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# The ins and outs of synthetic warranty insurance

**The use of warranty and indemnity (W&I) insurance for UK private company transactions has continued to grow in recent quarters. Tom Clarke and Alasdair Austin of Dechert LLP explain why any private company director considering a deal should be aware of the latest development in the W&I insurance market: synthetic warranty coverage.**

Traditional W&I insurance covers the breach of the insured warranties the seller gives to the buyer under the sale and purchase agreement (SPA). With a normal buy-side policy, if a warranty is breached, the seller pays an initial amount (usually equal to the policy excess) to the buyer, which then recovers any additional loss (up to the policy limit) from the insurer. This insurance provides a clean break for the seller and assures the buyer that it will recover its losses if a warranty is breached.

A synthetic policy covers the breach of warranties contained in the W&I policy, not the SPA. So, for a buy-side policy, any negotiations about the scope and limitations of the insured warranties will be between the buyer and the insurer.

Synthetic W&I insurance may be preferred where sellers are unable or unwilling to provide warranties or where the buyer wants to streamline the transaction by avoiding warranty negotiations with the seller.

## Enhancements or fully synthetic policies?

Buyer and seller need to consider whether a full synthetic policy is needed or whether certain synthetic enhancements may resolve any warranty-related disagreements.

Synthetic warranty enhancements can be used to cover particular risks for which the seller might refuse to provide a warranty. Often, they are used for tax warranties, capping the seller's exposure at £1. These enhancements can also effectively remove warranty qualifiers (e.g., knowledge or materiality) or extend the limitation periods for claims.

Fully synthetic policies can expedite the deal. Instead of one set of negotiations between buyer and insurer and another between buyer and seller on disclosure and warranties, you have one set of negotiations, between buyer and insurer. Moreover, by removing a potential source of disagreement between buyer and seller, you reduce the risk of a deal failing.

## Increased costs

A synthetic W&I policy theoretically poses an increased risk to the insurer. With a traditional policy, the insurer partly relies on the seller's negotiation of the insured warranty package and a thorough disclosure process (motivated by the seller's residual liability for the policy excess) to mitigate the risk of a successful claim under the W&I policy. So, for a purely synthetic policy, the insurer may charge a higher premium and the scope of the warranties covered may be narrower.

The buyer's due diligence process needs to be comprehensive, as the insurer relies on it when preparing the policy, given the lack of protection from a disclosure letter or schedule.

## Practical points

If opting for a fully synthetic policy, the buyer should approach insurers as soon as possible, to avoid any delays to the deal. Delays may occur particularly if:

- the insurer wants to carry out its own due diligence;
- seller and management engagement to support the buyer's due diligence process is lacking;
- the parties aren't familiar with how synthetic policies work;
- more time is needed for discussing how to quantify damages if claims arise under the policy, especially for complex distressed asset deals.

## Conclusion

The use of synthetic W&I insurance products looks likely to grow significantly in the years ahead. We think it will be increasingly important for buyers and sellers of private companies to understand how they work and the opportunities they can provide.

**Contact us**

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