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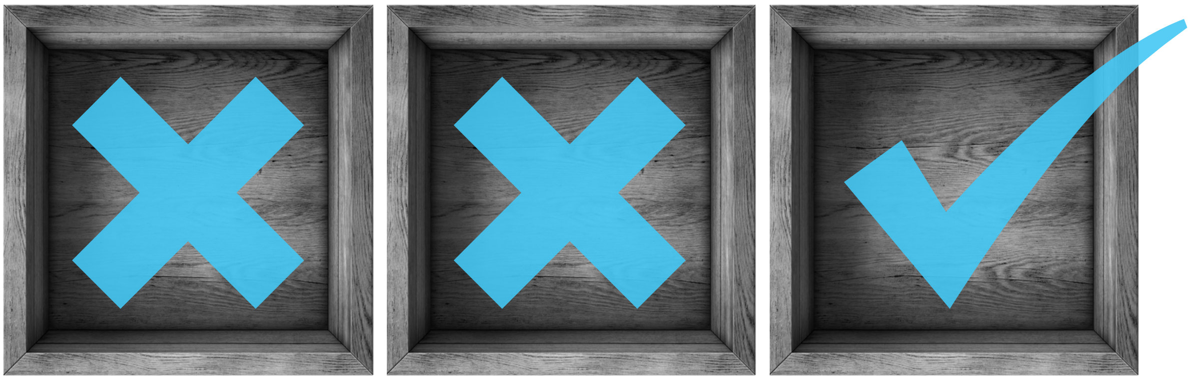

Opening Pandora's box?

Vendor due diligence in de-risking transactions

If you are the trustees or the sponsor of a scheme that is looking to secure your liabilities with an insurance company on an all-risks buy-out, you will need to consider whether it is worth undertaking a vendor due diligence exercise in relation to your scheme and the risks that come with it.

What is vendor due diligence?

Vendor due diligence is effectively conducting a due diligence exercise on your own scheme to determine whether there are any issues that are unidentified or will affect the price on which an insurer is willing to buy-out the scheme or the risks the insurer is willing to take on.

What due diligence will insurers undertake?

When a scheme is being bought out on an all-risks (or residual risks) basis, as part of the pricing process, insurers will typically conduct some quick "high level" due diligence using external lawyer on the scheme looking for obvious issues (eg NRA equalisation, improperly executed deeds, missing documents, amendments which may breach the amendment power, merger documentation etc) that may affect their pricing. This is typically in a competitive situation and they will offer a price subject to confirmatory due diligence.

Once an insurer has exclusivity, it will then instruct its lawyers to conduct its detailed confirmatory due diligence looking for any possible issues that could affect the risk it is taking on. This is very detailed and will typically look at all scheme documentation, trustee minutes (for evidence of issues, systemic complaints etc), the validity of all executed documents etc. It will also then look at whether actual scheme administration matches the documentation (particularly around mixed-NRA members, underpins etc).

The level of detail in which this due diligence is conducted means any possible issues will be identified. The end result of this due diligence will potentially influence the final premium and also warranties and exclusions from the all-risks cover.

Why undertake vendor due diligence?

Undertaking vendor due diligence in advance of the insurer's due diligence processes described above avoids any surprises coming to light in the pricing phases. It means that the trustees (and the sponsor) are aware of any issues in the scheme and can potentially take steps to correct them before the buy-out transaction or can factor them into the pricing to avoid unexpected jumps in pricing if issues are identified by the insurer. At the extreme end, it can prevent a transaction from aborting were an issue to be identified that was so significant that it took the scheme outside of the insurer's risk parameters or made the cost of insuring the additional risk unacceptably high. In such a circumstance, it may then be hard to re-engage with other insurers in the market who might be able to cover such a risk.

Vendor due diligence can be particularly helpful in the initial pricing stage when a vendor due dilligence report placed in the data room may give the competing insurers more confidence in their pricing as they will take comfort that the scheme has already "kicked the tyres" to ensure there are no unexpected issues. The real advantage for the scheme and the sponsor here is greater pricing certainty – if issues have already been identified, it will make it far less likely that the price will change based on insurer due diligence once exclusivity has been granted to an insurer. This means that the scheme and sponsor can take advantage of the competitive tension at the initial pricing stage and also means that the insurers are more likely to offer better pricing.

Are there any risks in undertaking vendor due diligence?

In the long run, probably not, as there is certainly a chance that undertaking vendor due diligence will uncover issues in connection with the scheme that need to be addressed sooner rather than later. As a result, some trustees or sponsors may feel that it is best to "let sleeping dogs lie" and not carry out vendor due diligence until it is necessary to deal with any issues as part of an imminent buy-out.

Whilst there is potentially some immediate economic saving to adopting this approach, in reality, any issues identified likely already exist within the scheme – they are merely hidden liabilities – and whether there is truly an economic advantage to keep them hidden is debatable. However, once the trustees of the scheme are aware of an issue they will not be able to ignore it. For example, if they find out that NRA equalisation was not successful and the scheme has a longer Barber window than anticipated, it would be difficult to continue to administer the scheme on that incorrect basis. Therefore, the further away from buy-out the scheme is, the less appealing conducting a thorough vendor due diligence process may seem (particularly to the sponsor).

It is also worth noting that, where issues are uncovered as part of the vendor due diligence process, they may need to be rectified and it may be necessary to look at whether any third party may be responsible for this. In the situation of a material issue, this investigation and rectification process may be so significant that it derails or postpones the buy-out transaction whilst it is being resolved. However, were the issue not to come to light (ie because no vendor due diligence was undertaken) the issue would almost certainly be discovered as part of insurer due diligence. Coming to light at this very late stage risks derailing the transaction (which could be occurring at a time critical point for the sponsor) and could weaken the trustee or sponsor's negotiating position with third parties over liability if the resolution needs to occur quickly in order to facilitate the buy-out.

Can (and will) the insurer rely on the vendor due diligence?

In almost all cases the answer is that insurers will not be able to rely on the vendor due diligence (from a legal point of view – it will have been prepared for the sponsor and/or trustees of the scheme) and insurers will want to undertake their own due diligence. However, in our experience, the insurers will take a lot of comfort in seeing a due diligence report prepared on behalf of the scheme that flags issues, confirms how they have (or will) be dealt with and confirms where there are no issues identified (particularly in relation to key risk areas). The insurers will use their lawyers to check the report and its findings, but a vendor due diligence report may reduce the initial high level due diligence period to a matter of days as insurers may simply look to confirm what is in the report.

Who should prepare the vendor due diligence report?

This can be a difficult question and may depend on the circumstances of the scheme. Where particular legal advisers have a long history with the scheme it is often useful to have a separate set of legal advisers prepare a vendor due diligence report because they can provide an independent view. Having a long term incumbent adviser prepare the report could be viewed as asking that adviser to "mark their own homework" (in other words, the advisers may find themselves in a position of conflict such as if they need to take a risk-based view on an issue they were involved in which may differ from the view an insurer would take of the same issue). A perceived lack of independence from the scheme may also result in the insurer placing less weight on the conclusions of the vendor due diligence report in the initial pricing phase which could work against the benefit of having such a report prepared.

However, the counter argument for using the incumbent advisors is that they are aware of the history and detail of the scheme and can probably prepare a vendor due diligence report more quickly than independent lawyers. They may also be better placed to advise on issues identified and to provide confirmation of previous actions taken as they will likely have more context.

The choice between an incumbent adviser and independent advisers may be less of an issue where a scheme has changed legal advisors more often during its history. Typically (although not always) issues uncovered as part of a due diligence process are historical and therefore incumbent advisers are looking back over work undertaken by other firms – reducing the risk of conflict and the perception (on the part of insurers) of a lack of independence.

How can we help you?

The Eversheds Sutherland Pensions De-Risking Team has a wealth of experience acting for both insurers and trustees in relation to pension scheme due diligence. Our experience acting for insurers means that we are very familiar with all of the issues that insurers will immediately focus their attention on and the priority of issues for insurers. We can use this experience to prepare vendor due diligence reports for trustees and/or sponsors quickly and cost effectively and also going into a level of detail that works for you.

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