PARTNERS

DE-STRESSING M&A

How can insurance help distressed M&A transactions?

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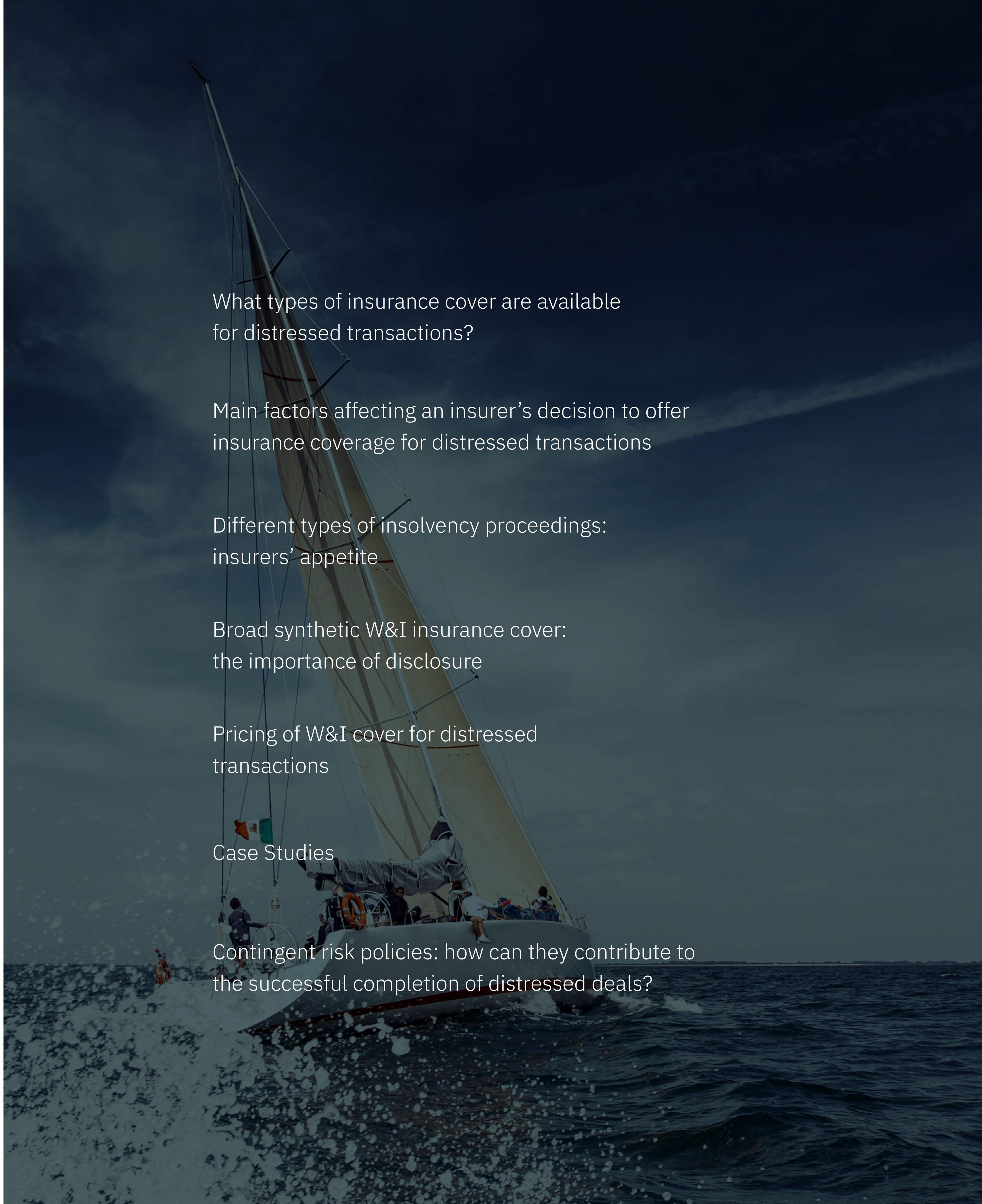
PROVIDING CERTAINTY

INTRODUCTION

Despite economies around the world receiving unprecedented governmental support in this challenging period, the financial repercussions of the pandemic have been looming over the fate of many businesses, forcing some to restructure or suspend their activities and others to close their operations permanently. Whilst it is difficult to make forecasts of the long-term effects of the current circumstances on the M&A world, it is expected that investors and corporates will look for opportunities to purchase distressed businesses to turn them around or integrate them within their existing operations. Recent developments in the M&A market show that, in fact, this trend has already started.

HWF conducted a detailed exercise interviewing seventeen insurers in the market in order to produce a paper that provides real insight and clear and extensive guidance of how warranty and indemnity **(W&I)** insurance and contingent risk insurance policies will be used in distressed transactions, outlining the available solutions as well as necessary requirements to get strategic insurance cover.



1.

What types of insurance cover are available for distressed transactions?

For distressed transactions, three insurance options can be offered:

TRADITIONAL W&I COVER

When can it be used?
When:

- Seller and/or management give warranties under the SPA;
- Adequate disclosure is provided by the sellers on the contents of the warranty suite in the SPA;
- Virtual data room or equivalent data filing system is available for review; and
- Buyer due diligence (external or internal) has been carried out covering the scope of the warranties in the SPA,

as standard for normal M&A transactions.

HWF observations:
Recommended option (where possible): this is mainly because insurers get comfort when someone with requisite knowledge of the business is willing to carry out a robust/fulsome disclosure exercise and stand behind the warranties and, even where the warrantor's liability is £1, they would still have liability for fraud. The result of this comfort is often broader coverage through negotiated warranties.
In certain distressed transactions, for the purpose of achieving such broader cover, the parties might want to consider incentivising management to give warranties and conduct a full disclosure process by offering them some benefits (e.g. sweet equity).

SYNTHETHIC COVER

In a synthetic W&I policy, insurers offer a suite of warranties solely under the policy as if they had been given by the seller and/or management in the transaction documents.
When can it be used?
When the seller, management, or the insolvency practitioner appointed in the insolvency proceeding are not willing to give any warranties in the SPA (or are willing to give only title and capacity warranties or certain operational warranties).
How does it work?
Insurers take the place of the seller/management/insolvency practitioner in providing recourse to the buyer, despite such type of recourse not being included in the transaction documents.
There are several requirements to be satisfied in order to get synthetic cover. These are outlined in more detail in the following sections.

HWF observations:
Synthetic cover is more expensive and is more limited in its scope than traditional W&I cover.

Why is this?
Because:

- The more limited disclosure that is generally available for this type of transaction, compared to fair disclosure that is required of warrantors who know the business;
- The different profile of the risk caused by the absence of any warranties (and therefore recourse for fraud and subrogation rights for an insurer) under the transaction documents; and
- In distressed transactions, the higher risk of moral hazard.

CONTINGENT COVER

When can it be used?

- When a specific risk has been identified (e.g. tax, environmental, litigation, contractual risks etc.);
- To free up balance sheet liabilities/contingent assets releasing much needed cash;
- When advice from a credible advisor on the risk is available (e.g. structure papers or legal opinions);
- When the risk is quantifiable; and
- When the probability of loss is relatively low.

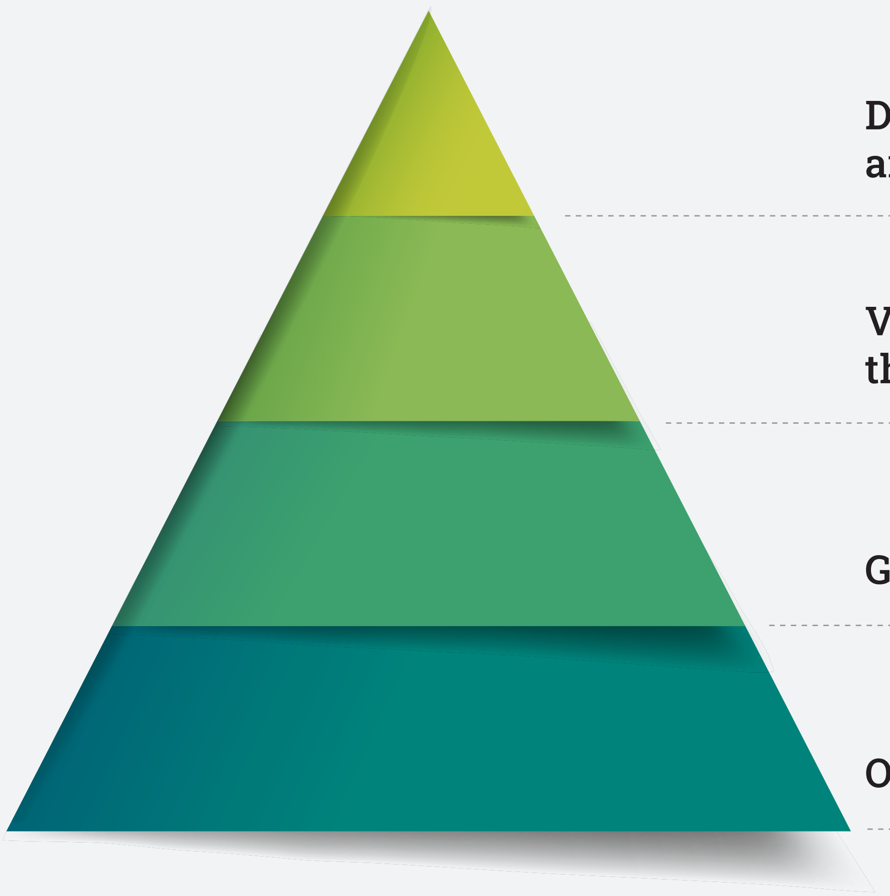
Contingent cover can also be used to provide catastrophe cover for higher risk items above a large policy excess set at the quantum of the most likely outcome.

HWF observations:
Contingent policies offer a substantial benefit and advantage to sellers, insolvency practitioners and buyers willing to explore insurance to resolve the high quantum, low risk items that regularly exist in targets but often result in being added to the list of debt like items or a purchase price reduction.
General characteristics:

- Premium levels: typically, 2-10% of limit insured (HWF have placed contingent policies with premia ranging from as low as 0.5% to as high as 45% of the limit);
- Policy excess often just for defence costs unless catastrophe cover is sought; and
- Policy term: up to 10 years.

2.

Main factors affecting an insurer's decision to offer insurance coverage for distressed transactions



1. Distress driver and deal dynamics

What is the primary driver that has caused the distress? Specifically, insurers will want to understand if the target was viable before the outbreak of COVID-19. In this regard, seeing the target's financials pre-crisis will be of utmost importance for insurers.

If, for example, the target's distress originates from liquidity issues, external debt liabilities or a specific event (e.g. material agreements falling away) post-COVID-19 but the underlying fundamentals underpinning the transaction remain positive, this will increase insurers' appetites for quoting the risk. Conversely, if the distress is deeply-rooted in the overall performance of the business, insurers might be warier about the risk, needing to get comfortable about the increased risk of moral hazard (such as management fraud) and provide narrower cover or, potentially, refuse to offer cover.

In addition, certain deal dynamics will be closely looked at:
- Nature and experience of the buyer (strategic, PE, individual);
- Reasons for the buyer's interest in the acquisition;
- Turnaround plans the buyer has for the acquired target/assets; and
- Deal structure – shares/assets sale.

2. Visibility on the business

Most insurers place great importance on having (i) a clear understanding of who has most visibility on and knowledge of the business and (ii) access to those individuals. In a distressed transaction this might be the directors, management team members or the insolvency practitioner.

3. Geography

Not all insurers have the same geographic appetite. Whilst this applies in general, in the current circumstances geography will play an even more important role in the insurers' decision making processes.

Certain insurers' appetite has remained unaltered. Others have instead adopted a more conservative approach in respect of countries that have been impacted more significantly by the financial repercussions of the pandemic. On the other hand, the recent decrease in the number of M&A transactions together with increasing competition in the market due to new entrants and, especially, Managing General Agents (MGAs), is contributing to some insurers' widening their geographic appetite to covering previously unfavoured jurisdictions.

4. Other factors

Other factors that might be relevant for an insurer when deciding whether to offer insurance coverage for distressed transactions may be:

• The scale of the business. It is less likely that insurers will consider offering cover for £1bn+ distressed deals (particularly if synthetic cover is required). This is mainly due to the likely complexity of targets of that size and the likely multi-national footprint.
• The industry in which the target operates. Similarly to the geographical factor, insurers' appetite varies depending on which sector the target operates in. Transactions in travel and leisure, aviation, retail, and food and drink sectors as well as acquisitions of highly regulated targets will be scrutinised in detail when presented to insurers, with some having flagged their inability to offer cover (especially synthetic cover) for those sectors. Other insurers remain open to the possibility of insuring such transactions, subject to their understanding of the specific nature of the target business' activities and its insolvency/distressed status on a case by case basis;

• Type of cover required (traditional W&I or synthetic);
• Going concern nature of the business; and/or
• Where applicable, type of insolvency proceedings in which the target is involved (see also section 3 "Different types of insolvency proceedings: insurers' appetite).

COVID-19 IMPACT:

Insurers will expect to see adequate due diligence in relation to the impact of COVID-19 on the target and its operations or receive sufficient information to be able to satisfactorily assess such impact themselves through their advisers. In particular, areas such as material contracts, supply chains and employment risks will have to be carefully diligenced under the COVID-19's lens. Generally speaking, all warranties for which cover is required and whose content might be affected by COVID-19 will have to be diligenced bearing in mind the impact of COVID-19. Should such diligence be deemed by the insurers as inadequate, insufficient, or inappropriate, a general COVID-19 exclusion or a narrower COVID-19 exclusion related to certain specific matters might apply.

For each transaction, we can advise on the COVID-19 related diligence requirements.

Thanks to our experience in and knowledge of the W&I insurance market, we can advise on the insurance solutions available for each transaction depending on its specific features.

3.

Different types of insolvency proceedings: insurers' appetite

No formal insolvency proceedings commenced

All insurers agree that the distressed scenario in respect of which they are likely to offer broadest cover is where seller or management are willing to give warranties. Often a formal insolvency process will make it more difficult for insurers and the buyer to obtain visibility on the business as well as receive adequate disclosures. Therefore, distressed targets that have not (yet) entered into formal insolvency proceedings are more easily insurable.

Formal insolvency proceedings commenced

Administration:
If the target is in formal insolvency proceedings, administration is considered by most insurers as the most likely insurable scenario as well as the easiest to provide broad warranty coverage for. This is mainly because of:

• The possibility to turn the target into a going concern that distinguishes a business in administration from a business in liquidation;
• Administration tending to be a more orderly/structured process; and
• Management may often still be involved, motivated and willing to respond effectively to insurers' requests for information, thereby facilitating the W&I underwriting process even if they are not giving warranties.

This said, it is important to note that W&I cover for targets in administration (as well as for receivership and liquidation) will often need to be synthetic and therefore all the requirements to be satisfied for synthetic cover to be provided need to be met (see Section 4 "Broad synthetic W&I insurance cover: the importance of disclosure").

Receivership and Liquidation
Whilst the terminal nature of receivership and liquidation proceedings makes W&I insurance less likely to be sought, depending on the stage of the process and the type of sale (asset sale vs. share sale), insurers may be able to consider offering insurance cover (with asset sales being the most likely insurable scenario).
Certain insurers have expressed preference for voluntary liquidations or administrative receiverships. Others have indicated their ability to offer cover for any type of liquidation or receivership. In case of receivership, insurers will need a clear understanding of who the lender/senior creditor is, the extent of the charge over the target's assets and the dynamics of the recovery control on the target and its other creditors.

What about pre-packs?
Based on their experience, insurers have expressed conflicting opinions on pre-pack administrations processes, their insurability and their appetite to insure targets subject to this type of proceedings. These can be categorised in two groups:

- The insurers in the first group have flagged that the tight timeline that often characterises pre-packs (combined with the materially high rates of pre-packs' failures) rule these transactions out of their appetite; and
- The insurers in the second group have instead argued that the higher level of control and better deal preparation by administrators (sometimes even including full VDD packs) that characterises pre-packs make them an appetible risk to insure.

We can advise on whether a particular pre-pack is insurable based on our knowledge of the W&I market's appetite and requirements.

Insurers' specific requirements for formal insolvency proceedings:

- Clarification required as to the role of any insolvency practitioners involved. Specifically, whether the insolvency practitioner is going to put together a data room or provide information to the buyer and it's advisors so that they can prepare a data room/deal documents package, and whether the insolvency petitioner is able to make any disclosures;
- An understanding of the level of due diligence being conducted on the transaction;
- Confirmation as to whether any warranties will be given or if a synthetic W&I solution will be required; and
- Depending on the situation, certain insurers may require the inclusion in the policy of a general exclusion for losses arising out of or in connection with the insolvency proceedings.

4.

Broad synthetic W&I insurance cover: the importance of disclosure

The scope of insurance coverage under a synthetic W&I policy is directly proportional to the extent and scope of the disclosures (assuming there will be no to fair disclosures by warrantors but a non-reliance population of a VDR and possibly participation in a Q&A process) made to and diligence performed by the buyer in relation to the warranties provided in the policy.

There are however some specific matters to be considered in relation to the level and type of disclosure required to obtain synthetic W&I cover. Given the general lack of involvement of and/or no recourse to the sellers/management in the disclosure process where no warranties are being given under the SPA, insurers will rely on the following elements to assess their final synthetic cover position:

Broad Synthetic Cover

Buyer's diligence

- Buyer's diligence (even if only internally produced) is an obvious source of comfort for insurers. The customary areas of due diligence will be required to be conducted across legal, financial and tax and should correspond to the synthetic warranty package sought. Some insurers may mandate a specific scope of work to be conducted by the buyer.
- Certain insurers may be able to carry out their own due diligence on the deal on the basis of the information provided in the virtual data room.
- Scope of cover, warranties and pricing will all be dictated by this workstream.

One key area to note is valuation: how the target has been valued is of utmost importance for insurers (e.g. liquidation value, book value, etc.).

Adequate VDR population

Insurers will expect the seller/management/trustees/insolvency practitioner to collate as much information as possible in an orderly manner in a virtual data room.

If an insolvency practitioner has been appointed and the seller/management have not populated a virtual data room, the insolvency practitioner should be encouraged to gather the available information on the target and organise it into a virtual data room or equivalent for the purposes of the buyer's insurance.

In either case, the quality of the information provided, how up to date such information is, and the extent to which it aligns with the required warranties will have a direct impact on the scope of the synthetic cover.

Exhaustive Q&A

- The more insurers can engage with the parties involved in the transaction, the broader their final cover is likely to be.

This is particularly important given that there will be no specific disclosure exercise and the Q&A will be the driving force for achieving this synthetically.

Where insurers are not conducting their own due diligence, they will want to be able to ask detailed questions to the buyer and their advisors and receive responses to fill any gaps in their understanding of the business or clarify any grey areas which might be excluded under the policy if not clarified.

In an ideal world access to the insolvency practitioner themselves will greatly assist in the Q&A process.

Policy Differences

The policy will be similar to a standard W&I policy with a few notable differences:

- **Definition of "Loss" in the SPA and policy:** for share deals, given many businesses would be technically of zero or low equity value, the policy would cover loss on an indemnity basis. For asset deals, loss can be defined on a case by case basis to reflect the nature of the transaction.
- **Warranties:** certain insurers are able to provide their own synthetic set of warranties pre-agreed at quote stage (which can be negotiated). Others require the buyer to provide a set that is then negotiated with the insurer as the diligence process unfolds. The former gives more certainty both as to cover and speed of delivery at the outset, whereas the latter may give more flexibility if time permits and information flow is favourable.
- **Limitations:** the policy will contain a standard set of limitations to claims such as matters taken into account in the accounts, buyer voluntary acts, change in law etc.
- **General disclosures:** the policy will contain a schedule of general disclosures which will mirror a market front end disclosure letter containing general disclosure of the virtual data room, matters such as those discoverable on the face of the accounts, from public registers, corporate searches etc.

Can all warranties be covered synthetically?

The short answer is "no". Typically the following types of warranties would not be covered:

1 Note that one insurer interviewed stated they would cover awareness qualified warranties. In order to claim the buyer would need to prove on the balance of probabilities that the management knew about the matter.

Given the probable lack of seller/management input, warranties whose content can be factually ascertained on the basis of the information provided to the insurers by way of disclosures in a virtual data room should be insurable synthetically. For example, with respect to material contracts/permits/licenses/litigation, a warranty that speaks to their validity can only cover those that are disclosed.

We have asked insurers to categorise warranties that are normally included in auction draft SPAs into three groups:

- **Green:** warranties that they consider as likely to be insurable subject to standard diligence;
- **Amber:** warranties whose insurability depends on the existence of specific diligence information; and
- **Red:** warranties that cannot be covered synthetically.

Our findings are summarised in the scheme below. Please note that this categorisation is for guidance purposes only and the warranties within each of the below headings (if insurable) would be fairly tightly drawn and seller friendly which would be assessed by insurers on a case by case basis.

Green warranties	Yellow warranties	Red warranties
• Title to shares (if applicable) • Capacity of sellers • Audited accounts • Assets (excluding sufficiency) • Contracts, licences and permits • Properties • IT/IP (excluding sufficiency) • Litigation • Employees	• Constitution and structure • Management accounts • Tax • Compliance with laws • Financing/debt • Insurance • Data protection • Bribery and corruption	• Related party/seller transactions • Maintenance of records • Financial performance since accounts date • Recoverability of debts • No undisclosed liabilities • Information sweeper

For each transaction, we can advise on:

- Viability of synthetic cover;
- Warranties we expect to be covered synthetically based on the diligence materials available; and
- Diligence requirements we believe insurers would expect to be satisfied to offer synthetic cover.

5.

Pricing of W&I cover for distressed transactions

One of the most frequent questions we have been asked in relation to distressed deals is whether there is any difference in pricing. This section outlines these differences as well as other important points to bear in mind when looking to insure a distressed deal.

NON-DISTRESSED SALE

Factors that impact on pricing

- Industry sector;
- Geographical exposure;
- Scope of the warranties; and
- Others specific to the transaction at issue (e.g. EV, pre-sale restructuring; etc).

Premium

Usually in the range of:

- 0.7-1.2% ROL for northern European countries; and
- 1%-1.4% ROL for CEE/southern European countries.

Underwriting fees

Usually between £15,000 and £30,000 (these may increase in respect of complex transactions or where local advisors have to be used).

DISTRESSED SALE

Factors that impact on pricing

Some of the below are not unique to distressed deals but are exacerbated by the distressed nature of the deal:

- **Type of insolvency:** if no formal insolvency proceedings have commenced, pricing will be less affected;
- **Industry sector:** some business activities which have been/are more exposed to the current economic crisis may be priced higher;
- **Geographical exposure:** the extent of the target activities' exposure to countries that have been/are more affected by the current economic crisis is likely to have an impact on pricing;
- **Financial strength** of the target;
- **Type of cover requested:** synthetic cover tends to be more expensive than traditional W&I cover (see below); and
- **Other factors** such as: i) scope and clarity of information that can be provided to insurers at quoting stage; ii) timing of the deal; iii) (if relevant) the gap between signing and closing; and iv) the scope of the warranties, in case of synthetic warranties where a set of predisposed warranties is presented to insurers at quotation stage (please see our recommendation in this regard in Section 7 overleaf).

Premium

Due to the number of factors affecting the insurers' quotation of distressed risks, it is very difficult to identify a general range of premia applicable. For this reason, when interviewing insurers we provided the hypothetical scenario of a **UK manufacturing business that they would have quoted for 1% ROL in a non-distressed** state and asked them to indicate the premium they would charge to cover the same business in a distressed scenario instead.

- **1.2% up to 2.5% ROL -** with the higher-end pricing applying to the most complex risks (e.g. synthetic cover if the business also has operations in highly exposed jurisdictions); and
- **no increase in ROL** (or the increase might be limited, **for example** 0.1 – 0.2%) where no formal insolvency proceedings are in place, the target is a going concern and the insolvency is caused by mere liquidity issues.

Premium levels may be reduced on a case by case basis by structuring certain tailored solutions **e.g.** by having:

- a higher policy retention and/or higher specific retention in respect of warranty areas considered by the insurers as riskier; and/or
- a higher policy de minimis or higher specific de minimis in respect of certain warranty areas considered by the insurers as riskier.

Please note that these solutions should be explored with the insurers as soon as possible in the W&I process. The more information we have when approaching insurers for terms, the more likely we will be able to negotiate such alternative structures.

Underwriting fees

There may be instances where these may be higher than in non-distressed transactions (e.g. if timing is tight or, especially in case of synthetic cover, where no significant due diligence is available from the buyer and insurers are required to carry out most of it through their advisers).

6.

Case Studies

SALE STRUCTURE AND INDUSTRY	BACKGROUND	INSURANCE SOLUTION
Share sale – Oil & Gas	Wider group in distress. Subsidiary company being sold was a profitable going concern. The appointed administrators were disposing of the target and the buyer required warranties to proceed with the transaction.	**Traditional W&I policy.** Management agreed to give warranties capping their liabilities under the SPA at £1 Policy limit: under £15m Premium: 1.2% ROL
Share sale – Real Estate	Real estate plots being sold by the administrators of a liquidated estate. The plots had been held in administration for four years prior to sale. The administrators had negotiated the warranties and disclosed against them, but mid-way through the deal they refused to give the warranties based on legal advice received. The warranties that had previously been in the SPA were then moved into a synthetic warranty suite under the W&I policy. The transaction would not have proceeded to completion without insurance coverage.	**Synthetic policy.** Policy limit: ca.€5m Premium: 0.85% ROL
Share sale – Retail	Fire sale of a division of a business in distress due to loss of key customers and certain supply-chain issues. No covenant strength on the sell side. Alternative recourse was required by the buyer to proceed with the transaction.	**Traditional W&I policy.** Policy limit: €6m Premium: 2% ROL
Share sale - Healthcare	Parent company in distress. Subsidiary company being sold was a profitable going concern.	**Traditional W&I policy.** Policy limit: $8m Premium: no impact of distressed status on pricing. Priced as a normal deal (minimum premium applied)
Share sale - Services	PE-held company in distress due to underperformance. Sale was hampered by the fact that the two executive directors had recently left the business and been replaced by temporary management who had been instructed to execute the transaction. The buyer was concerned about potential liabilities in the target business, the likely limited disclosure the management team could undertake and the limited covenant strength of management standing behind the warranties.	**Traditional W&I policy.** Policy limit: Undisclosed Premium: Double market rate
Asset sale - Manufacturing	Sale of business in administration (not due to COVID-19) with most of the deal value attributable to branding and other intellectual property. The administrator was only willing to sell on the normal "as is, where is" basis with no warranty protection. The buyer required warranty comfort on the critical intellectual property ownership and other key aspects of the business and assets being acquired to proceed with the transaction. The administrator facilitated the provision of information by the management to the buyer, the management team actively cooperated, and the buyer's advisers were very diligent and resourceful in finding alternative routes to obtaining information and documentation that could not be obtained from the administrators or management.	**Synthetic policy.** Thanks to the key cooperation of the administrator, the management team and the buyer's advisers, the insurer was able to offer synthetic cover on the areas key to the buyer's valuation Policy limit: more than purchase price to cover potentially greater exposures arising from third party claims and tax gross up on claims Premium: in the range of 1.5-2%
Asset sale - Real Estate	Sale of Irish shopping centre property in distress following the financial crisis. Due to its nature, the seller was not authorised to give warranties on its assets and no one else was found to give the warranties. No buyer was willing to buy the assets without warranties being given.	**Synthetic policy.** Policy limit: €30-40m range Premium: 1.2-1.7%

7.

Contingent risk policies: how can they contribute to the successful completion of distressed transactions?

These policies are often used strategically to overcome barriers to deal completions posed by the existence of specific known exposures such as tax, environmental, litigation, employment, regulatory and contractual risks.

In addition, with many companies struggling for cash, contingent insurance policies can be used outside of the M&A context. If a business has large contingent assets or liabilities on its balance sheet, insurance has been used many times to release those provisions and free up cash. The kinds of risks insured vary considerably from tax to IP, environmental to litigation and so on.

We have asked insurers to indicate which types of specific risks they expect to be likely to arise as a consequence of the current crisis. We have compiled the following ranking on the basis of their responses:

1. Tax and debt related risks;
2. Clearances and regulatory permissions related risks;
3. Exposures related to legitimacy of subsidies or loans received from governments during the pandemic (**e.g.** wage-subsidy programmes, loan schemes etc.);
4. Intellectual property risks such as patent infringement exposures;
5. Litigation risks, especially in relation to employment matters or contractual liabilities; and
6. Environmental risks.

We can advise on the appropriateness and viability of using any contingent risk policy on a case by case basis. We can advise on all areas but have provided some more information on contingent tax and environmental insurance below.

Tax contingent risk policies

Specific tax insurance is a highly flexible tool commonly used to de-risk historical tax issues identified in a proposed target during the acquisition due diligence process, potential tax issues that could crystallise as part of the transaction and/or ongoing operational tax issues for the holding structure or underlying business. It covers any tax, interest and penalties arising in the event of a successful challenge by a tax authority, together with any costs incurred in defending the challenge and any gross-up risk.

In a distressed context, there are **several heightened areas of tax risk**, for example:

- **Release of debt/debt for equity swaps:** often distressed assets have undergone a restructuring of their internal or external financing which involves a waiver or forgiveness of all or part of the debt (sometimes in exchange for an issue of shares). Whilst most countries have debt forgiveness rules that can treat such restructurings as non-taxable, there is often uncertainty around the application of these rules which potentially creates risk for a buyer;
- **Acquisition of debt at a discount:** similar to the point above, in certain distressed transactions the existing debt is acquired at a discount from its par value which can cause risks due to the complexity of the tax rules in some circumstances;
- **Management equity refreshes:** in a distressed scenario, the value break often occurs in the debt layers and, therefore, the shares held by the management team can be effectively worthless. Therefore, it is relatively common for the management equity plan to be refreshed to provide some value to the management team. Depending on how it is structured, the refresh can create tax issues (**e.g.** robustness of valuation) that a buyer may struggle to get comfortable with; and
- **Historical re-organisations:** for more complex target groups, a pre-sale re-organisation may have occurred e.g. for the purposes of separating profitable from distressed operations, transferring certain assets into a newco for sale etc. Such re-organisations can be complex from a tax perspective and can create a risk that capital gains taxes, transfer taxes (**e.g.** stamp duty, VAT) and/or corporation taxes could arise.

Specific tax insurance could also be of value to mitigate risks arising for insolvency practitioners due to their potential personal liability if a company is liquidated with unresolved tax liabilities and issues arising from the upcoming reinstatement of Crown Preference allowing HMRC to rank ahead of floating charge holders for unpaid PAYE and VAT liabilities.
We have seen numerous **examples of tax insurance** being used to remove risk items/create value in distressed transactions, including:

- The risk of corporation tax arising on the partial debt release for an underwater UK real estate asset prior to its enforced sale for breaking banking covenants;
- The risk that SDLT was triggered on the reorganisation of a real estate portfolio enforced by the lending bank as part of a wider group re-financing;
- The risk that the transfer of trade and assets on separation of a distressed operation from the remaining profitable part of the business prior to its sale would not qualify as a transfer of a going concern (and therefore be subject to VAT); and
- The risk that employment taxes would apply to the re-setting of a distressed group's management equity plan to allow for a new management team to be incentivised to turn-around the business.

Environmental risks and environmental policies

Where businesses need to sell, or where buyers are acquiring distressed assets, the ability to ring fence environmental exposures via insurance should be given due consideration. For example, we are seeing cash buyers buying up brownfield sites from distressed property portfolios but using Environmental Impairment Liabilities ("EIL") insurance to mitigate risks which may arise when they come to develop or sell those properties. Equally EIL insurers are able to cover known liabilities on "dirty" sites by syndicating the risk and building innovative programmes of insurance to take liabilities off balance sheets. As well as the manufacturing, energy, industrial, chemical, mining or waste management sectors, environmental risks may also exist in other "low risk" sectors, for example, real estate, renewables and hospitality transactions. The precedents below show how EIL policies have been strategically used on distressed transactions/liquidations.

Precedents from the market:

SALE STRUCTURE AND INDUSTRY	BACKGROUND	INSURANCE SOLUTION
Share sale (distressed) – Renewable Energy (Biofuel)	Whilst the insolvency practitioner was comfortable that it was protected from environmental liabilities under UK environmental law, it was concerned about the potential liability in surrendering the environmental permit for the site. A potential risk existed that the insolvency practitioner could be deemed to have an active role in the site and direct knowledge of the environmental condition of the site. An EIL policy was purchased by the insolvency practitioner, with the policy premium being funded out of the proceeds of the insolvency.	**Standard EIL policy.** Policy limit: £1m Policy term: 5 years Premium: £25,000
Fund liquidation – retail property	When buying the property, the Jersey vehicle had given the sellers an unlimited indemnity in relation to future environmental liabilities. The parties were going to appoint a liquidator to collapse the structure post sale and needed insurance protection in order to allow the liquidator to distribute the sale proceeds in full. An insurance policy was issued to the Jersey company, the individual directors, and the liquidator (together with, his heirs, estates and successors) that enabled the liquidation and distribution of sale proceeds without deduction.	**Contingent EIL policy** Policy limit: £1m Policy term: 7 years Premium: undisclosed
Asset sale – Coal mining	The insured owned a stake in a JV holding a mining company. When winding up the JV there was the possibility that regulators could force the Insured (as a result of it being one of the former shareholders in the mining business) to pay for clean-up costs pursuant to four specific pieces of environmental legislation. The procurement of EIL cover enabled successful winding up.	**EIL policy including cover for known risk.** Policy limit: £10m Policy term: 10 years Premium: £330,000

EIL policies – Main features overview

- Cover for clean-up, remediation, property damages and bodily injury costs. Scope of cover extends to changes in law, legal defence costs and business interruption costs;
- No relationship with the SPA. Trigger is the occurrence of the pollution related event/s covered by the policy;
- Both historical and future liabilities covered;
- Cover for both known and unknown risks;
- Cover for typically 5 to 10 years although cover can be offered for up to 15 years in some case;
- Premium varies as with W&I depending on risk profile and limit but is normally in the range of £20k to £300k; and
- No de minimis and low excess levels usually matching the materiality threshold applied in the due diligence.

Should you have any questions or wish to receive more information about W&I insurance for distressed transactions, please do not hesitate to contact us.

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