

The Diligence Debate

Maximising cover through vendor diligence and buyer top-up exercises

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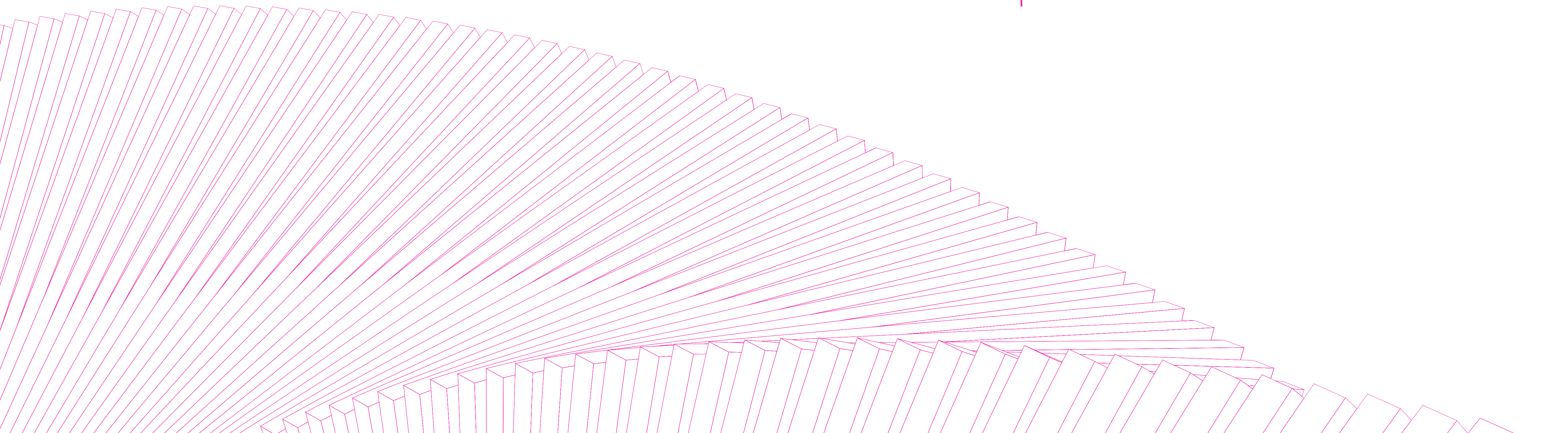
A good quality set of vendor due diligence reports can significantly reduce the burden on a buyer’s DD exercise and improve the availability of, and coverage under, a W&I policy.

The quality and depth of a vendor due diligence (“**VDD**”) pack will be scrutinised by insurers.

In some cases where high quality VDD has been made available, we have been able to structure policies based on VDD alone (although this is an exception to the general rule that insurers will expect to see buyer top-up DD). Conversely, an over-reliance on sell-side work that is either limited in scope or purely factual as opposed to analytical, particularly on a fast-moving auction process where there is pressure to sign a deal, is likely to lead to poor coverage under a W&I policy.

“Any diligence exercise, whether vendor or buyer led, needs to consider the interests of all parties reviewing the reports, including insurers. Any process using insurance needs to have an overall diligence package that is reasonable and proportionate to the size, shape and footprint of a target business, and it’s incumbent on us at HWF along with the insurer community to advise clients on those aspects so clients get the approach and scope of their DD right.”

Will Hemsley
Partner



What do insurers look at when reviewing VDD?

1. Does the sell-side work constitute DD and does it provide objective analysis? Insurers struggle to see value in factbooks and trading updates, although the latter can be useful to bridge the gap between the VDD cut-off date and signing date.
 2. What is the breadth of the scope? Insurers will want there to be a review of source documentation supplemented with a Q&A. Little credence will be given to reporting based solely on management questionnaires.
 3. Which workstreams are providing VDD and do they cover all the relevant areas to (i) the risk profile of the business and (ii) the potential exposures covered by the warranties? Insurers will look for the gaps and pre-emptively expect a buyer to plug them.
 4. Jurisdictions: insurers will expect the VDD exercise to encompass all material jurisdictions, but when dealing with complex multinational businesses we often see that there will be a number of possible geographies “left on the table” for a buyer to look at.
 5. Financial and time reporting limitations: insurers will 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.
 6. Date of reporting: insurers will want the reporting to be up to date. There will be an expectation on the buyer or seller to plug the gap where reports are outdated.
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How can HWF help?

1. We are able to critique VDD scopes based on our extensive experience and assess impact on any proposed insurance process.
2. We can advise on the appropriateness of a hard staple underwriting process and how to position the transaction with insurers, reducing buyer DD burden and reducing execution risk.
3. Early access to VDD will allow HWF to assess whether specific cover for known contingent issues is relevant. This would remove the risk of price chips or other consideration adjustment mechanisms, both of which sellers will want to avoid.

4. We can look to assess the value of VDD providers being engaged in the underwriting process. Reliance, if given by the advisor to the buyer, should also be used in order that the insurer's Q&A can be raised with that advisor.
5. Where transaction timetables shift and there is a need for additional or updated reporting, we can advise who is best placed to look at the workstream from a buyer / seller perspective to maximize time and minimize cost and duplication.

Whenever VDD is produced in conjunction with a transaction, we endeavour to make sure that it is not only assessed on its merits, but also that all parties (buyers and sellers) are clear as to the value placed on it by insurers and what the expectations would be for additional DD over and above the VDD reporting.

Vendor Diligence and Top-Up Exercises

A failure to align a DD top-up exercise with the requirements of an insurer is a common cause of poor coverage under a W&I policy. Whilst misalignment between insurers and buyers has always been a challenging area, it has been exacerbated in recent times by the pressures of compressed timetables, availability (or lack thereof) of DD providers and cost sensitivities on DD. Getting visibility on whether a top-up scope aligns to the insurer's needs and expectations will greatly improve the potential cover position.

The need for review of top-up DD exercises and extent of that review will be wholly determined by the quality of the VDD.

1. If a hard staple has not been used (and so the insurer has not already reviewed the VDD), it is imperative that the insurer's assessment of the VDD is sought early in the process. We can assist with this and feedback initial views early in the underwriting process to allow buyers to shape their top-up exercises.
2. We will share the scopes of the buyer top-up DD with the most competitive insurers for them to assess in advance of instructing an insurer to underwrite a transaction. In our view, it can't be the case that an insurer can tell a client when the scope is deficient, but not be able to advise when it appears sufficient (although of course we would expect them to make any such commentary subject to the underwriting process).
3. If a hard staple has been used and the insurer has provided an indication (typically a coverage note) of expected top-up areas to be covered, HWF will review the note and discuss the required top-up work with insurers in advance to gain clarity on their requirements and understand any areas of flexibility.
4. In compressed timetables we can assist in advising on DD scoping to roadmap post-signing or post-closing remediation of any material coverage gaps.

Key takeaway

VDD can be an incredibly useful tool where reports are well scoped and analysis is detailed. Early access to VDD from HWF's perspective allows us to analyse potential issues and feed into the DD process from an insurance perspective in order to facilitate an efficient underwriting process with successful bidders, reducing execution risk and deal disruption.

Buyers need to be in a position where their top up exercise will be sufficient to afford a broad cover position, having regard to the constant timing and cost pressures on buyer top-up DD exercises. HWF will involve insurers earlier in the process, where possible, to de-risk the exercise for insureds.

Key contacts



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Look out for the next piece in The Diligence Debate discussing internal due diligence.

In case you missed it, you can find our first piece on scoping diligence to maximise M&A insurance coverage [here](#) and our second piece on tax coverage [here](#).