

Show ‘em your cards

When commissioning a report on the insurance risk of a potential target, private equity firms should share the deal and credit agreements with the provider as soon as possible. Otherwise, they may leave themselves open to serious liabilities.

By Rob Kotecki

Private equity shops frequently hire insurance brokers or other due diligence firms to study the insurance risks of a potential acquisition. These experts delve into the minutia of insurance policies already in place, covering everything from workers' compensation to directors and boards. Unfortunately, providers sometimes complain that GPs often erode the quality of their own reports by remaining tight-lipped about the terms of the bid.

At first look, the deal or credit agreements may not appear relevant to gauging the current insurance risk. Yet, by assessing the details of the offer, the insurance due diligence team can identify when and how liabilities are transferred from the seller to the buy-

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er. Credit agreements often contain boilerplate language that can be irrelevant at best, or onerous to the buyer at worst. The earlier the insurance experts can be brought up to speed on the transaction, the better they will be at identifying and mitigating the risks before terms get locked into place.

“Our private equity clients often forget to provide us with drafts of transaction purchase and credit agreements in a timely fashion,” says Gabe Levitt of San Francisco-based Equity Risk Partners, an insurance brokerage firm specializing in providing insurance diligence and placement services to firms and their portfolio companies. “Without the opportunity to review these until right before closing, we are typically unable to influence insurance related terms and conditions.”

Some of that delay comes from GP concern about information leaks. “Instances where we’ve found GPs hesitant to share deal or credit terms usually involve public to private transactions where leaks can bring genuine legal consequences,” says Lee Stevenson, a managing director in the private equity and M&A division at Marsh, the insurance provider. While such concerns may be justified, there are real reasons why information sharing can, at times, save ships.

Essentially, deal and credit agreements contain vital information to the liability profile of a company. For example, one due diligence firm noted that if an acquisition is a subsidiary stock or asset purchase, entirely new insurance programs for the target need to be in place at the time of the closing.

If a target undergoes a change of control, many policies such as

directors and boards coverage will automatically go into “run-off,” which means it ceases to cover any claims made after the change in control. New policies will subsequently need to be in the place at the time of closing. However, it’s rare that new policies will cover claims made about alleged acts occurring pre-closing. In this case, the provider can recommend a “tail” policy to address this situation, but only if they are aware of that pending change in control.

A deal agreement will also spell out which liabilities will be assumed by the buyer and which will be retained by the seller. Even if the seller is providing some coverage for any pre-closing alleged acts that would come to light after ownership changes, that indemnification may be insufficient to cover the full cost of such events. The due diligence firm should be able to review the seller’s proposed coverage and determine if it adequately addresses the liabilities.

Credit agreements can likewise leave major gaps in coverage or impose hefty requirements that may be missed prior to close. Credit agreements rarely customize language for the insurance terms so certain clauses may have little to do with the transaction at hand. If a due diligence firm reviews these agreements they can recommend amendments more appropriate for the specific situation.

“We often find that the target has no products, completed operations, or environmental exposures but the lender’s standard insurance section requires coverage for them,” says Levitt. Boilerplate language can frequently limit borrowers to a \$50,000 deductible per claim for general liability insurance, even if a \$250,000 deductible is more economically efficient.

Another incongruity may be that the borrower requires workers’ comp insurance through a carrier of a certain rating, a rating above what the target has in place. Other points that can prove irksome include a requirement to issue a notice of renewal thirty days prior to the renewal taking place, when most carriers won’t issue such a notice until after the renewal begins. Lenders also require notice of a cancelled policy sixty days prior to the end of the policy, despite the industry standard of thirty days. These may be minor details, but they can nonetheless kink up a target’s coverage.

The deal and credit agreements are usually drafted late in the process, but given the pitfalls of missed requirements or coverage gaps, there are real advantages to sharing these documents as early as possible. This little extra effort may insure that the due diligence report is worth the fees already paid to produce it. ■