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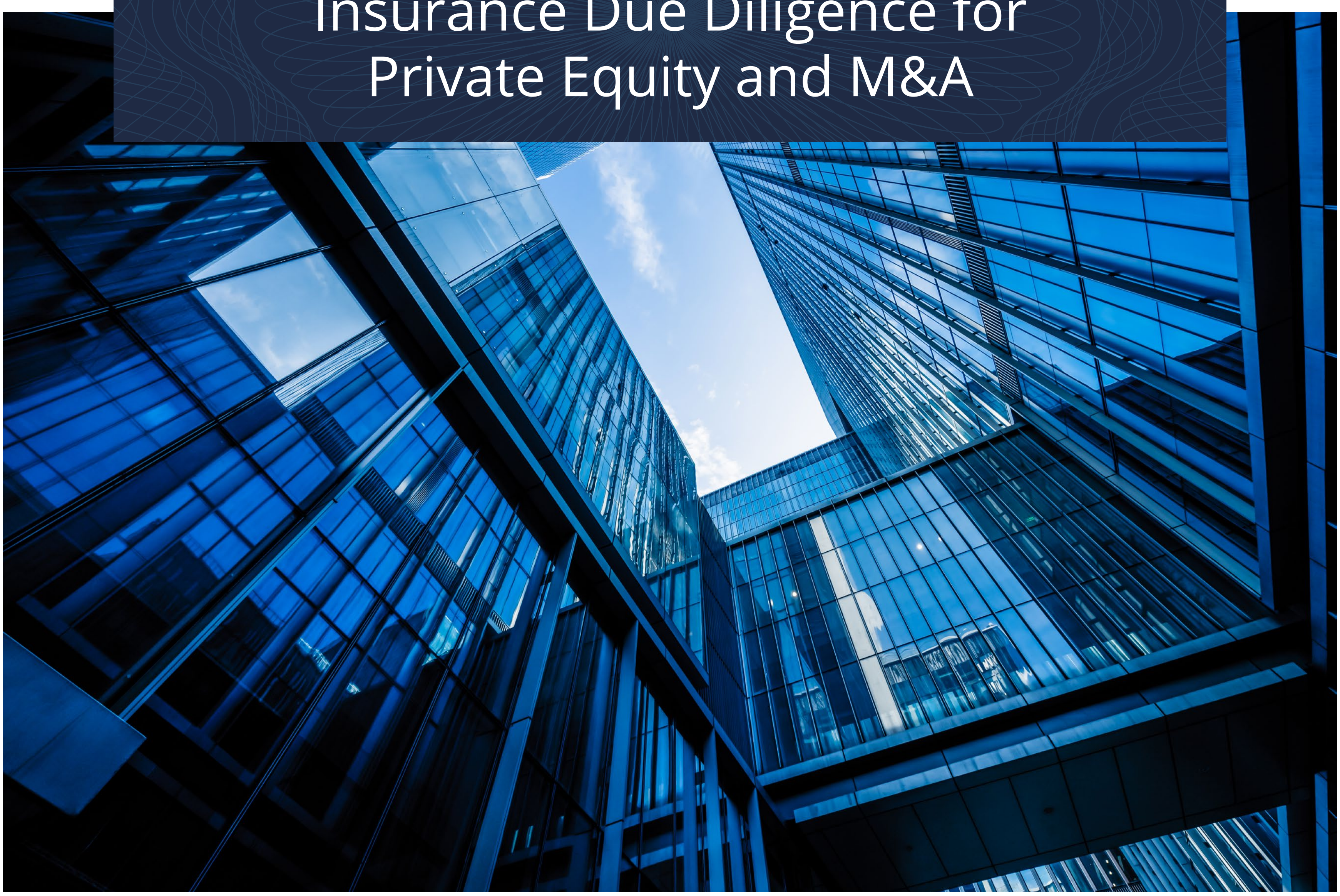
GUIDE TO TRANSACTIONAL RISK:

Insurance Due Diligence for Private Equity and M&A



Introduction

As we move deeper into the 2023 deal landscape, one thing is abundantly clear: Deal flow has experienced a significant slowdown over the last few quarters. According to PWC, private equity deal volume declined 22% during the second half of 2022 compared to the year prior. The drying up of the debt market, increases in inflation and interest rates, and the macropolitical environment are all ingredients that have led to the slowdown in deal activity. According to The Middle Market's *Mergers & Acquisitions*, "The world's dealmakers are enduring their worst start to a year in two decades, as economic and financing headwinds continue to prevent a bounce back in mergers and acquisitions."

However, with record levels of dry powder and new, recently closed buyout funds across the industry, we believe firms will find a way to get deals done in 2023—but their processes for doing so will have a higher acceptable diligence threshold to close. In other words, we expect investment teams will spend more time analyzing what's under the hood of a potential target acquisition in 2023 than they may have in 2020, 2021, and the first half of 2022. They will scrutinize areas such as financials, taxes, legal, operations, cyber, market outlook, and yes, even insurance and risk management.

On the other side of the equation, we expect operating partners and professionals at private equity firms to look to maximize EBITDA improvement mechanisms within the portfolio itself. Together with company management teams, they will hunt for ways to improve efficiencies, reduce costs, and maximize EBITDA margin improvement wherever possible in the face of macroeconomic headwinds.

For top-tier middle-market private equity firms, insurance and employee benefits program implementation is one area of increased focus. Since deals are few and far between thus far in early 2023, PE firms need to protect EBITDA of their new platform investment and be able to effectively integrate add-on acquisitions to existing platforms. If due diligence and implementation of insurance and employee benefits programs are executed poorly, acquirers and investors alike may be exposed to increased risks that could negatively impact EBITDA in the short term and diminish the value of the asset in the long term.

Drawing from over 25 years of experience working in the private equity and M&A community, we recommend performing insurance due diligence on every transaction to identify, quantify, mitigate, diminish, or otherwise transfer the potential risks that could negatively affect EBITDA for the portfolio company.

Furthermore, including an expert insurance advisory team on the buyer's due diligence bench will help avoid or mitigate potentially costly land mines, protect the investment in the short and long term, and ensure a cleaner exit. During due diligence, it's critical for a deal team to understand how the management team has historically approached insurance and employee benefits decisions in the past versus how it should handle them on a go-forward basis as a private-equity-owned business.

Introduction

The 2023 *Guide to Transactional Risk* explains how we help our private equity, growth equity, special purpose acquisition company (SPAC)/de-SPAC, and strategic acquirer clients through their transactions. We've developed this *Guide* and these best practices based on our experience in personally working on thousands of middle-market transactions, from before the letter of intent (LOI) through the transaction's closing, hold period, and continuing post-divestiture.

Broker expertise is an essential piece deal teams must consider when reviewing potential advisors—brokerages without in-house specialists may use outsourced Representations and Warranties teams or outsourced due diligence advisors. We have found that it is never in the best interest of the private equity buyer when a brokerage firm uses an outsourced or centralized due diligence team.

Hand-offs like these that occur before, during, and throughout the deal process and post-close brokerage services can lead to significant issues pertaining to the insurance and employee benefits programs.

Why Does Insurance Due Diligence Matter?

1. **Understand how EBITDA is being protected at the company level.** The overall goal of due diligence is to uncover the potential land mines that can negatively affect EBITDA for an acquisition in both the short and long term.

2. **Understand the foundation of insurance, general risk management strategy, and approach to employee benefits offerings that have been implemented historically to protect the business and employees prior to investment.** How has the management team viewed insurance and risk management up to the point of selling the company? Which of the company's risks are uninsured, underinsured, deficiently insured, or adequately insured? How has the team developed, implemented, and maintained the employee benefits package offered to employees?

3. **For de-SPAC transactions, prepare for the critical transition from a private company to a publicly traded company.** In every de-SPAC transaction, the target company will be merged with the publicly traded SPAC, and the private company will be publicly traded post-close. This transition has several key components—the most important being the conversion of the Management Liability (or D&O) program from private to public.

4. **Watch for implications on total cost of risk. Uncover opportunities for cost structure improvement post-close.** Is the target company overpaying (or underpaying) for insurance? Are there opportunities for the target company to take on more risk that will improve the cost structure and EBITDA over the long term? Are there ways of restructuring the Employee Benefits program or adjusting contribution strategies?

5. **Avoid exclusions or issues with the Representations and Warranties Insurance (RWI) process.** In almost every deal where RWI insurance is a component, the underwriter will request a report or memo for the insurance and benefits programs in place. If not answered correctly and adequately, exclusions may be added to the RWI policy. RWI sits in excess of all existing insurances of the target, so make sure the foundation is strong. This is particularly important regarding Cyber coverage, D&O, and other management liability lines.

6. **Understand historical losses.** Frequent losses are indicative of management's approach to risk management. Are historical losses likely to persist post-close? Is the current program set up to handle those losses? Do the losses indicate a potential for higher retentions or loss-sensitive financing arrangements to better control risks?

7. **Coordinate run-off policies.** Some existing policies could be exposed to run-off provisions. Insurance due diligence helps the deal team understand the potential risks of buying run-off or tail policies at close (or not buying them), ensures protection of the asset from close, and provides a clearer understanding of who is responsible for what risks, why, and when.

8. **Get a sense of evidence-based benchmarking.** How much commercial insurance does the target purchase? Is it enough? Is it too much? How does the Benefits program compare to peer companies?

9. **Identify potential new program needs.** Depending on the transaction structure and agreement language, a new Property, Casualty, Management Liability, or Employee Benefits program may need to be implemented at close.

10. **Respond to lender requests.** When new lenders are added to the financial structure, they will require certificates naming them as additional insured or lender's loss payable on the insurance program. Like RWI insurance underwriters, lenders will require a base review of the insurance program. There will be certificates required for closing.

> **Including an expert insurance advisor on the due diligence bench will enhance a deal team's understanding of the target acquisition pre-close —ensuring that no surprises come up post-close.**

Transaction Timeline from an Insurance Perspective

In any given transaction, various items can arise that will lengthen (or shorten) a transaction timeline. The two main insurance-related workstreams are the RWI and due diligence processes. Understanding how these two simultaneous workstreams weave into the broader transaction timeline will help you avoid delays at the end of the process. For more information on this process and other insurance insights, subscribe to our newsletter.

Here is the typical process for a stock buy-out transaction:

RWI Process:

Phase 1

5–6 days

- Information needs:
  - Confidential Information Memorandum (CIM) or management presentation
  - Financials (audited or reviewed); if unaudited, a quality of earnings report (QOE) will be required
  - Draft purchase agreement (preferably buyer markup)

Phase 2: Confirmatory Underwriting Due Diligence

5 Days — Sign/Close

- Non-refundable underwriting fee is paid (Day 1)
- Data room access granted to insurer and outside legal team (Day 1)
- All due diligence reports are supplied to the underwriter (Day 1)
- Two-hour underwriting call (Day 3)
- Draft policy and follow-up questions delivered to buyer (Day 5)
- Policy negotiation (Day 5–close)
- Policy bound (close date)

Due Diligence Process:

DAY 1
Data room access granted to diligence advisor

DAY 2
Information checklist provided to buyer

DAY 3
Intro call with management, as necessary

DAY 4–14
Data collection and due diligence

DAY 14
Due diligence report and go-forward applications delivered to buyer and underwriter for RWI if being sought

DAY 14–16
Diligence presentation and completion of go-forward applications

DAY 16–CLOSE
Go-forward marketing for new coverages

PRE-CLOSE
Lender requirements satisfied

CLOSE
New coverages bound

CLOSE + 7 DAYS
Broker transition

POST-CLOSE
Risk Management and Insurance Strategy Planning

Get more insight into *the RWI process* and other issues concerning M&A

Phase 1: Pre-LOI through Execution of LOI

One oversight many deal teams make is involving the insurance advisor too late in the process. This situation is typical because insurance tends to be a lower priority item compared to everything else going on during a deal. We have found that insurance due diligence advisors are not typically engaged until an LOI has been executed, and there is a definitive timeline and action plan to close (i.e., exclusivity has been granted, and the deal is officially moving forward). There is very little insurance due diligence to be performed pre-LOI, and private equity firms typically do not initiate the insurance diligence workstream until later in the process.

However, the pre-LOI period is often when an RWI broker partner is selected and becomes involved. We recommend including a fully vetted RWI proposal when a private equity firm nears completion of the LOI and looks toward submitting a second or final round bid for a target. This step demonstrates to a seller that the prospective buyer is not only committed to procuring an RWI policy as part of the transaction but that the buyer has also engaged with a broker and has gone through the initial stages of obtaining quotes and vetting out initial terms, conditions, and pricing. This move also sends a clear signal of the bidder's intent.

LOI Best Practices from an Insurance Perspective

- Involve your insurance advisor early in the deal process.
- Include a vetted RWI proposal near completion of the LOI.
- Complete administrative work on the due diligence side.
- Get familiar with the target company by reviewing the Confidential Information Memorandum, financials, management presentations, and initial insurance-related information.

In addition to RWI procurement, the pre-LOI stage is an ideal time to get administrative work on the due diligence side completed, such as mutual NDA execution, formalized engagement letters, initial diligence information checklists, data room access, etc. At this stage, the team can also get familiar with the target company by reviewing the Confidential Information Memorandum, proposed LOI, deal structure, financials, management presentations, and initial insurance-related information in the data room.

The overall purpose of this initial process is that if and when the deal moves forward into exclusivity, the insurance diligence team can hit the ground running with these initial administrative items completed.

With this step complete, the insurance advisory team can hit the ground running as soon as the LOI has been executed and a definitive closing timeline is established.

FOR MORE INFORMATION
on this process and other insurance insights, ***subscribe to our newsletter***.

Phase 2: Period of Exclusivity and Insurance Due Diligence

Once the LOI has been executed and there is a definite close date on the horizon, the buyer typically will kick off all third-party diligence workstreams. Insurance and Employee Benefits due diligence **should always** be one of these workstreams.

First, the advisory team becomes more acquainted with the target company by having a call with the management team and providing updated information checklists based on the data initially provided in the data room. As more information is gathered and supplied to the buyer's diligence teams, checklists are constantly refined in real-time, and the insurance advisory team begins work on the due diligence.

Members of the deal team are not insurance experts. The insurance advisor should be considered an extension of the deal team and a partner in EBITDA protection, as well as in risk mitigation and long-term insurance strategy.

The result of the diligence process should be a comprehensive, clear, and concise memo or formal due diligence report outlining key findings, recommendations, and next steps as the transaction process moves forward.

What is the diligence team looking to find during their analysis?

- Acceptably insured exposures
- Deficiently insured exposures
- Underinsured / over-insured exposures
- Uninsured exposures
- Underfunded / unfunded liability exposures
- Evidence-based benchmarking
- Cost and coverage efficiencies (or inefficiencies) that can be maximized (or minimized) at close and post-close

> **The goal of the insurance due diligence process is to uncover any instances or exposures that could negatively affect EBITDA for the target company pre-close, at close, or post-close in the short and long term.**

Phase 3: Pathway to Close and Closing

Once the due diligence is completed, several things need to happen prior to closing:

1. RWI Phase II Underwriting Process

Phase I of the RWI process is completed when the private equity firm's deal team chooses an RWI insurer to underwrite the transaction, executes the expense agreement for the chosen insurer, and wires the non-refundable underwriting fee directly to the insurer.

Phase II of the RWI process can move forward once the primary, underlying transaction due diligence has been completed, reports for each diligence workstream can be provided to the underwriter, and, most importantly, a draft of the disclosure schedules is made available. The chosen underwriter (and their outside legal advisors) will gain access to the data room and "diligence the diligence" by performing a desktop review of all the due diligence reports put together by the buyer's team. Following the initial review, a 90- to-120-minute underwriting call is coordinated, after which a draft policy and follow-up questions are delivered to the buyer.

From that point until closing, questions are resolved as new terms of the purchase agreement are developed, and policy negotiation moves forward simultaneously as the deal marches toward sign/close. By the time the deal is ready to sign/close, a fully underwritten and negotiated RWI policy is ready to bind.

2. Coordination of Run-Off Coverage for Any Policies That Have a Change in Control Provision

This typically includes existing Professional Liability, ***Management Liability***, and ***Cyber Liability*** policies.

3. Go-Forward Coverage Solicitation

Depending on the transaction's structure and the underlying policies in place, the insurance advisor should assist with soliciting and proposing coverage for the go-forward entity structure. For example, if the transaction is an asset-purchase, a new Property, Casualty, and Management Liability program should be implemented at close.

TRANSACTION STRUCTURES AND INSURANCE: ASSET VERSUS STOCK TRANSACTIONS

Explore the insurance implications associated with ***asset versus stock transactions***.

On the other hand, if the deal is a majority-controlled stock transaction, typically only those policies that include a Change in Control provision must be replaced at close. This coverage could include Professional Liability, Directors and Officers Liability, Employment Practices Liability, Fiduciary Liability, and Cyber Liability. Any other policies placed into run-off will also need to be replaced at close.

4. Certificate of Insurance Coordination

Lenders will need certificates of insurance validating that coverage is in place as of closing. Certain organizations will also need to be added to the insurance program as additional insureds or lender's loss payable and may also stipulate cancellation notification provisions. These additions need to be referenced in certificates of insurance, typically required prior to close, and are coordinated by the buy-side advisor but executed by the existing insurance broker.

Important note regarding certificate requirements for asset transactions:

If a new commercial insurance program is being implemented at close (in an asset transaction, for example), it is essential to understand the lender certificate process and timing to avoid delays. The lender will often stipulate the certificates are provided pre-close, including policy numbers, effective dates, etc. However, coverage cannot be bound until an insurable interest is created between the buyer and the target company. The insurable interest is created when the deal officially closes, but the lender will not fund the deal until it has the certificates of insurance. The insurance advisor must work hand-in-glove with the lender to ensure everything is ready and everyone is on the same page regarding these requirements.

Phase 4: Post-close Brokerage and Implementation

Once the deal closes, the real work and partnership begin between the operating partners of the private equity deal team, the management team of the newly acquired company, and the insurance broker team. Post-close is when the advisor begins implementing any recommendations that could not be or were not implemented at close. It is also when the due diligence advisory team works hand-in-glove with the management team to develop a comprehensive insurance and risk management strategy for the short, medium, and long term.

POST-CLOSE TIMELINE

Step 1 1–7 Days post-close	Broker transition: The portfolio company management team completes the necessary paperwork to transition the insurance program to the buyer's insurance advisor.
Step 2 2–3 Weeks post-close	In-person or virtual management meetings
Step 3 2–4 Weeks post-close	In-person or virtual insurance implementation and strategy planning session

Key Insurance Due Diligence Findings in 2022

Here are several key findings that Woodruff Sawyer is seeing in middle-market private and growth equity transactions:

No comprehensive, strategic approach to insurance and risk management

While a foundation of coverage has been established, no long-term insurance strategy for EBITDA protection has been developed or implemented. The insurance advisor should recommend ways to both professionalize the program and raise the level of sophistication of the insurance program post-close to maximize EBITDA protection over the lifecycle of the investment.

Key coverages are missing

For many target acquisitions, the deal represents the first time the company has accepted institutional investors or considered a buy-out from a private equity sponsor. This situation means new board members and potentially a new approach to insurance. What may have been treated as low-priority pre-close (due to cost, for example) may be treated differently with a new private equity owner or growth equity investment because the buyer or investor will always seek to protect their investment.

> Examples of missing coverages include Management Liability (Directors and Officers Liability), Commercial Crime, Cyber Liability, or Product Recall Liability.

Limits are inadequate

Like the previous point, a company pre-close will choose a limit for a variety of reasons. We have found the company typically has not performed any benchmarking analysis around limit adequacy. As an institutional investor becomes involved, there should be greater thought around limit adequacy to protect the short and long-term EBITDA of the company.

> Examples include Cyber Liability, Business Income and Extra Expense, Contingent Business Income, and Products Liability.

Key Insurance Due Diligence Findings in 2022

RWI continues to be used on most transactions, and it's becoming the norm even on deals smaller than $50 million.

A recent ABA study from 2022 noted the use of RWI at over 60% on all deals, with a much higher percentage expected for PE buyers. Three new entrants came into the market in the last six months of 2021 and another in 2022. At the beginning of 2023, we are seeing a very competitive landscape with pricing at 2.5–3.5% of the limit being purchased.

The market is responding to the slowing of deal flow by seeking out a broader range of risks. Many more traditionally challenging placements like healthcare and fintech are getting quoted broadly by multiple markets. There is also growth in the interest of providing coverage for tax risk and contingent liability.

There is continued growth and interest in smaller deals, with certain markets seeking to provide simpler coverage for lower pricing with a streamlined underwriting process. Additionally, we see the traditional RWI market actively seeking out secondaries and minority deals for coverage.

Cyber Liability continues to be the underwriter's greatest concern when looking at insurance diligence and is worth exploring early in the quoting process. Many targets in the small- to-mid- market world still come to market with no coverage in place, which can be challenging and impact RWI placement.

We are also seeing almost every RWI broker implementing new fee structures for compensation.

LEARN MORE ABOUT RWI

Guide to Representations and Warranties Insurance

Get more insight into the RWI trends we foresee in 2023.

Management teams should expect varying premium/rate increases dependent on product and industry on property, casualty, and management liability coverages.

Management teams should be prepared for continued rising rates throughout 2023 on several key lines of coverage. While the Cyber Liability market is normalizing, the Commercial Property marketplace continues to be in tough shape, given the catastrophic events throughout 2022.

READ MORE ABOUT THE RECENT RATE TRENDS IN:

Property & Casualty Looking Ahead

Directors & Officers Liability Looking Ahead

Cyber Liability Looking Ahead

The Importance of Due Diligence

Insurance and Employee Benefits due diligence may not be the top priority on a private equity, growth equity, or SPAC deal team's radar. After all, there are many other priorities during the hectic deal process. However, a comprehensive risk management and insurance strategy can bolster a company's EBITDA and protect against long-term issues. In the case of de-SPAC transactions, critical nuances from an insurance perspective must be implemented at close when the business combination completes, and a new publicly traded company is formed through the merger.

Woodruff Sawyer Expertise in Protecting Private Equity & Venture Capital Firms:

$350+ billion
total assets under management insured at the fund level

$150–$350 million
average platform transaction size

325+
private equity and venture capital clients

250+ active engagements
in the last 24 months

25+ years of working
in the private equity and M&A space

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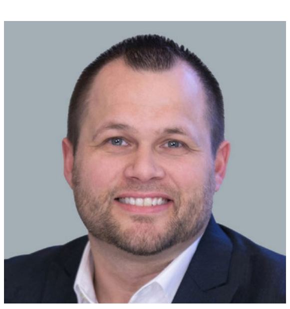

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About Woodruff Sawyer

As one of the largest insurance brokerage and consulting firms in the US, Woodruff Sawyer protects the people and assets of more than 4,000 companies. We provide expert counsel and fierce advocacy to protect clients against their most critical risks in Property & Casualty, Management Liability, Cyber Liability, Employee Benefits, and personal wealth management.

An active partner of Assurex Global and International Benefits Network, we provide expertise and customized solutions to insure innovation where clients need it, with headquarters in San Francisco, offices throughout the US, and global reach on six continents.

Additional Resources

- THE M&A NOTEBOOK
- THE SPAC NOTEBOOK
- THE D&O NOTEBOOK
- GUIDE TO D&O INSURANCE FOR SPAC IPOS
- GUIDE TO D&O INSURANCE FOR DE-SPAC TRANSACTIONS
- REPRESENTATIONS & WARRANTIES INSURANCE BUYING GUIDE
- TRENDS IN M&A RISK AND INSURANCE FOR 2023

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