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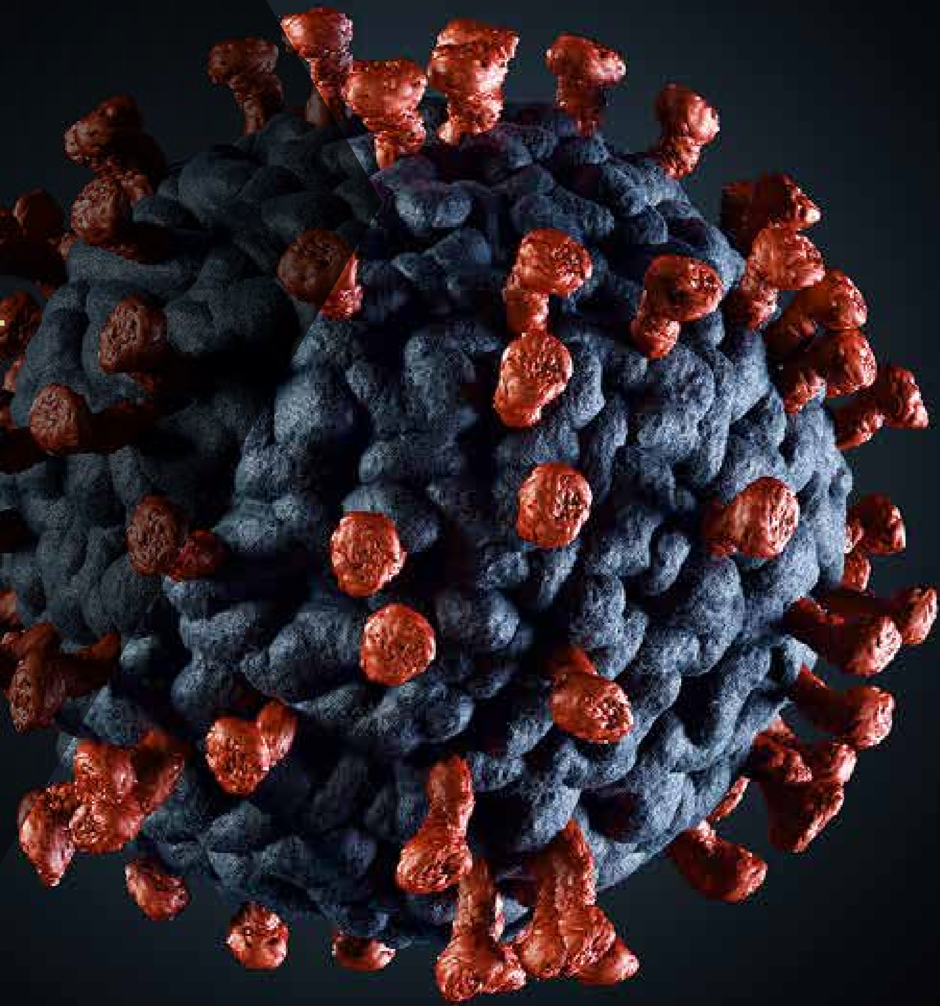
How is COVID-19 affecting M&A?

Key considerations for Warranty & Indemnity Insurance



March 2020

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INTRODUCTION

Only two weeks have passed since our **last article** on the impact of COVID-19 on the Warranty and Indemnity insurance ("W&I") market, but few could have predicted quite how much would have changed since then, and how quickly – both macroeconomically, politically and in the general M&A landscape. Much uncertainty also remains, as the situation continues to evolve.

It will be a surprise to very few that deal flow has slowed down considerably. New deal submissions are still coming in, but there are presently fewer of them, whilst those in underwriting tend to be moving more slowly. Having said that, we are still seeing deals sign, with more in the pipeline.

With all this in mind, and by way of an update to that previous note, we're taking a look at how the W&I market is continuing to respond to the situation, and what further developments may occur in the near future.

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HOW COVID-19 CONCERNS ARE BEING ADDRESSED IN THE W&I POLICY

It's not the purpose of a W&I policy to cover systemic risk, such as those caused by the fallout from the COVID-19 virus. Furthermore, there's an ongoing discussion on how a buyer values a business in the current uncertain environment: insurers do not wish to find themselves answering to buyers' remorse, particularly in the context of a deal that has presumably already factored the risk from the current pandemic into its pricing. Against this back-drop, we have seen insurers hardening in their contemplation of incorporating some form of COVID-19 exclusion into the W&I policy.

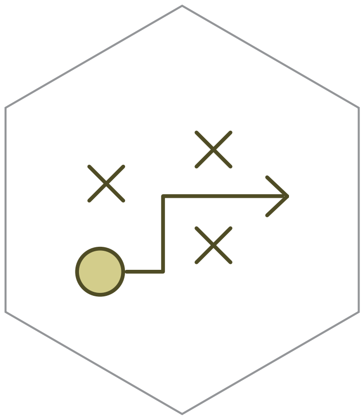
Clients, meanwhile, are understandably concerned not to see an exclusion so broad that it cuts across the entire suite of warranties, thereby diminishing the value of the policy. We have already seen at least one insurer lose out on selection for several deals in the past week due to its somewhat conservative stance regarding a mandated and broadly-worded COVID-19 exclusion. It will be interesting to see if our feedback to them leads to a softening of this position in the future.

In general, we are seeing something of a push-me-pull-you interplay at the moment. On the one hand, there appears to have been some homogenisation of insurers' proposed exclusion-wording, something which may have occurred either because of an exclusion drafted by the Lloyd's Market Association (LMA) (which includes a reference to the "fear or threat" of COVID-19 in its wording) or after insurers taking excess positions in a large program of insurance have seen the wording of the primary insurer and thereafter modified their own.
On the other hand, following discussions with brokers and in response to the outcome of competitive Non Binding Indication ("NBI") situations, others have softened their position as they look to remain competitive.

As things currently stand, insurers fall into one of the following categories:

- seeking to apply a mandated exclusion across the board (most cautious/conservative approach)
- flagging a general COVID-19 exclusion in their NBI, but then looking to narrow its scope during underwriting
- willing to consider their position on a case-by-case basis (we note that an insurer's reservation of position potentially exposes a client to uncertainty, although all insurers base their position at NBI stage as being subject to underwriting and this approach at least leaves the door open for greater negotiation than a mandated exclusion up front)
- identifying COVID-19 in their NBI as an area of heightened risk in underwriting

In short, what we are currently seeing is market forces playing out as insurers respond to a new reality, and we believe there is genuine scope for differentiation amongst them at the NBI stage in understanding how fixed they are in their attitude to an exclusion. We are therefore negotiating hard at this stage to secure our clients the most flexible and reasonable approach.



SOME THINGS TO CONSIDER WHEN REVIEWING AN INSURER'S COVID-19 EXCLUSION

- One insurer initially sought to address its COVID-19 concerns through the definition of Loss under the policy, but we succeeded in moving this wording to a separate policy exclusion. The effect of this is to move the burden of proof from the insured to the insurer
- Avoid language such as "relating to" or "in any way related to" COVID-19, in favor of "directly arising out of" or "directly from"
- Seek to avoid an overly general exclusion, such as "The Insurer will not pay for Loss arising out of or resulting from", instead only carving out proportionate losses with language such as "that portion of Loss" or "to the extent" (etc.)
- Try to get the insurer to be creative in its approach, agreeing only to apply its COVID-19 exclusion to specified warranties, and arguing that such an exclusion should not qualify fundamental warranties, certain statutory warranties (e.g. payment of taxes) and ownership of stock (etc.)

INSURERS' EXPECTATIONS OF THE DUE DILIGENCE AND THEIR LIKELY FOCUS IN UNDERWRITING IN RELATION TO COVID-19

Insurers do not appear to be outright avoiding particular sectors, but those of greater concern include transportation, entertainment, medical/healthcare, retail and hospitality. In general, insurers are paying close attention to the financial performance of a business, particularly those at the smaller end of the EV spectrum, those being sold by founders/individuals, or low-margin businesses likely having to cope with a reduced revenue due to the COVID-19 outbreak.

Insurers are also likely to pay even more attention than before to the underlying deal dynamics: are the sellers engaged and sophisticated? Is there a retention in the Share Purchase Agreement ("SPA") (i.e. do the sellers have 'skin in the game'?)?

For most operating businesses, insurers will require an enhanced level of diligence to be conducted (and updated to the date of signing) to get comfortable that the virus's impact on the target business is fully understood. In underwriting, they can be expected to focus on the target company's operating systems, capabilities, business continuity plans and other insurance arrangements. Depending on the target's sector, the types of questions they will ask over the coming weeks and months include:

- has the investment case been amended or remodeled in the current environment?
- have the financial statements/models been adjusted or reconciled? Has there been any change to key assumptions?
- are business continuity plans sufficient for current conditions?
- have there been, or are there likely to be, staff redundancies? Does the target rely on mobility of workers or agency staff? How many employees have been off sick?
- how robust is the target company's supply chain? Does it have the ability to diversify?
- is there an increased risk of termination or concentration of material contracts?
- what impact is COVID-19 having on the target's general insurance program?
- are the target's IT systems and disaster recovery plans adequate?

Certain warranties may be scrutinized in a slightly different way than previously, and with the expectation that the buyer has been provided with an up-to-date and detailed disclosure on the position by the seller, for example:

- no Material Adverse Change ("MAC") in the business/ordinary course operations
  since the last accounts date – insurers may look to qualify these with wording such as "other than interruptions or alterations that have similarly affected businesses operating in the same sector as the Target"
- compliance with banking covenants, appropriate reserves etc.
- no unusual fluctuations in customer/supplier relationships
- adequacy of systems (e.g. IT) – references to "current business needs" or "for the Business as currently conducted" or similar may be amended to "normal business needs" or "normally conducted"
- specific COVID-19 warranties – we do not expect insurers to have any appetite to cover these

DEALS WHICH HAVE SIGNED BUT NOT YET CLOSED

Given the current environment in the interim period, insurers will look with increased scrutiny at the warranties repeated at Closing, any updated disclosures (and how robust the mechanism is in the SPA for updating the operational position during the interim period) and how (and following what form of impact assessment) the insured has got comfortable in giving a clean Closing No Claims Declaration (i.e. in the event there is no mention in this of interim breaches caused by the COVID-19 environment).

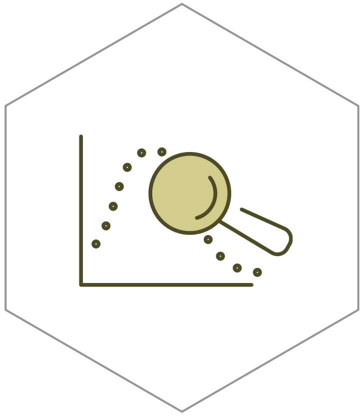
Also, given the recent resurgence of MAC clauses in SPAs with a split signing and closing, if none is included the insurer will look to understand how (other than through insurance) the buyer is intending to address the ongoing operational and other risks arising from COVID-19 in the interim period.

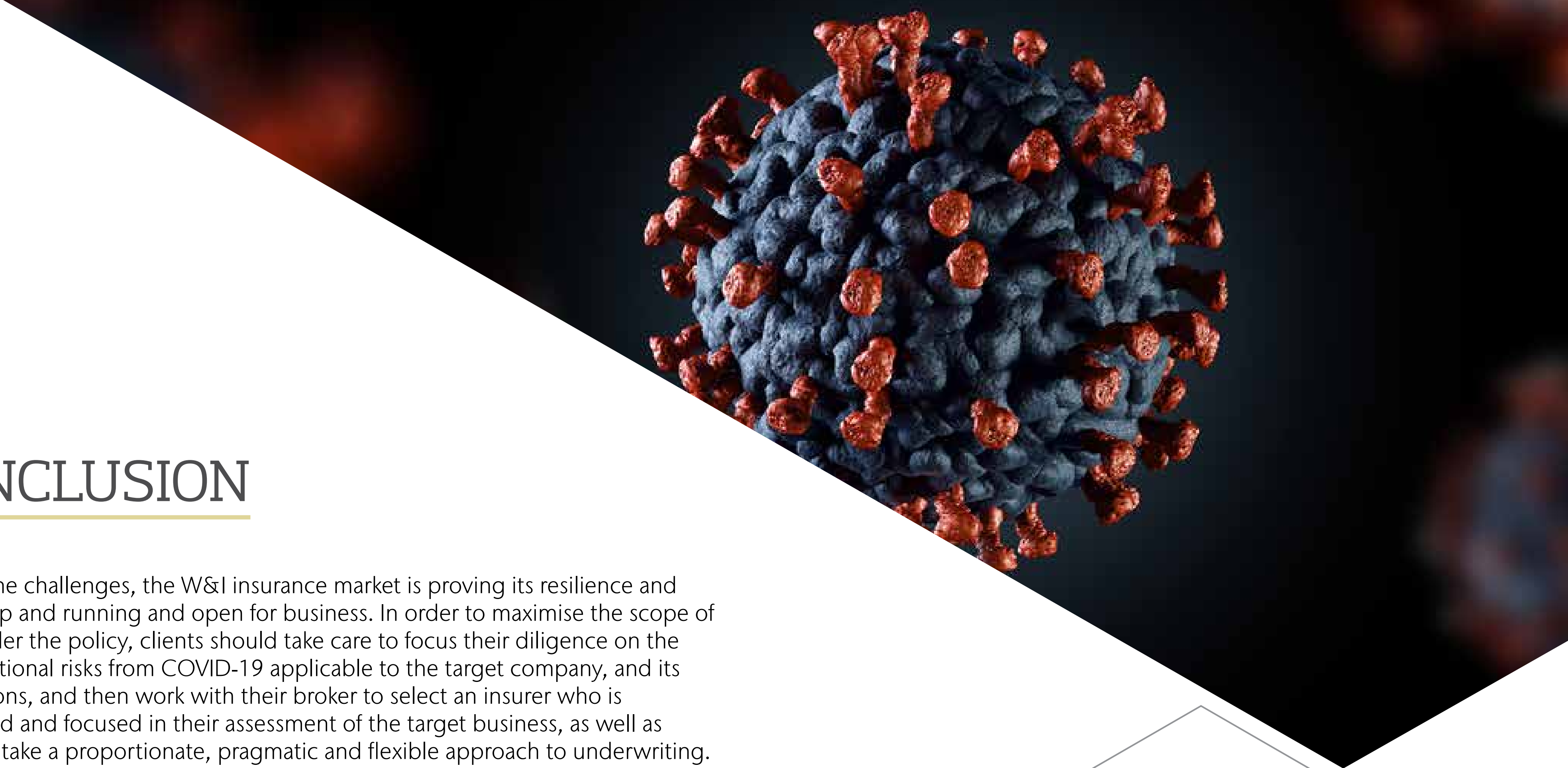
A TENTATIVE PREDICTION: THE RETURN OF SELL-SIDE POLICIES?

Historically, the W&I insurance product originated as a sell-side policy, whereby the seller retained meaningful liability for a breach of its warranties given to the buyer under the SPA and then obtained a W&I policy to insure itself in the event it suffered a loss from a subsequent claim made by the buyer for breach of warranty. In the aftermath of the financial crisis of 2008, a combination of factors led to the increased popularity of buy-side W&I policies, allowing sellers in a seller-friendly market to leverage their superior negotiating-position into walking away from a disposal with a limited outstanding liability, or even wholly clean exit, under the SPA, such that more than 95% of the policies placed in the last few years have been buy-side policies.

It is possible that we will now see a return in uptake of sell-side policies, to (i) reflect a possible shift in bargaining-power between seller and buyer and (ii) more importantly, address the current concerns regarding deficiencies in due diligence where it may be considerably more challenging for buyers to conduct high quality diligence (due to the lack of face-to-face meetings; inability to conduct physical site visits etc.).

In our experience over the past few years, certain insurers have proven considerably more open to requests for sell-side policies than others (and more flexible in their approach to underwriting); this will be a key consideration in insurer-selection in such circumstances.





CONCLUSION

Despite the challenges, the W&I insurance market is proving its resilience and remains up and running and open for business. In order to maximise the scope of cover under the policy, clients should take care to focus their diligence on the key operational risks from COVID-19 applicable to the target company, and its ramifications, and then work with their broker to select an insurer who is considered and focused in their assessment of the target business, as well as willing to take a proportionate, pragmatic and flexible approach to underwriting.

Given the general environment remains very fluid, it remains under constant review by all markets as to how best to address the challenges in connection with the COVID-19 pandemic. Furthermore, now more than ever before in recent memory, it will be key to partner with an experienced broker able to mobilise the combined strength of its influence and relationships, with a diverse customer base across multiple industries, jurisdictions and lines of business, and offering a broad suite of M&A service propositions.

We at Aon therefore recommend an early and ongoing dialogue with your broker and stand ready to work with our clients to address these issues.

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