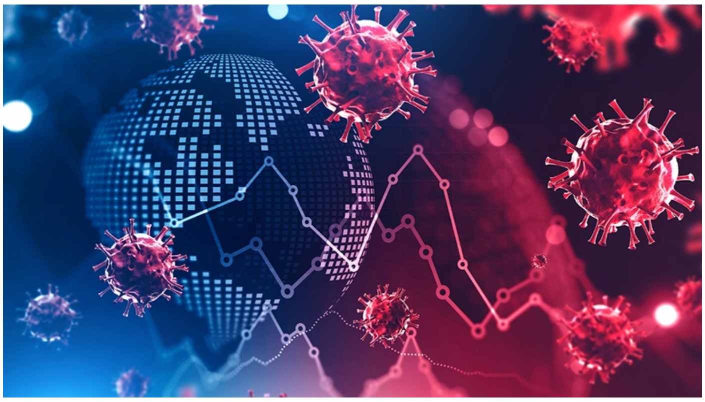
Focus: M&A carriers see upside in more flexible approach to Covid coverage

By William Monat, Mosaic

18 Apr 2021 | **OPINION**

While broad exclusions were the norm in lockdown last year, transactional liability underwriters are becoming more comfortable with accommodating the different impacts of the pandemic on M&A deals



AS TIME PASSED AND COVID'S IMPACTS COULD BE BETTER INVESTIGATED BY BUYERS, MOST INSURERS BEGAN TO ADOPT A MORE FLEXIBLE APPROACH *Source: ImageFlow/Shutterstock.com*

Corporate risk managers face fresh challenges as they navigate the transactional liability landscape a year down the road from Covid-19's staggering global impact.

In mergers and acquisitions (M&A), some of these issues relate to diligence relating to the target company's existing insurance programme. Yet in an environment where warranty and indemnity (W&I) coverage and representations and warranties insurance (RWI) have become staples for North American buyers, understanding how insurers have adapted their approach to deal liability during the pandemic is critical.

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Despite widespread economic uncertainty and Covid's negative blow to so many businesses and communities since April 2020, the M&A sector has emerged emboldened from the tumultuous past 12 months and made a robust recovery. The trend has not only underscored the resilience of the transactional market, but also the staying power and essential value of RWI, a product born in the late 1990s and now fully coming of age.

When the coronavirus first triggered country lockdowns in March 2020, a collective wait-and-see took hold as buyers and sellers tried to take stock of an unprecedented catalogue of unknowns. Covid fundamentally affected either revenues or expenses to alter profitability of a business and what parties were willing to pay. Some deals already at the finish line were able to sign. Others had purchase agreements, but no closures. Many were simply shelved.

Broad exclusions

Most M&A insurers implemented broad exclusions for potential Covid impacts on target businesses, leaving parties to allocate risk or determine impact via traditional indemnification or purchase price mechanics. After several slow months of activity, deals began to pick up as 2020 progressed, and several things became clear. First, there was a lot of capital available to invest, among both corporate and private equity buyers. Second, a collective lightbulb seemed to switch on as people realised there were still ways to get deals done. On-site diligence might have diminished, but virtual meetings, desktop reviews and selective, socially distanced inspections made progress possible.

An added impetus was the fact 2020 was a US election year. Spurred by predictions a Biden administration would hike taxes, there was no shortage of motivated sellers. It became a perfect storm of deal catalysts: available capital, motivated buyers and sellers and close to two financial quarters'-worth of pent-up demand delivering a backlog of deals ready to fast-forward. It was no surprise that September saw a veritable onslaught of M&A activity. And it kept going. The fourth quarter of 2020 was the busiest M&A quarter of my entire career.

Going strong in the US and growing globally, RWI policies are being used in the majority of private M&A transactions. The product has really tested the capacity of M&A insurers and the result has been a slew of deals of all sizes, from multibillion-dollar varieties to middle- and lower-middle market transactions. Every aspect of the sector was clicking by the end of 2020 and that robust M&A activity has continued through the first part of 2021.

How has Covid changed the M&A business? When lockdowns first hit nations in March 2020, many insurers rolled out broad exclusions related to any impacts of the pandemic on target businesses, including impacts on supply chains, operations, financial statements, employees, customers and sales.

That raised concern among deal parties of unintended consequences – excluding matters that should be indemnified. For example, while financial statements would clearly be affected if costs increased or sales decreased as a result of Covid, a breach of financial statement representations and warranties due to an accounting error that had nothing to do with Covid could potentially be excluded under such a sweeping approach.

Flexible approach

As time passed and Covid's impacts could be better investigated by buyers, most insurers began to adopt a more flexible approach, applying a conditional exclusion that could be narrowed once results were available. Now, insurers could properly exclude known impacts of Covid on the target business, ensuring fulsome due diligence had been conducted by the buyer for potential problems. It is important to bear in mind, however, that some insurers still have a mandatory exclusion as to actual sickness caused by coronavirus transmission.

In addition, M&A insurers do not generally have any appetite to cover governmental relief, such as Paycheck Protection Program loans or other stimulus under the Coronavirus Aid, Relief and Economic Security Act in the US. Risk managers should alert their internal deal teams that exposure for those matters need to be allocated between buyer and seller and if there are known Covid impacts identified in the due diligence process, W&I/RWI insurance will not cover those exposure, either.

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Managing M&A risk

Consider RWI in the event of an M&A deal: it has proven viable in the Covid-19 environment and is being effectively used in many transactions;

Be aware insurers are not going take risks on known, identified impacts the pandemic has had on a business you are looking to buy;

Make sure your team is doing diligence around the impacts of Covid, including potential impacts on the supply chain, operations, employees, customers and financials;

Conduct diligence on impacts on the target company's insurance program, including whether claims have been made and their status, as well as any potential recoveries around losses incurred;

Know whether the target company expects to experience any increase in workers' compensation claims and if compensation and related insurance for employees is adequate; and

Work closely with a broker that is knowledgeable and can help you navigate for the best outcome possible. Select a broker with specific, sophisticated expertise in M&A insurance.