M&A Insurance for Distressed Targets

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Paragon

HOW CAN A WARRANTY & INDEMNITY (W&I) INSURANCE ASSIST DURING THE SALE OF A DISTRESSED TARGET BUSINESS?

W&I insurance is a recognised M&A tool that allows the contingent warranty risks associated with transactions to be transferred to an insurer from the balance sheets of the seller and/or buyer.

The sale of a distressed business brings a number of challenges:

- Who will be able or willing to give reasonably sized warranties in the target business in the absence of receiving any material consideration?
- How will the liability be apportioned in the event of a breach?
- What is the security of the counterparty?

As a consequence, a seller may elect to go with a buyer at a price level that recognises minimal or no warranties will be provided.

The current market for W&I insurance has a number of structures that enable a broad suite of business warranties to be provided and with minimal or nil liability to the seller/warrantor:

1. **£/€1 (one) recourse:**
   warranties are given by the management of the target (commonly within a management warranty deed) with the financial liability of the warrantors capped at £1.
2. **Synthetic warranties:**
   these warranties exist only within the W&I policy and are negotiated between the buyer and the insurer.
3. **Adjusted clauses:**
   such as via a sweeping "awareness qualification" and/or capping the period of the liability.

THE UNDERWRITING PROCESS

In order to secure a reasonable level of cover in each of the above scenarios, the W&I underwriter will need to be confident that a good standard of information is available on the target business. Additionally, they will expect that the buyer has undertaken thorough due diligence (DD) of the available information and that this has been recorded within appropriate DD reports.

WHEN TO INVOLVE THE BROKER

Sell-side:

Early in the sale process. This will enable us to review the information available on the target, understand what the seller is seeking to achieve, provide detailed guidance on the insurance that can be structured into the transaction, advise how best to approach the W&I insurance market and provide a clear pathway as to how the insurance can be incepted. If specific risks are identified that will fall outside the scope of a W&I policy, we can provide alternative solutions from the insurance market to cover those issues.

Buy-side:

At the point of Non-Binding Offer (NBO): In circumstances where W&I insurance has not been considered by the sellers, the product can potentially provide the bidder with a material advantage. Once we have access to information on the target, we will quickly assess the W&I insurance options that can be structured and identify the most appropriate underwriters for the specific transaction. We will be able to provide a rough estimate at NBO stage and then more detailed quotes as more information becomes available through the DD process.

COST OF W&I FOR A DISTRESSED TRANSACTION

This will vary based on the particular profile of the transaction, however, for basic cover the "rate on line" (rate applied to the limit of liability required) should fall within a range of 0.6% to 1.5% - e.g. an aggregate policy limit of liability of £10,000,000 at a rate on line of 1.2% = a premium of £120,000. Additional costs will include taxes and underwriting fees.

CONTINGENT TAX RISKS FOR DISTRESSED BUSINESSES

Distressed businesses must overcome a range of complex financial and commercial challenges to keep their business afloat.

Often distressed businesses will undertake some form of debt restructuring such as debt releases/forgiveness or debt for equity swaps to manage liquidity concerns. These steps will undoubtedly have complex tax implications and care must be taken to ensure that no material tax exposures arise as a result.

A distressed corporation could also look to divest parts of its business which may involve a pre-sale reorganisation whereby assets are carved out and the part of the business, which is to be sold, is hived-down into a newly incorporated "clean" company. It is important to consider whether this would enable tax assets such as trading losses and capital allowances to be preserved. In addition, it must be considered whether the pre-sale reorganisation leads to any undesirable VAT outcomes or stamp duty land tax issues to the extent that any interest in land is being transferred.

Provided that sound tax advice has been obtained, it should be possible to mitigate these tax risks through specific tax insurance cover for the potential tax liability together with any interest, penalties and defence costs. The pricing of a tax insurance policy would depend on the nature of the tax risk, the supporting analysis and jurisdiction. A tax policy would enable the seller of a distressed business to maximise their sale proceeds and prevent having any funds held back in escrow at a time when cashflow is critical.

Insurance cover may also be available for a range of other contingent risks and scenarios which can provide peace of mind in a time of economic uncertainty.

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