


Mergers & Acquisitions

Navigating the Due Diligence Process in a Hardened Insurance Market and Challenging Socioeconomic Landscape



As the economy continues to experience shifts due to a global environment mired in uncertainty, mergers and acquisitions (M&As) continue in the middle market. Because of these challenges, it's critical that during the M&A due diligence process, private equity firms not only examine the seller's operational, legal, financial, and accounting records, but also its insurance program and employee benefits plan as early in the process as possible. Private equity firms also need to take a close look at insurance and benefits trends that may impact the deal. This enables you to properly determine the value of a potential new asset, uncover any possible risks that can negatively impact a company's EBITDA, and protect against post-transaction liabilities.

PROPERTY & CASUALTY INSURANCE DUE DILIGENCE PROCESS IN MERGERS & ACQUISITIONS

The Property & Casualty (P&C) due diligence process begins by working with an experienced M&A insurance broker to determine which of the target company's risks are properly insured, underinsured, or not insured at all. We'll ask to see all the seller's P&C insurance policies - Commercial General Liability, Commercial Property, Environmental Liability, Directors & Officers (D&O), Errors & Omissions (E&O), Cyber Liability, Crime, Excess Liability, and any other policies the entity may have.

We'll also ask for any information and records of policies dating as far back as possible, especially if the business is one that could be subject to long-tail liabilities. Long-tail liabilities are claims that can arise from incidents that occurred decades ago, such as asbestos contamination or sexual harassment.

Once we receive the policies, we initiate the vetting process, which includes the following (at a minimum):

- Whether or not the policies are aligned with the operation's risk profile
- The named insureds on the policies (for example, should any subsidiaries be covered?)
- Additional insured status of the seller on third-party agreements
- Policy deductibles and retentions
- The inclusion of policy "anti-assignment" or "change of control" clauses
- Relevant policy exclusions
- Claims history, pending claims, and/or potential claims that may erode policy limits in the future
- Retroactive premiums associated with a policy
- The availability of runoff or tail coverage to provide some coverage for pre-existing wrongful acts, occurring prior to the deal close

Upon completion of the policy review, we determine if any new additions and changes to the insurance program need to be implemented, depending on the merger or acquisition transaction structure and agreement language.

Today's Hard Insurance Market and Your Due Diligence Process

After an assessment of a seller's existing insurance policies, we will recommend any additional policies needed to address coverage gaps, with a keen eye on the state of today's insurance market and the impact it may have on the transaction moving forward. Because of the current state of the insurance market, partnering with an experienced and well-connected team is critical in navigating challenges that are likely to arise while trying to place coverage.

The insurance market today is characterized by higher insurance premiums, tighter underwriting guidelines, reduced appetite for risk, and diminished capacity. This means that the current insurance costs of a business are likely not indicative of what they will be at the closing of an M&A deal. Any additional Management Liability policies that may need to be added at closing will likely also be hit by higher rates, as well as narrowing of coverage, reduced sub-limits, and increased retentions.

For example, according to the Council of Insurance Agents & Brokers, D&O renewal rates averaged a 15 percent quarterly increase from 1Q 2020 to 4Q 2021, with a 13 percent increase in 4Q 2021. According to Business Insurance, in 2021, Umbrella rates increased 10 percent to 20 percent with higher layers seeing increases of 25 percent to 30 percent. In 2022, Umbrella rates will likely stabilize and increase 10 percent to 15 percent, and Excess rates will rise 5 percent to 10 percent.

Though most parts of the country have reopened after the wake of the coronavirus pandemic, we're continuing to see the economic aftershocks of this global phenomenon, which further strain an already hardened insurance market. Supply chain issues, extreme weather events, social inflation, labor shortages, cyberattacks, and economic inflation have come together at the same time to create layer upon layer of unpredictable risks for carriers. For investors, growing costs and interest rates reduce multiple expansion, limiting overall return rate for investments.

Cyber Security's Growing Importance in Due Diligence

Since the coronavirus pandemic, instances of cyberattacks skyrocketed around the world for businesses of all sizes and in all industries. Unfortunately, this is a trend that shows no signs of slowing down. Businesses witnessed a 50 percent increase in attacks on a weekly basis in 2021 compared to 2020, and **according to IBM's Cost of a Data Breach Report 2021, the average total cost of a data breach increased to \$4.24 million.** Ransomware attacks are a prevalent issue, with the United States Treasury Department reporting that the **average ransomware transaction per month in 2021 was \$102.3 million.**

While attacks on larger targets are those that make headlines, malicious actors are constantly on the lookout for anything that can make a potential target more vulnerable, regardless of its size.

This is why ransomware groups have begun turning their attention to smaller targets in the middle of acquisition. They see newly acquired, midsize companies as easy targets for the picking with less of the geopolitical risk tied to attacking a large company.





TREND WATCH

Because M&As usually come with publicity, this is a signal to attackers that their target will soon have available funds that they can pursue. Additionally, part of the acquisition process includes the convergence of IT systems with the involved parties, and this transition can create cybersecurity vulnerabilities that attackers exploit. During the M&A process, involved parties are also probably preoccupied with a multitude of changes and thus less likely to stop an attack. Therefore, attackers see organizations involved in M&As as easier targets. Private equity firms that choose to ignore these trends and fail to prioritize cybersecurity are taking a risk that could be financially devastating.

This alarming trend has made cyber carriers even more stringent with the private equity risk they're willing to take on. We're seeing carriers ask for proof of cybersecurity measures for all parties involved in a transaction from day one. Carriers are less willing to offer coverage to companies who don't already have the right cybersecurity measures in place before the M&A process even begins. This is why cybersecurity needs to be part of the baseline conversation in the diligence process. Our Private Equity team can help you navigate carrier requirements and implement missing security requirements, so you have financial protection from cyberattacks.

EMPLOYEE BENEFITS CRITICAL IN DUE DILIGENCE

Seller Employee Benefits programs can often contain compliance or accounting issues that need attention. The seller should be able to provide you with all the necessary documentation about its Employee Benefits programs, including its retirement plan, health and insurance plan documents (Wrap Plan, Section 125, etc.), Form 5500s, policies and procedures, renewal schedules, contracts with service providers, and more. The seller should also provide information about Internal Revenue Service (IRS) and U.S. Department of Labor (DOL) audits or other examinations that may have occurred in the past three years. After reviewing these documents, we can determine whether there is anything that may negatively impact you and determine a quick path to compliance before any transaction takes place. Special attention will be given to provisions concerning potential post-employment and post-sale liabilities.

For example, before the deal is finalized, the seller may need to follow the IRS's correction program (the Employee Plans Compliance Resolution System) or the DOL's correction program (the Voluntary Fiduciary Compliance Program or Delinquent Filer Voluntary Compliance Program). If a 401(k) is administered in-house, during the due diligence process we'll also take a close look at the timeliness of plan contributions, the available investment options, and whether any match or profit-sharing contribution was improperly calculated and allocated. We'll provide an analysis of the scope of any plan failures in terms of cost and time to resolve.

The Rising Costs of Benefits

Indications are that Employee Benefits costs are likely to rise in 2023 due to a return to delivering previously deferred non-COVID-19 care and a focus on building out robust benefits packages to attract and retain top candidates in the war for talent. In looking at a potential M&A deal, we'll pay attention to the impact of offering a competitive benefits package on a seller's health care spend, the benefits currently provided, and how these may shift moving forward.

Another driving force behind rising employer-sponsored health plan costs is the dramatic increase in the utilization of specialty prescriptions. While there is no silver bullet for specialty drug cost management, there are ways to bend the cost curve, sometimes with simple solutions, such as steering where the medications are delivered. During the due diligence process, we'll evaluate a seller's total Rx spend, including the costs of specialty drugs, to determine how to manage formularies and claims pre-deal closing.



Ensure that Property and Casualty insurance and Employee Benefits due diligence are part of the M&A process to help protect against potential liabilities and bolster the value of the asset you're considering acquiring. Involve your insurance advisor early in the deal process before any letter of intent is drawn so that potential issues can be addressed during the Representations and Warranties Insurance (RWI) process. In obtaining an RWI policy, the insurer will want to review the seller's insurance and Employee Benefits programs.

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