HWF PARTNERS

W&I to facilitate distressed M&A

by Philipp Heer

The Covid-19 pandemic has forced the world into a lock-down. It has started to impact the global economy significantly and in unthinkable ways. While the ultimate consequences remain to be seen, it will undoubtedly affect the M&A market significantly at least in the short and medium term. The past decade has seen an ever-increasing deal flow fuelled by the pressure to invest unutilized capital and cheap liquidity. This has shifted negotiation power for the benefit of sellers.

The M&A insurance marketplace, whilst now established, is still relatively young and has developed alongside these market dynamics. Consequently, it has created processes and products which have shifted the risk apportionment in M&A transactions. In particular, it has given rise to a number of tools to offset the seller-friendly market of the past years. However, in the booming economy since the financial crisis only a relatively limited number of distressed M&A deals have used W&I or tax liability insurance products.

In order to address the challenges deal-makers will face in the forthcoming months, M&A insurance solutions (principally W&I insurance) will again have to prove their resilience and adaptability in order to adjust to the specific challenges faced in distressed M&A scenarios. We have outlined below how M&A insurance can be used for these transactions to smoothen the process for both parties, optimize protection for buyers, and maximize the purchase price for sellers.

Process

1. Information flow, access, and availability

Generally, W&I insurance relies on the quality of the process conducted by the parties, i.e. it requires that (i) the information provided by the seller is comprehensive, accurate, and up to date; (ii) the quality of diligence undertaken by the buyer captures the risks of the target adequately; and (iii) the disclosure by the seller against warranties is fulsome and diligent. However, in a situation where sellers will not receive proceeds from the transaction, their motivation to engage in a market-standard, high-quality process is naturally limited. Where sellers are forced into some form of restructuring such as a debt for equity swap, or a target has moved into insolvency proceedings, the administrator might simply not have access to all information relevant in order to allow an adequate process.

Even in a functioning market the question of whether there is adequate motivation to carry out a fulsome disclosure exercise poses a challenge to the insurance workstream; however, it should be fair to assume that insurers will expect that certain risk areas are scrutinized even more heavily in the aftermath of Covid-19, e.g. contracts, supply-chains, compliance with health and safety regulations, no material changes after accounts date, insurance, etc.

Information-gathering and high-quality buy-side diligence processes will be key for market participants in order to obtain meaningful cover from the insurance markets. HWF can assist at an early stage of the transaction to assist in specific information requests or the compilation of data to ensure that buyers conduct the diligence expected from insurers.

2. Warranties & Disclosure

Similar to the motivation (or lack thereof) to run an adequate process, the motivation of sellers to provide meaningful warranties diminishes where the seller doesn't receive any cash-effective upside from the transaction. In addition, where sellers are unwilling to run a diligent process, their ability to give certain warranties falls away and they would incur a significant liability risk if warranties are given without adequately reviewing information. Once insolvency proceedings have been opened, the administrator, generally, is reluctant to give warranties at all to avoid personal liability or a liability against the estate. The same considerations affect the disclosure process in distressed situations: disclosure carries an inherent liability risk for the disclosing party. Naturally, where the proceeds of a transaction trend towards zero, sellers will be hesitant to incur potential future obligations.

Buyers will likely put specific focus on closing warranties in order to capture as many negative impacts of Covid-19 as possible; however, in order to extend cover to include repeated warranties insurers expect a bring-down disclosure and will likely look for a higher level of comfort in relation to the disclosure process undertaken. Where it was possible to obtain so-called new-breach cover for repeated warranties, this will likely no longer be available in the current situation.

Lastly, the insurance market will attempt to include specific Covid-19 exclusions into policies in order to avoid parties dealing with the financial impact of the crisis by way of warranty breaches rather than purchase price adjustments. Buyers assisted by their lawyers and broker will have to review any such Covid-19 exclusions very carefully to avoid gaps in cover. Accepting certain insurer-imposed limitations now seems reasonable as the impact of Covid-19 on current deals relates mainly to future events anyway and as such uninsurable. However, this creates the potential for a new, broad-based general exclusion parties will struggle with in future years when the impact is purely historical.

In recent distressed transactions, parties were regularly able to agree on a limited set of warranties which, nonetheless, captured the essence of the target business. Often, sellers are willing to provide a manageable number of warranties, and buyers are able to distill their warranty catalogues down to the required minimum without incurring unreasonable risk.

Where the complexity of the undertaking requires a broad range of warranties and the sellers are unwilling or unable to give them, stand-alone management warranty deeds have become commonplace. While this instrument has a longer history in the British market, it is rather novel in Continental European transactions. In situations where the management rolls over or stays on under new ownership, they can often be incentivized to provide a broad range of warranties and are – as a result of their operational involvement – best suited to act as warrantors.

Synthetic solutions – A growing market

HWF has placed a number of policies where an insurer has offered all or some of the warranties synthetically under the policy; however, it is of utmost importance to properly manage expectations and work closely with a broker from the very beginning in order to define the parameters under which certain warranties may be given synthetically. Generally, insurers will look to (i) obtain ultimate comfort in relation to the quality of the process undertaken, (ii) exert influence on the compilation of the data room and the information gathering through due diligence requests, (iii) influence the Q&A process in order to force a quasi-disclosure from the sellers, and (iv) limit any synthetic cover to warranties against which generally no disclosure is made, e.g. accounts warranties on the basis of audited accounts and high-quality financial due diligence.

Subsidies/state-aid

As an immediate measure to soften the impact of the global shut-down of the economy, national governments have granted various tax relief measures and other subsidy programs. Such measures are naturally designed to subsidize businesses "directly and not insignificantly" affected by the pandemic. Accordingly, tax authorities in future audits will scrutinize if a business has applied for and received tax relief measures it was not entitled to, and potentially demand repayments. This will impact cover for tax indemnities in transactions which are closing after such tax benefits are received. Insurers will require that the requirements for the respective relief or subsidy are diligenced in detail to avoid claw-back risks.

Where a governmental relief scheme includes tax deferral options, it is important to ensure during the diligence that these companies are carrying appropriate provisions in respect of these deferred tax accruals and that their tax creditor position is sufficiently robust.

Avoidance of Transactions (*Anfechtungsgesetz*)

Distressed transaction often further pose the risk that the seller subsequently falls into insolvency, and the sale of the target is subject to a challenge for avoidance of the sale. Generally, a challenge will be successful if the sale did not occur on arm's length terms.

Where a valuation from a reputable third party, independent advisor exists, the insurance market is – subject to reasonable retentions – able to specifically insure that a sale is avoided on this basis and, thus, provide comfort to buyers who expect their seller to commence insolvency proceedings after the transaction.

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