



UNCOMMONLY INDEPENDENT

Synthetic W&I Insurance Brochure

LOCKTON



■ Introduction

Synthetic W&I insurance is a form of insurance in which the insurer provides a suite of warranties under a W&I policy instead of the seller giving warranties under an SPA. The suite of warranties is negotiated between the buyer and insurer, rather than the buyer and the seller.

The product has witnessed substantial development and usage since its emergence in the market around 2017-2018. While its adoption rate is still relatively low compared to non-synthetic products, synthetic insurance has garnered attention for its flexibility, catering to both distressed and non-distressed deals. Notably, there has been a significant increase in the number of insurers offering synthetic insurance across various jurisdictions in Asia, reflecting its growing acceptance and adaptability to regional market dynamics.

As more insurers offer this product and its usage continues to expand, Lockton can advise and support all relevant stakeholders to leverage the flexibility and tailored coverage options offered by Synthetic W&I to navigate the complexities of the M&A landscape with confidence.





Distinguishing Synthetic W&I Insurance from Traditional W&I

When comparing Synthetic W&I Insurance to its traditional counterpart, notable disparities emerge:

- 1 Absence of Warranties in SPA:** In the Synthetic model, warranties typically do not appear in the Sale and Purchase Agreement (SPA). Since the insurer provides the warranties instead of the seller, negotiations regarding warranties occur directly with the insurer. Consequently, warranties are encompassed within the insurance policy, eliminating the need for negotiations with the seller.
- 2 Fuller Negotiation of Warranty Suite with Insurer:** Given the insurer's role in providing warranties, negotiations primarily occur between the buyer and the insurer. This dynamic results in a more robust negotiation process, with insurers offering feedback and comments on the suite of warranties. While some insurers offer pre-agreed synthetic warranties, others engage in negotiations as the diligence process unfolds. This negotiation with the insurer often streamlines the process compared to the traditional tri-partite negotiation involving the insurer, insured, and seller, presenting potential cost advantages.
- 3 No Residual Liability for Sellers:** Unlike traditional W&I contexts where sellers retain residual liability, Synthetic Insurance typically absolves sellers of such obligations. While insurers may seek to retain rights to subrogate into the buyer's shoes, especially in instances of fraud, this liability shift from seller to insurer is a distinguishing feature of Synthetic Insurance.
- 4 Absence of Knowledge Scrapes or Other Amendments in SPA:** As the suite of warranties in Synthetic Insurance represents the final set covered by insurers, there's no need for products like knowledge scrapes that modify warranties in the SPA.

Absence of Formal Disclosure Process and the Impact on Due Diligence and Warranty Coverage

In the Synthetic Insurance framework, the absence of a formal disclosure process by the seller against a suite of warranties accentuates the importance of robust due diligence. This heightened reliance on due diligence is crucial for insurers to grasp the nuances of the business or asset being insured. The customary due diligence areas, encompassing legal, technical, financial, and tax matters, remain imperative.

To compensate for the absence of seller disclosure, the policy typically includes a schedule of general disclosures, mirroring a standard market front-end disclosure letter. These disclosures cover matters ascertainable from accounts, public registers, corporate searches, etc. Moreover, a well-populated data room and a comprehensive seller/management Q&A process become essential.

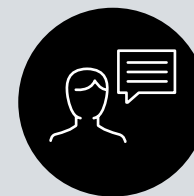
In instances where the process allows, particularly in bilateral sales, involving insurers in the due diligence questionnaire and virtual data room (VDR) population exercise is advisable. This involvement offers parties assurance that requisite information is provided to facilitate synthetic cover.

Given insurers' heightened reliance on due diligence materials, the suite of synthetic warranties aligns closely with the diligence scope. Consequently, the scope of warranties that insurers are willing to endorse may be more limited compared to a typical W&I process. It's crucial to note that not all warranties are amenable to synthetic cover. While the major risk areas of a target are generally insurable, certain warranties, typically used to hedge operational risks, may necessitate targeted Q&A due to the absence of relevant seller knowledge or disclosure.

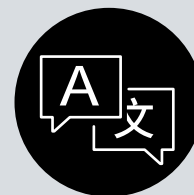
Specific warranty types that may pose challenges for synthetic cover include:



Warranties concerning third-party actions



Statements of opinion



Circumstantial or subjective language



Management accounts warranties



Ordinary course of business warranties



Compliance and regulatory warranties



Importance of Information Flow in Synthetic W&I Insurance

Similar to traditional W&I insurance, the scope of coverage under a synthetic W&I insurance policy is directly linked to the extent and quality of information disclosed and diligenced by the buyer and its advisors. However, the absence of a formal disclosure process necessitates specific considerations for insurers to assess their final synthetic cover position.

Population of the Virtual Data Room (VDR): The quality, timeliness, and alignment of this information with required warranties directly influence the breadth of coverage offered. In instances where feasible, involving insurers in the due diligence questionnaire and VDR population exercise is recommended. This ensures that relevant information is provided to enable synthetic cover. Lockton has collaborated with insurers to develop a crucial Q&A/VDR information request list.

Insurer's and Buyer's Q&A: Insurers seek to review the Buyer's Q&A and pose detailed questions to the buyer and their advisors. This process helps fill gaps in understanding the business and clarify any exclusions under the policy. In a synthetic process, insurers may propose limited and targeted Q&A, necessitating input from the warrantor to address gaps that would typically be addressed through a disclosure letter.

Buyer's Diligence: Buyer's diligence serves as a significant comfort factor for insurers, even if conducted internally. It encompasses customary areas such as legal, technical, financial, and tax matters, aligning with the synthetic warranty package sought. Some insurers may conduct additional diligence based on VDR information, while others may mandate specific scope of work by the buyer.

Scope of Coverage: In particular, synthetic W&I cover should consider the following types of warranties:

- Opinion-based warranties and third-party actions
- Position since the accounts date
- Compliance with laws
- Related party transactions

Awareness: Unlike a traditional W&I policy, a synthetic W&I policy typically does not contain knowledge qualifiers, as the seller is not the one giving the warranties. However, in certain circumstances, insurers have sought to impose deemed knowledge qualifiers against warranties based on the seller's awareness. This significantly narrows the breadth of the warranty, as it only covers the position that the seller knew something about the warranty in discussion but failed to provide that information through the Q&A and diligence process. This may potentially create difficulties in bringing a claim, requiring either the involvement of the seller in a claim or extrinsic evidence regarding what the seller knew at the time.

Calculating Loss: While traditional W&I policies incorporate the SPA definition of loss, there is no negotiating what qualifies as "loss" on a breach of warranty with the seller in a synthetic W&I deal. The absence of a contractual claim means the basis on which loss is determined must be set out in the policy and discussed with the insurer. This will be especially important in a distressed context where the value of the interests being acquired are de minimis. The calculation of loss may differ in various jurisdictions. The policy could specify that the loss will be determined by reference to a contractual measure of loss, such as the actual loss which the target could have avoided if the synthetic warranty had been correct, or insurers could be willing to follow indemnity measures of damages in certain scenarios.



Timelines and Cost Considerations

Concerns have arisen, particularly during the nascent stages of synthetic policies' adoption, regarding the expediency of implementing these policies. However, the utilization of synthetic insurance should not unduly impede the typical timelines for establishing a W&I policy. Despite the augmented importance of the Q&A process, the absence of a formal disclosure process by warrantors can alleviate a burdensome workstream from the transaction process. Therefore, engaging with Lockton and insurers at the earliest juncture is advisable, considering the varying requirements for placing a synthetic policy between insurers; especially in a distressed scenario where having a strong pre-agreed Policy wording in place would act as facilitator to agree on the coverage position swiftly.

Moreover, ensuring a robust due diligence scope and package is essential for insurers to ascertain the broadest coverage possible. Lockton can provide guidance and facilitate discussions with insurers early in the process to optimize coverage alignment.

Regarding cost, initial perceptions regarding the expense of synthetic policies compared to traditional W&I policies have evolved. Synthetic policies should not incur significantly higher pricing, particularly in the current M&A market climate, where insurers are motivated to secure transactions. While certain insurers may seek a premium uplift, this should generally fall within the range observed for other enhancements to a W&I policy, typically ranging from a 10-30% increase over traditional rates.

Insurers may require a slightly higher underwriting fee to accommodate the increased workload associated with warranty negotiation and the need for a rigorous Q&A process. We have seen the underwriting fees increase by around 20% compared to a standard placement.



Managing Expectations and Collaboration with Brokers in Synthetic W&I Insurance

Efficiently managing expectations and collaborating closely with a broker from the outset is paramount to defining the parameters for offering certain warranties synthetically. Lockton has the expertise and a long-standing track record to assist you from the very beginning in defining the parameters under which certain warranties may be given synthetically. Insurers typically aim to achieve several critical objectives with the broker's assistance. Firstly, they seek ultimate comfort in the quality of the process undertaken, evaluating the diligence conducted and the reliability of information compiled. Secondly, brokers play a crucial role in influencing the compilation of the data room and the process of gathering information through due diligence requests, ensuring comprehensive and accurate data is available for risk assessment and coverage evaluation. Additionally, brokers facilitate the Q&A process, shaping it to elicit quasi-disclosures from sellers, thereby aiding in obtaining crucial information not formally disclosed. Overall, the broker's involvement is fundamental in navigating the complexities of Synthetic W&I Insurance, ensuring alignment with coverage objectives and effective risk mitigation strategies right from the start.

Key Element Comparing Standard W&I vs Synthetic W&I		
Standard W&I Policy		Synthetic W&I Policy
Aligns with traditional SPA warranties and indemnities	Coverage Alignment	Offers flexibility to negotiate warranties directly with the insurer, potentially providing broader coverage
Involves seller in negotiations and discussions on warranties	Seller Involvement	Eliminates the need for seller involvement in warranty negotiations, streamlining the process
Typically involves formal disclosure by the seller	Disclosure Process	Absence of formal seller disclosure may expedite the transaction process
Sellers may retain residual liability, even with insurance	Liability for Sellers	Sellers may be absolved of residual liability, reducing post-transaction obligations
May encounter delays due to extensive negotiation processes	Timelines	Expedite timeframe, as there is no negotiation with seller over warranties and limitations
Tripartite negotiations involving buyer, seller, and insurer	Negotiation Complexity	Negotiations primarily between the buyer and insurer
Premiums may be lower, but negotiation costs can be significant	Cost	Premiums may be slightly higher due to increased underwriting and diligence requirements
Limited to warranties agreed upon in SPA negotiations	Coverage Limitations	Coverage may be more limited due to reliance on due diligence materials and insurer's risk appetite. The due diligence scope can be tailored to the synthetic warranty deed, resulting in costs savings



Distressed Deal:

Private capital and trade buyers alike still have access to equity reserves that have not yet been deployed. Along with inflation and interest rate rises, this convergence of opportunity may present itself to investors frustrated by market dynamics and sellers looking for an exit. When acquiring distressed assets, there are several differences that distinguish distressed transactions from traditional M&A transactions. Generally, there are compressed timelines, synonymous with acquiring assets out of administration. This is driven by the commercial reality that having new management in place and investment flow into the asset as soon as possible increases the likelihood of successfully turning the asset around. Lenders and other guarantors of support will be looking for comfort that their interests are similarly preserved and dissuaded from proceeding to liquidate assets, where any distribution made (if any) will likely be less attractive. Moreover, when an asset is distressed or likely to become distressed in the short to medium term, and a disposal is the agreed course of action, averting unnecessary protracted negotiations with bidders is a key determinant for successfully turning the asset around. Warranty protection offered by the seller or the insolvency practitioner to a prospective investor is likely to be limited, if provided at all. Insolvency practitioners are typically unwilling to provide comprehensive warranties around operational elements of the asset, given their capacity as an administrator.

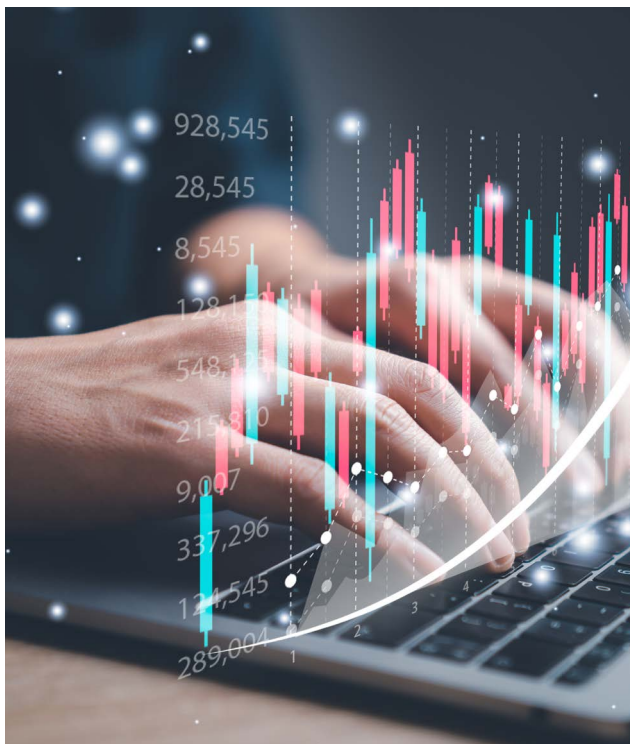
In distressed deals, such as those in liquidation or under administration, Synthetic W&I policies offer invaluable protection to buyers. These transactions often involve heightened uncertainty and limited seller warranties, making traditional W&I insurance challenging to obtain. However, Synthetic W&I policies provide an alternative by shifting the warranty risk from the financially distressed seller to the insurer. This allows buyers to proceed with confidence, knowing they are protected against potential breaches of warranties. Moreover, Synthetic W&I policies streamline the transaction process by eliminating the need for seller involvement in negotiations, expediting deal closure during critical time-sensitive situations.

Case Study:

Lockton was approached by one of the largest US real estate funds looking to buy two of the largest European shopping centres out of administration. The two assets were being sold via a receivership from a public company, although the administrators retained ownership of all the debt and shares pertaining to the Target Company were unable and unwilling to give any warranties. Conscious of the inability of their client to proceed without any contractual protection by way of warranties in an SPA, Lockton structured a synthetic warranty package that was negotiated between the buyer and the insurer. The warranty package sat outside of the SPA, and the buyer's diligence was tailored to meet the insurer's own diligence requirements to provide them with comfort to stand behind the synthetic warranties. This approach and structure allowed the buyer the protection of a comprehensive suite of warranties and was the motivation for the deal to go ahead.

Outside W&I - Know Your Litigation Risks and Relevant Local Regimes

In a similar manner to synthetic W&I insurance, insurers are prepared to hold risks associated with identified risks in a target entity for which a seller has been unwilling or unable to give any W&I. This cover is typically referred to as Contingent Risk Insurance and has been growing in popularity in transactions in recent years.



Wind-up Protection

Where an insolvency practitioner has had to make provisions for identified liabilities, these provisions can trap cash in the estate and prevent completion of any wind-up process for years. In certain circumstances, insurance protection is available to cover outstanding liabilities/provisions and enable the insolvency practitioner to distribute the remaining assets to creditors and complete the wind-up process more quickly.



Personal Liability Protection

Insolvency practitioners may incur personal liability for decisions they have taken or will take in their capacity as an administrator. Insurance is available to protect the insolvency practitioner from any personal liability and losses incurred. This coverage can also address concerns about challenges to actions that have been or could be taken.



After-the-Event (ATE) Insurance

This insurance provides protection to insolvency practitioners to pursue third parties for assets without taking on any adverse cost-risk on behalf of the insolvent estate. ATE insurance can also cover own side costs for disbursements, such as court fees and expert costs, as well as legal fees in some circumstances. Insurance is also available to provide security for costs if required.



Auction Process:

In competitive auction processes, Synthetic W&I policies serve as a significant differentiator for buyers, enhancing the attractiveness of their bids. Sellers and their advisors recognize the value of Synthetic W&I policies as they eliminate the uncertainty associated with seller warranties and expedite deal closure. Consequently, buyers leveraging Synthetic W&I policies gain a competitive edge over other bidders, positioning themselves as more attractive and reliable counterparts in the auction process.

Case study:

Lockton advised a bidder acquiring a Taiwanese business in the Telcom sector. During the process, the management, acting on behalf of the sellers, were not willing to provide any general warranties related to the operations of the business. The management also had a strong preference to not give any warranties at all. To facilitate completion of the acquisition and get ahead of the other interested buyers, our client adopted a synthetic warranty package, providing comfort to the buyer's management differentiating their bid from the standard W&I approach used by the other bidders.



P2P:

Where buyers are considering the acquisition of publicly listed companies through “take privates”, they often face the challenge of whether sellers will be able to provide a suitable set of warranties. In cases where the shares of a target are listed on a stock exchange, management’s ability to give warranties to a buyer may be limited or even prohibited by the relevant regulatory regime. To overcome this hurdle, Lockton has agreed a synthetic solution with insurers that would provide fundamental, general, and tax warranties.

Case Study:

Lockton was approached by a leading US private equity firm considering the acquisition of a publicly traded company listed on HKEX. The public-to-private deal was structured for the fully funded public offer by the private entity for all placed and outstanding ordinary shares of the listed company. The buyer did not enter into management incentivisation discussions prior to launching their offer, and as a result, management was unwilling to negotiate the warranty suite. In the absence of management providing suitable warranties to our client, Lockton assisted in placing a synthetic warranty deed with an insurer. This enabled the client to complete the acquisition.

Contact



Giovanni Colistra

Specialty M&A Risks

M: +65 9721 5104
+44 (0) 734 207 6648

E: Giovanni.Colistra@lockton.com



LOCKTON®

UNCOMMONLY INDEPENDENT