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M&A insurance: Changes, impact and opportunities for investors resulting from COVID-19

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OVERVIEW

There is no question that COVID-19 has impacted the financial markets with a drop in activity across sectors.

Notwithstanding the ongoing uncertainty, there are tentative signs of recovery within the M&A market, in particular, the increase of cash rich investors beginning to seek out new opportunities, particularly in the public to private ("P2P") space and with respect to distressed targets.

Many of these investors will look to insurance to provide them with additional protection in the midst of an uncertain market, but whether insurers will continue to have appetite to provide the broad cover of recent times at historically low prices remains to be seen.

In this article, we take an in-depth look at the issues affecting investors including:

- the impact of COVID-19 on the warranty & indemnity insurance market;
- changes that have been evident in the current environment and how we expect the market to adapt going forward;
- the opportunities for investors to utilize W&I insurance on distressed/insolvent transactions and P2P transactions.

IMPACT OF COVID-19 ON THE W&I INSURANCE MARKET

Following a relatively quiet period for private M&A transactions when the COVID-19 crisis first hit, deal volumes are starting to increase and processes re-emerge.

In contrast to the bank debt market, the W&I insurance market has continued to operate efficiently, with pricing in fact more competitive than pre COVID-19 levels as the same number of insurers vie for a smaller pool of business.

Despite this, COVID-19 has had a material impact on insurer expectations and, in some cases, policy terms. One of the most significant changes has been insurers' desire to see that meaningful and thorough due diligence is undertaken on all aspects of a target company, with a particular focus on the impact of COVID-19.

Anecdotally, in the current environment, the areas of most interest to insurers have been financial performance, workforce, and material customer and supplier contracts. Detailed due diligence on the areas impacted by COVID-19 is likely to continue to be required by underwriters during, and for many months after the COVID-19 crisis.

The one caveat to the compelling terms offered by insurers during the COVID period has been the emergence of a new exclusion for any loss arising out of or related to COVID-19.

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However, it is important to note that insurers across the market have adopted a variety of approaches when it comes to the wording and implementation of this exclusion.

Certain conservative insurers mandate a broad exclusion on every deal, while other more flexible markets are willing to consider narrowing or removing the exclusion altogether through underwriting.

It is critical that insurers are asked to confirm their approach to COVID-19 exclusions in the early stages of a transaction.

Raising this point early has enabled Howden M&A to fully remove the exclusion on a number of recent transactions and on other transactions where an exclusion has been required, it has provided the opportunity to narrow the drafting of the exclusion.

HOW WILL COVID-19 CHANGE THE M&A INSURANCE MARKET IN THE FUTURE?

Even before the current market volatility, claims on M&A policies had been steadily increasing and some insurers were starting to implement price increases.

This trend is likely to be exacerbated by large insurers suffering material losses, both from the M&A claims that we predict will hit in the coming months and from their offering across broader insurance.

Insurers may decide they are no longer willing to be exposed to M&A insurance at the low prices buyers currently enjoy and the managing general agents may struggle to secure the same level of capacity when their current binder agreements renew (largely in December 2020).

If this scenario plays out, early 2021 will almost certainly see price increases across the board, including M&A insurance.

Even prior to the COVID-19 outbreak, several insureds who received large pay outs under their policies found themselves to be under-insured. This saw the beginnings of a trend whereby buyers secured 15-25% of enterprise value ("EV") as a policy limit (vs. the historic norm of 10%).

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As a larger number of distressed transactions seek insurance and private equity funds commit a greater portion of equity to their transactions, we expect this trend to continue throughout 2020 and into 2021.

In line with securing larger policy limits and witnessing higher insolvency rates in the wider market, we anticipate that credit ratings will begin to play a larger role in the selection of insurers.

Whilst all the insurers in the M&A insurance market are rated A- or higher, a stronger preference for the AA- or better rated insurers may emerge. This will need to be balanced with the degree of cover offered by such insurers and the ease of their underwriting processes.

As the outlook for M&A investors remains uncertain, we are also seeing signs that buyers are less willing to 'take a view' on known risks, especially tax risks.

As a result of this, we have seen a notable increase in the number of enquiries for specific risk insurance policies (particularly in an environment where the financial stability of the seller may not be guaranteed or where the seller would rather pay for a policy than retain long-term liability).

NEW OPPORTUNITIES: DISTRESSED TRANSACTIONS AND P2PS

The marked decrease in the levels of more traditional private M&A activity during the COVID-19 crisis has forced insurers to think carefully about adapting M&A insurance products to create a pipeline of business going forward.

Given the uplift in the number of distressed transactions and the expectation that P2P transactions are likely to increase in frequency over the coming months, both of these areas seemed obvious focal points for insurers.

I. DISTRESSED AND INSOLVENT TRANSACTIONS

Historically, W&I insurers had limited appetite to underwrite transactions with a distressed or insolvent target company, citing them as being too 'risky' and/or lacking in due diligence.

However, over recent months, insurers have taken more time to consider these transactions and a number have established parameters under which they feel comfortable offering an insurance solution.

As such, W&I insurance is now a viable option for buyers of both distressed and insolvent targets.

DISTRESSED TRANSACTIONS

The process for placing insurance on distressed transactions will broadly mirror the W&I process for a more typical private M&A transaction. However, there are two key differences that buyers of distressed assets should keep in mind:

(1) **Pricing:** premiums and retentions are likely to be higher on distressed transactions than more traditional transactions (where it is common to see premiums below 1% of the policy limit and retentions of 0.25%-0.5% of the EV). For distressed transactions, our experience is that pricing is more likely to be in the region of 1.2%-2% of the policy limit, with retentions of 0.5%-1% of the EV;

(2) **Scope of cover:** the scope of cover will be highly dependent on the level of diligence conducted. Distressed transactions are often conducted on an expedited timeline and as such, there may be limited opportunity to undertake a fulsome diligence exercise. While insurers have indicated an openness to taking a more 'commercial' view given the higher premiums and higher retentions that will apply, there still needs to be a "real world" connection between the diligence undertaken and the scope of the warranties requested. As a result, we may find that the scope of cover offered at inception of the policy is narrower than one might find on a more traditional transaction. However, it should be noted that there is an option to do further diligence post signing which would enable insurers to endorse the policy to remove exclusions and expand cover. For certain transactions, it may even be possible to secure broader cover notwithstanding limited diligence, subject to applying a higher retention and a higher de minimis to the policy — both of which could be lowered once further diligence is completed.

INSOLVENT TRANSACTIONS

Turning to consider insolvent targets, crafting an insurance solution requires a greater level of creativity compared to distressed transactions.

In light of the fact that insolvency practitioners are usually unwilling or unable to provide warranties on transactions with an insolvent target, the W&I insurance policy is, instead, based on a synthetic warranty package, which is negotiated directly between the buyer and the insurer.

The use of a synthetic warranty package introduces additional complexity and potential concerns from insurers' perspectives. The first impact of this is that premiums and retentions are likely to be even higher than for distressed assets.

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Our expectation is that for insolvent transactions premiums will be 1.5%-3% of the policy limit and retentions will be at least 1% of the EV.

The second impact is that, in the absence of a disclosure process undertaken by the sell-side, insurers will place a lot of emphasis on the Q&A exercise.

This, in essence, will need to act as a proxy for a disclosure letter, with insurers keen to see that the buyer has asked a question and received a meaningful response to the subject matter of each of the warranties given by the insurer.

As such, it will be important to show that the target's management team has been involved in supporting the insolvency practitioner to prepare the VDR and to respond to Q&A.

It is worth noting that the same considerations noted above with respect to due diligence on distressed transactions will equally apply to insolvent transactions.

II. P2P TRANSACTIONS

Given the highly regulated nature of public markets, adopting a 'one size fits all' insurance solution is not appropriate. Each jurisdiction and, indeed, each deal will require a bespoke policy.

However, there are key trends and similarities in regulatory regimes across European jurisdictions, meaning that one of the following three approaches should broadly be applicable:

(1) The "traditional" approach: management gives warranties in a standalone warranty deed, with a nominal cap on their liability. Insurance is then used much in the same way as on a private M&A transaction;

(2) The "hybrid" approach: management negotiates a warranty suite and discloses against it but stops short of giving the warranties. The insurer then steps in to give the warranties on a synthetic basis but with the comfort that a 'typical' warranty and disclosure process has been followed; or

(3) The "fully synthetic" approach: management is not involved in negotiating the warranty suite at all. Rather, the warranties are negotiated solely between the insurer and the insured, to be given by the insurer on a synthetic basis.

The level of appetite within the insurance market to provide solutions for P2P transactions will depend on the approach followed — with most insurers able to provide a policy if the traditional approach is followed, while at the other end of the scale, only a handful of insurers will be willing to offer fully synthetic warranties.

Pricing and retentions will also vary depending on the approach taken but in all instances, we will see some uplift from the levels typically seen for private M&A deals.

Premium rates are expected to be 1%-3.5% of the policy limit for operational deals and 0.6%-1% of the policy limit for real estate deals. Retentions will be in the region of 1%-2% of the EV for operational deals and 0.5%-1% of the transaction value for real estate deals.

As this product develops and evolves, it is inevitable that the insurance market will need to grapple with and overcome potential challenges.

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Thinking specifically of the UK, we have worked with a panel of insurers to create a blueprint for an approach that utilizes a synthetic warranty package and which seeks to mitigate the potential obstacles posed by: (i) the Rule of Six; and (ii) the lighter touch due diligence exercises typically undertaken on P2P transactions.

The Proskauer and Howden teams have produced two podcasts on the above topic, links to these podcasts can be found below:

Part 1: https://bit.ly/33TqM5W

Part 2: https://bit.ly/3kCo4HQ

Please reach out to a member of the Proskauer or Howden teams if you would like to discuss any of the topics covered in this article in further detail.

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