Brown & Brown

What to Worry About When De-Risking Your Next Acquisition

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Presented By:
Hays Companies, Inc., an affiliate of Brown & Brown, Inc.

Today's Speakers

Kristine Olson
Senior Vice President
Brown & Brown

Kristine Olson is a Senior Vice President and leads the transactional risk team at Brown & Brown. She has been a mergers and acquisitions specialist in the risk management and insurance industry for 20 years, partnering with both private equity and strategic investors including negotiating insurance programs and servicing clients post-acquisition. Kristine also brokers representations and warranties insurance coverage for B&B clients.

Becky Dreier
Vice President
Brown & Brown

Becky Dreier is an account executive and member of the transactional risk team at Brown & Brown. She works with strategic acquirers and private equity groups to negotiate and secure representations and warranties insurance for transactions of all sizes. Prior to joining Brown & Brown, Becky was a practicing attorney for nine years, including seven years as in-house legal counsel for a Wisconsin-based manufacturing company.

Phil Bronsteatter
Managing Director
Pfingsten Partners

Mr. Bronsteatter has over 15 years of private equity experience and nearly 20 years of experience with middle-market companies. Since joining Pfingsten, he has been involved in all aspects of the firm's activities and currently leads the firm's corporate finance team and business development function, including the industry investment thesis process for direct transactions.

Preparing for a Sale

Analyze and adjust business on all fronts (financial, legal, insurance, people, environmental, IP, outstanding litigation)

- Identify and address any potential issues or liabilities that could be uncovered during the buyer's due diligence process

Ensure insurance policy coverage limits are in compliance with contractual obligations of your customer base to avoid issues

Document past insurance claims (nature of claims, the claim amounts and outcomes)

Organize and prepare documentation and records to expedite due diligence process

Preparing for a Sale

Audited financial statements

May be required for Representations and Warranties policies)

Quality of Earnings may be allowed but buyer side is preferred

Cyber liability insurance should be assessed in today's environment

Discuss with broker whether the company will need to maintain any insurance coverage post-sale - tail coverage on liability policies or insurance for any retained liabilities

Who should be involved?

Insurance broker

Management team (ownership / CFO)

Investment bank

Legal counsel

Letter of Intent (LOI) Signed – What's Next?

- ***How*** will you diligence the target and ***who*** will you include on your team?
- ***Engage*** the buyer's advisors early
- ***Request*** the right information from the target
- ***Consider*** insurance solutions – reps and warranties, tail/run-off coverage

Goals of Insurance Due Diligence

Understand the target's approach to risk management

- Identify areas of concern related to its current insurance program and associated un- or under-insured liabilities
- Identify legacy liabilities and consider insurance solution or indemnification

Evaluate loss history or OSHA fines

- Establish plan for loss control and facility improvements

Achieve optimal cost structure

- Compare cost of target's program vs. adding exposures to buyer's program vs. new program

Evaluate unexpected effects on EBITDA

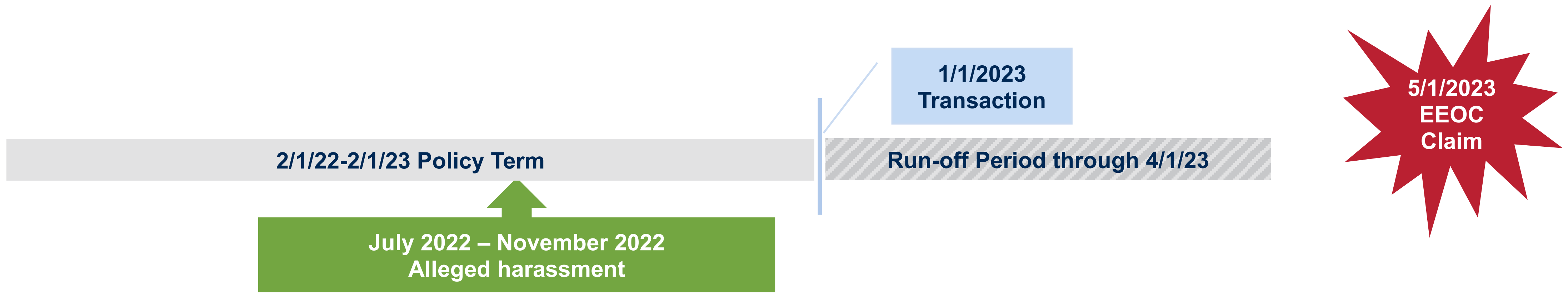
- Capital expenditures due to lack of improvements to target assets or operations
- Ongoing deductibles or retentions
- Change in lending requirements
- Increased insurance costs due to risk tolerance differences

Consider run-off or transaction-related insurance coverage

Run-Off Insurance Coverage

Why?

- Protect buyer or seller from claims which occurred pre-transaction
- Claims made policies may cancel or include change in control provisions triggered by the transaction
- This often includes cyber, directors and officers, and employment practices liability



- Generally priced at a percentage of the underlying policy
- Can negotiate coverage even if it was not previously purchased by target
- May negotiate for target company to pay premium
- Requires 1-2 weeks to secure quotes

Representations & Warranties Insurance

What types of representations and warranties are usually in a purchase agreement?

Financial Statements

Copies of the Acquired Companies' audited consolidated and combined financial statements … have been made available to Buyer in the Data Room. Except as set forth in Section 5.12 of the Disclosure Schedules, the Financial Statements have been prepared in accordance with GAAP …

Inventory / Products

All inventory of the Acquired Companies reflected in the Balance Sheet consists of a quality and quantity usable and salable in the ordinary course of business … All such inventory is owned by the Acquired Companies free and clear of all Encumbrances …

What is Representations & Warranties Insurance, and Why Do I Need It?

Transfers the risk of breach of a representation or warranty to an insurance company

- Escrow may be reduced or eliminated
- Seller can distribute proceeds sooner

Buy-side or Sell-side policies are available but 90% of policies placed are buy-side

- Allows for coverage of seller fraud

Designed to cover most warranties but there are standard and deal-specific exclusions

- Examples: Purchase price adjustment and forward-looking statements

How Much Reps & Warranties Insurance Do I Need, and What's the Cost?

- Limit is subjective based on risk tolerance and size of transaction
  - Limit Benchmark - 10% of the enterprise value (EV)
  - Retention - .5% to 1% of the EV
  - Premiums in range of 2% to 3% of the limit purchased

Example

- **EV = $100,000,000**
- **Limit = $10,000,000**
- **Retention = $500,000 - $1,000,000**
- **Premium = $200,000 - $300,000**

- Minimum premiums apply and are currently ***$100,000 to $150,000*** for most insurers
- Products are available in the marketplace for smaller deals

Process for Obtaining Reps & Warranties Insurance

1 Start early

- Insurers generally need at least two weeks to place a policy, but more time is recommended

2 Non-Binding Indication

- No cost
- Generally requires letter of intent and/or draft purchase agreement, management presentation and/or confidential information memorandum, and target financials (if available)

3 Underwriting

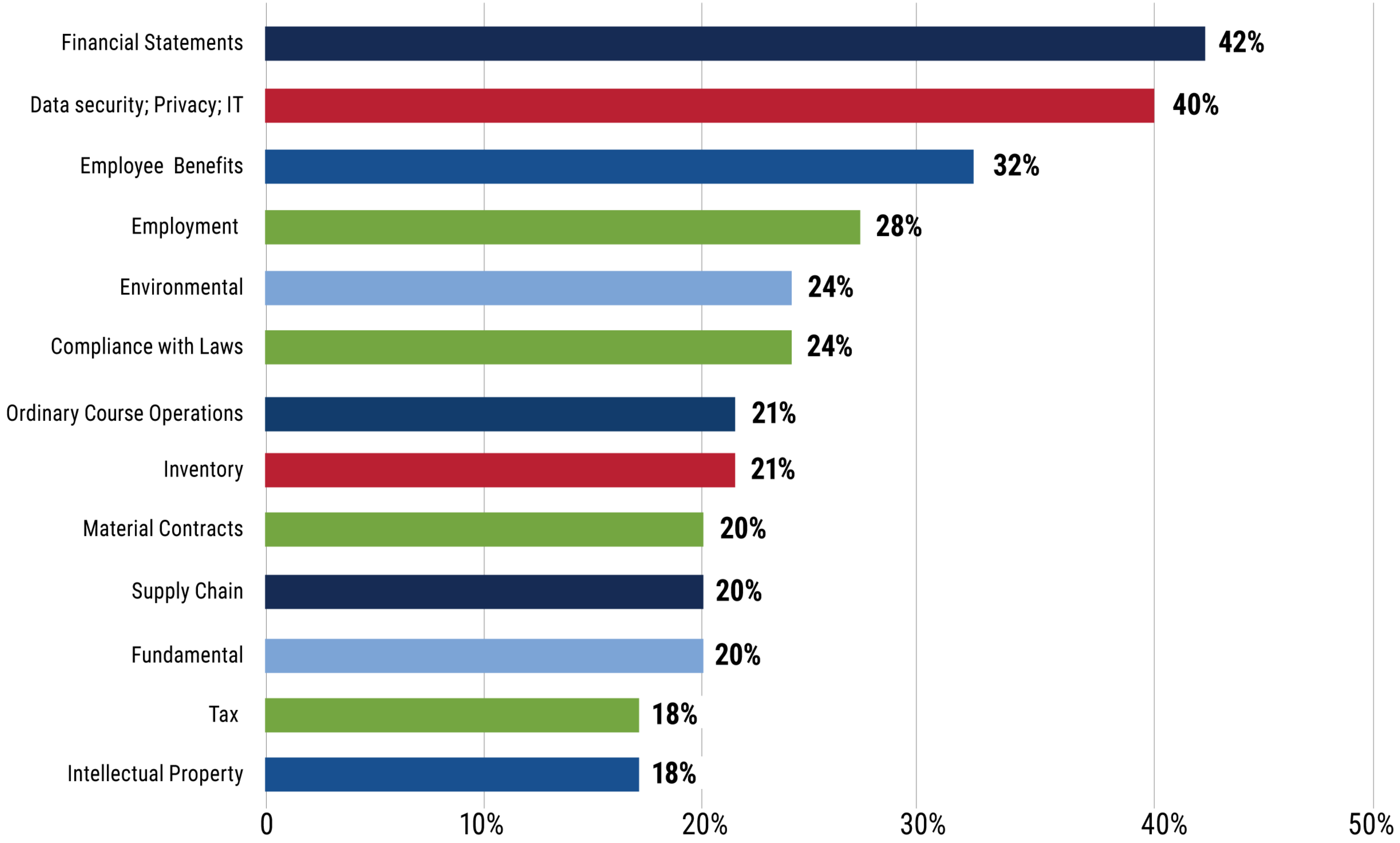
- Diligence fee of $30,000 - $40,000
- Underwritten based on:
  - Nature of the representations
  - Terms of the purchase agreement
  - Quality of the due diligence performed by the buyer
    - Internal vs. external due diligence
  - Quality of earnings, especially if no audited financials
  - Underwriting call with deal transaction team and due diligence providers

4 Transaction Execution

- Policy Negotiation
  - Bespoke policies
  - Coordinated with turns of the purchase agreement

Reps & Warranties Claims Update

Types of Breaches Reported in RWI Claims



Note: respondents were allowed to select more than one answer.
Source: Lowenstein Sandler RWI Insurance Claims Report 2023

Examples

» Buyer purchased a tech company based on the target's new product

- Target represented product was in final stages of development
- After closing, buyer learned target was significantly behind on development of product and was unable to deliver on contracts in place with customers
- Customers terminated contracts
- **Buyer alleges breach of representations of material contracts**

» Buyer purchased a manufacturing company

- Target represented it had $20M of saleable inventory
- Following closing, buyer discovered that over half of the inventory was obsolete and could not be sold.
- **Buyer alleges breach of representations related to inventory**

Closing Insurance Checklist

- Insurance due diligence complete
- Reps and warranties underwriting complete, final versions of purchase agreement and schedules approved by insurer, insurance policy fully negotiated
- Run-off policies are quoted and ready to bind
- Go-forward policies are quoted and ready to bind
- Certificates of insurance have been prepared, issued, and are satisfactory to lenders and other certificate holders

Post-Closing Steps

Call

Call with insurance contacts from the buyer and acquired company to answer any questions regarding the insurance transition

Cancel

Cancel insurance policies of acquired company that are no longer needed

Ensure

Ensure the acquired company has insurance policy information and understands the processes for claim reporting and any other internal processes related to insurance

For additional information:

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