SYMPHONY RISK

FROM LOI TO CEO – **AN ACQUISITION ENTREPRENEUR'S** GUIDE TO RISK & INSURANCE DILIGENCE

INTRODUCTION

There is no single, one-size-fits-all approach to insurance due diligence and the post-acquisition operating insurance strategy because each company presents its own unique set of risks and challenges – a realization most acquisition entrepreneurs come to AFTER they assume the role of CEO.

Over the last several years, acquisition entrepreneurs and investors, have suggested that an insurance diligence guide would be useful given the growth within this segment. While this isn't all encompassing, the idea is to help demystify the insurance diligence process and serve as a resource upon operating and divesting the business. At the very minimum, the acquisition entrepreneur will have a working framework into insurance diligence and how insurance will fit into the closing process to ensure a seamless transition.

Commercial insurance is specialized – determined by industry, size, company profile and geography. Unlike personal auto coverage — which can be procured in minutes online or on the phone — the placement of a competitive commercial insurance program involves working alongside a knowledgeable broker, completing applications, and addressing insurance company inquiries. The process commonly takes as little as a few days to a few weeks to complete, depending on the business.

Acquisition entrepreneurs may be surprised to discover insurance policies, including Property, General Liability, Workers' Compensation and Cyber can't simply be updated to include the new entity upon acquisition (especially in the case of an asset purchase). Lack of proper insurance can grind the process to a halt. For example, many acquisition entrepreneurs do not consider lender insurance requirements until counsel, or the lender request a Certificate of Insurance in order to fund the transition.

This guide is geared toward search fund and small-cap transactions where the target is using a traditional insurance program. For larger search fund, middle market transactions and companies in certain industries, there are more complex issues which are not addressed in this guide. This guide will be updated regularly with the latest best practices. Our next installment will include a look at transactional risk (Representation and Warranty Insurance) issues for Acquisition Entrepreneurs.

WHAT DOES INSURANCE DILIGENCE UNCOVER

DETERMINE THE ADEQUACY OF THE CURRENT INSURANCE.

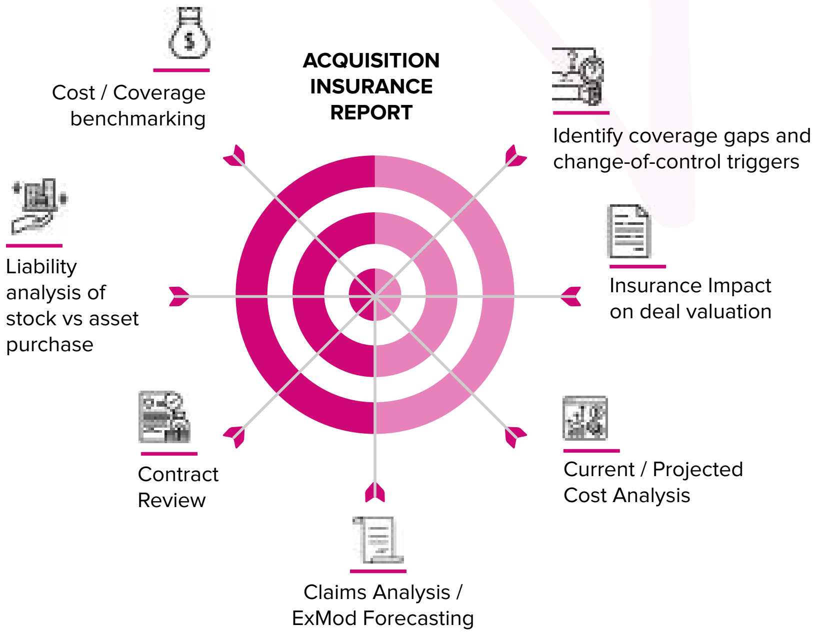
It's important to determine if the policies and coverages are appropriate for the target and if there any material exclusions or endorsements restricting coverage. Proper due diligence is essential for determining if the target has any uninsured operations or services, which create potential gaps in coverage.

CONFIRM ACCURATE EXPOSURES AND CLASSIFICATIONS.

This is essential and can have a meaningful impact on EBITDA. Some insurance policies, such as General Liability, Professional Liability and Workers' Compensation, are subject to audit. Workers' Compensation is always audited based on payrolll while General Liability can be audited off sales, payroll, number of patient visits, or other metrics

Examples:

- A home health care business generated $30 million in sales. However, the Professional Liability application reported only $4.0 million, which was used to calculate the initial premium. The audit generated a potential additional premium of $60,000 - $70,000.
- A plumbing company misclassified payroll between high-wage and low wage class codes.
- A staffing agency classified nurses as clerical vs nurses working at a hospital resulting in Additional premium $75,000.



REVIEW MATERIAL CUSTOMER CONTRACTS AND LEASE AGREEMENTS.

The acquired company should be in compliance with customer insurance requirements. Most customer contracts outline required coverages. These requirements stipulate the type, minimum limit and scope of coverage that are to be maintained. Some contracts even address the maximum allowable deductible and depending on the deficiency, unexpected cost increases at closing can result.

REVIEW LOSS CONTROL AND CLAIMS HISTORY.

A review of the seller's loss history can provide insight into the risk management processes and uncover any loss frequency or severity issues. When determining premium, insurers typically consider the loss history of the previous five years. Post-closing, the insurer will require loss runs from "OldCo" regardless of the change in ownership.

REVIEW EXPERIENCE MODIFICATION FACTOR (EXMOD).

Every state has some workers' compensation insurance requirement. Your ExMod, calculated using loss and payroll data over the experience rating period (typically the previous three policy years), determines your workers' comp costs. An improperly calculated ExMod can have a material impact on premium.

IDENTIFY POLICIES WITH CHANGE-OF-CONTROL TRIGGERS.

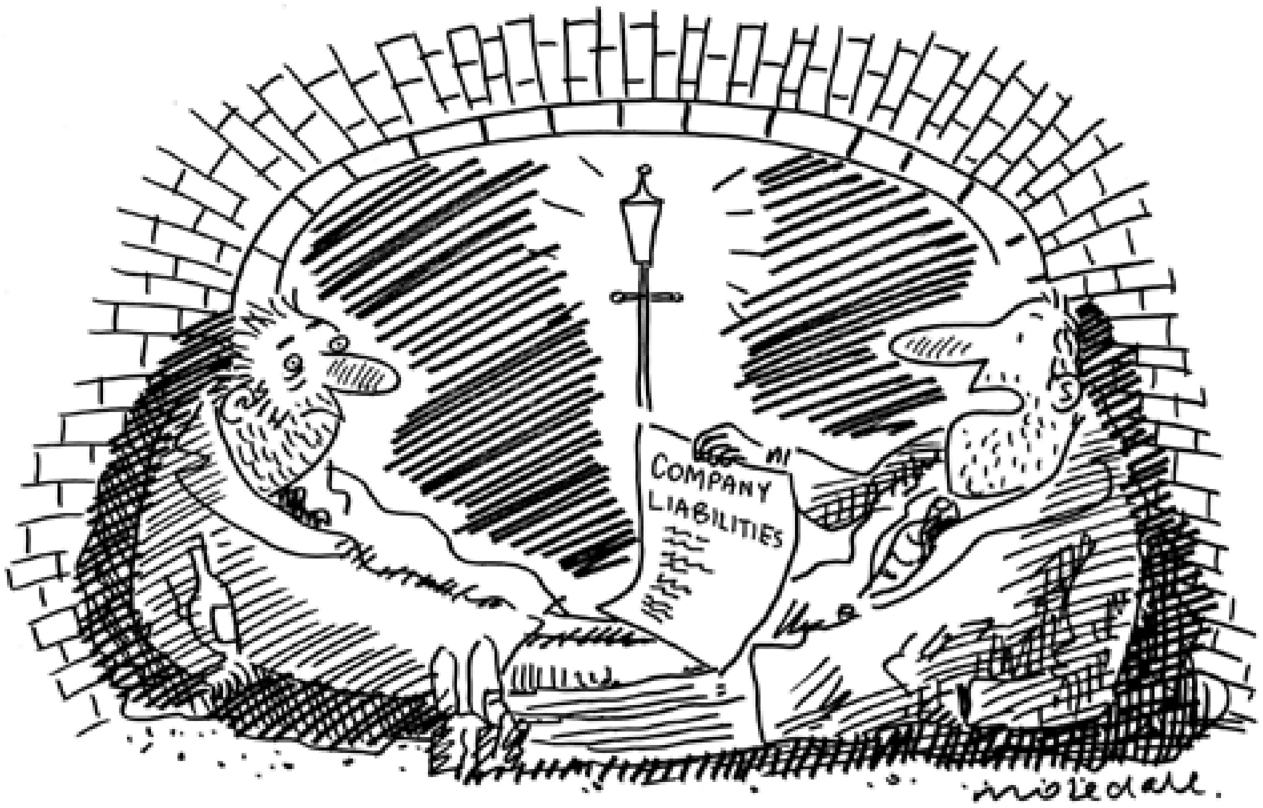
Many policies contain "change-of control" triggers or "anti-assignment" clauses, which would prevent the buyer from just assuming the existing seller policies. To avoid a gap of coverage and create a clean separation between buyer/seller, a go-forward policy and run-off policy will need to be procured. Run-off provides coverage for pre-close wrongful acts that are reported post-close.

FULFILL LENDER INSURANCE REQUIREMENTS.

As a condition of lender financing, a Certificate of Insurance (COI) and Evidence of Coverage will be required prior to closing. Each lender will have its own requirements, limits and coverages depending on the industry and assets of the business. Lenders will typically need to be named as an additional insured and require 30 days' notice of cancellation.

TRANSACTION STRUCTURES AND INSURANCE IMPLICATIONS

The transaction structure of an acquisition will set the stage for the insurance diligence workstream and the components it entails. Here are themost common types of acquisitions...



'My only real regret in life was not knowing the difference between an asset purchase and a share purchase.'

ASSET PURCHASE

The most common type of transaction for acquisition entrepreneurs, an asset purchases allows the buyer to determine which assets from the target company it wishes to acquire, such as physical plant, vehicles, equipment, and inventory.

Acquisition entrepreneurs may not assume the seller's liabilities in order to facilitate a clean separation. As a result, the insurance program will not transfer to NewCo, nor will insurers allow the program to be assigned. This requires a new insurance program at closing for the acquired entity and its assets.

An asset purchase requires a multi-step approach to insurance diligence:

Phase 1: Target insurance diligence.

Phase 2: Marketing and placement of go-forward program.

- In search fund transactions, it's common for the seller to own the building in which the target entity is housed, yet it is typically not included in the asset purchase agreement. When this is the case, the insurance advisor or broker should review the new lease agreement prior to execution. The lease agreement and lessor/lessee insurance requirements can be negotiated. Buyers must ensure each party acquires the proper coverage outlined in the lease.

- Loss history – good and bad – will be considered within the underwriting process for the next three to five years, post purchase. In order to ensure the ExMod for workers compensation continues to be properly applied, buyers will have to submit an ERM 14 – Confidential Request for Ownership Information Form.

- The insurance broker cannot release *evidence of insurance* (via a Certificate of Insurance) with new policy numbers and effective dates until the acquisition entrepreneur binds the policy and insurable interest is created. It is difficult to bind and unbind a policy, so appropriate management of timing is imperative. To manage this scenario, buyers should request the lender's insurance requirements 2 weeks prior to closing. Typically, the lender's counsel will generate several iterations on the insurance language contained in the requested certificates.

STOCK PURCHASE

Generally speaking, a stock purchase allows for an expedited insurance timeline. In a stock purchase, the buyer is assuming assets and liabilities from the seller. The acquisition entrepreneur will likely inherit the business insurance and employee benefits programs *except* for those policies which contain a *change-of-control provision*, such as directors and officers, employment practices and errors and omissions insurance. In such cases, the buyer will need *run-off* or tail coverage, which provides insurance for pre-closing wrongful acts that are reported post-close.

This assumes the insurance diligence did not uncover any red flags that would dissuade the acquisition entrepreneur taking over program. In addition, there are instances when it may make sense to restructure or remarket the insurance program prior to closing, as opposed to cleaning up the program post-close.

CARVE-OUTS

Some acquistion entrepreneurs will elect to buy a division or business unit rather than the entire company. This carve-out structure for acquisition entrepreneurs, while rare, demands several special considerations:

- In a carve-out, the buyer will have to create new insurance and employee benefits programs. Prior to completing a carve-out transaction, search funds should focus on the placement of the business insurance program and execute a transition services agreement (for a minimum of 90 days) to continue the existing employee benefits while finding new options. It is almost always a mistake to rush the employee benefits placement post-sale.
- It is not unusual for the corporate insurance allocation to the carve-out to be understated. An audit may not accurately reflect the amount of insurance spending for the carved-out entity. In addition, it may be difficult to determine an accurate claims and loss history for the carve-out.
- A corporation benefits from significant economies of scale and assumption of risk. The new company will have less leverage in the marketplace and, therefore, less flexibility in program design, risk assumption and interest from underwriters.

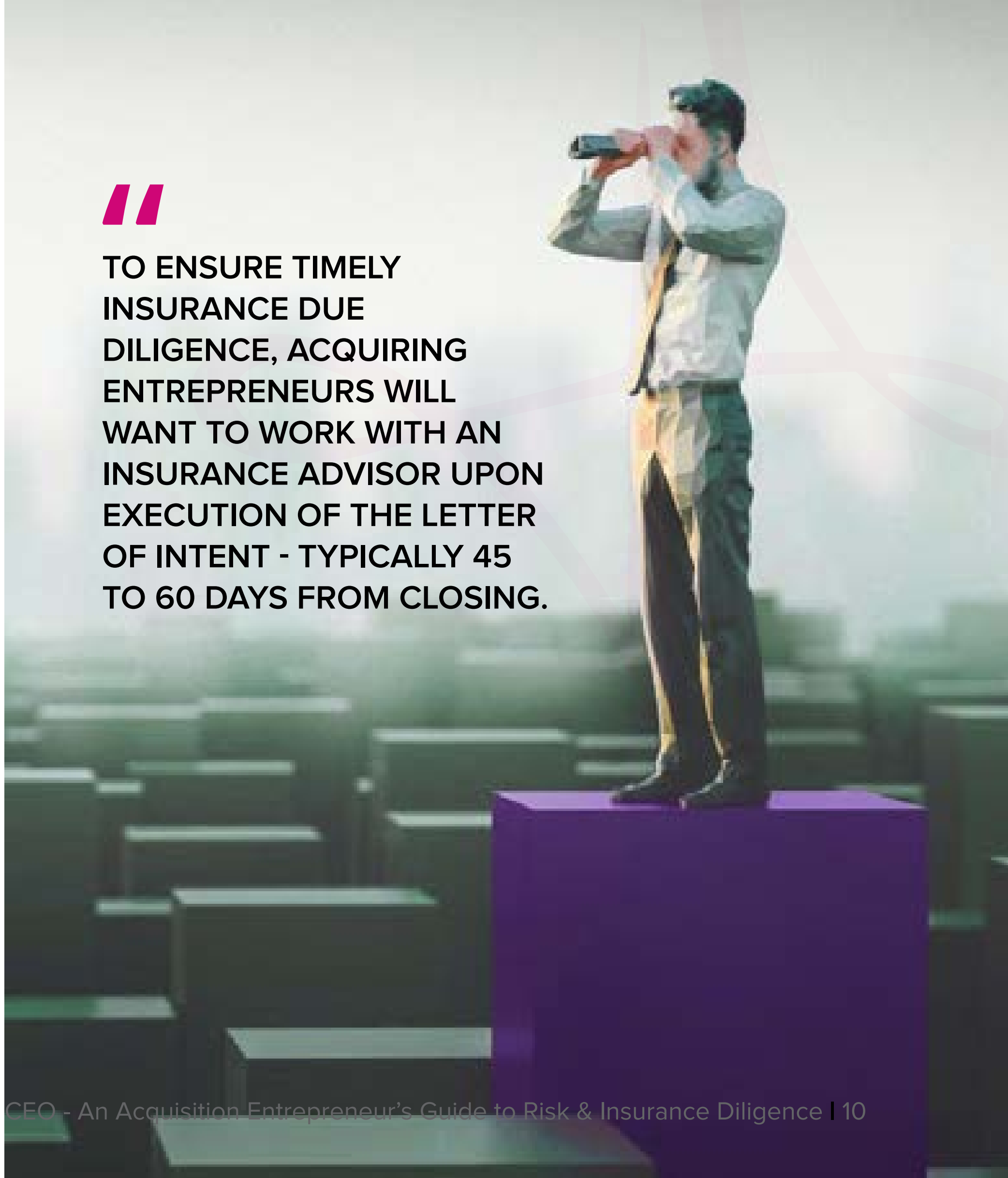
Acquisition entrepreneurs require little insurance due diligence in a carve-out. In lieu of a standard due diligence analysis, the buyer will get estimated cost projections for the standalone division and then focus is building a best-in-class go-forward insurance program.

A SEARCH FUNDING INSURANCE PLAN STARTS EARLY, ENDS LATE

When it comes to acquisition entrepreneur, securing the right deal with the business owner is just the beginning. Prior to the acquisition, the acquiring entrepreneur must engage in initial insurance due diligence, gathering information, providing an *Acquisition Insurance Report* (including claims history), identifying uninsured and underinsured exposures, confirming audit and classification codes, and additional due diligence as needed.

Phase II of the acquisition process will require marketing the post-closing insurance program. This will may happen simultaneously to Phase I.

When transitioning to the role of CEO, the acquisition entrepreneur will find that securing business insurance is more than just a necessary step in the acquisition process. It's also an opportunity to learn more about the business, its current, legacy, and future risks, and to build out a program that will forever serve as the backbone of the new organization.



"TO ENSURE TIMELY INSURANCE DUE DILIGENCE, ACQUIRING ENTREPRENEURS WILL WANT TO WORK WITH AN INSURANCE ADVISOR UPON EXECUTION OF THE LETTER OF INTENT - TYPICALLY 45 TO 60 DAYS FROM CLOSING.

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Symphony Search, a division of Symphony Risk Solutions is focused on the risk management, transactional risk and human capital needs of search fund, entrepreneurial investment, SMB acquisition, and operator-centric private equity communities.

Search Fund related businesses have unique and specialized risk management needs and require the dedicated resources and expertise of Symphony Search focused exclusively on their transactions and on-going businesses.

Symphony Search is led by Josh Richman – one of the nation's leading risk management professionals focused on insurance products and services for the search fund and private equity communities with more than a decade of exclusively focused M&A experience – and backed by the resources of Symphony Risk – whose management team have been the leading architects of private equity focused insurance services over the past 30 years.

APPENDIX

Policy items to source prior to acquisition diligence

Business Insurance policies

- Copies of all insurance policies
- Five Years of currently valued loss runs
- Material Contracts / Lease Agreement
- Financial Statements
- Details on any unreported payroll
- Investment Memo / CIM

Employee Benefits policies

- Most recent invoice for Medical, Dental, Vision, Short/Long-Term Disability, Life Insurance
- Employee / Employer contribution rates
- Employee Census
- Benefit Guides / Policy Summary