Warranty and indemnity insurance policies – The devil is in the detail

The warranty insurance market has seen significant growth in recent years and a recent survey from BDO indicated that warranty and indemnity insurance (W&I) is used in between 40 and 60% of the transactions the respondents were involved in. There are many advantages to having such a policy in place, but what if there is a dispute over the terms of the cover – how will this be interpreted by the court and what can the parties do to reduce the risk of being left without cover?

How will a W&I policy be interpreted?

When interpreting a W&I insurance policy the court will consider:

What the policy says

The natural meaning of the words used together with any other relevant provisions that are contained in the W&I policy will be considered to determine whether the specific facts relied on are covered. Where the terms of the policy are clear the court will not normally depart from the words used when interpreting what they mean – the parties have control over this language and must have been focusing on it before the contract was made. If the insured was not happy with this language then this issue should have been raised with the insurer before the policy was taken out (or other insurance found) and the court will not readily come to the rescue of the insured if, with the benefit of hindsight, they are unhappy with the terms of the policy they have taken out.

What the parties intended

Where the language of the policy is unclear, the court may depart from the normal meaning of the words used where the context suggests that an alternative meaning more accurately reflects the intention of the parties at the time the contract was made. This is an objective test to be assessed as what a reasonable person with the actual / presumed knowledge of the parties would have intended, rather than the subjective evidence of the parties after the event.

Commercial common sense

Where there are two (or more) possible constructions of a contractual provision, the court is entitled to prefer the construction that is consistent with business common sense and reject the other. Further, the court may intervene if the insurer later seeks to rely on an exclusion of liability clause in a way that would be inconsistent with or repugnant to the purpose of the insurance contract (i.e. an insurer is unlikely to be able to rely on an exclusion of liability clause if in doing so it substantially removes the benefit / purpose of the policy).

Sophistication of language used

When striking the balance between the language used and the context of the contractual arrangement the court will consider the quality of the drafting and how sophisticated / complex the contract is. This means that the words used in a W&I policy (typically drafted by a skilled professionals) are more likely to be upheld than more unsophisticated / simple contracts.

If there has been an obvious mistake

Where there is an obvious error in the policy this can be corrected if it is clear that a mistake has been made and it is clear what the provision is intended to say, although this is a high hurdle and a court will typically only intervene where the clause in question is an obvious nonsense.

How to reduce the risk of being left without cover?

The purpose of W&I insurance is to cover the risk of the unknown, so by definition it will be hard for the insured to consider all eventualities, however, the risk of being left without cover can be mitigated by taking the following steps:

Expert advice

Specialist insurance brokers working closely with experienced M&A lawyers will be able to help explain the terms of a policy and identify possible issues / limitations to the cover. It is unlikely the policy will cover every eventuality, so it is important the insured understands what is/isn't covered before the policy is entered into.

Due diligence

Insurance is not a substitute for proper due diligence. From a seller's perspective the insurance often excludes cover for known risks and from a buyer's perspective it is better that issues are discovered prior to a transaction being entered into, rather than relying on cover, which will only compensate for financial losses (at best).

Cover the fundamentals

Even with W&I insurance in place, a seller will typically be asked to give fundamental warranties over the key parts of the transaction (e.g. they have title to the shares that are being sold).

Uninsured risks

As part of the transaction the parties will need to agree who has the benefit of the W&I policy and who takes the risk for an uninsured risk. The uninsured risk will typically include known items, general standard exclusions and deal/transaction specific exclusions.

Read the small print

It seems obvious, but before taking out the policy the insured should read the terms of the policy carefully and be happy with the terms of cover. If there are any parts of the policy that are unclear then your advisors can help.

Go to market

The increase in popularity of W&I insurance means that there are a range of different insurers / policies that can be considered. An experienced broker, working alongside your legal team for the transaction, will help you navigate through the different options and find the best policy for your circumstances

How we can help

If you are considering buying / selling a business or would like further advice in relation to W&I please do not hesitate to contact us.

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