



How M&A Insurance can work for Distressed Transactions

The unprecedented coronavirus (COVID-19) pandemic has impacted every major economy and industry and the local and global insurance market is no exception. The immediate challenges associated with the pandemic and the resultant economic downturn are likely to bring lasting effects to the insurance marketplace. M&A insurers are reviewing the coverage provided under their range of products and governments are introducing new laws which directly and indirectly impact risk and insurance. The situation is constantly evolving and Willis Towers Watson is collaborating globally to consider the insurance implications.

Impact of COVID-19

The consequences of COVID-19 will see many companies facing distress and insolvency while others with cash and liquidity will see opportunities emerge. The M&A insurance market is preparing for an increased need for Warranty & Indemnity (W&I) insurance where the target company is distressed and/or insolvent and may be in formal administration/receivership or similar (**Distressed Transaction**). Traditionally, W&I insurance has shied away from Distressed Transactions but that will need to change. M&A insurers will still need to deploy capital to earn premium revenue during and after the pandemic. Their appetite will therefore need to adjust accordingly.

Some transactions are still moving forward because they are either in the later stages of negotiation or sector driven (e.g. FMCG, Healthcare, Infrastructure, Technology and Manufacturing), but most deals are being paused or pulled completely. Attention has turned to preserving value in portfolio companies and focusing on cash-flow management.

We have spoken to all M&A insurers operating within Australasia to test their appetite to insure Distressed Transactions and this article sets out the key discussion points, possible structures, exclusions and other items of note.

M&A Insurer appetite for Distressed Transactions

All M&A insurers operating within Australasia have expressed interest in insuring Distressed Transactions, through a share sale or asset sale, although the preference is for the latter. Typically, processes run by insolvency practitioners, such as a receivership or liquidation tend to be asset sales. A turnaround type transaction will likely be couched as a share sale and the owners will usually be required to give the warranties.

Distressed Transactions will likely be viewed as riskier which may have an impact on pricing and terms. There will also be greater underwriting focus on the ability to give a standard suite of financial/accounts warranties, the core operational warranties and the accuracy of title and capacity warranties. Some M&A insurers indicated they would likely require a higher than normal de minimis and retention – but this would be considered on a deal-by-deal basis.

Target as Warrantor

All M&A insurers operating in Australasia are willing to consider utilising a structure for Distressed Transactions where the target is the warrantor, provided that the parties acknowledge that there is likely to be a carve out for fraud of the warrantor given the M&A insurer's inability to subrogate against the owners of the target or the Insolvency practitioner in these circumstances. As with any other transaction where the target is the warrantor, M&A insurers will be acutely focused on understanding:

- the level of disclosure and verification by the target/management and (if applicable e.g. in a turnaround transaction) key sellers
- the warranty negotiations and the input which management have had into this process.

Synthetic Warranties

This refers to a set of warranties where there is no actual warrantor and the warranties are contained in the W&I policy itself. M&A insurers have a mixed appetite for synthetic warranties - some indicated they would be willing to consider this structure on a case-by-case basis while others considered the structure problematic. Moreover, in our experience, synthetic warranty structures typically offer more limited coverage than a tailored set of warranties, and have broader exclusions.

The challenge with synthetic warranties will be producing a set which a potential buyer/insured sees enough value in terms of core operational warranties to pay a premium. Further, the W&I insurer needs to be comfortable that the buyer's/insured's due diligence is sufficiently representative of the synthetic warranties required and that the necessary disclosure exercise can be demonstrated.

Additional exclusions/notes for Distressed Transactions

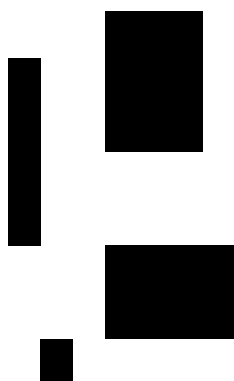
While exclusions are always considered on a case-by-case basis, it is likely that typical solvency/insolvency warranties would be excluded from a Distressed Transaction. Accounts warranties and historical financials would also be looked at closely and coverage may be more limited than usual.

Typical W&I enhancements such as nil de minimis and nil retention for title and capacity warranties and New Breach Cover would need to be assessed on a case-by-case basis and would likely be subject to more scrutiny than usual. Coverage for multiples of EBITDA and Material Adverse Change warranties will need to be considered in the context of the deal.

The path forward

At some point there will be a robust recovery of M&A activity, although it is impossible to predict exactly when. What is certain is that the 2020 vintage deals will be different to prior years and, even with the promise of extensive governmental support, some businesses will inevitably face distress.

If nothing else, the current market is characterised by uncertainty and deal-making will certainly be difficult. To help you or your clients weather these challenges, navigate uncertainty and preserve value in a difficult market, the Willis Towers Watson Transactional Risk team has been actively working with M&A insurers to offer a suite of flexible risk transfer solutions to help facilitate special situations and distressed deals, by providing meaningful buyer recourse secured against top-rated insurance capital.



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