CLIENT NOTE

NEGOTIATIONS OFF THE TABLE?
SYNTHETIC WARRANTIES ARE HERE FOR HELP!

INTRODUCTION

The deployment of Synthetic Warranties (also known as "Warranties and Indemnities" or "W&I") has maximized the successful chances in negotiations in M&A transactions by providing de-risking tools for buyer's relief (within SPA/STA) engaged in M&A transactions.

During Mergers and Acquisitions ("M&A"), buyers are bearing the risks of the financial, legal and operational positions of the target entity, and normally seek warranties and indemnities from the seller's side to manage and alleviate those risks. Should the warranty be untrue and inaccurate, and the buyer incurs financial losses and damages as a result, reimbursement is typically sought from the sellers.

As a solution, the contractual parties are calling up Warranties and Indemnities or W&Is, which attract a higher premium than traditional W&I insurance policies, as the seller is not "providing" the warranties, i.e. the parties are not going through a rigorous and time-consuming process of negotiations (including exchange and flow of information, required level of due diligence comfortable to the underwriting insurer) the warranties and the seller and/or management are deprived of preparation a fulsome or traditional disclosure schedule.

In turn, this mechanism allows the sellers to pocket the financial means from the proposed sale, on the one hand, and allocate the main risks arising therefrom, on the other hand.

SYNTHETIC WARRANTY AS A RESCUE TOOL

Under conventional W&I scenario, the warrantors (sellers) would give a robust set of title, operational and tax warranties under the SPA/STA, and the relevant agreement would establish absolute right of recourse in the event of a warranty breach. The W&I insurer would then retain a narrow right to subrogate against a warrantor (namely, the seller), essentially directly claim against.

On the contrast, synthetic warranties are standalone warranties negotiated outside of a sale and purchase agreement (whether on a business sale or a share sale) between the insured (namely, the buyers or purchasers) and the insurer (those are licensed financial institutions). Synthetic warranties are insured on a "as if" basis, in the sense that is deemed that those warranties had been given by a seller to a buyer in the ordinary way.

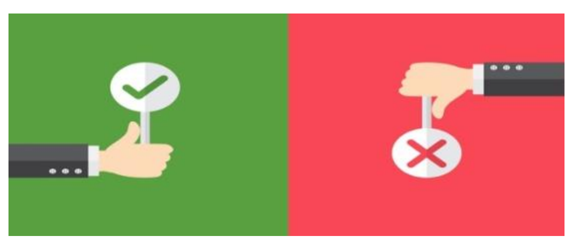
The synthetic concept is not new. On a smaller and more specific scale, insurers in the W&I market have been providing synthetic policy enhancements alongside their W&I insurance policies for many years. The first fully synthetic W&I policy was placed in the UK in 2018. However, fully synthetic W&I policies have been limited and largely confined to transactions involving the acquisition of relatively simple businesses, such as the acquisition of property holding SPVs or asset backed businesses.

Synthetic policy enhancements have enabled W&I policies to bridge the gap between the protections a buyer is seeking under an SPA versus those which a seller is prepared to give. Different types of W&Is are used within M&As based on peculiarities of specific transaction as follows:

(i) **Knowledge Scrape W&I**: which effectively removes the knowledge qualifiers in the warranties in the SPA;
(ii) **Materiality Scrape W&I**: which effectively removes the materiality qualifiers in the warranties as prescribed under the SPA;
(iii) **Basis of Recovery W&I**: permitting any recovery made under the W&I policy to be made on an indemnity basis of damages;
(iv) **Extension of Statute of Limitations W&I**: extending the warranty limitation period beyond that set out in the SPA;
(v) **Tax Deeds W&I:** "covenant to pay" the buyer/purchaser the amount of any pre-completion tax liabilities on a pound for poud basis.

PROS AND CONS OF SYNTHETIC WARRANTIES

<u>Advantages for Buyer/Purchaser</u>



(i) **Time Efficiency**. Fully synthetic W&I policy may expedite the timeframe of a specific transaction;
(ii) **Absence of Negotiations**. There will be no negotiation with the seller over the warranties and limitations and only one negotiation of the warranty coverage (between the insurer and the purchaser/buyer);
(iii) **Risk Mitigation**. Fully synthetic W&Is allow the buyers/purchaser to reduce the risks inherent to the M&A transactions; and
(iv) **No Need of Due Diligence**. it enables the buyer to tailor its due diligence limited only to the synthetic warranty coverage issues (potentially cutting the significant amount of costs) with insurer.

Advantages for Seller

(i) **Buyer-Pitching**. W&I would widen the pool of potential buyers for prospective sellers; and
(ii) **High Value**. Fully synthetic W&I policy would result in increase of the purchase price.

Cons of Synthetic W&I

(i) **Absence of Right of Recourse.** The insurer should not have ny subrogation rights (even in the case of fraud) against the seller, even in fraudulent practice is present; and
(ii) High Insurance Costs. Synthetic warranties may attract a higher premium in comparison to traditional W&I insurance policies, outlining the added uncertainty the insurer assumes.
(iii) Time Limitations. Synthetic warranties provided by insurers are commonly time-barred (effective for up to 2-5 years from the date of issuance of relevant warranty).

HOW WE CAN HELP?

Taking into consideration the practice for W&I, where a party is considering the use of a W&I policy, it is essential to take appropriate and comprehensive advice on the most appropriate insurers to reach out and on what policy enhancements and/or tailored insurance solutions might be upstanding and effective.

NOTE: This material is for general information only and is not intended to provide legal advice

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