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Warranty and Indemnity insurance for social care sector M&A

Social care in the M&A market

Transactions in the social care sector (including nursing homes, domiciliary care and specialist care businesses) have been and continue to be active in the M&A market. Despite challenges faced in light of the COVID-19 pandemic which has had a significant impact on social care businesses as a result of their nature and key demographics, many buyers and sellers remain positive and eager to transact and we have been involved in the progression and successful completion of a number of sales of social care businesses during the periods of lockdown.

Recently, we have received more enquiries from investors and operators in the sector preparing themselves for acquisitions, in particular with a view to targeting:

- distressed businesses in the near future as the economic impact of the pandemic begins to take its toll; or
- family owned businesses without a viable internal succession plan.

A number of interested parties have sights on multiple acquisitions over a relatively short period of time, selecting targets based on a set of criteria with the intention of consolidating the businesses before exiting for a profit, either by way of a corporate sale or listing.

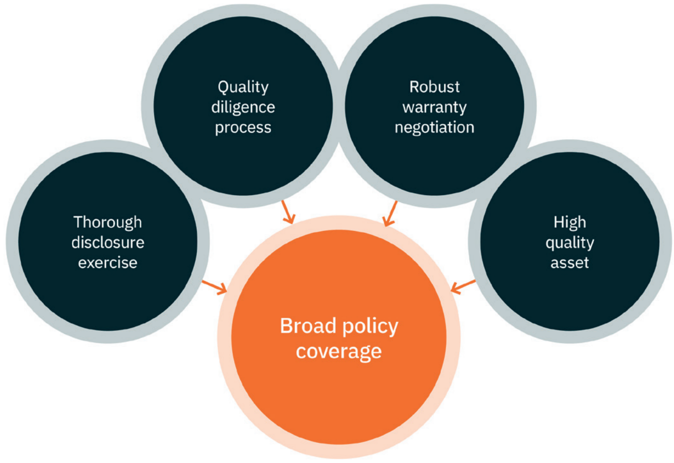
Whether buying or selling a single or multiple social care businesses, M&A insurance can be an extremely useful tool in overcoming potential deal roadblocks and increasing efficiency (particularly in the context of accelerated sales) and can make a bidder's offer more attractive where there is strong competition for the asset on sale.

W&I overview

Warranty and Indemnity ("W&I") insurance can be obtained either by the buyer (buy-side) or the seller (sell-side) in a transaction to protect either the buyer or the seller from unknown or unforeseen liabilities resulting in financial loss from a breach by the seller of the warranties (and/or indemnities) contained in the sale agreement. The majority of policies placed are buy-side, so for the purposes of this article, we have assumed a buy-side policy is being considered.

In a typical transaction, the buyer will seek broad warranties from the seller to protect against losses which the target (or the buyer) may suffer as a result of a breach of those warranties. A seller on the other hand, will seek to limit the warranties it gives to the buyer. W&I insurance is a key tool used to bridge this gap. From the buyer's perspective, a buy-side W&I insurance policy will, subject (usually) to a policy excess, serve as the direct (and in many cases only) indemnity for breach of the warranties given by the seller.

Key Drivers	
For Seller	For Buyer
Heading to or in distress	Distress
Carve out of non-core assets	Bid enhancement
Seller clean exit	Seller solvency/covenant strength
Pre-emptively wrapping up known matters	Protect roll-over management team
Bridging expectation gaps	Satisfy requirements of lenders or internal risk management
Removing high liability caps	Buying from liquidators/ trustees



The key determinants as to what insurers will look for within a deal process are set out above. So long as the insurer is satisfied that the process has been:

- full and thorough;
- conducted in a manner in which is comparable to market norms; and
- carried out as would be expected in the absence of insurance,

then a broad cover position should be achieved and any misrepresentation or non-disclosure that results in a breach of a warranty would be insured under the policy.

All policies contain standard exclusions such as known matters, forward looking statements, pollution, transfer pricing, loss of tax assets and purchase price adjustments. Given the activities that targets undertake within the social care sector, certain other general exclusions may apply. Please note these exclusions would only be included to the extent they are relevant:

- Specific indemnities (please see below for contingent risk policies that insurers can provide for these identified risks);
- Negligence, services liabilities (including bodily injury liabilities) and other professional indemnity type matters that an insurer would expect the Target to have separate insurance policies for;
- Pension underfunding; and
- Condition of property/assets.

Insurers will have assumed that the buyer has undertaken a thorough due diligence process for all jurisdictions in which the target operates and covering the areas which the business has material exposures. In this sector insurers would expect at a minimum legal, financial and tax due diligence in the case of share sales. The following are examples of certain key risk areas which insurers would expect to be reviewed (which we discuss in more detail in sections 2 and 5 below):

- Compliance with GDPR;
- TUPE;
- Employees misclassification;
- Sleep-in; and
- CQC or other regulatory compliance.

If external advisors have not been used then this should be flagged with insurers from the outset so they can assess the robustness of the due diligence process to confirm if the terms indicated stand. If the due diligence process has been conducted by the buyer internally, the insurer will want comfort that it has been carried out by suitably qualified individuals.

Contingent Risk Policies

One of the largest areas of growth in the M&A insurance market has been the use of contingent risk policies where cover is required for any known matters or specific indemnities. These policies are often used strategically to overcome barriers to deal completions posed by the existence of specific known exposures.

The key function of contingent risk insurance is to remove the financial uncertainty of an adverse determination or crystallisation of the relevant liability. Generally speaking, for a risk to be insurable the following criteria are necessary:

- advice from a credible advisor - this can include due diligence reports, structure papers or legal opinions;
- the risk must be quantifiable; and
- the probability of loss needs to be relatively low.

Due to the higher risk nature of covering an identified potential exposure, if it can be wrapped up into the W&I policy it is likely to attract an additional premium. Alternatively, there may be a separate contingent risk policy, which deals solely with the identified issue.

Examples of contingent risk policies in social care transactions	
Care home transactions present a number of risks that are specific to this sector, and which often become hurdles to deal completions and lead to price negotiations. The insurance market has placed a number of contingent risk policies in this space that have solved these problems for buyers and sellers. Most notably in respect of the following liabilities:	
Sleep-in:	While the Court of Appeal has refused appeal in the case of Royal Mencap Society-v-Tomlinson-Blake giving some comfort to providers, this case was fact specific and so it is possible that wage liabilities for sleep in carers could still be debated as a material risk going forward. Instead of seeking indemnities buyers can avail themselves of insurance cover.

Examples of contingent risk policies in social care transactions	
TUPE risk:	Since a number of deals in this sector are either asset deals or carve-outs from larger groups (particularly in distressed scenarios), there is often a need to consider whether TUPE might apply and if it does what the potential buy-side/target risk might be. In the absence of an indemnity from reluctant sellers insurance can remove this risk.
Employee v contractor risk:	Many businesses in the care home industry have locum staff and workers rather than strict employees. Depending on the contractual arrangements in place the risk of businesses being required to account for PAYE and NICs for these "employees" often arises. Insurance can de-risk this issue for buyers or can help sellers negotiate out an indemnity being requested.

Aggregation and the benefits of this approach

As noted above, W&I offers a number of benefits to both buyers and sellers, and particularly where multiple transactions are envisaged.

Auctions:

- **Sellers:** Sellers looking to dispose of assets using a marketing/auction process might consider lining up a W&I insurance policy during the preparatory phase. Initiating the W&I process and building the insurance into the legal documentation with the form of policy attached and issued with the marketing materials ensures bidders are clear on the position of the sellers up front. This is particularly beneficial if the seller has a number of businesses it wants to sell from across its portfolio as there is potential for "standard form" policies and sale documents to be rolled out across the transactions.
- **Buyers:** If bidding on a target business which does not anticipate the use of an insurance solution as part of the sale package, a bidder might include in its offer document a statement that it is willing to take out a W&I policy and cap the seller's liability for warranty claims at £1. Where competitive stakes are high, as is often the case for quality assets, this can be an attractive proposition for a seller as it provides a clean break. This may therefore give the bidder a competitive edge, especially where the seller is a family/individual and/or requires an accelerated exit.
- If a buyer is intending to purchase multiple businesses, a pipeline of policies is likely to result in more competitive terms from insurers. Future deals would also benefit from the efficiencies of having an agreed W&I policy and processes with a W&I insurer.

Efficiency:

- **Less time spent negotiating:** A W&I policy which allows a seller's liability to be capped at £1 can significantly reduce the level of dialogue and negotiation around warranty cover and the associated seller limitations on liability. These areas are often the most contentious in the sale and purchase agreement and can become quite an emotive issue for sellers who could otherwise be liable in relation to any breaches of warranty. As well as the time-saving benefit, which can be vital to the success of an accelerated sale, this can also result in less legal costs being incurred.
- **Underwriting process:** Putting in place a W&I policy would not dispense with the need to carry out a thorough due diligence exercise or the seller's obligations to carry out a proper disclosure exercise. It is always important for a seller to understand that they need to do that. However, portfolio sellers or aggregating buyers who choose to offer W&I across their transactions would benefit from getting a potential insurer on board early. This is likely to provide cost and efficiency benefits over the course of the acquisition as the insurer becomes more familiar with the buyer's approach towards due diligence and stance on the standard policy documentation.

Summary of key benefits	
Auctions sales:	• Seller can initiate the W&I process and build it into the legal documentation being presented to bidders at the outset. • If not already considered by the sellers, building W&I into their bid can provide potential buyers with a competitive edge, particularly when offering a £1 cap on warranty claims.
Efficiency:	• Less focus on warranty cover and limitations on liability. • Familiarity with expectations and approach taken by insurer and buyer can avoid revisiting the same points on each transaction.

Insurer appetite

The M&A insurance market continues to prove attractive for insurers, resulting in a number of new entrants in the last year. In total there are now over 24 insurers that specialise in writing W&I business, and over 10 that have specific tax risk teams. Not all insurers have the same appetite in terms of sector, deal size and jurisdiction, however we are seeing an increase in those willing to take on more risk. The recent sharp 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 appetite including both a downward shift in pricing and broadening of cover in the care sector. The insurance market has placed many policies in the sector ranging from the sales of portfolios, whether they are being split up and sold off individually or as one large group, through to small single asset deals.

Portfolios and aggregation

As outlined in section 3, there are a number of benefits for buyers and sellers when an aggregation approach is taken in respect of the W&I. In addition to those benefits, it should also be borne in mind that most insurers have a minimum premium which may make insuring some individual care home sales disproportionately expensive.

Certain insurers are now willing to quote individual transactions (on the basis the portfolio is being sold off in a number of transactions) at below minimum premium on the premise that they are the chosen insurer for each and every transaction as and when they go ahead. This approach is risky in some insurers' eyes as there may only be a few transactions that go ahead, however certain insurers see past this. These insurers understand that in theory, each transaction should become more efficient as the insurer becomes comfortable with either the seller or buyer's (depending on the party that is consistent on each of the transactions) approach to the transaction and how the process is run.

Large transactions

It will come as no surprise that there are certain insurers who have larger limits that they are able to put down, and so have an increased appetite for larger and more complex transactions. In the social care sector, this can span to businesses with an international presence and to a variety of different specialist care homes and would be relevant for businesses with an enterprise value of over £200m.

As well as individual insurers being able to put up large limits, the insurance market has also placed a number of insurance programmes (i.e. syndicated insurance with multiple insurers) for transactions that require a large insurance limit. The maximum limit available for any single transaction, in theory, is excess of £1 billion, using all capacity from the insurance market as part of the programme. In these instances, the transaction is underwritten by the primary insurer who will undertake the underwriting review and policy negotiation. Excess insurance capacity is then sourced and structured to sit above the primary insurer up to the required policy limit.

Smaller transactions

There are now a number of insurers who have chosen to focus on SME deals (enterprise values of less than £25m) which has resulted in a reduction of minimum premiums, which can now be as low as £20,000 plus taxes and fees. These entrants have opened up the M&A insurance market for smaller deals that otherwise would have been priced out. However, smaller deals often present risks to insurers that may not exist on larger transactions as a result of the approach taken towards due diligence. While there will inevitably be cost sensitivities on smaller transactions, insurers will still require the parties to conduct a thorough and appropriate due diligence process and a comprehensive disclosure exercise with a well organised data room that the insurer will need to access.

Due diligence scope

Whilst W&I insurance may seem to offer a quick fix to remove transaction risks on both sides, it does not remove the requirement for a proper due diligence exercise to be undertaken on the buyer side and disclosure exercise on the seller side.

Before underwriting any W&I insurance policy an insurer will need to be satisfied that all negotiations are conducted between the buyer and the seller at arms' length and as though the transaction

did not involve W&I insurance. The insurer will expect to see evidence that:

- the warranties included in the SPA have been negotiated on arm's length terms (to the extent reasonable) as though the transaction does not involve a W&I policy and that they are reasonably market standard;
- a proper disclosure exercise has been carried out;
- the buyer has undertaken due diligence that is customary and standard for a transaction of the nature of the deal in questions; and
- enquiries have been raised by the buyer and answered by the seller.

Key areas of a social care business which an insurer will expect to see covered by the due diligence process include:

- the current provider's CQC/CIW/CI registration (depending on the jurisdiction of the relevant home);
- employment;
- property; and
- material contracts (e.g. contracts with the local authority).

We would suggest that a buyer considers engaging lawyers with specialists in these key areas to carry out the due diligence process on its behalf and who can work with the insurer to provide sufficient comfort regarding the thoroughness of the exercise as quickly as possible.

The quality of the due diligence exercise will be tested by the insurer on an underwriting call (or through underwriting questions) and that insurer may be unwilling to underwrite the policy if insufficient comfort is given in this regard.

COVID-19 impact

Key points **As a result of the pandemic, we can expect to see more:**
• Distressed sales
• Reliance on synthetic insurance
• Scrutiny of due diligence and expectations of due diligence in areas of the business typically affected

Distressed deals: as a result of the COVID-19 crisis, a number of businesses will unfortunately be at risk of failure whilst others will see opportunities where there is distress in the market. Whilst the healthcare sector as a whole has remained relatively resilient compared to other industries, some social care businesses are likely to face financial difficulties resulting from (or exacerbated by) losses or additional expenditure relating to the pandemic, e.g.:

- additional PPE expenditure;
- decreased occupancy;
- expiration or termination of local authority "block contracts" put in place during the initial lockdown;
- anticipated investments/sales/funding aborted or postponed as a result of investors/acquirers/lenders "tightening their belts" in the Spring/Summer.

We can therefore expect to see (and have already started seeing) prospective buyers getting themselves into position for when the right opportunity comes along, particularly in relation to domiciliary and specialist care businesses.

If a formal insolvency process has been initiated, the buyer will be given no warranty protection to rely on. Even if the situation has not got that far, if the seller is in financial distress, any warranties given by it are effectively worthless without a guarantor with sufficient covenant strength. In these circumstance W&I insurance could provide the buyer with protection against unforeseen losses it would not otherwise get.

Synthetic insurance:

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.

These types of policies are typically used when the seller, management, or the insolvency practitioner appointed in the insolvency proceeding are not willing or able to give any warranties in the SPA (or are willing to give only title and capacity warranties or certain operational warranties).

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.

The scope of insurance coverage under a synthetic W&I policy is directly proportional to the extent and scope of the information provided by the seller(s) (assuming there will be no disclosures as no warranties given/no warrantors but a non-reliance population of a virtual data room and possibly participation in a Q&A process) 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:

- **Buyer's DD:** Buyer's diligence (even if 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 insist on a specific scope of work to be satisfied. 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 data room 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 the cover 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 by the insurer will greatly assist in the Q&A process.

Heavier scrutiny/DD requirements:

Against the background of the COVID-19 crisis and its global impact on markets and business operations, W&I insurers are now expecting buyers to carry out specific DD on all areas which might be, or have been affected by the pandemic (in addition to the traditional DD requirements) and which are covered by the warranties in the SPA. In the social care sector, the following areas should be carefully considered by buyers and their advisors:

Employment

- **Guidance and implementation:** has the target considered and implemented the directions contained in international and national guidance issued on employment matters as a consequence of the COVID-19 outbreak (where applicable) including by amending its internal policies and procedures (e.g. "Getting your workplace ready for COVID-19" issued by the World Health Organization; "COVID-19: guidance for employees, employers and businesses" issued by the UK Government; "Coronavirus (COVID-19): right to work checks" issued by the UK Government etc.)?
- **Health and safety:** what measures have been taken to guarantee the health and safety of the target's employees and were adequate procedures in place? In addition to this, have vulnerable employees been adequately protected?

Material contracts

- **Contracts review:** have all material contracts been adequately reviewed to assess if the circumstances created by Covid 19 have (a) affected the supplier/customer relationship or the performance of contractual obligations; or (b) triggered any specific rights/obligations e.g. termination rights, limits on the parties' liabilities, relevant costs or change in law provisions?
- **Commercial considerations and renegotiations:** has there been any disruption to supply chains and were the relevant risks or liabilities identified? In addition, have any commercial terms in material contracts been renegotiated since the outbreak of the crisis (e.g. performance terms)? If so, has the buyer / their advisors assessed whether any breach of the old terms has occurred?

Valuation and consideration

Understanding the valuation method applied by the buyer in determining the purchase price of the target is of utmost importance for W&I insurers. In a claim scenario, this will assist in determining the amount of loss recoverable under the policy. Due to the impact of COVID-19, underwriters will seek more details on what valuation method was used, what assumptions were made when using the method, and how (if at all) the impact of COVID-19 was factored into the valuation. It will be important to show that consideration has been given to:

- the size of the COVID-19 impact and length of time such impact has had and is expected to have on the target (this is likely to depend on the nature of the relevant business, e.g. care home for the elderly, domiciliary care or specialist care);
- the treatment of debts and how easily these will be able to be turned into cash;
- what cost savings and deferrals could be made; and
- what help the Government is providing to the target.

Regardless of any mitigating factors, there is likely to be a shift in balance in the M&A market with buyers being able to acquire businesses for less than they would have prior to the pandemic. While this should be a positive for insurers, where valuations go down significantly insurers could find themselves insuring a large business from an assets perspective for a low value and find themselves with greater exposure.

Tax and finance:

- **Impact on finance and solvency:** has the diligence covered the impact of COVID-19 on the target from a financial performance point of view? Has any solvency or other material risk been identified? Have applicable Government subsidies/ incentives received by the target and all relevant obligations (e.g. under local authority "block contracts", Infection Control Grants, the COVID-19 Corporate Financing Facility (CCFF), the Coronavirus Business Interruption Loan Scheme (CBILS), or the HMRC Time To Pay Scheme) been taken into account when assessing the target's financial situation?
- **Financial arrangements review:** have all financing and banking arrangements of the target been reviewed to assess whether the COVID-19 crisis has had an impact on those? Considering, for example:
  - any termination events/rights triggered under the arrangement;
  - any market disruption clauses in the arrangement;
  - any breach of the arrangement terms or covenants identified and, if so, the materiality of such breach; and
  - whether the risk of cross-default was assessed.

Overview of the process

Planning

Involving a broker early in the transaction is important to help to inform the sales agreement and due diligence process and provide insight into what potential insurers will be looking for. This is particularly useful when on the sell-side as you can factor these into the sales process and early draft of the sales agreement saving time further into the transaction.

The broker will want to see copies of any marketing materials e.g. information memorandum as well as copies of any diligence reports and the transaction documents.

Broker Marketing and Engagement

The broker will go to market and obtain quotes from a range of insurers. They will then typically present the results in the form of a report with a recommendation – this recommendation is usually based on the broker's view on the overall offer provided by the insurer e.g. price, excess, coverage and ability to execute the relevant transaction. If the market is particularly competitive, the broker may also feed back to the insurers after this initial round to see if there's any scope for movement in their quotes.

Once an insurer has been selected, the buyer will be expected to enter into an engagement letter with the broker and an expense agreement with the insurer. The primary purpose of these letters is to deal with timing and conditionality (if any) of the payment of fees.

Underwriting and Due Diligence

To issue the insurance policy the insurer will need to carry out an underwriting review in which they will examine the due diligence process that has been run, review the sales documentation and get comfortable with the risk that they will be underwriting.

Insurers will usually then issue two sets of underwriting questions. The first set are generic in nature and will focus on the background to the transaction and how the process has been run. The second set will include deal specific questions focussed on specific matters arising from the DD review.

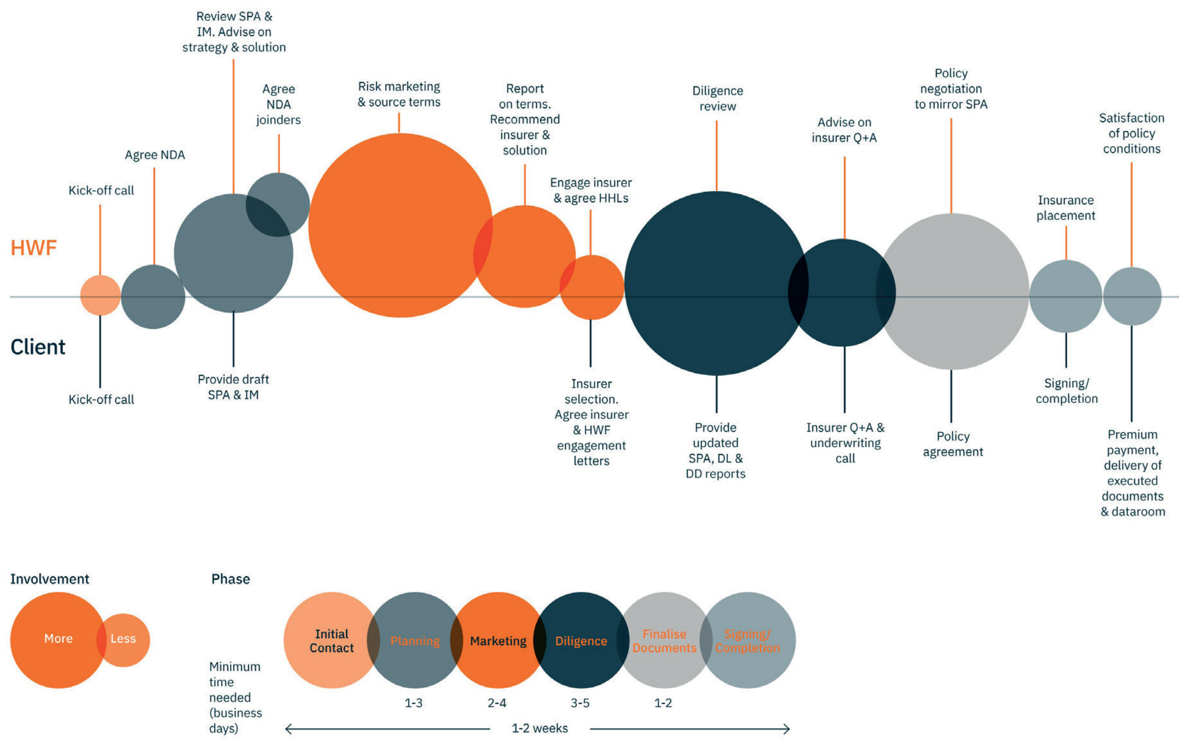
Documentation, Policy Negotiation and Inception

The insurer and the buyer will need to agree the terms of the W&I policy which will usually be issued at completion (or exchange if there is a split exchange and completion).

Timeline

The diagrams below provide an overview of the steps required and indicative timeline for arranging a W&I policy.

General Process Overview



How can we help?

Within our teams we have extensive experience assisting clients in obtaining both buy-side and sell-side policies and can assist at each stage of the process up to implementation of the policy.

Burges Salmon

The Burges Salmon team has over 20 years' experience in the social care sector acting for investors, operators and funders. The quality of service provided by the team is recognised by our shortlisting for legal awards at the market-leading Health Investor Awards and Laing Buisson Awards for the third year running.

Collaboration is the key to our service. We work closely with specialist social care lawyers from across our firm to provide advice tailored to each client. With a pool of expertise spanning areas including banking, corporate, commercial, construction, employment, planning, real estate, and regulatory at our disposal, we provide a complete legal service on the full range of services in the sector.

In addition to English and Welsh law specialists, our team includes Scottish and Northern Irish qualified lawyers, allowing us to offer advice and support with transactional and operational matters across the whole of the UK.

HWF

The team at HWF consists of senior professionals with extensive experience in providing advice and placing bespoke transactional risk policies on M&A transactions.

Recognised as a market leader, HWF brings together individuals from legal and insurance backgrounds who have led SPA negotiations and due diligence processes at international law firms, led the offering at a major global risk advisory and broking firms, as well as individuals who have underwritten M&A insurance for leading insurance companies. This collective experience on the broking, legal and underwriting side allows us to provide specialist insight to clients.

The team have a combined 40 years of experience in this marketplace and advised on over 2,000 transactions and structured over 750 policies with considerable experience in this sector.

Contact us

Please feel free to contact us if you have any questions or would like to further discuss any of the issues raised in this article.

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