Note on Navigating Risks with W&I Insurance

This Note sets out the requirements of insurers on the due diligence to be conducted in relation to a proposed M&A transaction, in the event that the parties intend to procure a W&I insurance for such transaction, as set out in the report "Bringing Risk to Light" issued by Eversheds Sutherland and Lockton Transactional Risks.

Baseline Requirement for Due Diligence

The golden rule is that if parties are seeking W&I cover on an element, due diligence must be performed, documented and provided to insurers for review. Accordingly, it is important to consider the scope of due diligence on legal, finance and tax fronts as early as possible to ensure there is a solid foundation for the insurer to review. Without this, parties may end up with more limited coverage (for example, an increased de minimis level to match the materiality threshold), a higher premium or a denial of policy altogether. Having said that, strong W&I insurers should not require the cart to lead the horse' in terms of the W&I policy driving the due diligence process.

When underwriting a policy, an insurer will consider legal and other due diligence reports, the status of negotiations and the manner in which the transaction has developed, even though the insurers do not put any formal legal reliance on due diligence reports. In addition, insurers will seek a written or oral Q&A with the insured and their advisers to supplement their underwriting process.

External Due Diligence vs In-House Due Diligence

Due Diligence by External Advisors vs Due Diligence done In-House

Generally, insurers prefer to see the expertise of external advisers opining on matters in the due diligence, but if the buyer has similar capability in-house, the insurers are willing to accommodate internal due diligence to the following extent:

(i) Proper Documentation: If an in-house team is undertaking the due diligence, a documented report must be provided, which the insurer can review and underwrite;

(ii) Tax Due Diligence: Tax due diligence is an area on which insurers much prefer to see external advice, as tax landscapes across jurisdictional boundaries are ever-evolving;

(iii) Legal and Financial Due Diligence: Insurers tend to be more accepting of internal due diligence in respect of legal and financial due diligence, but it is preferable that one or two of these areas are assessed internally to supplement an external report as opposed to all legal and financial matters; and

(iv) Experience: Insurers may require advice on the experience of the individuals who prepared the internal reports.

Due Diligence in a Multi-Jurisdictional Deal

What is the Scope of Due Diligence Expected by Insurers in a Multi-Jurisdictional Deal?

On large multi-jurisdictional deals, it may not be efficient in terms of time and costs to carry out a thorough due diligence exercise on all global operations or assets.

The insurer generally expects any jurisdiction which accounts for over 5% of the group's turnover to have been covered by full due diligence. Beneath that level, the extent of required due diligence to satisfy the insurer to provide broad cover will depend upon the nature and significance of the activities carried out in the relevant jurisdiction. Desktop reviews' or high-level due diligence on more minor regions is generally fine if it is justifiable in terms of their importance and financial value in the overall target business. For example, an insurer may be able to get comfortable with limited due diligence being carried out on a company which has been incorporated in a foreign jurisdiction to act as a representative office, and which holds no material assets or contracts and has no employees. However, if no due diligence has been undertaken at all, the insurer will likely exclude cover for the activities in that jurisdiction.

Further, in areas which are technical or legislation- or regulatory-heavy, the insurers expect local advisors to be engaged. In particular, insurers expect local counsel to assess compliance issues, such as employment and corporate compliance, and to conduct finance and tax due diligence.

Vendor Due Diligence

Can Vendor Due Diligence Replace Buyer Due Diligence?

The insurers require some form of buy-side due diligence to be conducted, even when vendor due diligence has been undertaken. This is because a vendor due diligence report will likely be subject to a specific scope and assumptions, which will typically result in exclusions in coverage if there is no additional due diligence by the buyer. Further, it is often the case that a vendor due diligence report has been prepared up to a date that is several months prior to the signing of the transaction and an insurer typically prefers the due diligence to be updated by the buyer.

Sell-Side W&I Policy vs Buy-Side W&I Policy

Are Sell-Side W&I Policies Readily Available?

As a matter of market practice, W&I policies are typically procured by the buyers. Insurers are cautious and selective about sell-side W&I policies. When they do offer them, they are effectively performing the due diligence themselves by investing time in the data room and analysing the underlying documents. There is a material cost element to this resulting in an increased underwriting fee, but importantly the target has to be a business that the insurer can understand and analyse itself (as opposed to relying on buyer due diligence). Consequently, sell-side W&I may not be available for larger and more complex transactions.

Due Diligence in the context of Sell-Side W&I Policy

For a sell-side policy, insurers would ideally prefer vendor due diligence reports. However, it is still possible to obtain a sell-side policy if there is a well presented data room and evidence of robust Q&A and disclosure processes as insurers generally take the view that, unlike a buy-side policy, with a sell-side policy there is a greater alignment between the insurer and the insured as the seller will remain liable to the buyer in the event that the policy does not respond for any reason.

Due Diligence in Specific Areas

As a matter of general principle, expectations around specific due diligence will depend on the type of business of the target company. We highlight below the requirements relating to specific due diligence in the certain specialist areas:

Information Technology	An insurer would expect extensive IT and IP due diligence to be undertaken in relation to a software business whose main revenues derive from the ability to use or monetise bespoke software. However, in the case of a manufacturing business which uses only 'off the shelf' software for example, technical IT due diligence would not be expected. A black duck report is relevant when the target business has developed bespoke software and the buyer wants to understand what open source has been used in the code to ensure that there are no licence violations. If the insurer is asked to cover open source warranties or warranties as to the ownership of the software, they will typically expect thorough due diligence in the form of a "black duck" report although in certain circumstances, where there is evidence of contemporaneous and consistent monitoring of open source licence use, a "black duck" report may not be essential.
Insurance	Insurance warranties in a sale and purchase agreement are typically focused on disclosure of the terms of the policies and claims history. Insurers would therefore not be expected to insist on insurance due diligence being undertaken.
Environmental	If the target business owns freehold property or is involved in manufacturing, then the insurer is likely to expect the buyer to have commissioned separate environmental due diligence. Minimally, the insurers would expect what is called a phase one environmental report to be prepared in respect of key sites. The phase one review is a non-invasive, desktop review conducted by specialist environmental consultants that will look at the target business' environmental compliance, and seek to identify actual or potential contamination or non-compliance. To the extent any issues are identified, then the buyer may need to consider carrying out a more invasive survey.
Data Privacy	Insurers may expect the detailed requirements of compliance with data privacy laws (such as the General Data Protection Regulation and Singapore Personal Data Protection Act 2012) to have been looked at by specialist data privacy lawyers and cover will be limited or excluded if such diligence has not been undertaken. In the event that adequate due diligence is undertaken and issues are identified, that may well also lead to exclusions from cover.
Regulated Industries	Insurers expect specialist due diligence to be undertaken when the target business is regulated.

Affirmative Coverage for Known Issues

W&I insurance generally do not cover known risks, which include issues uncovered during the due diligence exercise. However, insurers are increasingly willing to provide cover for risk areas flagged in the due diligence reports - this is known as affirmative cover. Affirmative cover is more forthcoming where the risk lies in an area where there is technical uncertainty but insurer is satisfied based on the due diligence conducted that the risk is low in practice.

In particular, any tax risks identified as part of due diligence are historically excluded from any W&I policy, meaning that if a buyer wanted to insure those risks, it would have to purchase specific tax risk insurance. However, insurers are increasingly willing to not apply the exclusion for matters disclosed in relation to specifically identified tax risks, provided that these risks have been considered in sufficient detail as part of the due diligence and has reasonably been concluded that they are low risk.

Where it is not possible to convince an insurer to cover a particular tax risk, there are a few further options open to a buyer. It could seek a reduction in the price, require a retention or seek to put the risk on the seller by way of a specific indemnity.