WOODRUFF SAWYER

Guide to Transactional Risk:

Insurance Due Diligence for Private Equity and M&A Transactions

2024 Edition

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The Deal Landscape: Bright Signs for 2024

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The Deal Landscape: Bright Signs for 2024

As we move further into the 2024 transaction landscape, we're getting a better sense of where 2023 ended in the private equity and mergers and acquisitions (M&A) market. The headline is: More of the same throughout 2023, but there are bright signs for 2024 dealmaking.

According to EY's "Private Equity Pulse," inflationary headwinds, rising interest rates, geopolitical unrest, and general macroeconomic uncertainty led to dealmakers largely tapping the brakes throughout 2023. In the US, Q4 2023 deal value declined by 22.6% year over year, and total deal count also decreased year over year compared to 2022. However, absent the inflated deal flow count and deal values of 2021 and 2022, 2023 was largely back to pre-COVID and pre-SPAC days—6,636 total deals in 2023 compared to 2018–2020 deal counts of 6,064, 6,273, and 6,280, respectively. Although a tough deal environment, 2023 was still the third most active year on record in terms of total deal count.

Factors Stalling Deals in 2023

- Inflation
- Rising interest rates
- Geopolitical unrest
- Macroeconomic uncertainty

Source: EY Private Equity Pulse Q4 2023

So, there are still deals getting done, albeit on the smaller side, via add-on acquisition or growth equity structures as opposed to traditional buyouts. This allows teams to avoid much of the uncertainty associated with leveraged buyouts. According to Pitchbook, the growth equity share of total US PE value increased to 12.7% compared to 9.9% in 2022; in comparison, traditional buyout activity decreased to 18.9% of all PE deals in 2023.

What does this mean for the rest of 2024? Based on our historical experience of cyclical trends in private equity deals and our research, we believe the deal landscape will improve in Q2 and Q3 2024. At some point, exit activity must pick up, which will spur additional fundraising efforts. Both these areas have seen significant downturns in activity. According to Pitchbook, a snapback in exit activity is what's needed to spark a broad-based recovery in PE dealmaking in 2024 after several years of continued declining exit activity. As dealmakers continue to face a new reality of valuation multiples, pressure from LPs to exit high-performing assets will increase.

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 2024—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 2024 than they may have in previous years, and deals will likely take longer to close as a result. They will continue to scrutinize areas such as financials, taxes, legal, operations, cyber, market outlook, and insurance and risk management.

Increased Focus on EBITDA and Benefits

On the other side of the equation, we expect General Partners and operating professionals within private equity firms to look to maximize EBITDA improvement mechanisms within the portfolio itself. As noted in McKinsey's *2024 Global Private Markets Review*, with falling multiples and higher financing costs, revenue growth and margin expansion are taking center stage. Together with company management teams, GPs will search for ways to improve efficiencies, reduce costs, and maximize EBITDA margin improvement wherever possible, including in the insurance and risk management functions.

For top-tier middle-market private equity firms, insurance and employee benefits program implementation is an area of increased focus, and engaging an expert in this space is critical.

Due Diligence is Essential

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 versus how it should handle them on a go-forward basis as a private-equity-owned business.

Choose a Broker with In-House Specialists

The 2024 Guide to Transactional Risk explains how we help our private equity, growth equity, and strategic acquirer clients through their transactions. We've developed this Guide and these best practices based on our experience 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 for RWI brokerage services, insurance due diligence, and/or post-close brokerage work. It is never in the best interest of the private equity buyer if a brokerage firm uses an outsourced diligence team or centralized broker marketing model.

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

> It is never in the best interest of the private equity buyer if a brokerage firm uses an outsourced diligence team or centralized broker marketing model.

2.0

Why Does Insurance Due Diligence Matter?

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Here's why we believe it is critical to perform insurance due diligence on any transaction:

Understand how EBITDA is being protected at the company level.

The overall goal of due diligence is to uncover potential land mines that can negatively affect EBITDA for a target acquisition in both the short and long term.

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 before an acquisition.

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?

Watch for implications on the 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 to improve the cost structure and positively impact EBITDA over the long term from an insurance perspective? Are there ways of restructuring the employee benefits program or adjusting contribution strategies?

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 insurance policies the target has, so make sure the foundation is strong. This is particularly important regarding cyber coverage, directors and officers (D&O) coverage, and other management liability lines.

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?

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.

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?

What value-added resources are being offered?

What additional loss control or claims management resources is the target company using, and how could that impact long-term strategic thinking and cost management?

Identify potential new program needs.

Depending on the transaction structure and agreement language, you may need to implement a new property, casualty, management liability, or employee benefits program at close.

Respond to lender requests.

When new lenders are added to the financial structure, they will require certificates naming them as the additional insured or lender's loss payable on the insurance program. Like RWI 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.

3.0

Transaction Timeline from an Insurance Perspective

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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 M&A newsletter.

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

Phase 1 (5-6 days)	Phase 2 (5 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)

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 | Phase 2 | Phase 3 | Phase 4

Phase 1: Pre-LOI Through Execution of LOI

The pre-LOI period is often when a buyer engages an RWI broker to approach the marketplace to obtain quotes for the transaction. This is known as Phase I of the RWI brokerage process and includes submitting several pieces of key information to the broad RWI marketplace.

In the tougher deal environments of 2022 and 2023, some prospective buyers are engaging the insurance diligence advisor earlier in the process, and sometimes even in the pre-LOI stage if the intent is to pre-empt the process with an aggressive bid package versus simply a LOI. Typically, in these instances, there is not a full insurance diligence process performed; rather, the advisor will perform a higher-level due diligence with more limited information.

LOI Best Practices from an Insurance Perspective

- Involve your insurance advisor early in the deal process.
- Include a vetted RWI proposal with first or second round bid packages.
- Complete administrative work on the due diligence side to prepare for diligence to begin.
- Get familiar with the target company by reviewing the Confidential Information Memorandum, financials, management presentations, and initial insurance-related information.

Phase 1 | **Phase 2** | Phase 3 | Phase 4

Phase 2: Period of Exclusivity and Insurance Due Diligence

Once the LOI has been executed and the deal moves into exclusivity, the buyer will kick off all third-party diligence workstreams. Insurance and employee benefits due diligence should always be one of these workstreams.

> 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.

First, the diligence team becomes acquainted with the target company by having a call with the management team to provide clarity on the insurance process and answer any insurance checklist-related questions. As more information is gathered and supplied to the buyer's team, the insurance diligence 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, risk mitigation, and overall insurance strategy.

The result of the diligence process should be a comprehensive, clear, and concise 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

Phase 3: Pathway to Close and Closing

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

1. RWI Phase II Underwriting Process

Phase II 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 nonrefundable 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. Following the initial review, we coordinate a 90- to 120-minute underwriting call, after which underwriters deliver a draft policy and follow-up questions to the buyer.

From that point until closing, follow-up 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 step typically includes existing professional liability, management liability, and cyber policies.

3. Go-Forward Coverage Solicitation

Depending on the transaction's structure and the underlying policies in place, you will need to solicit and implement various new go-forward coverages at close. For example, if the transaction is an asset-purchase, you should implement a property, casualty, and management liability program close. Alternatively, if the deal is a majority-controlled stock transaction, only those policies that include a Change in Control provision must be replaced at close.

Typical policies that include Change in Control provisions:

- Management Liability (D&O, EPL, and Fiduciary Liability)
- Cyber Liability
- Professional Liability/Errors & Omissions
- Any other claims-made policies

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, which are typically required before close.

Transaction Structures and Insurance:
Asset versus Stock Transactions >>

Explore the insurance implications associated with asset versus stock transactions.

Phase 1 | Phase 2 | Phase 3 | **Phase 4**

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 firm, 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

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5 Key Insurance Due Diligence Findings in 2023

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5 Key Insurance Due Diligence Findings in 2023

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

1 **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

2 **Key coverages are missing:**

For many target acquisitions, the deal represents the first time the company has accepted institutional investors or considered a buyout 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, and product recall liability.

3 **Limits are inadequate:** As in 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. When 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 of coverages with inadequate limits include cyber liability, business income and extra expense, contingent business income, and products liability.

4 **RWI continues to be used on most transactions, and it's becoming the norm even on deals smaller than $50 million**. The market is responding to the slowing of deal flow by seeking out a broader range of risks. There is a lot of discussion and marketing around contingent risk and litigation risk, and tax continues to be a focus 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.

Read more about RWI market trends later in this guide>>

5 **Management teams should expect varying premium/rate increases depending on product and industry on property, casualty, and management liability coverages.** Management teams should be prepared for continued rising rates throughout 2024 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 rate trends in:

Quarterly Commercial Lines Market Update: Trends and Pricing Predictions >>

Property & Casualty Looking Ahead >>

Directors & Officers Liability Looking Ahead >>

Cyber Liability Looking Ahead >>

5.0

Spotlight: Reps & Warranties Insurance Trends

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Spotlight:
Reps & Warranties Insurance Trends

As we've stated, RWI continues to be used on most transactions. An ABA study from 2022 noted the use of RWI at over 60% on all deals, with a much higher percentage expected for PE buyers. Movement of underwriters between companies has continued to be high and we expect even more new entrants into the market in 2204. At the beginning of 2024, we are seeing a very competitive landscape with pricing at 2.2.5%–3% of the limit being purchased. At the same time, we are seeing an increase in claims and expect a heavier deal flow through 2024 than we did in 2023. So, expect to a slight rise in prices as the year goes on.

Learn more about RWI in our Guide to Representations and Warranties Insurance >>

Get insight into the RWI claims trends in 2023 >>

The market is responding to the slowing of deal flow by seeking out a broader range of risks. As we stated in the "Key Insurance Due Diligence Findings" section, there is a lot of discussion and marketing around contingent risk and litigation risk. These are growing areas and pricing is hardening in contrast to the RWI market. Tax continues to be a focus and its increased use in the last few years has allowed for easier underwriting and stabilizing prices. The smaller deals market is still popular and several underwriters are trying to find "RWI light" approaches, 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.

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

A Strong Risk Management Strategy Can Bolster Your Company's EBITDA

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

250+
private equity and venture capital clients

250+
active engagements in the last 24 months

30+ years
of working in the Private Equity, Venture Capital, and M&A space

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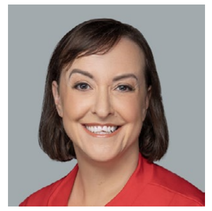

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About Woodruff Sawyer

As one of the largest independent 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 and 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.

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