# The Rise of Synthetic W&I Insurance – A Gamechanger in a Challenging Market?

Challenging market conditions can cause sellers to be reluctant or unable to provide a comprehensive package of warranties. Coupled with the urgency to complete transactions quickly to avoid market volatility, it's no surprise that fully synthetic W&I policies are gaining traction. These policies also offer buyers a way to stand out in a competitive auction and allow private equity firms a 'clean exit'. In this Strelia M&A Series, we explore the concept and role of synthetic W&I insurance, along with the key considerations for parties using this type of insurance.

## What is synthetic W&I insurance?

Synthetic warranties are standalone warranties negotiated directly between the insurer and the buyer—without the seller's involvement—outside of any transaction documentation. These warranties are insured on a "deemed" basis, as if the seller were to provide them normally to the buyer. The insurer covers any financial liability for breaches. Though synthetic warranties, such as tax warranties, and synthetic policy enhancements have been part of traditional W&I policies for years, their use is expanding beyond insolvency sales to broader scenarios.

The gap between the warranties a seller offers and the comfort a buyer seeks dictates whether synthetic policy enhancements or a full set of synthetic warranties are needed. Common synthetic policy enhancements include knowledge scrape, materiality scrape, basis of recovery, and extended limitation periods. Synthetic tax deeds are also increasingly common. Full synthetic warranties are suitable if regulatory environments prevent sellers from offering warranties directly, or if sellers are unwilling or unable to provide them.

## How does synthetic W&I Insurance differ from traditional W&I Insurance?

Traditional W&I policies back the warranties that sellers give in the SPA. The insured and the insurer negotiate the scope, limitations, and the extent to which the warranties in the SPA are covered by the W&I policy. The underwriting typically coincides with negotiating the main transaction documents. In contrast, since synthetic W&I insurance negotiation does not involve the seller at all, this requires an even higher standard of due diligence to offset the lack of direct seller–buyer warranty negotiations. Fully synthetic policies offer narrower warranties at a higher price than traditional W&I policies.

## Considerations

Parties should consider the following if they want to use synthetic W&I insurance:

- **More Due Diligence and Seller Engagement in Disclosure:** The more thorough the due diligence and more seller engagement in the disclosure process, the more feasible the synthetic W&I policy would become. Without seller/management involvement, the quality of the due diligence and coverage scope could be compromised.
- **Knowledge Qualifiers:** Unlike traditional W&I policies, synthetic policies usually lack knowledge qualifiers. But insurers can impose deemed knowledge qualifiers, which complicates a buyer's claim

processes.

- **Subrogation Rights:** Insurers often retain subrogation rights against sellers. This undermines the key benefit that synthetic W&I can offer to sellers, which is to avoid residual liability.
- **Loss Definition:** Synthetic W&I does not involve negotiations with the seller on what constitutes loss. The buyer and the insurer must negotiate and define this clearly in the policy.
- **Cost and Efficiency:** The cost gap between the two types of policies is narrowing. Synthetic policies offer cost and time efficiencies, as extensive SPA negotiations with the seller and time-consuming insurance process can be omitted. However, perceived higher risks can lead to higher excesses and de *minimis* thresholds.

## Conclusion

In conclusion, although fully synthetic W&I policies are not market standard yet, current market conditions and needs are driving them to become increasingly common, thereby changing the M&A game gradually. The considerations discussed can help the parties when embarking on fully synthetic W&I insurance.

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