

## SYNTHETIC W&I INSURANCE – A WAY FORWARD IN A DIFFICULT MARKET?

We've heard about artificial intelligence and its potential effects on global economies, but what about artificial insurance? Against the backdrop of economic volatility, could fully synthetic insurance policies be a way forward for corporate real estate in a difficult economic market? In this briefing we will look at the latest developments in warranty and indemnity insurance (W&I), the rise of fully synthetic insurance policies and the implications for those involved in real estate transactions.

### TRADITIONAL W&I

W&I has experienced a remarkable transformation over the past three decades. From a niche sell-side product used on a handful of transactions in the 1980's, W&I has evolved into a cornerstone of the M&A market, used by private equity houses and institutional investors alike. Traditional W&I works by allowing sellers to cap their liability for the warranties and indemnities given to buyers at a nominal amount (typically £1), with the buyer instead seeking to pursue the W&I insurer for any breaches of those warranties or indemnities where this is covered by the W&I policy. However, with traditional W&I the seller however typically retains liability for fraud or deliberate breach of warranties and therefore the seller must negotiate the terms of the warranties and still carry out a full disclosure process to mitigate this residual risk.

### THE RISE OF SYNTHETIC W&I POLICIES

With the looming threat of an economic downturn and continued pressure on prices, sellers in the corporate real estate market may be reluctant or, in cases such as insolvency sales, unable to give a market-standard comprehensive package of warranties, even on the basis of a £1 cap on liability. Combined with the need to complete transactions quickly and efficiently to avoid falling foul of significant market movements, it comes as no surprise that fully synthetic W&I policies are being considered in an increasing number of transactions.

Synthetic warranties themselves are not new and have been included in traditional W&I policies for several years, particularly around areas such as tax. A synthetic warranty is not given by the seller, or included in the sale and purchase agreement at all, but is simply negotiated between the insurer and

#### Key issues

- Unlike traditional W&I policies, synthetic W&I policies are negotiated between the insurer and the buyer without involving the seller in the process.
- The use of synthetic W&I policies has increased as a result of market conditions which have caused some sellers to resist giving market-standard comprehensive warranty packages (even with a £1 cap) at the same time as parties seek to progress deals as quickly as possible to avoid falling victim to volatile economic conditions.
- Whilst synthetic W&I policies present an opportunity for buyers to differentiate themselves and are no longer a materially more expensive option when compared to traditional W&I, the product is not yet embedded enough to provide a "cure-all" for either side in a typical transaction. Buyers in particular should be cautious when seeking a synthetic W&I policy as, if implemented incorrectly, they could find themselves with a significant gap in their rights of recourse.

the policy holder. This avoids the need for a seller to concern themselves with any residual liability connected with that warranty and, in theory at least, removes the need for a disclosure exercise.

A fully synthetic W&I policy takes this one step further and removes the seller entirely from the negotiation of the warranty package. Buyers instead negotiate the warranty package directly with the insurers outside of the sale and purchase agreement process.

It is believed that the first fully synthetic W&I policy was placed in 2018. Use of these policies has traditionally been limited to insolvency sales (where insolvency practitioners sell the relevant company on a "sold as seen" basis) but they are beginning to be seen in a wider range of circumstances, such as on-selling businesses originally bought by way of a distressed sale or situations such as joint venture buy-outs where an exiting seller may not want to give operational warranties to a remaining JV partner acquiring their interest. The common theme is that sellers are increasingly unwilling to incur time and cost on the negotiation of warranties and participating in the disclosure process, and dislike retaining even residual liability for a wide range of operational warranties.

## **CONSIDERATIONS FOR TRANSACTION PARTIES**

So is a synthetic W&I policy the band-aid for the current market turmoil and, if looking into placing such a policy, what commercial considerations should buyers and sellers be aware of?

The historic concern with synthetic W&I policies were that they took longer to incept and were materially more expensive to put in place. However, insurers are increasingly efficient in underwriting these policies and the difference in time and cost for placing synthetic W&I instead of traditional W&I is significantly narrowing. There are, nonetheless, additional considerations that should be considered before embarking on a synthetic W&I process:

- **Increased due diligence** – As the seller is not giving any warranties, insurers do not have the comfort of a full disclosure process being undertaken by a seller, but instead must rely on the due diligence process. As result, insurers will want the sellers to provide an extensive range of diligence materials and engage in a comprehensive Q&A exercise. This can limit the use of synthetic W&I where key information is not readily available from the sell-side and can also mean that some of the work that would have taken place in respect of the form of the warranties effectively gets transferred to the form of responses that a seller is prepared to give to the buyer's Q&A exercise. Ultimately, a synthetic W&I policy does not represent a "get-out-of-jail-free" card for sellers looking to avoid a diligence process and well-advised buyers should push sellers to provide as much information as possible. Failure to do this may mean that the insurers cannot get comfortable and may refuse to offer, or significantly limit the protection offered by, a synthetic W&I policy.
- **Scope of warranties** – Warranty packages on a synthetic W&I deal tend not to be as extensive as those negotiated between a buyer and seller. Instead the buyer will typically present a list of the areas they would like to be covered to the insurer, which the insurer subsequently considers and often narrows down further.

- **Awareness** – Logically, and unlike a traditional W&I policy, a synthetic W&I policy doesn't usually 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. Obviously this significantly narrows the breadth of the warranty as it will only effectively cover 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 potentially creates significant difficulties in bringing a claim, requiring either the involvement of the seller in a claim or extrinsic evidence as to what the seller knew at the time.
- **Subrogation** – As mentioned, a key benefit of synthetic W&I for sellers is avoiding residual liability, particularly around fraud or deliberate breach of warranties. To achieve this, well-advised sellers will seek to ensure that an insurer waives any rights of subrogation that it may have against the seller. However, insurers are increasingly looking to retain these subrogation rights, especially in respect of fraud. Consequently, notwithstanding that there is no traditional disclosure exercise, a seller who has given fraudulent or deliberately untrue responses to a Q&A process may still find themselves with potential liability.
- **Loss** – Unlike in a traditional W&I deal, there is no negotiating what qualifies as "loss" on a breach of warranty with the seller in a synthetic W&I deal. Instead this must all 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. This is one of the more complex elements of synthetic W&I policies and will be one of the key areas of focus in making the policy work for the buyer.
- **Cost savings and efficiencies** – In terms of cost, whilst historically there may have been a differentiator, current market appetite means that any cost gap between synthetic W&I policies and traditional W&I policies is narrowing. There are also likely to be other efficiencies realised as a result of following the synthetic W&I route, particularly in terms of limiting the amount of negotiation required with the seller on the sale and purchase agreement as well as the potential to consolidate the insurance process generally and avoid the dual negotiation required as part of a traditional W&I process. However, the perceived higher risk to insurers in a synthetic W&I policy can result in higher excesses and de minimis being included that might be avoidable in the traditional W&I route.

## CONCLUSION

So does fully synthetic W&I represent a panacea for commercially and economically complex transactions? Insurers still require that fully synthetic W&I policies sit hand-in-hand with a thorough disclosure process and a seller must still fully engage with the diligence process or the coverage provided by the policy will be significantly compromised. However, the benefit of avoiding a tri-partite negotiation on the terms of warranties is considerable and the fact that a buyer is willing to accept synthetic W&I coverage could be a strategic differentiator in competitive processes. As synthetic W&I becomes more common, there may also be further economies of scale, with increasingly standardised sets of synthetic warranties removing the amount of negotiation required. As long as insurer interest in the W&I market remains strong, we

expect to see fully synthetic W&I policies become an increasingly common feature in an increasingly wide range of corporate real estate transactions.

*Clifford Chance's Real Estate team have a broad and varied experience in advising both buyers and sellers on traditional and synthetic warranty and indemnity insurance policies, as well as more generally on corporate real estate matters, joint ventures and indirect acquisitions. If you would like to hear more about the issues discussed in this briefing or any other corporate real estate issues, please contact our real estate team or your usual Clifford Chance contact.*

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