COVID-19: DISTRESSED M&A IN THE UK AND W&I INSURANCE SOLUTIONS TO WARRANTY COVERAGE ISSUES

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UK M&A Alert

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INTRODUCTION

COVID-19 and the ensuing economic turmoil are continuing to adversely impact businesses worldwide. As a result, in the months ahead, it is anticipated that many companies either will be unable to survive on a stand-alone basis or will conclude they are better positioned if they merge with a stronger partner.

For buyers, these financially distressed companies can represent favorable acquisition opportunities. However, acquiring a financially distressed company is very different (and often more challenging) than acquiring a financially healthy company in a normal M&A process. In light of the different process and risks involved, buyers should approach distressed M&A opportunities with their "eyes wide open."

In this alert, we focus on:

- the challenges posed to the due diligence process in a distressed sale; and
- the use of synthetic warranty and indemnity insurance as a potential solution to concerns about: (i) the reluctance of a seller, the target's management team or an insolvency practitioner (where a formal insolvency process is in play) to give warranties on the distressed business; and (ii) the credit worthiness of a seller to stand behind any future warranty claims.

UNIQUE ASPECTS AND CHALLENGES OF DISTRESSED M&A DILIGENCE PROCESS

Purchasers will need to be aware of a number of challenges to the due diligence process when acquiring distressed assets as compared to a financially sound business:

- Reduced Timeframe – Generally, the negotiation timeline will be accelerated due to the deteriorating financial situation of the target, creditor demands, and the potential near-term loss of significant business relationships (customers, employees, suppliers, etc.).
- Reduced Scope – Diligence is often limited in scope and incomplete. The target may be leanly staffed due to constrained financial resources, and the target may have experienced key departures. Oftentimes, distressed sales are managed by third parties (creditors, restructuring advisors, receivers, assignees, etc.) who do not have full sets of records or the in-depth knowledge that an operator would have in non-stressed situations.

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- Reduced Visibility into Target's Finances – The target's accounting/finance team may be preoccupied with liquidity problems. The damage of financial stress to the operational business may not show up immediately, and the true financial picture is often worse than advertised. The distressed nature of the business often continues to trend downward and may spiral quickly.

THE USE OF SYNTHETIC WARRANTY AND INDEMNITY INSURANCE

Distressed deals often involve sellers that have incurred a substantial financial loss. Thus, sellers are often unwilling to provide significant protection to the buyer in the form of deferred or continent consideration, indemnification or escrows, or meaningful guarantees. However, even if sellers are willing to offer some contractual protection, they may or may not be creditworthy.

The UK W&I insurance market has though responded to the current COVID-19 crises to consider and provide policies based on, so called, synthetic warranties. These are warranty suites that are stapled to the insurance policy itself and negotiated directly with the insurer rather than being set out in the purchase agreement or warranty deed that is negotiated with the sell side team.

This is a positive development in the W&I insurance market which could assist to bring a deal over the line. Purchasers should though note that the product may not be a panacea for all distressed acquisitions:

- Given insurers' general position that for coverage to be provided in an area it must first be diligenced, a purchaser will still need to consider if the scope of coverage is acceptable where limited diligence is able to be undertaken.
- Premiums will be more expensive and expected to be double what they typically would be (between 1.5% - 3% of the level of cover).
- The range of policy options and insurers interested in covering a distressed deal is expected to be greater but this is still a young product and insurers may still be wary of covering distressed deals.
- Insurers will be more willing to cover a deal (i) the less financially distressed the target is; (ii) the more management/sellers are engaged in the process; and (iii) where the target is headquartered in developed jurisdictions and operates in less risky sectors.
- How loss is defined under the policy will be an important consideration if shares are being sold at nominal value as the reduction in the value in the shares will be negligible. In these circumstances consideration will need to be given to warranties being given on an indemnity basis.
- W&I insurance policies are increasingly excluding COVID-19 risks from coverage. Most insurers will include a broad COVID-19 exclusion and negotiation of this at the outset of the process will be important to ensure coverage is not inadvertently narrowed.

CONCLUSION

In a world where diligence may be limited and sellers unable or unwilling to provide warranties, the development of synthetic warranties as part of the options available when taking out W&I insurance is expected to be a useful tool for a purchaser of a distressed business. That said, purchaser's should tread carefully and with their eyes open as to what is and is not covered by these synthetic warranties and the W&I Insurance policy.

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FOR MORE INFORMATION

While the primary authors are UK based, most of the commentary on distressed M&A above applies internationally. Our global distressed M&A team, with lawyers in Asia, Australia, Europe, Middle East, North America and South America, stands ready to assist you.

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