HWF

The Diligence Debate

Positioning tax and additional diligence workstreams to maximise coverage

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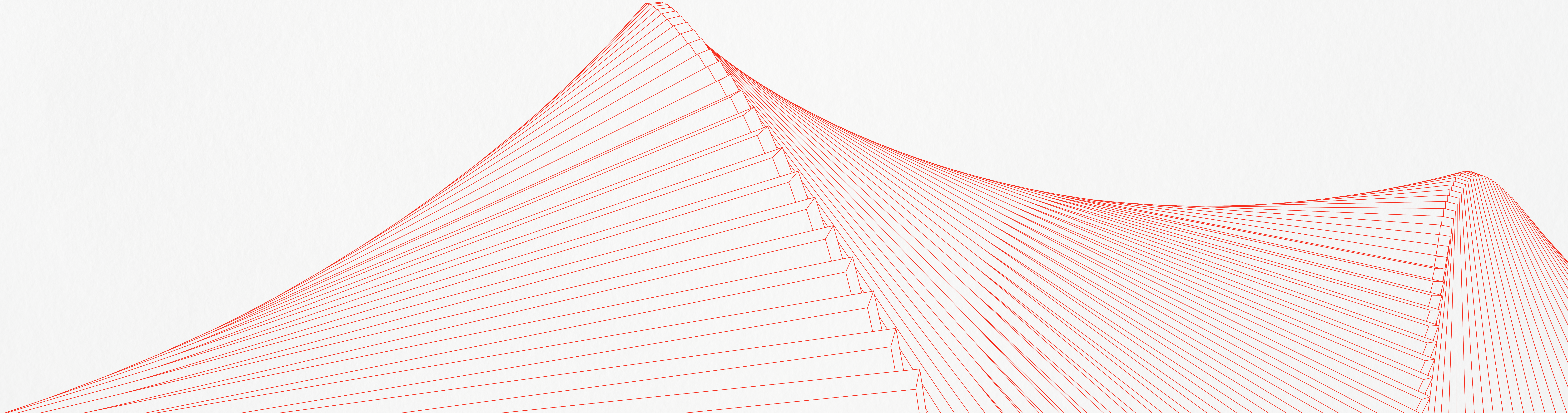
Tax and other diligence workstreams have increasingly come under the microscope of insurers as W&I is adopted more widely for more complex and more cross-jurisdictional transactions.

Tax due diligence ("**TDD**") has increasingly come under the microscope of insurers. This isn't just because tax makes up around 20% of yearly claim notifications, but as W&I is adopted more widely for more complex and more cross-jurisdictional transactions, the more complex and sizeable the potential tax issues become.

Insurers have expanded their teams with experienced professionals outside of corporate and tax disciplines. Consequently, where buyers have moved past the core legal, financial and tax diligence and carried out specialist additional diligence based on the nature and operations of a target business, insurers can provide enhanced coverage and underwriting expertise to look at specific risks.

> "Going into a W&I process with adequately scoped TDD can be invaluable for insured parties to ensure that they are not only presented with the best possible coverage terms up front, but also to allow for a smooth and timely tax underwriting process with the chosen insurer.
> HWF are increasingly feeding into the scoping of TDD from the outset to refine scopes and highlight crucial areas of scrutiny, all facilitating the best possible coverage position".

Tim Dobbing
Associate Director - Tax



Focus on Tax Reporting

As highlighted in the last briefing, it's not the case that coverage under W&I will only be given to the extent a risk area has been fully diligenced, and tax coverage is no different. However, as the W&I market has become more sophisticated, insurers and their tax counsel are scrutinising TDD to ensure unknown potential liabilities they are covering are still "unknowns" following a reasonable and measured DD exercise.

When commissioning TDD as part of a transaction with W&I, the first question an insurer will ask is whether the TDD scope is sufficient to identify all material tax liabilities.

The answer can be broken down into five key scoping points to consider when commissioning a TDD exercise:

1. Local Advice:

If a target group includes entities incorporated in different jurisdictions or it has a taxable presence (but not an incorporated entity) it should be considered whether local tax advice should form part of the TDD. This decision should be based on how material business operations are in the context of the target group, or how material certain jurisdictions are for tax structuring purposes (e.g. substance in financing jurisdictions where cash may be repatriated). It should be assumed that the key taxes in jurisdictions where the target group has a material presence should receive input from local advisers to ensure suitable coverage. If the target group has tax liabilities arising in multiple jurisdictions that are not reviewed within the TDD, insurers will want to understand why these are outside of scope, otherwise coverage will likely be difficult to obtain. Insures will also focus on any recent regulatory and/or tax legislation changes in relevant jurisdictions and, if relevant, will expect TDD from local advisers to include such items in the scope of review for material jurisdictions.

2. Covered Taxes:

A TDD report should review any taxes with a material application to the business. "Material" in this context should mean any taxes which, to the extent arising, could put the target group in a payment or recovery position in excess of the materiality threshold, which should align with the W&I policy de minimis to avoid a disconnect. There is no one-size-fits-all approach, and this is where HWF's experience can be utilised to advise on what the market expectations are for in-scope taxes (e.g. a TDD report covering a UK target holding an office building should sensibly not contain a single word on application of import taxes, however, an international payment processing business should go into detail on the VAT position of its cross-border suppliers).

3. Accounting Periods Reviewed:

The TDD review period should ideally run all the way up to the last full accounting year where returns have been filed and audited accounts are available, in order to give the most up-to-date picture of the current tax position. If there is any material gap since the end of the last full accounting period, any available draft accounts and tax computations should be reviewed to understand if they are in line with the historical filing position or if the target group has undertaken any non-ordinary course activities in the period. Typically, the review period should also go back at least three full accounting periods for an operational business.

4. Provision for Tax in the Accounts:

In an accounts (including a *locked box*) based transaction, insurers will want to understand if the provision for tax within the set of deal accounts (to the extent they are available) has been reviewed, discussed with the seller and/or are reasonable from the perspective of the TDD provider, given the historical tax filing position. A common complaint from insurers is that provisions for tax in *locked box* accounts have not been reviewed by TDD advisors leading to a policy exclusion which would be relatively easily avoided if the TDD scope included review of the *locked box* accounts.

5. Tax Control Environment:

It is common for this to form the preamble of any well-written TDD report. However, the TDD should convey the level of sophistication and appropriateness of the target group's tax control environment to ensure that it is suitable for its size and complexity. Ideally, the TDD provider will join a call with the compliance team of the target group as part of the TDD workstream to understand their roles and involvement. Where the target group is international, the TDD provider should also have some access to the local compliance teams to understand their roles within the local jurisdictions.

Focus on Additional Diligence Workstreams

In addition to the core legal, financial and tax diligence workstreams, insurers will underwrite a transaction through the lens of:

i. what hasn't been covered in those core reports,
ii. what is touched on by the warranties but not the DD, and
iii. is there anything in addition to the main diligence reporting (whether commissioned externally or undertaken in-house) that can give additional information on risks, particularly from a sector or industry specific standpoint?

The answer to those questions will vary for each transaction and HWF frequently assist in scoping/tailoring the DD suite to ensure broad cover is achievable.

The most common additional diligence areas and requirements include:

Insurance Diligence:

Insurers will expect a report to address existing insurance policies, adequacy of policies, records of claims notifications and claims and policy expiry dates. This is particularly useful on carve out transactions where insurers' main concern is that the W&I shouldn't pick up historic liabilities simply because the target ceases to benefit from a retained group policy with effect from completion.

IT/Technology Diligence:

Insurers will expect this to cover the product and/or services, IT architecture and infrastructure, IT processes and cyber security (including penetration testing), software development including open-source code assessment (such as a *Black Duck* scan) and any required licenses and permits.

Regulatory Diligence:

A standalone report can be highly valuable. HWF have experience advising clients across financial services, gambling, healthcare / pharmaceutical, energy and infrastructure sectors where such reports are used to guide insurers through the underwriting process.

Re-organisation/Carve out Reports:

Insurers do not typically provide cover for liabilities flowing from the implementation of such arrangements, however they are frequently able to do so if they are provided with structure and/or steps papers and documents implementing any arrangements in accordance with those papers which do not raise material concerns.

Commercial Diligence:

An area of key value to clients which deals with the forward-looking prospects of a target. Whilst often of limited value to insurers, they will be focused on understanding customer concentration (i.e. if the target has very few or many material customers), any recent amendments to material contracts and material items such as change of control clauses which may be triggered.

Environmental Diligence:

Pollution and asbestos exposures are usually excluded from W&I policies, however if there is targeted diligence it is possible for insurers to provide cover within a W&I policy. Cover for environmental compliance is typically subject to underwriting, with insurers requesting a clean phase 1 environmental report in order to remove the exclusion.

Property valuation/surveys:

In real estate focused or heavy transactions, if site inspections, surveys or similar are being carried out they will need to be provided to the insurer for review.

Assets, Plant and Machinery:

Condition of assets is a common exclusion under W&I policies and in asset heavy businesses where material value is tied up in assets, if cover is going to be obtained detailed reports covering technical matters, surveys and site inspections will be required.

Others:

To the extent any other reports or memos are prepared in connection with the transaction (whether internal or external) you should discuss with HWF whether they should be provided to the insurer for review. Note that this does not extend to internal investment committee memos or similar which should remain confidential to an investor.

Key takeaways

Correctly scoping TDD is critical to ensuring proper tax coverage under a W&I policy. Any buyer or seller should give careful consideration to the TDD scope and an objectively reasonable approach depending on the nature and operations of the underlying target business is key. Early engagement with HWF will mean we can advise on scopes based on our extensive market experience to ensure the best possible tax coverage and a smooth underwriting process in respect of the TDD.

Advisors should ask clients at the outset of a process which DD reports or memos will be prepared (whether internal or external) and communicate that list to HWF. It is not uncommon for us to be notified of additional reports late in a transaction process, frequently after insurers have had the underwriting call and/or formed a view on that specific issue or subject area. Late disclosure can be challenging for us to achieve effective coverage.

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Look out for the next piece in The Diligence Debate discussing how to maximise cover through vendor and buyer top-up diligence.

In case you missed it, you can find our first piece
Scoping diligence to maximise M&A insurance coverage here.