

WARRANTY & INDEMNITY INSURANCE

KEY CONSIDERATIONS SHOULD A POTENTIAL BREACH OF WARRANTY ARISE

INTRODUCTION

Warranty and Indemnity ("**W&I**") insurance provides insurance cover against loss caused by some (but likely not all) breaches of warranties given by the counterparty/ies in the sale and purchase of a business, or where there would be a claim under an indemnity from the counterparty/ies. Over recent years, W&I Insurance has become increasingly commonplace in M&A transactions. Whilst it is possible to obtain both buyer-side and seller-side warranty and indemnity insurance, this note focusses on buyer-side insurance as this is the form most commonly used.

The key benefit of W&I insurance is that it provides recourse against an insurer instead of the seller, thereby substantially removing credit or enforceability risks. It is often viewed as providing a 'clean break' as, in most instances, it will not be necessary to involve the seller.

In the event that information comes to light that suggests there may have been a breach of any warranties in the sale agreement, it is vital to give immediate consideration to your obligations under your W&I policy ("**W&I policy**"). W&I policies often specify time periods in which actions must be taken, and also impose obligations which may need to be strictly followed.

This note sets out the key considerations when an issue arises which may trigger a claim. Every case is of course different, and it will be important to consider carefully the precise obligations under any specific policy.

PRE-COMPLETION

1. Post Signing Developments

Where signing and completion are not simultaneous, it is likely that you will be required to confirm to the insurer(s) at completion that you are not aware of any breaches of warranty and, if aware of any breach, to set out the relevant details.

Prior to giving the confirmation, it is important to consider whether any specific steps are required (for example, undertaking searches of specified public registers) and reflect upon any information that has been received since signing.

If any concerns arise as to providing the confirmation without caveat, it would be prudent to discuss these with your legal advisors and broker as soon as possible.

Key Points to Note

- Consider the insurance position promptly if you become aware of circumstances that may indicate a potential breach of a warranty given prior to completion. You may be required to inform your insurer(s) and, if so, failing to do so promptly might invalidate your claim.
- The policy will set out what needs to be notified and how. In particular, it may be necessary to provide a reasonable amount of detail to the insurer(s) about a potential claim, and to seek to quantify the claim.
- Where the claim relates to a third party liability, it may be necessary to liaise with the insurer(s) before incurring costs to defend the claim in order to seek their consent, and to involve them in the defence of the third party claim.
- Be careful not to act in a manner which might prejudice any claims the insurer(s) may be entitled to bring against the counterparty, including where the right to claim against the counterparty is very limited.
- Take steps to preserve relevant documents and other evidence that may be relevant to potential breaches, particularly where individuals may have left or be leaving the business.
- Carefully consider issues of privilege in respect of any potential future legal proceedings against (i) the insurer(s) and/or (ii) the counterparty. Particular issues can arise when communicating with the target company, or when dealing with third parties such as brokers who are not lawyers.

2. Variations to SPA

Following the issuance of the W&I policy, it should be borne in mind that the insurer(s) ought to be consulted regarding any revisions to the transaction documents including any consents or waivers that might be granted. The W&I policy may set out express provisions in respect of such variations.

POST-COMPLETION

1. Notification to Insurer(s)

Your W&I policy will set out specific obligations to inform the insurer(s) of circumstances that may give rise to a claim, or of a claim itself. These will, in particular, deal with (i) what needs to be notified, and (ii) when notification needs to be made.

It is likely that you will be obliged to notify your insurer(s) as soon as reasonably possible upon discovery of circumstances that could give rise to a claim under the W&I policy. Even if the potential loss does not exceed the retention, notification may still need to be made. The impact of the breach might be more significant than envisaged or the loss may erode the retention and, unfortunately, it is not unusual that where one breach of warranty is discovered more breaches are subsequently identified.

It is important to ensure that these notification obligations are complied with. A failure to comply with the notification requirements may result in the insurer(s) being entitled to reduce the cover available in full or in part.

If circumstances indicating there may have been a breach of warranty arise, consideration should be given to whether other insurance that may respond is held, including excess insurance and policies held by the acquired entities. You may be required to give notifications or make claims under these policies and failing to do so may impact the cover available under the W&I policy.

2. Third Party Costs

Your W&I policy may provide cover for third party costs incurred in respect of a breach of warranty. For example, the W&I policy may cover the costs of investigating and defending a claim made against the company where the existence of that claim may represent or arise from a breach of warranty.

If such cover is available, it is likely that you will be required to seek the consent of the insurer(s) before incurring such costs, and relevant requirements under the W&I policy should be checked before a third party is engaged where cover may be available.

MAKING AND PROVING A CLAIM

1. Claim Notice

Your W&I policy will set out specific steps that should be followed when making a claim under the W&I policy. Commonly, you will be required to set out the relevant circumstances, identify which insured warranties have been breached and how, and provide an estimate of the loss suffered. It is important to follow the specific process set out within the W&I policy, in particular complying with any applicable time limits.

The burden of proving the claim rests on the insured so, even if not expressly required under the W&I policy, the insurer(s) should be provided with supporting documentation (where possible) together with the claim notice.

2. Assessing Claimable Loss

Quantifying loss is not always straightforward. In particular:

- a) The retention will not be recoverable from the insurer(s) and there may be provisions limiting what might be claimed (for example, a de minimis for individual claims).
- b) The claimable loss is determined at the time of breach, i.e. when the relevant warranty is breached at signing and/or completion. The most common approach to assessing the claimable loss is the difference between what the target ought to have been worth (which may or may not be the purchase price) and what the target was actually worth (known as 'warranty true vs warranty false'). The valuation methodology used to determine the purchase price is therefore likely to be relevant to the assessment of the loss.

The quantum of the loss is often the most contentious part of a warranty and indemnity insurance claim and this element of the claim will likely be closely scrutinised by the insurer(s). It may be prudent to engage an experienced expert to advise on the appropriate valuation for a claim.

3. Insurer Queries and Requests

Upon receipt of a claim notice, the insurer(s) will undertake an assessment of whether (i) there has been a breach of any insured warranties, (ii) whether any exclusions apply, and (iii) what loss has arisen due to the breach of any insured warranties that it assesses have been breached.

Following receipt of the claim notice, it is common for the insurer(s) to request additional information and/or documentation in order to assist in their assessment of the claim. Such requests may be specific (e.g. a relevant contract) or general (e.g. all documents relevant to a specific issue that has arisen). In addition to considering the proportionality of requests, care should be taken to ensure that all relevant laws are complied with when undertaking any searches and/or in providing documents to the insurer(s) (for example, data protection rules and local employment laws may be relevant).

Following the provision of additional information/documentation to the insurer(s), the insurer(s) may raise further requests and there may be a number of requests and responses before the insurer(s) consider they have sufficient information to confirm or deny the claim is covered under the W&I policy.

In the course of this exchange, the insurer(s) may confirm that they accept parts of the claim made (for example, that certain warranties have been breached) but maintain that further information/documentation is required to prove other parts of the claim.

4. Settlement of Claim and Next Steps

If, following the provision of information/documentation, the insurer(s) accepts there has been a breach of an insured warranty and the quantum of the loss is agreed then the settlement will commonly be recorded in a settlement or release agreement that makes clear the scope of the settlement.

If the insurer(s) do not accept there has been a breach of warranty and/or it does not prove possible to agree the loss suffered, then consideration will need to be given to whether to pursue the claim further. The W&I policy will likely provide for disputes to be resolved by either the Courts of a specified jurisdiction

or arbitration but, depending on the nature of the unresolved issues, agreeing with the insurer(s) to attempt to resolve the dispute through mediation (a structured settlement meeting facilitated by an independent mediator) may also provide the means to unlock a settlement without the need to commence formal proceedings against the insurer(s).

OTHER MATTERS

1. Notification to Seller(s) and Preserving Insurer Subrogation Rights

In general terms, once an insurer has paid an insurance claim, it will gain rights to make claims against third parties that caused or contributed to the loss, and the insured is under an obligation to preserve those subrogation rights. Whilst under a W&I policy it is likely that the insurer(s) will have waived their subrogation rights in certain respects, it is unlikely the insurer(s) will have waived their subrogation rights in all circumstances.

Where there is a possibility (even if not seemingly possible on the facts presently known) that the insurer(s) will obtain subrogation rights, care should be taken to ensure the insurer(s)'s position is protected. In the context of a W&I policy, this will commonly include consideration of any relevant time limits to notify, and/or commence proceedings against, the seller(s). Care should also be taken in any communications with the sellers to avoid making any statements that might adversely impact any subrogated claim that might be made by the insurer(s).

2. Retention of Records

It is likely that the W&I policy will require you to ensure that all records relating to the transaction including due diligence and negotiation documents are retained. These documents may also be necessary to support any claims on the W&I policy that might be made and so, even if there is no express obligation to retain these documents, it would be prudent to ensure they are retained and readily available.

It is also likely the Policy will require you to ensure that potentially relevant records are maintained by the target group. You should therefore ensure that the target group has in place document retention policies that reflect any obligations on you under the W&I policy and consider taking steps to prevent the deletion/ destruction of potentially relevant records.

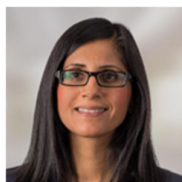
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CONTACTS



Christopher Ingham
Partner

T +44 207006 4518
E christopher.ingham
 @cliffordchance.com



Baljit Rai
Director of Insurance
Litigation

T +44 207006 8714
E baljit.raai
 @cliffordchance.com



Benjamin Mackinnon
Senior Associate

T +44 207006 2239
E benjamin.mackinnon
 @cliffordchance.com



Alex Gabriel
Senior Associate

T +44 207006 1169
E alex.gabriel
 @cliffordchance.com

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www.cliffordchance.com

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London, E14 5JJ

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