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The Diligence Debate

A four part series examining
due diligence in W&I insurance

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Part 1: 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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Part 2: 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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Part 3: 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.

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.

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Part 4: The internal diligence question

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HWF are increasingly being asked whether insurers will accept internal DD when underwriting a W&I policy.

Traditionally, insurers have been restricted by obligations to underlying capacity providers who require underwriters to have access to external third-party DD materials when assessing risks. Certain insurers have also historically experienced a higher claims ratio on transactions for which significant portions of the DD process were conducted in-house. Therefore a limited number of insurers were historically able to underwrite transactions where the DD was done largely, or wholly, in-house.

However, given the increase in the number of both large corporates (who have significant M&A capabilities and track records as well as highly qualified internal teams) and specialist dedicated sector investors (such as renewable and infrastructure funds) using W&I insurance, insurers and their underlying capacity providers have become more welcoming of internal DD processes. To achieve a comparable result to a transaction with external DD reporting, it is imperative that insurers can underwrite the transaction in a similar way and take the same degree of risk analysis from the internal reporting.

"Where claims have arisen from matters which were not discovered via in-house DD, the criticism was that the reporting only focussed on commercial, forward-looking issues thereby missing key risks relevant to warranty breaches. However, the depth of expertise some clients have in-house to really drill down into a target's operations can give insurers a level of insight and understanding in the relevant sector a third-party provider might not be able to achieve. So provided we can show a sound DD exercise and objective reporting of historic risks there can be a real benefit to leveraging that internal knowledge base."

Adrian Furlonge
Partner

The key principles insurers will focus on when considering internal DD are:

1. **The team**
   Who has carried out the work and are they qualified/do they have relevant experience (in-house or externally) to do that work?

2. **Scope**
   Does the scope extend to what would be looked at if a third-party provider was undertaking the exercise? Any internal reports will need to look at the historic risks in the target business to which the warranties relate, rather than focusing on forward-looking benefits such as the commercial, synergistic or operational efficiencies resulting from a proposed acquisition. That said, typically it will be easier for DD scopes to be refined in order to pick up insurer comments during underwriting in the event that internal DD is being carried out. If different DD workstreams are being carried by internal and external parties, insurers will also look at alignment between the internal and external scopes to ensure risk areas are being fully reviewed and not falling in the gaps between scopes.

3. **Materials**
   Does the process include a review of all relevant materials, and what proportion of the materials in the data room have been reviewed? Does the work include relevant Q&A and follow up with the sellers and/or target management?

4. **Reporting**
   Is there objective analysis that bottoms out the risk profile of issues, and are the findings and conclusions drawn as to the materiality of issues or potential remedies considered? Insurers will take comfort from exposures being identified which reinforces that an appropriate process has been carried out. Particularly on the tax side, insurers will find it helpful to see some form of debt-like items schedule which shows how findings have fed through to the wider transaction structure.

5. **Format**
   Insurers will be focused on content over form, so reporting by email or in internal memos for example can be fine provided the materials provide analysis and recommendations rather than simply reporting on facts and discussions. That said, we would always recommend replicating the “look and feel” of an external report where possible.

How can HWF assist?

1. Whilst in rare instances it has been possible to structure solutions in the absence of formal reporting, it usually leads to poor results. We can assist by understanding what the tangible output of the internal workstreams will be and advising on any changes that can be made (in some cases cosmetically) to assist insurers in their review and improve the cover position.

2. In advance of the internal report being prepared we can review scopes and advise on potential gaps in the usual way. In addition, we would look to share DD scopes, team bios, indices of the documents reviewed and Q&A with insurers to allow them to get comfortable with the exercise and flag any concerns or highlight any gaps.

3. We can assess the opportunity for integration of smaller or more focused internal workstreams into internal and external reporting. Importantly, this can be relevant to specific DD areas around plant & machinery, stock, IT, IP and insurance.

4. Our aim is that every insured that carries out the DD internally (in whole or in part) has the knowledge of the insurer's requirements to enable them to get coverage comparable to a DD exercise conducted using external providers.

Key takeaway

Internal DD is not a bar to obtaining W&I insurance. HWF frequently advise clients who use internal reporting and obtain cover commensurate with cover we would achieve had external DD been conducted. Early engagement with HWF will be important in order that we can understand the scope and form of reporting and ensure cover reflects a buyer's expectations.

Key contacts

For more insights visit hwfpartners.com/insight.

If you have any questions on the contents of this series or would like to discuss transactional risk with one of our experts, please reach out to us:

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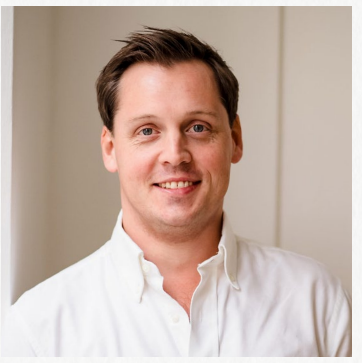

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