HWF

The Diligence Debate

Scoping diligence to maximise M&A insurance coverage

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At HWF we believe quality of coverage should be the key focus for any client.

HWF are increasingly seeing the scope and coverage of due diligence ("**DD**") being scrutinised by insurers. Whilst the activities, size and scale of a target business can't be changed, the largest factor impacting coverage remains the scope, quality and reporting of DD. At HWF we believe quality of coverage should be the key focus for any client.

In this series of short briefings, HWF will consider common issues arising in insured transactions flowing from buyer and vendor DD exercises and ultimately the steps that can be taken to mitigate issues, thereby maximising coverage from your transaction insurance.

Increased insurer focus on DD has been driven by:

Wider use of insurance and increase in claims:

A lot more deals are using insurance, across a huge range of geographies, sectors and transaction scenarios. As a result, claims activity and ultimately payments under policies have also increased. These developments have necessarily led to a broadening in the underwriting approach from insurers and arguably a higher bar for comfort during the underwriting process.

Growth in insurer numbers and shift in underwriting approach:

With over 30 primary insurers now writing business in London, teams of underwriters in the market have varying ability and experience levels. Whilst not exclusively the case, certain insurers increasingly rely on external advisors to support the underwriting process whose advice is typically far more conservative. In respect of certain underwriters and advisers this external advice isn't filtered to a sufficient extent which can result in undesirable coverage positions. Insurer selection and underwriting approach are therefore increasingly important and a focus for HWF in recommending insurance solutions.

Depth and scope of DD:

In part driven by record levels of deal activity since the Covid pandemic, the depth and scope of DD exercises and quality of tangible reporting now varies more than seen historically. Whilst there are a number of drivers for a reduced scope of DD being carried out (e.g. compressed transaction timetables), this has led to much greater scrutiny by insurers looking to flush out issues and minimise risk.

"The impact of this increased scrutiny means it is more important than ever for insured parties to appropriately set scopes of diligence. As there isn't a one-size-fits-all approach to appropriate DD, HWF are increasingly feeding into processes at an early stage in order to refine scopes and pre-empt potential issues. The first question that will arise in that exercise is the level of materiality to apply and then the extent of reporting required to secure broad coverage."

David Wall
Director, Co-Head of Private Equity

Materiality: What Insurers Want

It isn't the case (and never has been) that coverage under W&I is only given if a risk area has been fully diligenced. W&I exists to provide cover for unknown liabilities and insurers do not expect DD to be broader in scope or more granular than a buyer would do on an uninsured deal.

The purpose of insurer's underwriting is to see that material operations have been subject to diligence which will allow a buyer to understand the target business and allow the insurer to assess risk, and ultimately extend coverage beyond areas specifically diligenced. Nevertheless, there is a real risk of differing seller / buyer / insurer opinion leading to gaps in coverage.

When assessing materiality insurers will need to understand:

Jurisdictions:

A common reason used by insurers to justify exclusions is that certain jurisdictions or risk areas haven't been subject to DD, however this isn't always justified in light of the wider process or transaction. What is the target's footprint and has the DD covered all material geographies? Insurers will expect the DD exercise to include review by local advisors of key legal and tax risks. Materiality in the jurisdictional context is frequently set by reference to revenues or operations (see below). One important tax specific caveat is that in jurisdictions with systematic and routine audits (e.g. Germany), insurers will expect full diligence if operations in such jurisdiction are material as they will not want to provide coverage for any potential "true up risk".

Revenues:

What is the target's revenue (broken down by jurisdiction and/or legal entity if relevant) and does the DD cover a material portion of that revenue (typically at least c.60-70%)? The question of material revenues frequently overlaps with material jurisdictions, and insurers will expect reporting on jurisdictions accounting for a material portion of revenues. Sampling exercises are acceptable where revenues are made up of a high number of smaller contracts, but the sampling approach needs to be appropriate and clearly explained.

Operations:

What operations are required for the business to function and have they been covered in DD? This needs to include items such as employees, real estate, assets, supply agreements, material contracts, IP, IT, permits, etc. and insurer focus will be on areas that are a priority for the target business (e.g. distributor contracts for a target with a network of commercial agents).

Industry/Sector:

What sector does the target operate in, and does the DD cover common industry risks? This is particularly important in regulated sectors where insurers expect analysis of regulatory frameworks (e.g. FCA, PRA or equivalent rules for financial services businesses; CQC regulations for healthcare businesses; Ofgem, Ofcom or Ofwat rules for infrastructure and energy assets). This also covers employment status of workforces or contractor bases which may require specific DD. Target businesses operating in multiple jurisdictions will also need to be analysed through the lens of laws, practices and regimes applying in such jurisdiction.

Form of Reporting: What Insurers Want

It is key to ensure information is presented to insurers in an appropriate format. Typically insurers expect a minimum standard of legal, financial and tax diligence. In addition to this, an insurer will then expect the buyer to have commissioned additional work (either internally or using external advisors) to plug any gaps outside of the mainstream reporting, or to cover material risk areas of a target business.

When assessing form and extent of reporting insurers will need to understand:

Substance of review:

Insurers expect a well populated data room which broadly aligns with the scope of the warranties to have been reviewed coupled, if applicable, with robust Q&A to allow advisors carrying out DD to report sensibly. Little credence is given to reporting based solely on management questionnaires with no review of underlying source materials. Reporting on an exceptions only/red flag basis is typical and not problematic, however, by the nature of red flag reports an assessment of materiality is required which draws back to the importance of the above points.

Financial and time reporting limitations:

Insurers expect the review to match materiality thresholds in the SPA or policy (once negotiated) and with lookback periods commensurate to both the warranties and market norms. We usually also see a reporting threshold applied which insurers will use to align with the de minimis under a W&I policy, meaning matters below the reporting threshold will not be recoverable or count towards the excess of a policy. We frequently see different thresholds applied by the different workstreams which if aligned would remove an area of friction.

Key takeaway

Scope and materiality are crucial and need to be analysed for each transaction independently; there isn’t a one-size-fits-all approach that can be adopted. If a buyer is looking for an insurance solution, careful consideration of any materiality applied to scoping exercises and an objectively justifiable rationale for the approach are key to securing broad coverage. Insureds need to be able to clearly articulate where materiality doesn’t apply and should do so early in a process, before insurers have the parameters set clearly in their minds. Early engagement with HWF will mean we can advise on scopes based on our extensive market experience to ensure broad coverage.

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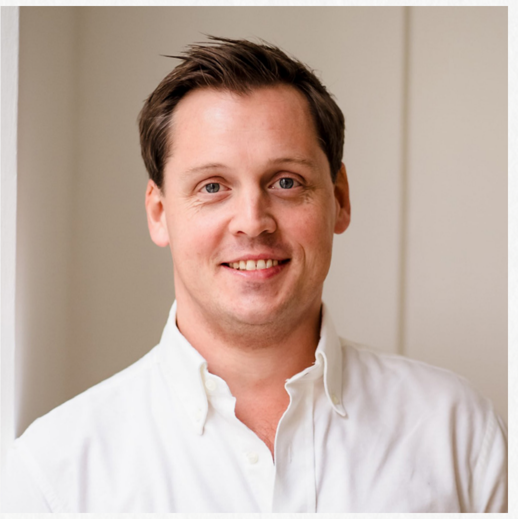

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Look out for the next piece in The Diligence Debate covering tax and specialist diligence.