Jurimesh

W&I INSURANCE: FROM THE BROKER'S SEAT

PAPER 2

THE W&I SERIES

By Jurimesh, in conversation with Peter Zwijnenburg, Aon M&A

AON

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This is the second paper in the Jurimesh series on due diligence and the deal, following our paper with Raphaël Delsaux of Howden on what W&I is. In this conversation Peter Zwijnenburg, who leads the regional team of Aon M&A, explains how the market actually reads a transaction: when to involve a broker, what insurers are really pricing, what gives underwriters comfort, and where AI is starting to change the equation.

1 When to bring in the broker

At what point in a deal do you typically get called in, and when should you? What does it cost a buyer to bring you in too late?

Peter: The standard adviser's answer is that you're always brought in too late, so that will be my answer as well. It depends heavily on the type of transaction. If you want to make optimal use of W&I, you have to bring it in early. On the buy-side, that is the moment you agree the scope of your due diligence, because can help shape that scope so it delivers the best possible cover under the policy. That is really the ideal moment.

In Europe you also have the sell-side route, where a broker is engaged early to prepare W&I, and the policy then flips to the buyer once bidders appear. That has real advantages. The most important one is that it makes the bids as comparable as possible, because everyone works off the same parameters. Another is that the vendor due diligence scoping already accounts for W&I, so the seller knows in advance which of the buyer's requested warranties will fall under cover, which means less to argue about and lighter, more efficient negotiations.

Sometimes brokers are pulled in very late. The upside is that you can occasionally still rescue a deal that otherwise might derail, precisely because there is so much discussion about the reps and warranties, and the insurance removes friction. But on the real cover of the instrument you simply have less negotiating room, because the time to run a proper negotiation with the insurers is gone.

Does it get more expensive if you're called in late?

Peter: Not necessarily. In principle the cost is no different. Our broker fee is the same either way. It is success-based and paid as commission, a percentage of the premium we receive from the insurers. Some brokers may charge break fees and other fees; my team believes that we should be fully aligned with our clients and hence rely on success.

And who usually brings you the deals?

Peter: It varies. We have a number of frequent M&A players, some large private equity firms, where we hold a kind of preferred-broker relationship. They find us directly and instruct their lawyers to work with us. The same goes for some large corporates that do a lot of M&A. Aon's broader, trusted corporate relationships also play a role. Beyond that it differs by market: in the Dutch market it is very much driven by lawyers; in the Belgian market it is largely via lawyers, and partly family offices and smaller private equity or financial investors reaching out directly.

2 What you're selling to insurers

When you present a deal to insurers, what are you really selling them?

Peter: With W&I, basically it is the risk. The risk of the target: the sector, the location, and the perceived quality of the company. And that perceived quality is justified by the due diligence, or by the absence of findings in it. An underwriter checks the DD reports for findings and looks closely at how well-kept the data room is.

So the first and most important element is perceived risk, driven by sector and location.
The second is the confirmation of that first picture via the diligence performed.

3 Where the broker adds value

Where does your value as a broker mostly show up?

Peter: Good question, and a live one. I have deliberately steered our team towards quality improvement and value-add. A broker could simply pick out a few insurers it already knows, approach them, and place the deal with whoever is cheapest. That might be a valid approach to some. However Aon takes a very different approach. We always approach the whole market. There are brokers who go to six, seven, eight parties they know; we try to reach the entire market, because you never know whether someone happens to have appetite for this particular transaction, even one that on face value is not likely. For W&I in the Benelux that can be close to 30 parties, so it is a sizeable pool.

Then we proactively look for the best cover. We have added clear improvements across the technical and legal clauses of the contract, to the point where the cover under a W&I now puts a buyer in a much better position than could ever be negotiated directly between buyer and seller in the SPA. We deliberately depart from what the SPA says on a range of points, and improve them in the policy in the buyer's favour.

Where W&I basically limited the liability for the Seller in the original set-up; we have pushed the market to creating an optimal cover for the Buyer. That is why smart use of W&I now provides a better outcome for both parties. I guess that is the reason for the frequent use of this instrument in today's M&A market.

4 Diligence quality and the underwriting call

What separates a DD team that walks out with good coverage from one that walks out with a long exclusion list?

Peter: A very fair question. Unintentional unawareness of the consequences of how items are addressed in the reporting often is the key.

First, underwriting calls are rarely done in the Benelux market now, so this varies by market. Here it is mostly handled through written due diligence questions, answered in writing. What a lot of DD advisers do not grasp is the purpose of the question, and the purpose of W&I. Some advisers, when they are not certain, default to treating something as a risk when it need not be one at all. The answer may not be directly available, but it may well have been explained verbally with a high level of comfort.

Where you instead get overly defensive answers from the less experienced diligence advisers, that can land very negatively in the policy, because it leads to exclusions. Some advisers will too easily say: we are not entirely sure, so we advise the client to ask for an indemnity. Firstly this is not helpful for the M&A negotiations and obviously, the moment you ask for an indemnity, that de facto becomes an exclusion under W&I. This consequence is not always seen or understood by the adviser or CF adviser. It is exactly why my team always reviews the answers that have been given, because there is often simple unawareness in how people phrase them.

Do you see advisers accounting for the fact that a deal will fall under W&I?

Peter: Due Diligence finding should clearly mark the risks that are within the target. Therefore various reports should never produce a different finding. It always has to be the correct finding and qualification. What can be filtered out is where, out of convenience, someone says: just make it an indemnity as we lack information. Those are the elements you want to strip out for the purpose of insurance, because they create the wrong perception, and once the wrong perception is there it is hard to negotiate back. We are strongly against anything like creating two versions of a similar due diligence report. That is an absolute no-go. We seldom encounter advisers or clients that want to go that way.

When a lawyer says “we reviewed everything and found no issues,” how does an underwriter read that: confidence, or concern?

Peter: It depends on the lawyer and the scope of the diligence. It is fine if there are no material issues. Materiality is a key determinant here. In fact, if there are no material issues, and there are always a few rough edges, that is very good in itself. It does not create distrust.

Do you look closely at who the lawyer is: tier 1, tier 2, tier 3?

Peter: It may affect the appetite of the insurers. It is not so much name-linked; it is the type of firm.
Are they experienced in M&A? Do they do a lot of deals? Are they known from other transactions? Logically, there is more trust versus a firm that no one has seen before. Bear in mind we see so many transactions, and the insurers see so many across Europe, that they can tell fairly quickly from lawyer’s responses or output whether it makes sense, or whether it is something they do not normally come across.

There is no exclusion for using an unknown lawyer. But the insurer does want comfort that the people who looked at the file know what they are doing. The same applies to companies running their own diligence because they are the experts in it. That is no problem at all.
The insurer simply wants to know that whoever carried it out the investigation is credible, knows the subject, and has produced a report of some standard: clear scoping, what was examined, what materiality was used. Often, when something is very company-specific or sector-specific, you may get a better outcome than by using external advisers.

Are there signals in a DD report that tell you the person knew what they were doing?

Peter: Take technical due diligence. If a target runs a factory with certain machines, and the buyer works with those same type of machines, you might have your own maintenance engineer inspect them and carry out the technical review. That can lead to real possibilities to warrant and cover the quality of those machines under W&I. It is an example of reliance placed on specific expertise.

What's the most common reason a deal ends up with a worse exclusion list than it should?

Peter: You see it above all with unclear scoping. That is an important one, because otherwise we try to catch it earlier in the process. Our team is educated and trained to spot these risks. We improve our client's cover position best while the insurers are still in competition with each other, because then they simply have more to gain by conceding on certain points.

The true answer is that surprises never contribute to a good M&A transaction. Preparation is key. This also counts for W&I. Surprises that appear relatively late following the diligence, or subjects that turn out not to have been examined even though warranties are being requested on them. Those are typically the points where cover is hard to get.

5 AI-generated due diligence

What would an AI-generated DD report need to contain for you to feel comfortable presenting it to insurers without caveats?

Peter: I do not think the fear of AI is all that great. For now, as standard, they would still want to see a manual review of what was done and whether it is correct. And again, it is the scoping up-front that matters, and the materiality thresholds that have been set. Does that make sense for the size of the company, its services, its activities?

Then there are sector-specific points. We keep lists per sector of the specific matters insurers want to see reflected in the diligence, and if those do not come back, it leads to exclusions. Cyber and tech risk sit in there too. It is not strictly legal, but it has specific impact that is bigger in some sectors than others, and that drives particular diligence or insurance requirements.

What effect would an AI-generated DD report have on premiums?

Peter: Pricing is not really driven by how the due diligence has been performed. Diligence tends to drive exclusions and inclusions. Pricing is mostly determined by the key risks of the target, and there I come back to sector, location, quality of management, and the confirmation of all that by the diligence performed.

Do you see AI changing and improving the underwriting process itself, or mainly the way DD is produced?

Peter: I hope it has a significant impact on how diligence is done. Some parties are more advanced than others in applying it. Ultimately I believe well-applied AI may produce better-quality due diligence, and in doing so takes risk out of the M&A market, partly because it becomes easier to include things that today are left out of scope purely for reasons of cost and labour intensity. Some parts are currently dropped, or done on a sample basis rather than an all-inclusive one. With AI it is far easier to broaden that, and you get a better picture, a lower risk profile on the transaction, and therefore more appetite from the insurance market.

The direct pricing impact I would expect to be marginal, but only because the market is already so competitive that current pricing levels are very low.

Will insurers apply AI themselves to go through the data room in depth, or does it stay mostly on the reports advisers deliver?

Peter: AI is definitely being applied. I would expect it to be different from AI models that perform DD. The Insurer’s AI models will be aimed and trained more at cross-referencing the various diligence streams and spotting the odd things that fall out of those cross-references.

6 Claims

When a claim arises, what usually determines whether it goes smoothly or becomes a dispute?

Peter: We have a dedicated claims-team that tracks trends and helps clients in filing the claims in the most effective manner. The hard part with claims is that you quickly are comparing apples with oranges. Every case is unique. So we try to guard our clients against claim rejections by paying very close attention to the legal structure and definitions used. That is why our team consists of experienced ex-lawyers with years of experience drafting contracts and structuring deals. What does it mean to apply seller's knowledge, what is the impact of the applied definition of loss, that sort of things. I believe that a professional broker that deals with sensitive matters, needs to be a true sparring partner to the lawyers that work on the deal.

Due diligence is an important defence mechanism in a claim, because ultimately the question is: did you know about this when you did the transaction, or not? Simply put: if you knew, then it is fair to assume that you priced that risk into the deal. If you know a window is cracked, and you still pay the full price for the car or the house, you cannot complain afterwards that you want to repair the window and claim those costs from someone.

What we increasingly see is that you can scrape certain things, scrape the data room or the diligence, so the insurer has no sight of them and cannot lean on them in its defence. That costs extra, and logically so. The market is really maturing toward wanting to improve deals and offer buyers more certainty, and it is our job to optimise that in line with the client's needs. Based on the vast amount of deals we do, we have proper insights on what is possible and what's not. A great advantage of working as a single team across Europe.

Is there a type of claim buyers typically underestimate or misunderstand?

Peter: Every year we produce a claims report, because we look at where most claims sit, what is paid out, how much is notified and in which areas, so we can feed that data back into improving our negotiation on cover. We do it worldwide, as we work as a global business line within Aon. We compare markets, geographies and draw lessons from that. We just published the new claims report at the start of the summer.

For Northern Europe we are seeing claims rise sharply, and that has to do with the installed base growing: there are simply more W&I policies, so more points at which claims can arise. It is a volume effect. A lot gets notified on tax: were the taxes properly paid or not, was there a general tax indemnity. On material contracts: were there change-of-ownership clauses, or had a contract been terminated without you knowing. And obviously claims related to misclassification in the financial statements. Those are the main areas where claims arise.

7 One piece of advice

If you were advising a PE fund doing their first deal with W&I, what's the one thing you'd tell them that nobody else would?

Peter: My first question would be: sell-side or buy-side? Let us take buy-side. The single most important thing to note is that smart usage of W&I neutralises the part of the reps-and-warranties negotiation that is painful and that potentially derails a deal. And if you apply it a little cleverly, you can end up in a better position than you could ever have negotiated in the SPA in the first place. The costs are currently so low that, financially, it should not even be a discussion whether to use W&I or not.