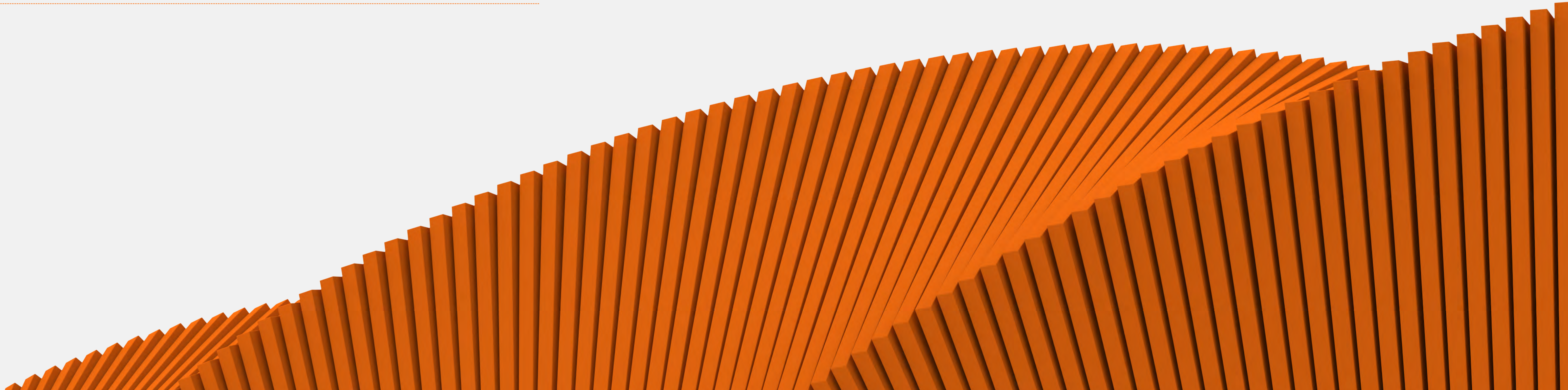
HWF

hwfpartners.com

SYNTHETIC W&I INSURANCE IN DISTRESSED REAL ESTATE TRANSACTIONS



EXECUTIVE SUMMARY

2023 has so far been a more challenging year for M&A than many immediately preceding it, and this has been particularly acute in the real estate sector.

The continuing series of interest rate rises which have been introduced across many jurisdictions to combat rising levels of inflation have posed particular challenges for investors looking to (re)finance and obtain the types of return which they had become accustomed to, with resulting impact upon property valuations.

With the increased cost of finance come questions around the ability for certain investors to keep servicing their debt obligations, with corresponding opportunities for distressed sales.

In this context, investors and their advisors may be faced with sellers who are unwilling or unable to provide a suite of warranties, even those which may be capped at £1 or equivalent.

This can often be the case where liquidators, administrators or other insolvency practitioners / third parties (e.g. lenders) are seeking to realize the remaining value of distressed assets.

In such scenarios, businesses are often sold on an ‘as is’ basis by such parties, who may have no or very limited knowledge on the underlying business and so are unwilling to stand behind warranties, even if there is a customary cap of £1 as they may still be exposed to potential subrogation claims from the insurers for fraud and potentially other matters.

There will be no appetite for such insolvency practitioners / lenders to assume any sort of personal liability in this type of transaction.

Synthetic W&I insurance is a useful product that can be deployed in this type of distressed real estate transaction, providing buyers with meaningful recourse to the insurer in the event problems subsequently emerge in relation to the asset, without the need to expose insolvency practitioners or lenders to related liabilities.

This note refreshes on select key points to consider in relation to the use of this product.

WHAT IS SYNTHETIC W&I INSURANCE?

Synthetic insurance is a form of insurance where the insurer provides a suite of warranties under a W&I policy rather than a seller itself giving warranties under an SPA, which are then underwritten by an insurer.

The suite of warranties is therefore negotiated between the buyer and insurer rather than the buyer and the seller, and therefore would usually appear in the insurance policy itself rather than the SPA as would be customary in a non-synthetic W&I transaction.

The product has emerged over the last several years (with the first use of the product emerging in the market around 2018), though its use is still relatively low vs. use of non-synthetic products.

It is worth noting however that on the title insurance side, policies are frequently ‘synthetic’, in the sense that they do not need to rely on the warranties in an SPA and instead provide coverage by reference to a list of insured events set out in the policy where this is a standalone title policy (rather than a ‘follow-form’ title top-up policy, which would instead track the terms of the underlying W&I policy and SPA provisions for a non-synthetic deal).

WHAT ARE THE KEY DIFFERENCES WITH TRADITIONAL W&I INSURANCE?

NO WARRANTIES IN SPA

As mentioned above, as the insurer is providing the warranties rather than the seller, there will usually be no warranties in the SPA unless there are matters which are being warranted by the seller other than those within the scope of an insurance solution, which would seem unlikely in most distressed scenarios.

The suite of warranties will instead feature in the insurance policy itself. There is therefore no negotiation with the seller on the suite of warranties and instead these will be discussed and agreed with the insurer.

FULLER NEGOTIATION OF WARRANTY SUITE WITH INSURER (RATHER THAN SELLER)

Given the above, as the warranty suite is being provided by the insurer rather than the seller, the insurer will play the primary role in negotiating the suite of warranties and so the insured can expect a greater degree of comments from them than would normally be the case where warranties are provided by the seller.

Certain insurers can provide their own synthetic set of warranties pre-agreed at quote stage. Others require the buyer to provide a set that is then negotiated with the insurer as the diligence process unfolds. There are advantages to both.

The former gives more certainty both as to cover and speed of delivery at the outset, whereas the latter may give broader coverage if time permits and information flow is favorable.

Either way, a negotiation with the insurer may mean a more streamlined process than would be the case where warranties are effectively negotiated and discussed in a tri-partite manner, as would be the case in a traditional W&I process where the insurer, insured and seller are all involved. Clearly this can also present advantages from a costs perspective.

NO RESIDUAL LIABILITY FOR SELLERS

As noted above, in a traditional W&I context, sellers will still remain liable even if there is a nominal financial cap for fraud as a result of an insurer's usual right under the policy to subrogate into the buyer's shoes and make such claims against the seller.

This should not be the case where warranties are provided by the insurer, although it is worth noting that there have been instances where insurers are still pushing for these rights to be retained even in a synthetic context.

NO KNOWLEDGE SCRAPE OR OTHER PRODUCTS /CHANGES AMENDING WARRANTY SUITE IN SPA

As the suite of warranties which will feature in the policy represents the final set of warranties to be covered by insurers, there is no requirement for products such as knowledge scrapes which modify the underlying suite of warranties in an SPA.

Continues ↓

NO FORMAL DISCLOSURE PROCESS AND LETTER /ENHANCED IMPORTANCE OF DUE DILIGENCE AND IMPACT ON WARRANTY COVERAGE

There will be no formal disclosure process by the seller against a suite of warranties, and so as a result the value of a robust due diligence process will be key for insurers so that they can understand the nature of the business / asset being insured.

The customary areas of due diligence will still be required conducted across legal, technical, financial and tax matters, as well as other specific areas which may be appropriate given the property trade in question. The policy will contain a schedule of general disclosures which would mirror a market front-end disclosure letter containing matters such as those discoverable on the face of the accounts, from public registers, corporate searches etc.

In the absence of disclosure, there will also need to be a well populated data room and a robust seller / management Q&A process will need to take place. Where the process permits (i.e. bilateral sales), we recommend involving insurers in the due diligence questionnaire / VDR population exercise, as parties can gain comfort that the relevant level information is provided to allow for synthetic cover.

As a result of the insurer's increased reliance on due diligence materials, the suite of synthetic warranties an insurer will provide will be even more closely aligned to the scope of the diligence which is being carried out, which can mean that the scope of warranties an insurer is willing to stand behind can in practice be more limited than might be the case in a typical W&I process.

It must be noted that not all warranties are capable of synthetic cover. The major risk areas of a target are generally insurable. However, certain types of warranties that are commonly used to ringfence operational risks of a target business may not be coverable without targeted Q&A as there is no relevant seller knowledge and/or disclosure against them. This could apply to:

- Knowledge qualified warranties
- Warranties about actions of third parties
- Statements of opinion
- Circumstantial / subjective language
- Management accounts warranties
- Ordinary course of business warranties
- Compliance / regulatory warranties
- Solvency related warranties

TIMELINES

Although there have been questions (especially in the early days of synthetic policies' usage) on the speed with which these policies can be put in place, the use of synthetic insurance should not adversely affect the usual timelines for putting in place a W&I policy. In fact, even with the increased importance of the Q&A process, as there is no formal disclosure process by warrantors, this can remove an often burdensome workstream from the overall transaction process.

In any event we would recommend engaging with HWF and insurers as early as possible as requirements for placement of a synthetic policy between the insurers can vary. Furthermore and as discussed above, ensuring a robust due diligence scope and package is in place will be key for insurers to ensure the broadest coverage, which we can help to advise on / discuss with insurers early on in the process.

COST

While initially there was a perception that synthetic policies were much more costly than traditional W&I policies, these should not attract a significantly higher pricing, especially as insurers now find themselves in a slacker M&A market and so are more incentivized to win what transactions there are in the market.

While some insurers will still seek to charge a higher premium, these should still be within the range seen for other enhancements that can be sought in relation to a W&I policy (i.e. a 10-30% premium uplift to a traditional W&I rate).

As mentioned above, the fact that there are no warranty negotiations with seller as well as insurer can also have advantages from a costs standpoint.

Insurers will typically also require a slightly higher underwriting fee to reflect the higher workload involved in the warranty negotiation / need for a more rigorous Q&A process – insureds should expect this to again be around 10-30% higher than usual pricing.

ABOUT US

We are an independent advisor and broker of transactional and tax risk insurance which allows for value creation and risk mitigation. In addition, we provide bespoke insurance solutions that mitigate tax liabilities arising in the lifecycle of investment structures and operational companies. We are recognised as a market leader.

Our team, comprising of individuals who have significant insurance, legal and tax backgrounds with extensive advisory, broking and underwriting experience, have advised on over 4,000 transactions and structured over 1,000 policies in over 50 jurisdictions. In addition, we have offices in London, Dubai, Frankfurt, Munich, Paris, Warsaw and New York and specialists dedicated in their focus on the MENA, CEE and Southern European regions.

This collective expertise allows us to provide specialist insight with an advisory focus, taking ownership of any insurance structured and allowing our clients to focus on the wider transaction.

We would be happy to provide references if required and for further details about us please see hwfpartners.com

KEY CONTACTS

Adam Regan
Head of Real Estate
+44 7834 889 893
adam.regan@hwfpartners.com

Adrian Furlonge
Partner
+44 7976 205 251
adrian.furlonge@hwfpartners.com

Hemsley Wynne Furlonge Partners Limited (also trading as HWF and HWF Partners) is an Appointed Representative of Ardonagh Specialty Limited which is authorised and regulated by the Financial Conduct Authority. Registered office: 2 Minster Court, London, EC3R 7PD. Registered in England and Wales with company number 13179703. Copyright © 2023 Hemsley Wynne Furlonge Partners Limited All rights reserved.