WHY ARE PRIVATE EQUITY TRANSACTIONS INSURED? A NEO-INSTITUTIONAL THEORY PERSPECTIVE

Abstract

We employ, and build on, neo-institutional theory and strategic entrepreneurship thinking to explain the growing use of representations & warranty ('reps') insurance (RWI) - an innovative product that mitigates the risks (costs) of legal disputes when private equity is involved on both the buy-side and sell-side of strategic transactions. Our analysis suggests that transaction risks and uncertainties motivate managers of private equity sponsored leveraged buyouts (LBOs) and liability insurers to cooperate and change the 'rules-of-the-game' using creative customized contracts. The transformation of embedded institutional logics enables contracting parties not only to realize gains from collaboration, but also from concessions that radically alter custom and practice. Our analysis suggests that the use of RWI in private equity transactions is both a determinant and consequence of institutional change in financial markets. We conclude that the private equity-RWI relation is a classical case of experimental institutionalism in action.

Introduction

In this study, we employ, and build on, neo-institutional theory and strategic entrepreneurship thinking to explain the growing use of representations & warranty ('reps') insurance (RWI) over the last decade or so.[1] RWI is an innovative indemnification product that mitigates the risks (costs) of legal disputes arising when private equity is involved on both the buy-side and sale-side of strategic transactions[2]. Entities engaged in private equity sponsored

[1]RWI policies are 'first-party' liability insurance contracts. With these policies, the principal litigation exposure is between the buyer and seller in a transaction, and not with disputes involving third parties, as typically covered in other legal liability indemnity products, such as general liability insurance. This aspect makes RWI providers potentially less susceptible to 'negligent inspection' tortuous claims made by third parties, and consequently, less likely to lower their due diligence of private equity firms because of this legal risk (e.g., see Logue, 2015). Another distinctive feature of RWI policies is that, like Directors' and Officers' (D&O) insurance, they are 'claims-made' contracts, which means they cover claims reported and made during the policy period. In contrast, general liability insurance policies are 'retrospective' contracts that can, within limits, cover claims that occurred prior to the policy period in which they are reported.

[2] Griffith (2020) notes that the vast majority (90%+) of RWI policies issued in the United States (US) private equity market are buy-side policies.

strategic acquisitions - leveraged buyouts (LBOs) - are usually organized as limited liability partnerships (LPs) comprising syndicates of mainly passive loan-finance investors. Private equity investors can range from institutional investors, such as banks and pension funds to wealthy individuals (Fang, Ivashina & Lerber, 2013).[3] Typically, LP buyout funds are (e.g., for tax reasons) structured as closed-end accounts of fixed duration of between five to ten years (Braun, Jenkinson & Schemmerl, 2020).

Today, private equity markets are global in scope, and comprise multifarious financial structures that not only mainly include LBOs of mature privately-held companies, but also vehicles that take minority controlling stakes in new start-ups (Lerner, Mao, Schoar & Zhang, 2022). In these scenarios, private equity fund managers function as performance-incentivized 'general partners' (GPs), who select investment strategies that aim to maximize returns for investors and increase payoffs under personalized bonus plans (Caselli & Negri, 2018). In reducing the likelihood of hold-up costs by transferring the risk of delays in closing deals to third party liability insurers, RWI can help create value for private equity buyout firms. Value creation through RWI can be achieved by reducing risk aversion among GPs, thereby, ensuring that private equity transactions continue to generate 'momentum profits' by taking calculated risk-taking investments (Griffith, 2020)[4]. In this way, RWI can promote the public reputations (brand-names) of private equity buyout firms as successful deal-makers, and thus enhance their ability to raise funds as future 'repeat players' in the market for corporate control (Balboa & Marti, 2007).

[3]Griffith (2020) reports that while private equity buyers are highly leveraged (typically 60% to 70% of fund value), their financial structure can also include invested equity, a small proportion of which (usually 1% to 2%) may be contributed by the fund managers.

[4]It is not clear from the extant literature whether or not RWI is positively associated with larger private equity transactions, where information asymmetries and risk exposures are likely to be most acute. This potential adverse selection problem can, as we note later in the paper, be effectively controlled through contracting arrangements, such as risk-sharing terms and policy limits. Insurers can also mitigate excessive risk accumulation by holding diversified underwriting portfolios and using reinsurance (Mayers & Smith, 1982).

The present study focuses on the use of RWI in private equity LBOs for three reasons. First, private equity buyouts are typically characterized by their large financial scale and potentially high investment risk (Spindler, 2009). For example, Bain & Company (2019) report that in 2018, there were roughly 3,000 private equity LBOs worldwide valued at approximately US$592 billion. This figure represents just under 20% of the total value of global corporate acquisitions completed in that year. Second, some private equity (low-tier) syndicate investors (e.g., wealthy individuals) may be poorly diversified against investment risks (Moskowitz & Vissing-Jörgensen,2002), and/or limited in their ability to effectively handle liquidity 'shocks' over the period that funds are committed to LBOs (Lerner et al., 2022)[5]. These structural limitations among different investors could motivate GPs to purchase RWI from well-diversified liability insurers rather than incur the costs (e.g., loss of tax deductibility) of retaining dealing risks internally. Self-retaining dealing risks could also mean that private equity buyout firms lose investment opportunities if the prices bid for targets are overly discounted to reflect the possibility of mis-information at the point of exchange. Third, in contrast to most high value private equity LBOs, venture capital investments in early stage business undertakings tend to be of a much smaller scale, and subject to close 'delegated monitoring' by well-diversified bank financiers (Diamond, 1984). Therefore, other things being equal, we expect that compared with private equity transactions, the lower information problems generally associated with venture capital-funded projects are less likely to require insurance protection.

The present study fits within the stream of neo-institutional entrepreneurship literature on strategic alliances, joint-ventures, and other forms of inter-firm cooperation and financial market investment. Indeed, scholars

[5]Griffith (2020) reports that holding dealing risks within the private equity structure reduces the internal rate of return (IRR) used to measure fund performance, and determine GPs' bonuses. This is because self-retained losses have to be absorbed by fund capital, thereby reducing returns. Hence, there can be private incentives for LPs and GPs to use RWI rather than self-retain dealing risks.

(e.g., Janney & Dess, 2006; Reuer, Ariño & Mellewigt, 2006; Bruton, Ahlstrom & Li, 2010) have called for more theoretical and investigative work to be conducted on the mechanics of alliance formation and entrepreneurial risk mitigation in complex and transnational institutional environments. This study is further motivated by our belief that a better conceptual understanding of the increased demand for, and supply of, RWI can provide deeper insights into the ways major entrepreneurial transactions are, and may in the future be, conducted in global financial markets. Our research also builds on the existing strategic entrepreneurship literature by widening awareness of the processes underpinning relationship-building in, and between, innovative sectors of the international financial system. These intrinsic attributes of our research could enlighten entrepreneurship scholarship, and inform private equity investors, fund managers, and other relevant parties (e.g., insurers and public policymakers) as to the future direction of entrepreneurship in uncertain and highly dynamic business environments (Bruton & Ahlstrom, 2003). Indeed, as Bylund & McCaffrey (2017, p. 466) report " . . . relatively little research has been done on institutional uncertainty".

Our analysis suggests that RWI is contracting efficient when delays to deal closure are expected to result in buy-side and sell-side negative cash flows. These transactional risks and uncertainties can motivate the GPs of inventive private equity buyout firms to actively collaborate with like-minded innovative professional actors (e.g., actuaries and underwriters) in liability insurers. Such inter-industry cooperative behavior has the effect of radically changing conventional field boundaries and traditional ways of doing business. The transformation of embedded institutional logics, not only enables private equity buyout firms and RWI providers to gain economically from collaboration, but also benefit from altered 'embedded agency' relationships (e.g., through new shared information networks)[6]. This situation represents an extension to current neo-institutional entrepreneurial thinking that blends the concepts of organizational institutionalism (e.g., the use of intrinsic resource capabilities) with comparative institutional perspectives that focus on how institutions reconfigure logics to step outside their field boundaries in order to add value in turbulent business environments, as witnessed in the years following the 2007/8 global financial crisis (Ahmadjian, 2016).

Furthermore, our research on the private equity-insurance interface points to a potential exploitable source of inventive opportunity and risk mitigation in fields other than just the private equity industry. For example, insurance solutions to strategic risks in the venture capital and angel finance sectors could be employed to optimize the gains from entrepreneurship. Whilst strategic adaption to changing environmental circumstances has been noted in prior private equity research (e.g., Hoskisson, Shi, Yi & Jin, 2013), the use of transformative cooperative insurance solutions in private equity markets has not, to the best of our knowledge, been emphasized in the neo-institutional theory literature. This aspect of our research could thus encourage new, and potentially interesting, lines of future scholarly research in the fields of strategic entrepreneurship, corporate finance, and investment management, amongst others.

The remainder of this paper proceeds as follows. The next section, describes the key features of the private equity industry and the development of RWI. This section is followed by an explanation of the aspects of neo-institutional theory relevant to this private equity-insurance study. The paper then outlines new ways of thinking about institutional innovation based on the

[6]For example, survey evidence reported in Griffith (2020) suggests that RWI is a profitable line of business for liability insurers given that most claims, including legal costs, are settled within policy retention limits. By expanding new business opportunities, RWI providers can also increase premium volumes, and direct enhanced cash inflows into financial assets, thereby, increasing investment returns. As Heimer (2013, p. 487) observes, insurers' profits are mainly " . . . investment profits, not underwriting profits."

recent growth in the market demand for, and supply of, RWI in private equity LBOs. Finally, a discussion of the key observations derived from our theoretical analysis is presented along with some conclusive remarks.

Private Equity & the Development of RWI

Global private equity firms (e.g., Blackstone, Carlyle, and Kohlberg, Kravis, Roberts (KKR)) are widely regarded as prominent and archetypical entrepreneurial organizations (Kaplan & Strömberg, 2009; Meuleman, Amess, Wright & Scholes, 2009; Meuleman & Wright, 2011). Private equity is now well-recognized as being a major institutionalized feature of the international financial architecture. As a financial intermediary function, private equity provides potential advantages for capitalist economies, including a broadened market for corporate control, stimulated entrepreneurialism, and improved levels of capital allocation and national productivity (Klein, Chapman & Modelli, 2013). Indeed, recent statistics (e.g., Batt & Appelbaum, 2021) indicate that in 2020 the global private equity industry in its varies guises accounted for nearly US$4.4 trillion of assets under management.

Private equity LBOs seek to create value by inventively restructuring the operational and governance systems of acquired firms, and incentivizing retained managerial agents to meet newly set profit targets (Croce & Marti, 2016). RWI is more commonly observed in private equity transactions than in strategic investment deals conducted by publicly-listed companies (Griffith, 2020). Private equity firms also do not benefit from the greater financial disclosures that are mandated for public corporations under accounting standards (Fidrmuc, Roosenbaum, Paap & Teunissen, 2012).[7] Therefore, private equity GPs will actively seek to reduce exposure to deal mis-pricing by

[7]For example, in the US the Sarbanes-Oxley Act (2002) and Securities Exchange Commission (SEC) rules prescribe, amongst other things, that publicly-listed companies provide detailed annual and quarterly financial statements, be subject to annual audits, and maintain sound systems of internal control. In contrast, private equity firms do not have such statutory disclosure and filing obligations.

requiring their exchange counterparts to 'fully and truthfully' disclose deal-relevant information ('representations') and provide indemnifications ('warranties') against errors and/or omissions that might have materially adverse effects on the post-completion valuation of invested assets (Welch, Pavićevic & Kell, 2019). However, drafting 'rep agreements' to cover incomplete information, and if necessary, enforcing 'reps' in a court of law, is both costly and interruptive for private equity investors. This is particularly the case given that most private equity LBO portfolio targets are private companies that have lower disclosure requirements compared with publicly listed firms (Wilson, Amini & Wright, 2022). Therefore, to alleviate costly contracting, and the mis-pricing effects of asymmetric information as well as reduce the delays and disruption costs of 'reps' breaches, private equity LBOs are increasingly purchasing RWI (Gallozzi & Phillips, 2002)[8].

To provide background information on the innovative RWI line of business, and to shed some light on its growing use in private equity markets, we summarize the key advantages and disadvantages of RWI in Figure 1, and briefly consider these aspects below.

[Insert Figure 1 here]

Seog (2006) reports that absent 'loss-leader' pricing, insurance underwriters set premiums and policy limits based on an 'actuarially fair' assessment of the risks to be underwritten. As a result, a low (high) RWI premium-coverage mix is likely to reflect low (high) dealing risk, and therefore,

[8]Other contractual contingencies can also help GPs manage transaction risks in corporate acquisition and divestment agreements. For example, termination fees provide 'liquidated damages' to the plaintiff in the event that the counterparty reneges on the purchase or sales agreement before the contract is signed-off (Butler & Sauska, 2014). However, termination fees do not cover ex-post completion risks; plus they are not 'insurance' in a strictly legal sense (and hence, not a tax-deductible expense) as they do not involve the transfer of risk to a third party insurer. Also, 'hostage' (escrow) accounts may be used, where contracting parties lodge funds (e.g., with a third party, such as a bank) to compensate a petitioner ex-post for 'reps' breaches. However, escrow deposits are also not tax-deductible, and may be more expensive than RWI, especially when premium rates fall in response to growth in insurers' capital capacity during the 'soft' market conditions of insurance underwriting cycles (Griffith, 2020).

serve as a credible market signal of the quality of private equity transactions. Cable (2020) adds that for private equity LPs and GPs, RWI has the added benefit of translating uncertain future cash flows into a quantifiable and recurrent insurance cost that stabilizes future cash flows and mitigates transaction risks. As we noted earlier, this contracting efficiency feature of RWI allows private equity buyout firms to avoid costly contract hold-ups, realize 'momentum profits', and assure investors that expected returns will be realized over the period of investment (Davidoff, 2009). In this way, RWI can also alleviate agency incentive conflicts between LPs and GPs. In fact, Batt & Appelbaum (2021) show that such agency problems (costs) are potentially severe in private equity firms making large scale and potentially complicated overseas investments. RWI could also enable loan investors to optimize their investment strategies ex-ante by protecting their fixed claims against ex-post dilution in the value of acquired assets due to protracted delays in deal closure (Wilson & Wright, 2013).

In addition, by mitigating agency costs in private equity LBOs, RWI can help ensure that investors are able to maintain the flow of funds to investment projects on favorable financial terms given that unforeseen dealing risks will be underwritten by well-capitalized third party insurers (Gallozzi & Phillips, 2002).This attribute can help private equity buyout firms maintain their competitive advantages over rivals in the market for corporate control. Additionally, Gompers, Kaplan & Mukharlyamov (2016) report that the system of incentivized compensation typically used in private equity LBOs is time-sensitive, and set to compensate investors for their limited exit rights[9].

[9]Cheffins & Armour (2008) report that the incentive compensation systems of private equity buyout firms typically involve an end of investment period profit-share arrangement between investors (80%) and managers (20%). This is payable once gains exceed a previously set hurdle rate of capital (often 8%), which is calculated using the IRR. Private equity GPs also receive an annual management fee payable over the lifespan of the fund. The fee is calculated as a percentage of capital committed by investors over the agreed investment period (normally 1% to 2% per annum), and paid irrespective of investment performance (Kaplan & Strömberg, 2009).

Therefore, the mitigation of the costs associated with transactional hold-ups is likely to be valuable in private equity LBOs, and, as we noted earlier, enables GPs to advance their public reputations as successful 'deal-makers' and respected 'repeat players' in the international market for corporate control. Moreover, private equity firms often retain the human capital capabilities of the senior managers of target firms in order to help realize embedded growth options (Croce & Marti, 2016). Therefore, transferring the risks (costs) of 'reps' breaches to third party RWI providers mitigates the costs of business disruption, and other problems (e.g., loss of goodwill) that might arise if retained target firm managers are embroiled in ex-post legal disputes in which they may be held responsible in a court of law.

On the other hand, purchasing RWI could be costly for private equity buyout firms as insurance premiums are loaded not only for the expected actuarial value of loss, but also for insurers' expenses, reserve margins, and profits (Mayers & Smith, 1982). In addition, the provision of RWI is also associated with potentially severe market frictions for liability insurers, notably the well-known information asymmetry problems of adverse selection (i.e., the mis-pricing of assumed risks at the point of sale due to incomplete (hidden) risk-relevant information); and moral hazard (i.e., the incentives of insured agents to act carelessly (or fraudulently) because third party indemnification relieves them of the burden of bearing the full economic costs of their actions) (Smith & King, 2009). Williamson's (2000) transaction cost economics analysis thus suggests that frictional costs need to be efficiently and effectively controlled (internalized) by insurers by means of careful risk selection and contract design (e.g., the use of policy exclusions) if the market for RWI is to survive and prosper long-term. Griffith (2020) adds that another possible downside of RWI is that in shifting the risk of 'reps' breaches onto third party insurers, the GPs of private equity entities can side-step the 'disciplinary effects' of litigation, and therefore, become unduly lax in their scrutiny of investment opportunities and the performance of due diligence. This agency problem can reduce the efficiency of the market for corporate control by undermining the ability of contracting parties to make credible commitments in their dealings with each other. In light of these institutional imperfections, it is thus not immediately obvious why private equity investors should incur the transaction costs and imported market frictions of purchasing RWI.

Yet, in the more constrained financial investment period after the 2007/8 global financial crisis, the use of RWI by 'deal-hungry' private equity buyout firms has increased steadily (Griffith, 2020). For instance, Even-Tov, Ryans & Solomon, (2020) report that from a proprietary database held by an anonymous multinational insurer, about US$545 million in RWI premiums were raised on private equity transactions valued at a mean (median) cost of approximately US$278 billion (US$120 billion)[10].The standard deviation statistic of US$ 493 billion reported by Even-Tov et al. (2020) further suggests variability in the distribution of RWI usage across deals of different financial size.[11]The percentage of private equity buyouts purchasing RWI in Even-Tov et al.'s (2020) sample increased from 8% in 2011 to 17% in 2016 (peaking at 33% in 2015). In addition, Even-Tov et al.'s (2020) data set reveals that claims for 'reps' breaches estimated at about 10% of deal value were made in approximately 20% of cases where RWI policies had been taken out - mainly as a result of financial statement misrepresentations. Therefore, in face of the aforementioned costs of purchasing RWI, its growing use, and not insignificant financial scale, in private equity markets represents a conundrum, which the present study seeks

[10] Estimates drawn from surveys conducted by Bain & Company (2019) suggest that between 2011 and 2016 approximately 2,100 private equity LBOs were conducted globally. Therefore, the database (n=1,690) used in Even-Tov et al. (2020) is a representative reflection of the level of international RWI activity between 2011 and 2016.

[11]For example, it is possible that private equity transactions of lower value may (e.g., for industry-specific reasons) be complicated to navigate. Therefore, both financially large and small private equity deals could potentially benefit from purchasing RWI.

to investigate by employing an analytical framework drawn from the neo-institutional theory literature.

Neo-Institutional Theory & Strategic Entrepreneurship

Neo-institutional theory is a well-established conceptual framework that has been used extensively in the organizational management and entrepreneurship literature for explaining the emergence, resilience, and legitimatization of formalized organizational structures and business practices (e.g., see DiMaggio & Powell, 1991; Battilana, Leca & Boxenbaum, 2009; Alvesson & Spicer, 2019). Scholars of the organizational school of institutional theory, including Bruton, et al. (2010), Jennings, Greenwood, Lounsbury & Suddaby (2013), amongst others, note that new perspectives have been applied to examine the processes of innovative institutional change, and the motivations of entrepreneurial agents to gainfully modify the 'rules-of-the-game'. Indeed, strategic entrepreneurship has become a significant theme within the broader neo-institutional theory literature (Greenwood & Hinings, 1996). Potential determinants of institutional entrepreneurship highlighted in previous studies, include field characteristics (e.g., the impact of changing market conditions), political expediency, resource mobilization capabilities, and the socio-political standing of institutional agents (e.g., arising their professional expertise and social standing) (Battilana et al., 2009).Once new institutional ideas and practices become environmentally embedded, they can then secure pragmatic and cognitive legitimacy in economy and society, and consequently, become accepted 'rules-of-the-game' (Suchman, 1995).

Some prior studies (e.g., Reuer et al., 2006) have examined intra-industry joint-ventures between entrepreneurial agents that formalize strategic alliances by means of relational contracts, such as shared-financing agreements. Other neo-institutionalism studies (e.g., Ahmadjian, 2016) integrate organizational institutionalism with comparative institutional perspectives. Such a blended analytical approach highlights how at the micro-level, organizations can employ resources to innovate and move outside their traditional field boundaries to form hierarchies of complimentary meso-level configurations (strategic alliances). Such a strategy can cost effectively reduce market risks and uncertainties, and enable co-operating parties to tap sources of comparative advantage that can be shared for mutual economic gain. This process of complimentary strategic navigation at the meso-level, and the associated possibilities for positive change that can arise, are particularly evident in cross-border transactions conducted by multinational enterprises (MNEs) (e.g., Jackson & Deeg, 2008). We consider that a comparative institutionalism perspective is also apt in the context of the present study as private equity funds are frequently syndicated by overseas investors, and increasingly function at a global scale (Meuleman & Wright, 2011). Crouch (2005) also reports that reasoned (rationalist) collaborations and strategic alliances between organizations from different institutional fields create opportunities for product and process innovations, and the realization of shared economic benefits, such as witnessed from the use of RWI in private equity markets. Therefore, as advocated by Kostova, Roth & Dacin (2008), our study of the private equity-RWI relation combines insights from both the organizational and comparative institutionalism streams of the extant neo-institutional theory literature.

However, we believe that the use of such a 'blended' neo-institutional perspective has not previously focused on the contracting interface between insurance and private equity firms - two important and all-pervasive institutional structures that function in, and across, contemporary market economies. As a result, we believe that neo-institutional theory is an intuitively appealing framework to use in examining how entrepreneurially-minded private equity and liability insurance firms actively collaborate to initiate and implement institutional change through the use of RWI. Indeed, as Bruton et al. (2010, p. 433) aptly observe, ". . . if institutions matter, then institutional theory should be employed as part of the analytical framework."

Garud, Hardy & Maguire (2007) report that orthodox institutional theory-based scholarship has tended to focus on explaining the resilience and legitimacy of conformist (isomorphic) institutions and organizational structures, and the sustained resilience of 'taken-for-granted' practices and belief systems (so-called 'institutionalized templates'). Such theoretical analysis revolves around three institutional pillars, namely: (a) coercive influences (e.g., regulatory and legal prescriptions); (b) normative drivers (e.g., conventions on social and economic conduct); and (c) cognitive forces (e.g., socio-cultural norms of conduct). These three pillars define the field boundaries of organizational and socio-economic activities, and thus help explain how institutionalized structures and social/political agents interact to attain functional legitimacy in economy and society (Bruton et al., 2010). However, recent advances in neo-institutional theorizing highlight the importance of dynamic evolutionary processes rather than institutionally embedded factors in explaining the evolving nature of organizational structures and the actions of social actors operating under the conditions of market capitalism. The drivers of structural institutional change can include, amongst other things, the interactive relational effects of public policy, increased levels of competition, and optimal shared risk-taking by entrepreneurial agents (Dacin, Goodstein & Scott, 2002).

Geels (2004) argues that neo-institutional theorizing is particularly relevant for better understanding the dynamic interplay of institutional structures and agents in entrepreneurial settings. DiMaggio & Powell (1991) add that in instigating institutional change, entrepreneurial agents deploy unique resource capabilities (e.g., financial expertise) to challenge and alter existing organizational structures and business practices. From a comparative institutional advantage perspective, financial entrepreneurs could be motivated to cooperate with each other in order to embed their institutional legitimacy through jointly inventive, and mutually beneficial, lines of business activity. The functional interaction between private equity buyout firms and liability insurers witnessed in corporate takeover markets over the last decade or so represents, in our view, an apt case study of creative institutional collaboration and radical change in 'taken-for-granted' business practices.

We illustrate our thinking in Figure 2. We then go on to explain in the next section of the paper how our thinking complements, yet expands, neo-institutional theorising as it applies to entrepreneurship in the global financial sector. We also articulate a contextually portable proposition that might help guide and direct future empirical research in the fields of strategic management and institutional entrepreneurship.

[Insert Figure 2 here]

Theoretical Extension

Historically, the path-dependence of the private equity industry emanates from exogenous neo-liberalist political forces operating in Anglo-American market economies during the late 1970s/early1980s, and the associated global diffusion and up-take of new financial market logics (Hoskisson et al., 2013)[12]. During this time, political agents sought to capture the financial skill-sets of GPs and the resources of newly formed private equity vehicles. The institutional economic and political drivers behind the private equity concept were to stimulate the processes of financial entrepreneurialism through the assignment of politico-legalistic dispensations (e.g., tax benefits) and infrastructural (e.g., public policy) support (Kaufman & Englender, 1993).The development of the private equity industry thus reflects the contention of Dillard, Rigsby & Goodman (2004) that institutional transformation often arises as a result of the efforts of politically powerful agents and a resource-endowed state apparatus (bureaucracy) to accomplish the goals of a constitutionally elected policy agenda. The recent history of the private equity industry thus accords with

[12]This process is referred to in the neo-institutional theory literature as 'financialization' (Krippner, 2005).

Garud et al.'s (2007, p. 962) observation that ". . . it is not surprising that institutional entrepreneurship is viewed as an intensely political process."

From these beginnings, private equity structures carved-out new fields of activity that extended across jurisdictions (Meuleman et al., 2009). This gives the private equity industry an international dimension - a perspective that is reflective in much of the comparative capitalism and legal origins literature (e.g., see Jackson & Deeg, 2008; Allen, 2013; Bedu & Montalban, 2014). For example, Bedu & Montalban's (2014) cross-country analysis suggests that a key reason why private equity first took root in the US, and then spread to other jurisdictions, such as Canada and the United Kingdom (UK), is that these jurisdictions share closely configured financial systems and similar legislative and regulatory infrastructures.[13] Allen (2013) also argues that the liberal market economies characteristic of Anglo-American countries promotes cross-border inter-firm and inter-industry networks, which in turn fosters the development and global diffusion of radically innovative activities[14].

In contrast to the development of the private equity industry, the path-dependency of RWI is an endogenous ('embedded agency') feature of the longstanding institution of liability insurance. Ericson, Doyle & Barry (2003) argue that liability insurance has over time become a powerful institutional force whose structural and professionalized influence extends beyond its traditional field boundaries into other commercial and public policy arenas. To illustrate their point, Ericson et al. (2003) highlight the major role played by liability insurance in shaping the theory and practice behind judicial decisions

[13]To support this point, statistical data reported by Even-Tov et al. (2020) indicates that approximately 62% of the total number of private equity transactions in their data set that involved the use of RWI emanated from the US, Canada, and UK.

[14]Griffith (2020) notes that whilst RWI emerged in the US in the 1990s, RWI policies had in fact evolved out of tax liability insurance policies connected with leasing transactions that were originally developed at the Lloyd's of London insurance market back in the 1980s.

delivered in tortuous disputes and negligence claims[15]. These expansive and influential institutional traits distinguish liability insurers as 'pace-setter' firms operating in an industry (field), which is otherwise widely publicly perceived to be an inert and staid part of the international financial system (Johne & Davies, 1999). In other words, the growth in RWI represents a special case of divergent change in the liability insurance sector that hitherto rarely occurs given entrenched institutionalized structures and well-established risk management practices and traditions of the wider insurance industry.

The institutional evolution of RWI alongside, and interconnected with, the growth of the private equity industry can, as we noted earlier, be viewed as a classical case of convergent and co-evolving entrepreneurial interests collaborating creatively and pragmatically for mutual economic gain. Prior studies (e.g., Sarason, Dean & Dillard, 2006) view that cooperative entrepreneurialism results from the interconnection between market opportunity and the desire of institutional agents to enact change in order to secure shared economic gains. Toms, Wilson & Wright (2019) argue that the risk management expertise of, and business-relevant advice provided by, financial intermediaries (e.g., insurers and brokers) can usefully moderate this relation, and thus help stimulate entrepreneurial risk-taking and economic development[16]. Pacheco, York, Dean & Saravathy (2010, p. 989) also point out

[15]The legal liability insurance industry in Anglo-American countries has its antecedence in the enactment of employers' workplace negligence legislation during the nineteenth century (McNeely, 1941). Today, liability insurance is mainly written by a small number of large international insurers, such as the American International Group (AIG), and specialist underwriting syndicates operating at the Lloyd's of London insurance market (Adams, Upreti & Chen, 2019). Moreover, the technical and specialist nature of liability insurance means that barriers of entry to the market are high, thereby, restricting competition and enabling incumbents to protect and grow innovative lines of business, such as RWI.

[16]The role of insurance brokers in influencing and facilitating contractual change in the private equity-RWI relation is a potentially interesting new line of research inquiry, which we note at the end of the paper. We contend that the involvement of brokers in the development of RWI policies, is particularly likely if such policies are extensively underwritten at broker-orientated markets, such as the Lloyd's of London insurance market rather than in the direct

that institutional entrepreneurs often ". . . work in collaboration . . . taking advantage of convergent interests and relying on collective action to influence macro level institutions . . . and [thus] change the nature of legitimate practices in a field." Therefore, from an organizational institutionalism perspective, private equity entrepreneurs (LPs) and their financially expert managerial agents (GPs) are likely to intentionally seek access to, and usage of, additional specialist resource competencies and capabilities (e.g., risk management expertise) that traditionally reside within the domain of other organizations (insurers) and the functional skill-sets of their serving elite professional agents (actuaries and underwriters) (e.g., see Lounsbury, 2002). As Su, Zhai & Karlsson (2017) make clear, heightened institutional risks and uncertainties induce changes in patterns of conduct amongst entrepreneurial agents, and encourages them to seek-out mutually co-constituted fields of new business opportunity in order to maximize private economic and social benefits. Leyden, Link & Siegal (2014) also note that in embracing risk and uncertainty, and bringing highly inventive ideas to market, entrepreneurial agents will search for, and acquire, new knowledge and institutional arrangements through the process of relational networking and reconfigured, but legitimated, business arrangements. Carpenter & Feroz (2001) further argue that institutional innovations are more likely to take root in fields, such as private equity and insurance, with high levels of professionalized (finance and actuarial) activity, and the necessary institutionalized socio-cultural authority to effectively implement and legitimate changes in economy and society.

In our opinion, bilateral bargaining between private equity buyout firms and liability insurers (perhaps involving brokers) over such matters as RWI policy language, risk-sharing arrangements, and policy exclusions are typical examples of strategically pragmatic cooperation and institutional

placement company market. For an informative analysis of brokers as institutional 'market-makers' in insurance markets see Cummins & Doherty (2006).

experimentalism at both the firm-level and industry-level. Such cooperation allows optimal hybrid solutions to be agreed between contracting parties that help avoid costly 'hold-ups' in idiosyncratic transactional settings that typically characterize private equity (dis)investment decisions (Griffith, 2020). This form of cooperative contracting is implicitly based on the maintenance of trust between the parties, and the expectation that as a result, mutual economic gains will be realized. This implied aspect of the private equity-RWI relation helps mitigate the potential risk, highlighted by Griffith (2020), that the GPs of private equity LBO firms may become complacent in their due diligence if they transfer litigation risks to third party liability insurers through RWI policies. Reuer et al. (2006) also report that in such technically sophisticated commercial situations, entrepreneurial agents actively trade-off the complexity of costly contracting design and contractual renegotiation against the mutual economic gains that can arise from flexible dealing. Such activities are reflective of increased institutional financialization in economy and society, whereby private equity and liability insurance firms capture and distribute the economic value created from RWI through carefully engineered and negotiated strategic collaboration (e.g., see Kristensen & Morgan, 2012).

Interestingly, and in an extension to strategic entrepreneurship thinking, Griffith (2020) reports that reciprocation arrangements between private equity buyout firms and RWI providers extend beyond cooperation on matters, such as information risk-sharing, and the drafting of policy terms and conditions, to also include novel contracting concessions and streamlined routines. These procedural initiatives have a transformational impact on established custom and practice (institutional logics)[17]. For example, in their dealings with private

[17]Negotiated concessions to the established 'rules-of-the-game' between private equity buyout firms and RWI providers are explicit (formal) changes in the process of contracting rather than implicit (informal) 'gentlemen's' agreements that occasionally arise in complex transactional settings that have been highlighted elsewhere in the entrepreneurship literature (e.g., see Godley, 2013).

equity buyout firms, liability insurers often relax their normally rigorous and costly pre-insurance due diligence routines. Instead, liability insurers rely more heavily ('free-ride') on the veracity of pre-contract checks performed by private equity managers and/or their trusted professional agents (e.g., deal lawyers). Such pre-contracting reliance will nonetheless be predicated on RWI providers and/or their nominated agents (e.g., brokers) conducting secondary cursory reviews of the pre-contract checks performed by private equity GPs (Griffith, 2020).[18]

To ensure dynamic trading in private equity markets, RWI providers will also refrain from providing detailed loss prevention and risk mitigation advice on the conduct of private equity transactions (Cable, 2020). Under normal insurance trading conditions, risk management guidance is often deemed by commentators to be a valuable 'real service' commonly provided by insurers to their commercial clients (Mayers & Smith, 1982). This departure from 'taken-for-granted' organizational and industry logics means that RWI providers will tend not to deeply evaluate, and so set premium rates that actuarially reflect the financial risks of individual acquisition and sales agreements. Insurers would, nevertheless, normally perform such tasks when, for example, providing indemnity coverage for more standardized lines of business, such as property

[18]If the GPs in private equity LBOs identify, or should have reasonably identified, risks during their due diligence work, but fail to disclose such exposures to insurers prior to contracting out of concern that such risks may be excluded from policy coverage, then the insurance contract would be rescinded under the legal doctrine of 'utmost good faith'. This well-established principle of insurance law requires insured agents to 'fully and truthfully' disclose at the outset known risks that might materially increase the probability and severity of future claims (Rea, 1993). The selective exclusion of known risks mitigates adverse selection for RWI providers, and helps ensure their financial viability. The doctrine of 'utmost good faith' thus provides an incentive for private equity GPs to conduct thorough due diligence. GPs are likely to be further motivated to perform sound due diligence in order to protect their public reputations as competent and responsible 'deal makers'. In addition, private equity GPs will be incentivized to perform effective pre-contractual checks in order to set the 'right' price range (and hence, targeted profit margins) for negotiations with exchange counterparties. This is likely to be particularly important in auction acquisitions in which private equity buyout firms are frequently involved (Fidrmuc et al., 2012).

(Zou & Adams, 2008).[19] For example, fire risk prevention data are broadly applicable across assets insurance portfolios, thereby, enabling property insurers to realize scale and scope economies from investment in due diligence. With RWI, however, underwriting information on the risk of 'reps' breaches' is highly idiosyncratic with limited application beyond the particular deal being conducted[20]. This makes comprehensive due diligence of private equity transactions not only time-consuming, but also operationally uneconomic for RWI providers.

On the other hand, RWI providers cover any heightened risk using a combination of selective and extensive RWI policy exclusions (e.g., time limits on the admissibility of notified claims), coverage limits, and risk retention clauses (deductibles) (Griffith, 2020). These bilaterally negotiated contractual changes in institutional logics enable RWI providers to encourage GPs and/or their professional agents (e.g., deal lawyers) to conduct sound self-due diligence

[19]The absence of external monitoring by liability insurers, and indeed, by regulatory agencies, in the private equity-RWI transacting process could reflect the LP structure of private equity buyout firms. For example, Holderness (1990) reports that the demand for external monitoring is greatest where, as in public corporations, agency incentive conflicts between residual claimants (principals) and managers (agents) are acute. In contrast, LPs could, in theory, be sophisticated and active co-participants in asset allocation decisions, and given their limited exit rights under investment agreements, be close and effective internal monitors of GPs' activities. However, as we made clear earlier, in private equity settings LPs, perhaps due to their limited in-house expertise, tend to be passive investors that delegate investment decisions to GPs. Still, both LPs and GPs are likely to be incentivized under compensation plans to make corporate investments that payoff at exit (Cheffins & Armour, 2008). Hence, the concessionary and 'light touch' due diligence practices of RWI providers fits well with the institutional entrepreneurial structure that pervades in private equity markets.

[20]Although D&O insurers may conduct some pre-insurance checks (e.g., on the credentials of corporate directors), their loss prevention due diligence, particularly in public corporations, is also 'light touch' (Baker & Griffith, 2007). However, the risks associated with 'reps' breaches are arguably more idiosyncratic in the relatively newer and specialist RWI line of business than in the more commonly transacted D&O line of liability insurance. This likely results in more closely negotiated and concessionary contracting between private equity buyout firms and RWI providers than tends to be the case between companies and D&O insurers. In addition, D&O policies tend to use fairly standardized forms of contract, with assumed shareholder litigation risks are effectively spread across large portfolios of international D&O insurance business and reinsurance.

so that they can effectively control losses, and realize profit targets. Private equity buyout firms are expected to benefit from such contracting concessions and streamlined routines if it promotes their credibility as 'deal makers' and 'repeat players' in global markets for corporate control. Such reasoning suggests that the private equity-insurance relation analyzed in this study represents not only a case of cost-efficient contracting between parties, but also reflective of commercially effective collaborative institutional entrepreneurship in action. In this regard, the reputational incentives of private equity LBO firms to truthfully disclose information and lower screening costs for insurers has close parallels with the cooperative relationships that private equity LBO firms build over time with bank investors in order to reduce the costs of financing target acquisitions (e.g., see Ivashina & Kovner, 2011; Fang et al. 2013)[21].

Lounsbury (2002) also notes that structural institutional change provides opportunities for professionalized social actors (e.g., actuaries and underwriters) acting on behalf of innovative-type organizations (e.g., liability insurers) to manage institutional risks and uncertainties by building on business networks and utilizing practice-specific technical know-how to realize economic gains from innovations, such as RWI. Smith & King (2009) point out that when faced with seemingly insurmountable impediments and transaction costs, entrepreneurial organizations, such as private equity buyout firms, may not just innovate and collaborate with other organizations (insurers) to achieve technical-rationalist (risk mitigation) goals, but also build new logics, and then signal the legitimacy of such practices in the public domain. This would allow private equity GPs to enhance their entrepreneurial credentials by enabling them to make effective decisions under conditions of uncertainty, and hence, contribute positively to economic progress and public policymaking (Wright, 2013). Without significant adjustments to established custom and practice,

[21] It is likely that in lowering the agency costs of debt, RWI can further have economic benefits for private equity LBO firms. We highlight this point as a research contribution in the Discussion & Conclusion section of the paper.

institutional entrepreneurs, such as private equity buyout firms, could find it difficult to survive in increasingly competitive corporate acquisition markets (Elert &Henrekson, 2016). Therefore, as Bylund & McCaffrey (2017, p. 464) remark, entrepreneurs that " . . . believe institutions inhibit profitable investments . . . can act to evade their constraints . . . [by contemplating] new or alternative means of organizing new forms of contract. . . .". Therefore, we suggest the following generalized proposition to help guide future empirical research:

> Proposition: Heightened costs of transactional risks and uncertainties in private equity markets are likely to motivate managers in private equity firms and liability insurers to design, negotiate, and draft new contractual forms that radically alter established custom and practice in ways that realize mutual economic gains.

Discussion & Conclusion

This study highlights that whilst the purchase of RWI mitigates costly contracting and incomplete information in private equity (dis)investment deals, it can nevertheless also introduce frictions into the transacting process. This raises the intriguing question as to why RWI has become increasingly popular over the last decade or so as a risk management mechanism in corporate takeover markets in which private equity buyout firms feature prominently. Our neo-institutional theoretical analysis suggests that RWI alleviates the risks and uncertainties that might arise in private equity-sponsored transactions. Such benefits can also include protecting the public credibility of private equity LPs and GPs as skilled 'deal-makers', and facilitating the sustainability of future investment. These intrinsic qualities of RWI enable private equity buyout firms to create future value by strategically exploiting profitable entrepreneurial opportunities, maximizing investment returns, and more effectively competing with private equity rivals and other competitors (e.g., hedge funds) in tight market conditions. For liability insurers, RWI represents an innovative product-line that can help capture new and profitable market opportunities. The development and growth of RWI in private equity markets is reflective of pragmatic collaboration and institutional configuration between liability insurers and private equity buyout firms operating across different jurisdictions. This situation thus represents an interesting case study of institutional entrepreneurialism and strategic collaboration in the financial sector that embraces both the organizational and comparative institutionalism perspectives found in the neo-institutional theory literature.

More specifically, institutionalized cooperation in the private equity-insurance relation includes the negotiation of bespoke contracting arrangements (e.g., the use of mutually agreed policy language), and radical changes to the 'rules-of-the-game'. Such transformative logics include the adoption of 'light touch' due diligence by RWI providers and greater reliance on the assiduousness preliminary checks conducted by private equity GPs, and the use of selective risk protection (e.g., policy exclusion) measures in contractual design. These radical changes to established insurance industry custom and practice allow RWI providers to effectively promote their strategic objective of growing new profitable lines of business, yet concomitantly controlling their loss liability positions. For private equity buyout firms, cooperation and bilateral compromises with liability insurers provide for timely and cost-effective deal closure, which allows them meet their strategic financial goals in line with prior commitments made to their investors. Moreover, the notion of compromise and contracting concessions is a novel aspect that has rarely been emphasized and investigated in the strategic entrepreneurship field. We further offer-up a generalized proposition that could help guide future entrepreneurship theorizing and provide a basis for future empirical testing.

The neo-institutional theory framework adopted in this paper makes four further key contributions to the extant literature. First, the study highlights the motives (e.g., the economic need for timely deal completion) underpinning the growing demand for RWI in private equity transactions. Such insights could provide academics, asset managers, policymakers, and others, with a sharper understanding of the transformational conditions promoting the processes of institutional entrepreneurship in international markets, including emerging economies. This attribute could also help shape and direct future corporate and public policy proposals aimed at improving the efficacy of global corporate takeover markets through the use of private equity capital and the purchase of RWI. For example, the purchase RWI by private equity buyout firms could be particularly beneficial in facilitating the successful and timely completion of cross-border corporate investment and divestment transactions, where valuation uncertainty and deal completion risks are likely to be acute. Additionally, incomplete convergence in the accounting for international business combinations increases transaction risks for corporate acquirers, thereby, highlighting the need for RWI and potential cooperative contracting.

Second, our research suggests that by alleviating contracting frictions and information problems in private equity transactions, RWI acts as a cost-effective substitute for expensive lawyer-drafted acquisition and sales agreements. In addition, RWI can improve the efficiency of private equity markets by alleviating contracting imperfections, reducing agency costs, and enabling private equity firms to realize competitive advantages over rivals by securing timely deal completions. This facet of the current study could help regulators and policymakers to better evaluate the effectiveness of the governance structures, and investment and financing operations of private equity firms. This could, for example, help in developing future guidelines and financial standards in private equity markets - an area of regulatory focus that has so far been under-played by political agents. In addition, the importance of complimentary organizational reconfigurations between private equity and insurance firms can help facilitate transnational investment. Again, this aspect of the current study could have important policy implications for investment and economic development strategies in emerging economies.

Third, the present study presents opportunities for both researchers and practitioners to examine whether or not the purchase of RWI helps private equity LBO firms to further lower borrowing costs, and thus, enhance their reputational relationships with syndicate banks that fund their corporate acquisition activities. Indeed, given the prevalence of bank-sponsored private equity investments (Fang et al., 2013), RWI could by, mitigating the risk of transaction delay, help lower volatility risk and other (e.g., regulatory) costs for bank investors. These risk management attributes of insurance protection have not, to the best of our knowledge, been examined previously in the private equity financing literature,

Fourth, the theoretical analysis presented here adds to the wider strategic finance, and entrepreneurship literature on the growing risk management role that insurance plays in promoting institutional innovations in the finance sector and beyond. This is a cross-industry-relevant aspect of our research that few prior entrepreneurial-focused studies have neither sufficiently highlighted nor examined in detail. Whilst increasingly used as an analytical framework for strategic entrepreneurship research, neo-institutional theory has not, to the best of our knowledge, been used to investigate the emergent, and increasing, use of RWI in private equity-backed corporate acquisitions and sales. Our theoretical analysis of the private equity-insurance relation could thus direct researchers to new, and potentially interesting, lines of future scholarly endeavour on the dynamics and mechanics of institutional transformation and practice adaption.

The analysis conducted in the present study could also provide an intuitive context for further investigative scholarship and empirical analysis in the field of entrepreneurship. For example, future empirical research could, given the current general absence of publicly available data on RWI purchases and claims, use primary data collection methods, such as interviews, in order to validate and build on the insights gleaned from the present study. Such a research approach that focuses on the micro-organizational (e.g., investor/manager decision-maker) level of analysis could highlight the relative cost-benefit aspects of RWI to private equity buyout firms operating in different industrial settings and/or diverse institutional environments. These lines of scholarly inquiry could also provide a context for interesting comparative macro-micro (institutional-individual) entrepreneurial analysis at both the domestic and international levels of research investigation.

In addition, to the foregoing contributions, we consider that the present study could further stimulate research activity in six lines of inquiry. First, empirical research could investigate whether RWI is used more or less in different types of private equity-backed transactions, such as 'over-the-counter' deals compared with initial public offerings (IPOs). Second, the research community could examine whether the use of RWI varies across private equity funds of different size and/or syndicates comprising investors with different levels of in-house financial and risk management expertise. Third, future empirical research could investigate opportunities for strategic entrepreneurial partnerships, and the potential for changes in institutional logics in other parts of the insurance industry. Fourth, another potentially interesting line of empirical investigation would be for scholars to identify and explain variations in the take-up of RWI amongst different types of private equity LBO transactions (e.g., LBOs initiated by industry specialist versus general private equity entities). Such research endeavours could further usefully inform business management scholarship, public policy, and commercial practice - for example, by improving our understanding of the relative cost-benefit potential of externally insured and self-insured strategic investment dealings. Fifth, researchers could investigate the role of other intermediaries (e.g., brokers and lawyers) in promoting entrepreneurialism amongst institutional actors, such as private equity buyout firms and insurers, that operate in global financial markets. Finally, the empirical analysis of the use of insurance in mitigating transaction risks in other entrepreneurial settings (e.g., venture capital investments) could also be another fruitful line of future research activity.

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Figure 1: Potential Benefits & Costs of RWI for Private Equity LBOs

Benefits	Costs
• Risk transfer & cost certainty	Premium charges
• Reduced transaction risk & valuation uncertainty	Policy exclusions, deductibles & coverage limits increase potential liability
• Timely claims settlement	RWI may be long-tail & so affect claims management efficiency
• Reduces financial risk in leveraged buy-outs	Adverse selection may foster overly risky investments
• More tax efficient than alternatives (e.g., escrow accounts)	Marginal tax benefits of RWI may be muted for existing tax-favored private equity firms
• May compensate for due diligence errors	May induce lax due diligence (moral hazard)

Figure 2: Private Equity and RWI providers: Entrepreneurial Linkages

PRIVATE EQUITY	ATTRIBUTE	RWI
Financial markets	Antecedence	Insurance industry
Exogenous (political)	Evolutionary Trigger	Endogenous (industrial)
Maximize investors' returns	Key Function	Maximize investors' returns
Uncertainty of deal completion	"Roadblock"	Mis-priced risks
Transfer risk	Collaborative Motive	Accept Risk
Policy exclusions to avoid hold-up costs	Concessions	Reduced due diligence to avoid hold-up costs
Momentum profits & realized bonuses	Outcomes	New business profits & realized bonuses
Investors & managers	Beneficiaries	Investors & managers