

Expert Analysis

What COVID-19 Means For The M&A Insurance Market

By Alvin Reynolds and Richard French (May 20, 2020)

The COVID-19 pandemic is continuing to wreak havoc on the global economy. The widespread shutdown of large swaths of the world has sent public equity markets into a nosedive, constricted public and private debt markets, and resulted in many M&A processes being put on hold or abandoned.

Despite the turmoil, deals are still getting done and insured. Looking ahead, private equity sponsors are sitting on a record \$1.5 trillion of dry powder^[1] and there will undoubtedly be opportunities to purchase distressed targets and/or assets being sold in insolvency proceedings, an area that has historically seen limited use of M&A insurance solutions.

This article addresses the impact of COVID-19 on M&A insurance market dynamics, policy terms and claims, and details new applications of the product to support distressed transactions.

Key Takeaways

- The M&A insurance market remains open for new business.
- Pricing remains competitive as insurers compete over a smaller pool of deals.
- M&A insurance premiums are expected to increase in the midterm as the double hit of a spike in claims activity and deteriorating investment returns hits carriers across all product lines.
- Carriers are seeking to limit direct exposure to COVID-19 matters.
- Heightened diligence is required on the impact of COVID-19, with a focus on material contracts, supply chains, international exposure and employment risks.
- M&A insurance claims are expected to increase as insureds seek to recoup lost value.
- Demand for contingent risk insurance may increase as buyers assert growing leverage over processes.
- Demand may increase for M&A insurance to de-risk distressed transactions, including sales under Section 363 of the U.S. Bankruptcy Code.



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COVID-19 Impact on the M&A Insurance Market

Open for Business

In recent weeks, we have seen many M&A processes paused or abandoned at a rate not seen since the financial crisis. Even deals that signed before the pandemic are uncertain, with buyers considering whether to invoke termination rights afforded by material adverse effect, or MAE, clauses.

However, many deals in the final throws did cross the line and close, despite the growing pandemic. We have also seen deals in defensive sectors (e.g., technology, industrials, healthcare) be more resilient.

Despite the turmoil, the M&A insurance market is very much open for business and deals are being insured, but volumes have dramatically reduced.

Impact on Premium Rates

At the end of last year, we predicted that premium rates would stabilize and, in some cases, increase in 2020. While one might expect the immediate reaction among carriers to be rate hikes, we predict that representations and warranties insurance, or RWI, rates will remain stable and potentially fall in the short term. This is because fewer deals are being brought to the insurance market, so carriers are competing over a smaller pool of deals.

In the medium term, COVID-19 is likely to increase premium rates for M&A insurance products as a result of the double hit being felt by reinsurers.

First, COVID-19 is going to result in large claim volumes across all lines of insurance. From business interruption to travel insurers paying out for unreachable vacations, the impact will be immense.

Second and perhaps more notably, equity markets have nosedived, and unprecedented monetary stimulus has pushed interest rates to record lows. This will severely dampen insurers' investment returns, an important source of income.

For the M&A insurance market, a possible impact of the double hit is carriers diverting capacity to traditional lines of insurance (e.g., property and casualty, directors and officers), which are enjoying premium hikes not seen for years.

The extent of this reallocation of capacity will determine the level of M&A insurance premium increases. Given that the M&A insurance product line continues to enjoy favorable underwriting results and comparatively low claim volumes, we predict any midterm price increases to be modest as carriers believe in the long-term viability of the M&A insurance class.

Impact on Terms and the COVID-19 Exclusion

The most immediate impact on policy terms is carriers' attempt to introduce COVID-19 related exclusions. COVID-19 exclusions are something that we have been resisting and, for deals in active underwriting, we have largely been successful limiting their impact to any breach of the closing representations.

As time progresses and until we have additional clarity, the prevalence of COVID-19 exclusions will likely increase. Carriers are principally concerned with the challenge of determining the impact of the pandemic on a particular target business, and whether this might give rise to an unknown breach.

From the perspective of our clients, broad COVID-19 exclusions unfairly allocate all of this risk to policyholders. We are negotiating targeted solutions to balance this risk, for example, by ensuring the following revisions in RWI policies: (1) making COVID-19 exclusions apply solely to "absence of certain changes" representations; or (2) limiting the scope of certain specified representations so that they are only given at closing.

Due Diligence Expectations

Carriers are requiring robust diligence into the potential impact of COVID-19, in particular on financial forecasts, valuation, supply chain management, material contracts and employment matters.

Buyers are placing far more scrutiny on insurance arrangements and whether there is cover for business-critical risks. Obtaining fulsome cover under RWI policies for key risks (e.g., product liability, cybersecurity) requires robust analyses of the underlying insurance policies protecting against these risks. COVID-19 has widened RWI carriers' focus to include other policies such as property insurance.

Selective Carrier Behavior and Capacity Restrictions

In the medium term, we expect insurers to limit available capacity by reducing the maximum policy limits they are willing to offer on any given deal. Furthermore, we expect insurers to be more selective regarding the jurisdictions and industry sectors they are exposed to.

While this should not affect the majority of transactions, large cap deals or those in noncore jurisdictions/industry sectors may struggle to secure the levels of capacity enjoyed in the pre-coronavirus world.

Carriers' desire to focus on target companies in defensive sectors will be counterbalanced by likely deal flow. The deals that will be consummated over the coming weeks and months will largely be distressed in nature.

RWI carriers have always had heightened sensitivity to turnaround deals for several reasons, including the following: (1) companies in distress might point to poorly managed businesses, increasing the probability of an unknown breach; and (2) if buyers fail to rescue businesses, they will seek to recoup losses through issued RWI policies (i.e., such policies are backed by A-rated carriers).

To remain competitive, RWI carriers will need to overcome this reticence and adapt to the new environment.

The Changing Deal Environment and its Impact on M&A Insurance

A Buyer's Market?

Our tentative view is that, at least in the short-term, COVID-19 will signal a pause in the sellers' market and will hand back a greater degree of control to buyers.

As a result, buyers may begin to place pressure on solvent sellers to provide indemnities for amounts falling within the RWI policy retention amounts and/or matters excluded by such policies.

As buyers will be less willing to take a view on known risks, especially tax matters, they will seek cover from the contingent risk insurance market (particularly in an environment where the financial stability of sellers may not be guaranteed or where sellers would rather pay for policies than retain potential long-tail liabilities).

In addition to demand for insurance to cover identified risks (e.g., tax, environmental, litigation), we expect greater demand for top-up insurance to protect buyers for breaches of fundamental representations (i.e., title, capacity and authority) up to 100% of enterprise value and generally sits above underlying RWI insurance.

MAE Clauses and Closing Representations

The established market position that RWI insurers will provide cover for closing representations will remain, albeit we expect a tightening of terms.

Twenty-four months ago, many carriers restricted the maximum interim period to 120 days. However, over the last 18 months we regularly secured cover for interim periods of up to a year with no requirement for updated diligence (albeit additional premium may apply).

We expect certain carriers to reimpose restrictions around the length of interim periods in light of COVID-19. In addition, there will be heightened scrutiny on bring-down calls, with the need for carriers to fully understand the operations of businesses during interim periods and the impacts of COVID-19 (e.g., compliance with loan covenants, material contracts).

With respect to transaction documents, MAE clauses are already a hotly debated topic, with the addition of specific COVID-19 references being commonplace. Although limited RWI carriers have been offering interim breach coverage over the last 18 months, it is almost certain that any insurers continuing to offer this will exclude losses arising from COVID-19.

Given RWI is not going to be a solution to interim breach risk as it relates to COVID-19, a potential middle ground will be for sellers to stand behind interim breaches. This will provide sellers with certainty of closing, absent MAEs, while buyers will be indemnified by sellers for interim breaches.

Even if this middle ground is reached, the risk of sellers being unable to meet their obligations will remain. The insurance industry may be able to provide a solution here, and we would be delighted to discuss this in further detail.

Deferred Consideration

We expect to see increased use of deferred consideration and earn-out structures. On typical transactions with deferred consideration/earn-out components, policyholders and their advisers must consider what policy limits are suitable.

On any given deal, for example, the policyholder must debate whether to base the policy limit (i.e., typically 5%-20% of the transaction value) on the potential total consideration — including potential earn-out payments and other deferred compensation — or the initial purchase price. Notably, the latter approach may inappropriately restrict recovery in the event of a claim.

If significant consideration is deferred, this also raises the question of whether to base the retention amount on upfront consideration, total purchase price or something in between.

Given the current market, there is a strong argument that any deferred consideration is far from certain and, therefore, should be based on upfront consideration only. COVID-19 Impact on M&A Insurance Claims

Increased Claims

Economic downturns always lead to increased rates of insurance claims as purchasers of companies/assets look to mitigate losses. We expect the same to be true for M&A insurance, particularly as we have observed a general increase in the frequency of claims and payouts under M&A policies in recent years.

This development is due primarily to insureds becoming increasingly adept at navigating the claims process and demonstrating more willingness to bring claims against insurers, as opposed to sellers.

We expect a notable number of these additional claims to arise from material contract disputes. While the COVID-19 outbreak is currently a post-signing event for policies placed prior to 2020, sponsors, portfolio companies and indeed their customers will be carefully reviewing material contracts to assess whether they have been complied with.

It is likely that some of the issues identified will constitute presigning breaches, with insureds seeking recourse for these matters via RWI policies. Adherence to these contracts would not be such a point of emphasis had the COVID-19 outbreak not occurred.

With the safety net of employment status now looking significantly more attractive, contractors and other nonemployee staff are also likely to assess whether they could qualify as employees in order to take advantage of the greater protections this status offers.

Wage and hour and other employment related claims can be expected, with such claims more common after dismissals. Accordingly, employment related claims — typically a relatively small percentage of total claims — could well increase in the coming months, albeit this risk may be mitigated somewhat by the emergency financial measures being implemented by governments across the world.

M&A Insurance to Support Insolvency Proceedings

As distressed transactions become commonplace, the M&A insurance market will need to shift from underwriting profitable/fast growth businesses and grapple with more challenging targets. While certain risks associated with such transactions are elevated and fulsome diligence is often difficult, sophisticated insurers will be able to adjust their approach.

Recent events will accelerate the trend of asset sales arising from insolvency proceedings, or Section 363 sales. Although significant risk is removed from such transactions as sales are generally completed free and clear of all prebankruptcy interests, certain key risks remain.

Certain successor liabilities (e.g., product liability, environmental, employment) will typically survive. There are several other areas, including intellectual property, where buyers will value the protections afforded by RWI policies.

Likewise, from the perspective of a bankruptcy trustee, RWI policies avoid the need for escrows which have become more common in the context of Section 363 sales. Furthermore, RWI policies allow trustees to command more favorable terms from would be buyers as potential unknown liabilities are ring-fenced by RWI policies.

Conclusion

COVID-19 has and will present novel and evolving challenges to both the M&A and insurance markets. These challenges will need to be carefully managed to ensure M&A insurance continues to deliver the risk transfer benefits that buyers and sellers have come to expect.

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[1] <https://www.bloomberg.com/news/articles/2020-01-02/private-equity-is-starting-2020-with-more-cash-than-ever-before>.

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We have practices dedicated to: i) M&A insurance serving private equity sponsors and strategic acquirers; ii) structured credit insurance serving commercial banks, investment banks and institutional lenders; and iii) structured solutions serving private equity sponsors, hedge funds, alternative asset managers and corporates.

Our experienced team includes attorneys (tax, M&A, litigation), investment bankers, insurance professionals and tax & accountancy experts. We have an established track record advising clients across a multitude of sectors and transaction structures, including acquisitions, divestitures, carveouts, growth equity investments and other matters.

Our M&A practice covers all aspects of insurance in the context of private and public transactions, including representations & warranties, tax liability, litigation buyout, environmental and other contingent risk insurance policies, along with comprehensive post-closing claims services. Through our partners, we also provide insurance and employment due diligence services.

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