Client Alert | **M&A– Italy**

Synthetic W&I Insurance: Broadening Warranty Protection in M&A

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Warranty & indemnity ("**W&I**") insurance is playing an increasingly important role in M&A transactions. With the evolving transactional risk market, synthetic W&I insurance has become a viable alternative when traditional W&I insurance is not available for various reasons or if there is a desire to avoid the negotiation of representations and warranties. Once confined to distressed M&A deals, synthetic W&I is now expanding its reach and being used in asset-heavy sectors like energy and mainstream M&A deals.

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What is Synthetic W&I?

Synthetic W&I differs from traditional W&I since warranties and/or tax indemnities are included directly in the insurance policy rather than in the Sale and Purchase Agreement ("**SPA**") or Warranty Deed ("**WD**").

There are three key structures:

1. **Fully Synthetic**: Insurers provide a full suite of warranties when none are included in the SPA or WD.

2. **Partially Synthetic**: The SPA or WD contains limited warranties, supplemented by additional policy-based warranties.

3. **Synthetic Tax Indemnity**: A tax indemnity is provided within the policy to cover unknown pre-completion tax liabilities.

When is Synthetic W&I Used?

Synthetic W&I insurance proves particularly useful in scenarios where sellers or managers are unwilling or unable to provide warranties. This issue is becoming increasingly common due to concerns of insurers recourse against sellers or managers. In distressed M&A deals, for instance, insolvency practitioners, lenders, or administrators often sell assets on an "as is" basis, making it impractical to offer warranties. Synthetic W&I steps in to fill this gap, offering buyers the necessary protection. In an increasing number of strategic or sponsor led sell side M&A transactions, sellers or managers refuse to give a comprehensive set of business warranties (even on a nil liability basis) or to provide adequate disclosures that can permit to obtain a traditional W&I policy. In such cases, synthetic W&I can bridge the gaps in protection, ensuring buyers are covered and enabling the sellers or managers to avoid giving warranties.

Furthermore, when minority shareholders exit, they typically do so without involving management, thereby limiting their ability to provide a comprehensive set of business warranties. In these cases the lack of warranties may lead to a discount on the sale price to the minorities or may become a point that kills the deal. Synthetic W&I can be a valuable option for a seller or buyer in these situations.

Lastly, in public-to-private (P2P) transactions, selling shareholders may not be involved in the day to day business and have limited historical knowledge of the business or they may refuse to provide a comprehensive set of warranties (or assist with the disclosure process). Here, synthetic W&I can provide a solution to a situation in which warranties would otherwise not be available.

Key Considerations: Traditional vs. Synthetic W&I

While both insurance types require an underwriting process, synthetic W&I differs from traditional W&I in the following material areas:

Aspect	Traditional W&I Insurance	Synthetic W&I Insurance
Timing	7-10 business days	10-15 business days
Due Diligence	Standard diligence	Extensive due diligence required, reliance on VDR disclosures and Q&A processes
Disclosure	Formal disclosure letter with customary seller disclosures	General disclosures through VDR and detailed Q&A responses
Pricing	Standard pricing	Standard pricing, but possible 10-30% premium uplift for complex transactions

Due diligence

It is crucial to involve insurers at the early stages of the transaction to confirm the feasibility of obtaining synthetic W&I insurance and, where appropriate, to consider having the sellers prepare a vendor due diligence (VDD) report as an optional tool that can facilitate the underwriting process. Early engagement allows for a thorough assessment of the transaction's risk profile and ensures that the necessary coverage can be arranged without hindering the deal's timeline.

Access to a complete Virtual Data Room (VDR) and Q&A process are pivotal in the underwriting of synthetic W&I insurance. To secure comprehensive warranty protection, it is essential to structure these processes meticulously. The VDR should be organized to provide insurers with clear, detailed, and accessible information about the target business. An efficiently managed Q&A process, where potential concerns and queries from insurers are promptly addressed, further supports the underwriting process. This approach not only aids in obtaining broad warranty coverage, but also enhances the overall transparency and attractiveness of the transaction. Where sellers elect to prepare a VDD, insurers benefit from an additional layer of diligence, further streamlining underwriting and enhancing deal transparency.

Synthetic W&I insurance policies come with their own set of limitations and exclusions. One significant difference from traditional W&I insurance is the absence of seller-backed disclosures. Buyers should expect synthetic policies to rely heavily on the information provided during the due diligence process, without the benefit of seller warranties or indemnities. Any gaps or inaccuracies in the disclosed information could impact the scope of coverage, making it vital for buyers to work closely with their advisors—and, if a seller-prepared VDD pack is available, to leverage its findings—in order to mitigate potential risks associated with the lack of seller-backed disclosures.

Warranties

Traditional W&I: In traditional W&I insurance, warranties are included in the Sale and Purchase Agreement (SPA) or the management warranty deed (WD) and negotiated between the buyer and seller in the usual manner. Once agreed, insurers review these warranties as part of their underwriting process and may modify coverage in the policy based on their risk assessment. This approach follows standard deal negotiations while allowing insurers to refine the coverage where necessary. Disclosure schedules, prepared by the seller or management and their counsel, form a critical component of the warranty framework and are scrutinized both by the buyer and the insurer. These schedules qualify and limit the scope of the warranties, and their completeness and accuracy directly affect the extent of insurance coverage available.

Synthetic W&I: In contrast, synthetic W&I insurance takes a different approach, as warranties are not negotiated between the buyer and seller, but instead are agreed directly with the insurer. The policy itself contains the suite of warranties, eliminating the need for negotiations with the sell-side. While this can streamline the transaction, it shifts the focus of discussions to the insurer.

Insurers take varying approaches to structuring synthetic warranties. Some provide a pre-agreed set of warranties at the quote stage, offering greater certainty and a faster process. Others require the buyer to propose a set of warranties, which are then negotiated with the insurer as the diligence process unfolds. Each approach has its own advantages and downsides. A pre-agreed warranty set ensures efficiency and predictability from the outset but may leave certain areas uncovered. A buyer-led approach can lead to broader coverage, provided there is sufficient time and a favorable flow of information. In practice, broader coverage is more likely when the buyer defines the warranty suite and controls the starting position, as this allows for greater flexibility in tailoring the scope of protections.

In synthetic W&I deals, the treatment of disclosure schedules must also be considered carefully. Although there is no negotiated warranty package, insurers often require a form of disclosure exercise to support underwriting and coverage. This can include buyer-prepared schedules or, where feasible, disclosure schedules prepared by the sellers or management and their counsel. While not mandatory, seller or management involvement in the preparation of disclosure schedules can significantly enhance the insurer's comfort and result in improved coverage or reduced exclusions. An active involvement of management in the disclosure process can also provide buyer with adequate comfort on the accuracy of the warranty set.

In synthetic W&I insurance, coverage for warranty repetitions at closing is generally not provided unless a bring-down disclosure is conducted. This process requires some level of input from the sellers or warrantors, either through a signed bring-down document or by updating the Q&A between the buyer and sellers/warrantors before closing.

Under certain circumstances, particularly when the time lag between signing and closing is limited, "New Breach Cover" may also be available, allowing the buyer to claim for breaches of insured warranties or the tax indemnity that (i) occur during the interim period between signing and closing and (ii) come to the buyer's actual knowledge within that timeframe.

Conclusions

Synthetic W&I is an innovative solution for situations where seller/management -backed warranties are unavailable, enabling buyers to secure warranty coverage and streamline transaction execution. However, early engagement with insurers and thorough due diligence are crucial to obtaining optimal policy terms and ensuring a smooth transaction process.

It is essential to involve experienced legal counsels throughout the process to navigate the complexities of synthetic W&I insurance and ensure robust risk allocation. Legal input is particularly critical in drafting or reviewing disclosure materials and coordinating with insurers to secure optimal coverage.

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