

COVID-19 AND WHAT IT MEANS FOR W&I INSURANCES

INTRODUCTION

The recent outbreak of COVID-19 has given rise to a number of questions in relation to W&I insurances used in M&A transactions that have not yet been incepted. The following is a summary of some of the key points to consider in relation to W&I with respect to COVID-19, and we give our recommendations as to what measures should be taken in order to achieve the optimal coverage position.

This brief is written based on our experiences from the Danish market acting for sell-side, buy-side and the underwriter, but many of the considerations also extend beyond the Danish jurisdiction.

INITIAL CONSIDERATIONS WHEN CHOOSING THE UNDERWRITER

Prior to entering into a W&I policy, the insurance broker will have gathered a number of indications from typically four to five underwriters in what is referred to as the Indication Memorandum. This will set out the key terms upon which the various underwriters are willing to offer to underwrite the transaction.

The Indication Memorandum will, *inter alia*, set out the de-minimis amount, basket amount (i.e. retention amount) and cap amount with the corresponding policy premium that the various underwriters are willing to offer. In addition, the Indication Memorandum will also list the key exclusions and other key terms which will apply to the policy offered by each of the underwriters.

It is important to note that the Indication Memorandum will typically also indicate which of the underwriters are willing to offer what is referred to as New Breach Cover (i.e. bring down of warranties on closing). In the Danish market, it is not common for the underwriters to generally offer such New Breach Cover, and for those who do, it will typically be associated with a substantial addition to the insurance premium.

Given that a W&I policy will only cover warranties as of the inception date (i.e. not forward looking warranties), we **recommend** engaging with the insurance broker prior to choosing the underwriter in order to understand to what extent and under what circumstances it will be possible to achieve New Breach Cover in order to cater for the significant uncertainty that COVID-19 will otherwise pose in the time between signing and closing.

EXTENT OF COVERAGE UNDER A W&I POLICY

While a typical Danish negotiated share purchase agreement (“SPA”) will limit the definition of a “loss” to only cover direct losses and costs associated with such loss (e.g. costs to advisors related to the claim), it is important to note that the loss definition in a W&I policy will typically be broader and will also allow for reasonable foreseeable indirect and consequential losses to be included based on the latest market standard.

The losses which may arise from the outbreak of COVID-19 must generally be assumed to be perceived as consequential or indirect losses since such losses may be e.g. loss of profits following a decrease in sales due to the outbreak.

Accordingly, we **recommend** considering a W&I solution in transactions where the COVID-19 outbreak might have significant adverse consequences for the target business, and where the seller is not willing to take on such risk with regard to indirect and consequential losses.

DUE DILIGENCE MEASURES IN ORDER TO OBTAIN OPTIMAL COVERAGE

Prior to the issuance of a W&I policy, the underwriter will perform its own review of the various due diligence work streams undertaken by the buyer (and seller in case vendor due diligence has been carried out). The primary aim of this review is to uncover whether there are areas that have been neglected in due diligence, or whether there are specific areas of concern for the business in question vis-à-vis the warranties that are underwritten. If such are identified, the underwriter will typically seek to either exclude them from coverage and/or limit the reach of the relevant warranties.

Accordingly, we expect that underwriters will now pay special attention to the uncertainties which COVID-19 causes in relation to a potential breach of warranties. Therefore, we **recommend** that all due diligence work streams pay special attention to the potential effects of COVID-19, including e.g. with regard to (i) the insurance programmes of the target (e.g. exclusions on epidemics or pandemics), (ii) supply chain risks (e.g. contractual terms on force majeure that will be triggered by COVID-19) and (iii) financial stability and the possible exposure of the given sector. Moreover, the valuation of the target business should be studied in detail to make sure that such e.g. takes into account the latest financials to make sure that the buyer can demonstrate a thorough understanding of the potential impact on the valuation of the target business as a result of COVID-19.

SPECIFIC WARRANTIES DEALING WITH COVID-19

It remains to be seen whether underwriters will have the appetite for underwriting warranties dealing specifically with COVID-19 and the effects hereof on the target business.

We would expect the key driver here to be whether the underwriter can get comfortable with the extent of the underlying risk, which, as set out above, will require a detailed due diligence analysis. Such might be offered as additional coverage subject to extra premium.

If the target business in question is especially vulnerable to the effects of COVID-19, we **recommend** engaging with the broker and underwriter in order to clarify whether it will be possible to get specific coverage for such in addition to the current market standard warranties which may cover some of the effects of COVID-19 indirectly, due to the broad wording of these.

SPECIFIC MEASURES IN THE SPA DEALING WITH COVID-19

As previously mentioned, the period between signing and closing is likely to constitute a significant risk for the buyer given the uncertainty that COVID-19 poses, and if the underwriter in addition hereto is not willing to offer New Breach Cover, the buyer must then turn to the SPA to mitigate such risk.

One way to mitigate the risk between signing and closing is for the parties to agree on a material adverse change clause ("MAC Clause"). A MAC Clause is a clause which allows the parties to terminate the SPA in case of a material adverse change to the target business in the period between signing and closing.

It will be up to the parties to determine a detailed definition of what constitutes a material adverse change, but it should of course cater to the potential effects of COVID-19.

Another tool to consider in the SPA is the inclusion of certain condition precedent clauses whereby the buyer and/or seller will be able to terminate the SPA in case of certain events occurring (or not occurring).

A condition precedent clause can be structured in many ways depending on the nature of the target business (e.g. confirmation that the order intake will not fall below a certain agreed level in the time between signing and closing), or that there has not been a material breach of certain warranties given on signing in order to cater for the uncertainty and risk posed by COVID-19 on the target business.

Accordingly, we **recommend** considering inclusion of a MAC Clause and/or condition precedent clause should New Breach Cover either not be obtainable and/or not provide sufficient protection for the buyer against the potential effects of COVID-19.

FORCE MAJEURE AND W&I POLICIES

Naturally, the question of whether the COVID-19 outbreak can be seen as a force majeure event is likely to be raised. A force majeure clause concerns certain events which may excuse the parties' failure to perform one or more of its obligations under the concerned agreement.

Typically, W&I policies do not contain such provisions allowing the underwriter to be excluded from liability in case of a breach of warranties. Accordingly, the governing law of the W&I policy and the underlying jurisprudence will determine to what extent – if any – the underwriter can be excused from liability under the W&I policy in relation to COVID-19.

OUR ASSESSMENT

The COVID-19 outbreak has been very extensive and it is difficult to predict the future impact on M&A transactions, including how underwriters will react with regard to W&I Policies. However, we hope that this brief will have provided a better understanding of some of the key considerations one should make when entering into a W&I policy vis-à-vis the COVID-19 outbreak.

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