early stages of the transaction whether they wish to include W&I insurance in their deal.

W&I insurance – A key consideration for M&A transactions...*continued*

While W&I insurance is not intended to replace negotiation of a sale agreement, transactions covered by W&I insurance generally benefit both parties by reducing the amount of time that is spent negotiating the sale agreement and frees up time to run the business of the underlying target.

Key considerations in procuring W&I insurance

It is important that parties decide in the early stages of the transaction whether they wish to include W&I insurance in their deal. The transaction timelines for a deal that is covered by W&I insurance need to cater for the underwriting process. Understanding how this process will dovetail with deal negotiation and execution from the early stages can save the parties time and costs.

W&I insurance is not designed to replace due diligence. On the contrary, the extent of the coverage received under a W&I policy (particularly a buy-side policy) is largely dependent on the adequacy of due diligence performed. In order to attract cover, the insured party needs to illustrate to the insurer that each warranty and indemnity has been adequately investigated. This has two major practical implications:

- (i) a sale agreement with a comprehensive "shopping list" of warranties and indemnities will not likely attract comprehensive cover under a W&I policy unless each of those warranties has been the subject of some form of due diligence. It is not uncommon for sale agreements to be packed with extensive warranties which, in some cases, are not relevant to the target's business and, as a result, have not been the subject of due diligence. These warranties are likely to be excluded from the cover provided under a W&I policy; and

- (ii) the nature of the due diligence performed will differ where a deal includes W&I insurance as opposed to a deal which does not. As part of its underwriting process, an insurer (or its counsel) will interrogate the data room and due diligence reports prepared by the parties' counsel to ensure that the warranties and indemnities included in the sale agreement have, in fact, been the subject of investigation. The more extensive the due diligence, the more comfort the insurer will have in standing behind the warranties. As a result, a comprehensive due diligence report (both in terms of scope and detail of reporting) is strongly advised for deals involving W&I insurance.

With the above in mind, it is also important that the scope of the due diligence investigation is commensurate with the scope of the warranties and indemnities in the sale agreement. Where there is a large disconnect between the two, the parties may need to supplement their due diligence at a later date in order to obtain cover under the W&I policy, which comes with obvious adverse time and cost implications.

The other major reason for commencing with the W&I insurance process upfront is that the parties want certainty when they sign the sale agreement as to how the warranties and indemnities are covered. As a result, the W&I policy is typically negotiated and signed simultaneously with the transaction agreements, or alternatively is catered for as a condition precedent to a transaction. Understanding that a deal will be covered by W&I insurance also allows the parties to draft the sale agreement with the insurance in mind, rather than having to amend the sale agreement after it has been concluded to cater for typical W&I insurance provisions (which are discussed in further detail below).

W&I insurance – A key consideration for M&A transactions...*continued*

There is no one-size-fits all approach to procuring W&I insurance and the process will usually be deal-specific.

Overview of the process

There is no one-size-fits all approach to procuring W&I insurance and the process will usually be deal-specific. In addition, as the market becomes more familiar with W&I insurance products and these products develop to meet the needs of transacting parties, so too does the underwriting process evolve. The overview of the W&I insurance process below is based on our experience of historical transactions.

A broker is usually appointed to manage the W&I process. The broker will usually use initial drafts of the main transaction agreements or a transaction memorandum to obtain a range of indicative or non-binding offers from underwriters. Once an underwriter has been selected, they will be given access to the due diligence data room and the final due diligence reports. They will also be given the transaction agreements containing the warranties and indemnities to be underwritten.

The underwriter will interrogate the scoping documents, the data room, the due diligence reports and the warranty/indemnity lists, after which they will generally submit written questions and request written responses from the insured party. After these exchanges, there will usually be an "underwriting call" where the insurers (and their counsel) investigate how the insured party and its counsel obtained comfort on the issues discovered during the due diligence process. It is advisable to maintain a paper trail of questions and answers between the due diligence service providers and the target to be able to illustrate to the insurer how the parties obtained comfort on risks identified during the course of the due diligence.

Following the underwriting call, the insurance policy will be drafted and negotiated. The insurance policy is typically negotiated between the insured and the insurer. Depending on the level of

activity in the market, the complexity of the deal and the amount of material that insurers and their counsel are required to review, obtaining W&I insurance (i.e. signing the insurance policy) will generally take between 2 and 5 weeks.

Typical terms of the W&I insurance

A W&I policy usually has limited or no conditions precedent and will usually provide cover from the closing date of a transaction. On the inception date of the policy, there will be a bring down process where the representations and warranties are confirmed in an inception date no claims declaration that is signed by the insured party and delivered to the insurer. The insured party will also have a duty to pay the premium and to deliver to the insurer final copies of the transaction agreements, disclosure materials and other prescribed information, within a certain number of days from the inception date to avoid the W&I policy being terminated.

It is important to recognise that a W&I policy will not necessarily cover all the warranties and indemnities in a given sale agreement. A policy will contain a number of exclusions or limitations on cover, including:

- (i) certain standard exclusions (which will differ from insurer to insurer) which generally relate to bribery or corruption, price adjustments, forward looking information, post-closing events, asbestos, certain environmental risks and tax risks (such as transfer pricing). On sell side insurance, a seller will also typically not be covered for fraud or fraudulent non-disclosure by the seller; and
- (ii) specific exclusions or partial carve outs from cover relating to issues that are within the parties' actual knowledge or issues that have been disclosed or identified during the due diligence process. These are known risks that an insurer will not cover.

At Cliffe Dekker Hofmeyr, we have extensive experience in guiding our clients through the W&I process and ensuring that the transaction agreements are geared towards and cater for W&I insurance appropriately.

W&I insurance – A key consideration for M&A transactions...*continued*

The cover on warranties and indemnities is also usually limited under the policy to the extent that any matter, fact, or circumstance has been disclosed during the due diligence or is included in a disclosure schedule or other disclosure materials. There are also ongoing obligations on the parties to disclose matters they become aware of during the interim period between signing of a sale agreement and the closing date. To the extent that an insured party is not willing to accept and bear the risk of the policy exclusions, it will have to find comfort in some other way. This may include allocating the risk to the seller in the sale agreement (if this can be agreed) or obtaining additional specialised insurance relating to the applicable risk or by implementing mitigation measures post-closing.

In addition, a W&I policy will typically include various limitations to the insured party's ability to claim against the insurers. These include a *de minimis* threshold (a minimum amount that may be claimed in any one claim), a retention amount (an amount that needs to be eroded entirely by prior claim(s) before the insured party has recourse for any claims against the insurer), and a limitation on the insurer's total liability. The level at which these limitations are set can impact on the premium payable under the policy.

A buy side W&I policy will also usually limit the insurer's rights to subrogate settled claims against a seller, except in situations where the seller has been fraudulent or has acted in wilful default.

Catering for W&I insurance in the sale agreement

The sale agreement will usually contain provisions dealing with the W&I insurance arrangements between the contracting parties. These include provisions allocating the responsibility for paying the insurance premium and the costs of obtaining insurance and delivering the no claims declarations and other documents to the

insurer under the policy. The W&I policy may also be catered for as a condition precedent to a transaction closing.

In the case of buy-side policies, it is important to ensure that the relevant concepts under the sale agreement relating to losses, liabilities, claims periods, adverse consequences and the like are replicated in the W&I policy to ensure that there is no residual recourse to a seller under the sale agreement. For this reason, where a deal is covered by a buy-side policy, the sale agreement will usually contain general provisions that limit or exclude the buyer's recourse against the seller for warranty or indemnity claims.

The insurer will need to approve and sign off on the material transaction agreements. There is also usually a general restriction on material amendments to the transaction agreements without the prior written consent of the insurer.

Conclusion

While it has its drawbacks, the benefits of W&I insurance make it an attractive prospect in the context of a wide variety of M&A transactions and offer significant comfort to a buyer and seller. W&I insurance may be unsuitable for smaller deals, given the costs involved and the extent to which insurers require the insured party to share in a level of the risk.

However, at the very least, obtaining W&I insurance should be a consideration at the start of any deal involving the provision of warranties and indemnities. Transacting parties should raise the possibility of obtaining W&I insurance with their advisors at the earliest opportunity. At Cliffe Dekker Hofmeyr, we have extensive experience in guiding our clients through the W&I process and ensuring that the transaction agreements are geared towards and cater for W&I insurance appropriately.

Andrew Giliam and Anita Moolman

2020 CONSISTENT LEADERS IN M&A LEGAL DEALMAKERS

DealMakers

2020

1st by M&A Deal Flow.
 1st by BEE Deal Flow.
 1st by BEE Deal Value.
 2nd by General Corporate Finance Deal Flow.
 2nd by General Corporate Finance Deal Value.
 3rd by M&A Deal Value.
 Catalyst Private Equity Deal of the Year.

2019

M&A Legal DealMakers of the Decade by Deal Flow: 2010-2019.
 1st by BEE M&A Deal Flow.
 1st by General Corporate Finance Deal Flow.
 2nd by M&A Deal Value.
 2nd by M&A Deal Flow.

2018

1st by M&A Deal Flow.
 1st by M&A Deal Value.
 2nd by General Corporate Finance Deal Flow.
 1st by BEE M&A Deal Value.
 2nd by BEE M&A Deal Flow.
 Lead legal advisers on the Private Equity Deal of the Year.

2017

2nd by M&A Deal Value.
 1st by General Corporate Finance Deal Flow for the 6th time in 7 years.
 1st by General Corporate Finance Deal Value.
 2nd by M&A Deal Flow and Deal Value (Africa, excluding South Africa).
 2nd by BEE Deal Flow and Deal Value.

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CDH's Corporate, Commercial and M&A practice is ranked as a Top-Tier firm in THE LEGAL 500 EMEA 2021.

Ian Hayes is ranked in the Hall of Fame in Corporate & Commercial and M&A in THE LEGAL 500 EMEA 2021.

David Pinnock is ranked as a Leading Individual in Corporate, Commercial and M&A in THE LEGAL 500 EMEA 2021.

Willem Jacobs is ranked as a Leading Individual in Corporate, Commercial and M&A in THE LEGAL 500 EMEA 2021.

Justine Krige is ranked as a Next Generation Partner in Corporate, Commercial and M&A in THE LEGAL 500 EMEA 2021.

Johan Latsky is recommended in Corporate, Commercial and M&A in THE LEGAL 500 EMEA 2021.

Peter Hesseling is recommended in Corporate, Commercial and M&A in THE LEGAL 500 EMEA 2021.

Rachel Kelly is recommended in Corporate, Commercial and M&A in THE LEGAL 500 EMEA 2021.

Vivien Chaplin is recommended in Corporate, Commercial and M&A in THE LEGAL 500 EMEA 2021.

Roux van der Merwe is recommended in Corporate, Commercial and M&A in THE LEGAL 500 EMEA 2021.

CDH's Investment Funds practice is ranked in Tier 3 in THE LEGAL 500 EMEA 2021.

John Gillmer is recommended in Investment Funds in THE LEGAL 500 EMEA 2021.

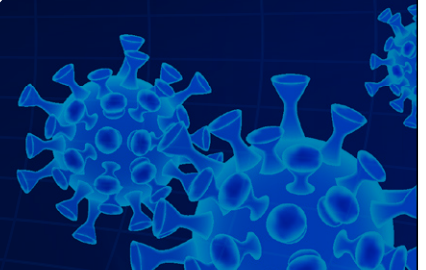
Mark Linington is recommended in Investment Funds in THE LEGAL 500 EMEA 2021.

Wayne Murray is ranked as a Rising Star in Investment Funds in THE LEGAL 500 EMEA 2021.



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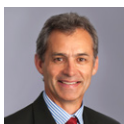


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BBBEE STATUS: LEVEL ONE CONTRIBUTOR

Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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