Gallagher

Insurance | Risk Management | Consulting

McDermott Will & Emery

Insurance 101:

Market Trends, Best Practices, and Other Key Considerations When Working Through a Transaction

HCPEA

HEALTHCARE PRIVATE EQUITY ASSOCIATION

Evolution & Current Market

Timeline

1998 - 2010

Relatively obscure insurance product with several periods of fluctuating popularity largely in response to changes in insurer appetite

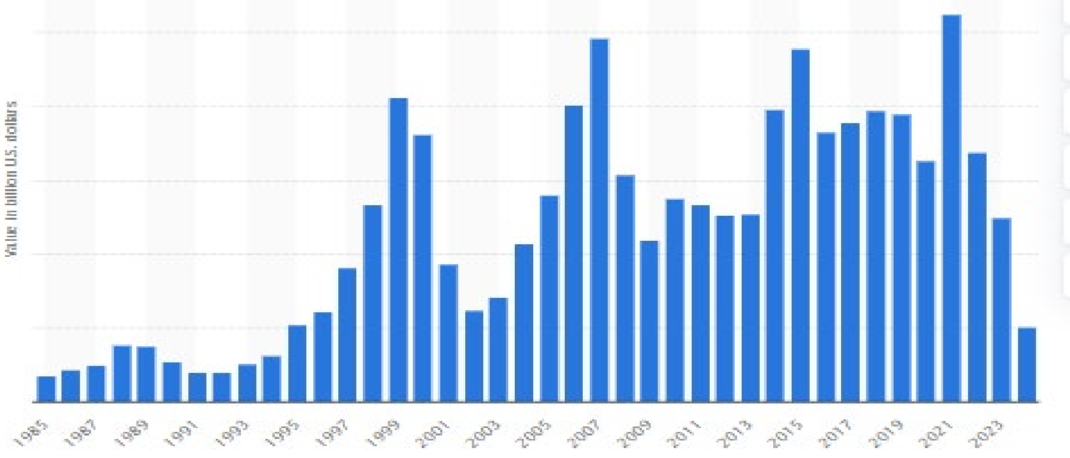
2011 - 2013

Expanded use by buyers to enhance bids

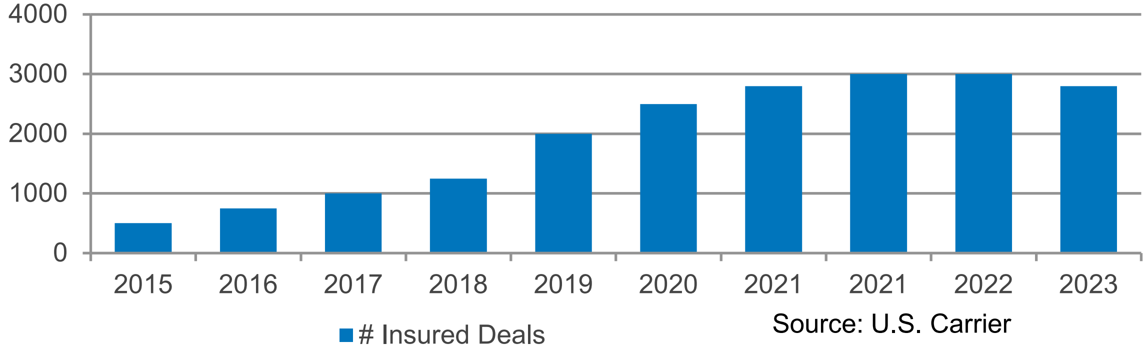
2014 - 2024

- Prepackaged terms prepared by Seller/Advisors as part of bid specs
- Driven largely by Private Equity
- 30-40% of Strategics now leveraging insurance

Global M&A Volume



Reps & Warranties Primary Policies Bound



Although RWI insurance has been in existence for decades, its use has recently increased substantially, primarily due to:

- Lower premiums
- Favorable terms, such as higher coverage limits, lower deductibles, longer policy periods and narrower exclusions
- More efficient underwriting – very time sensitive
- Greater exposure to, and acceptance among, both insurers and potential insureds, and often pushed by Private Equity firms

RWI: Benefits of Coverage

Why Buyers Request Coverage

- Buyer is unable to obtain desired level of seller escrow and indemnification.
- Buyer is unable to obtain the duration of indemnification it wants.
- Buyer is concerned about its ability to collect on the indemnity.
- Buyer wants to protect key relationships.
- Recourse in Public Transactions.
- Buyer wants to distinguish its bid over other bids in competitive auction.
- Buyer wants to protect its deal and ensure insurable factors don't damage profitability
- Assignability.

Why Sellers Request Coverage

- Seller wants to reduce the risk of contingent liabilities.
- Seller wants to distribute sale proceeds faster.
- Seller is motivated by strategic considerations.
- Seller wants to supplement its due diligence and disclosure process.
- Seller is motivated by financial considerations.
- Seller needs to address stakeholder concerns.
- Cost of capital considerations.

RWI Coverage Basics

RWI supplements / replaces contractual indemnity and protects against unknown risks (subject to policy exclusions)

Scope of Coverage

- ✓ Representations and warranties of the seller and/or company given in the underlying purchase agreement (including fundamental representations)
- ✓ Pre-closing taxes (but narrower than typical contractual indemnity)
- × Covenant breaches
- × Working capital shortfalls
- × Known matters (scheduled and actual knowledge of buyer's deal team)
- × Market and deal specific exclusions – *SEE RIGHT COLUMN*

Considerations

- Insurers require an arms' length process, requiring the seller to negotiate the representations and engage in a thorough disclosure exercise
- Quality of buyer's access to information and how diligence findings are presented to insurer greatly influences the policy outcome

Survival Period in Policy

- Three-year term for general representations
- Six-year term for fundamental representations, tax representations, and pre-closing tax indemnity

Market and Deal Specific Exclusions	
Customary Exclusions	• Actual knowledge of the buyer's internal deal team • Interim Breaches • Fines / penalties uninsurable by law • Purchase price adjustments • Underfunding of defined benefit schemes • Asbestos / PCBs or recognized environmental conditions • Non-availability of carry-forward NOLs and tax assets • Transfer pricing • Medical malpractice • COVID-19 / CARES Act • Specific indemnities (case-by-case)
Focus of insurers' underwriting (covered subject to underwriting)	• Healthcare compliance • Billing / coding • Cybersecurity / data protection (including HIPAA matters) • Product liability • Financial matters (e.g., GAAP compliance) • FLSA / wage & hour matters • E&O / professional services liability

Coverages, Costs & Trends

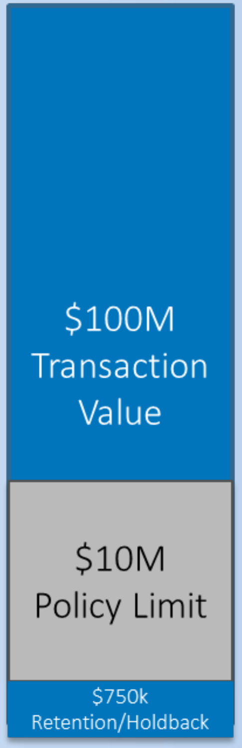
Trends

- Premium is generally 2.5% to 3.5% of **limit purchased**
  - Layered programs with larger total limits and using multiple carriers will see small price per million declines in each subsequent layer

- Initial retention are typically 0.75 - 1% of **enterprise value (EV)**, stepping down to 0.5% (or lower) 12 months after close

- Underwriting Fee:
  - Varies between carrier and depends on nature and complexity of risk
  - Typically $35k to $50k

Example



$100M Transaction Value

Policy Limit:
Typically 10% to 20% of Transaction Value

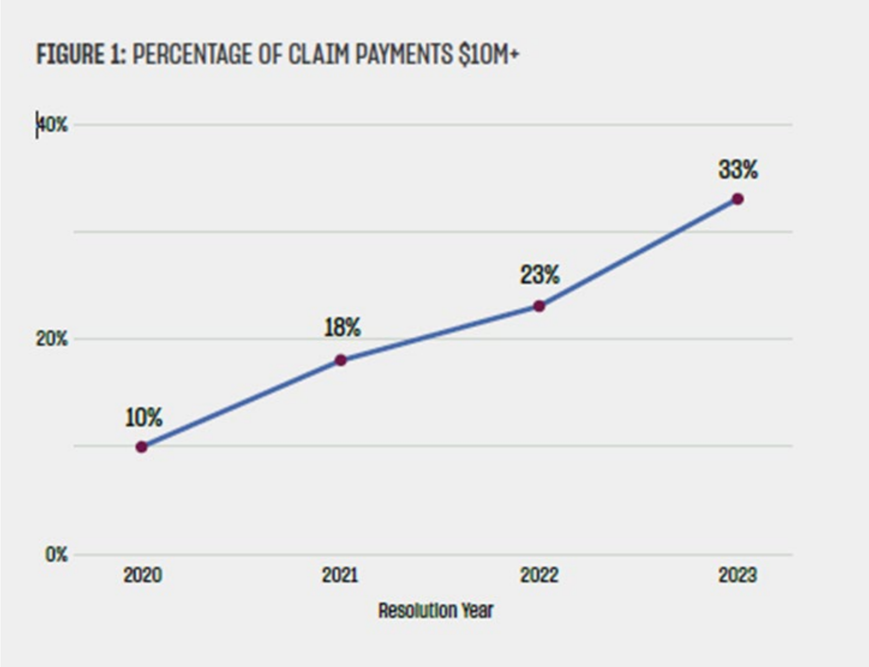
Premium:
2.5% to 3.5% of Limit
(~ $250 to $350k here)

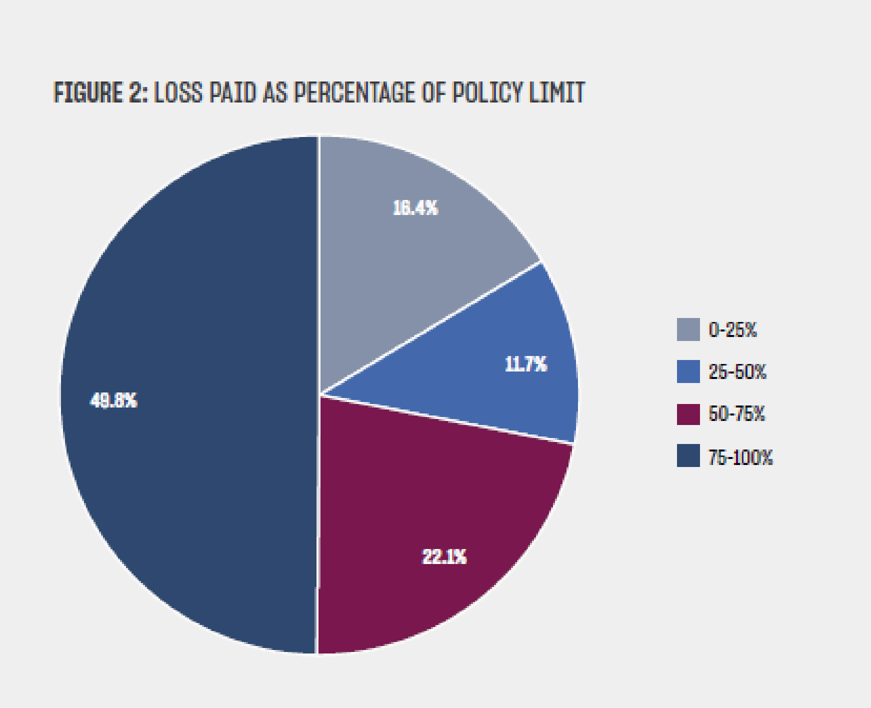
Retention/Holdback:
0.75% of Enterprise Value

Recent Trends in Coverage Terms

- ✓ Nil retention for true fundamentals (including fundamentals in ancillary documents)
- ✓ Synthetic definition for “losses” irrespective of the definition in the purchase agreement
- ✓ Broader definition of “fundamental” representations (e.g., title to assets, affiliate transactions, etc.)
- ✓ Increased threshold for seller no-claims declaration (e.g., 40% of post-closing ownership)
- ✓ Increased willingness to give “conditional exclusions” that are subject to satisfactory diligence after the policy has already been bound

Claims



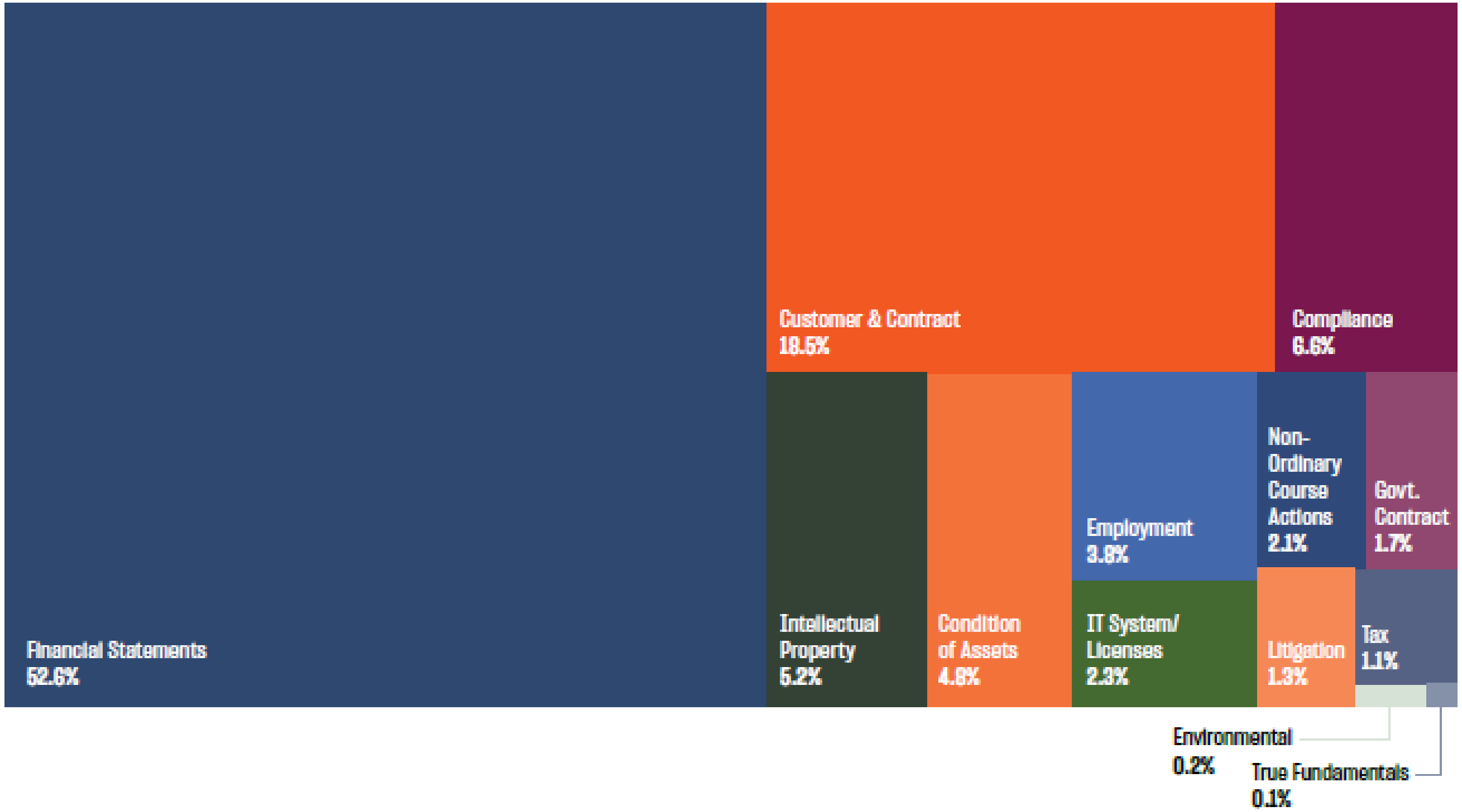


Frequency and Severity of Claims:

- Claim frequency remains constant at an average of one-in five policies;
- The frequency of financial statements and material contracts breaches increases with deal sizes;
- Though globally claim frequency has remained somewhat steady at approximately 20%, the severity of claims has ticked up

Types of Breaches

FIGURE 3: LOSS PAID BY CLAIM TYPE



Data Reference: Euclid Claims Study 2024

Purchase Agreement

Key Considerations

Purchase Agreement Considerations	
Representations and Warranties	• Due diligence • Appropriate qualifiers: knowledge, materiality • Appropriate drafting: subjectivity • Scope: split-retention/coverage for fundamental reps vs. full walk-away deal • No undisclosed liabilities, customer contracts, MAE
Survival Periods & Financial Limitations	Notwithstanding what the parties agree in the purchase agreement, the R&W policy can disregard any financial limitation and survival periods for the purpose of recovery under the R&W policy.
Definition of Loss and Types of Damages	Insurers will generally match silence with respect to the recovery of certain types of damages (multiplied damages, consequential or indirect losses, DIV) in the purchase agreement, with silence in the R&W policy. Sometimes standalone definitions of loss / damages are obtainable.
Materiality Scrape	Impact of seller liability vs. nil seller liability and mismatch in the approach to disclosure with cover under the policy.
Fraud	Insurer will only subrogate against the seller in the event of seller fraud but need the seller's limitations on liability to not apply in the event of seller fraud.

Drafting Points: Set Expectations Early!

Buyer Drafting Points

- Extent and Priority of Recourse: In what order must Buyer seek its remedies?
  - For fundamental reps, Buyer may want the ability to pursue the Sellers for damages in excess of the amount of the coverage available under the R&W policy.
  - For indemnification claims other than R&W breaches (e.g., covenant breaches), must Buyer deplete the indemnification escrow or may Buyer go directly after the Sellers?
- R&W Policy a condition to closing
- Allocation of R&W Costs (take into account ancillary costs)
- Cooperation of Seller
- How to handle carve-outs from coverage – set expectations early

Seller Drafting Points

- Policy clearly states that Insurer has no right to subrogate against Seller or any affiliates of Seller, including officers, directors, members, stockholders, managers, owners, employees and agents except solely with respect to Seller in connection with Fraud
- Seller has third party beneficiary rights to policy with respect to subrogation and amendment provisions in Policy
- Source of Recovery:
  - Limit to R&W policy as much as possible
  - Collection efforts of Buyer under policy—best efforts
  - Buyer should not have recourse against Seller if lack of availability of policy is due to Buyer's noncompliance with agreement

Underwriting Process & Timing

	Account Clearance	• Initial conversations with Gallagher Team
	Execution of NDAs	
	Initial Submission	• CIM or Management Presentation • Draft Purchase Agreement • Financials of Target • LOI • Expected diligence workstream
(2-3 Days)	Non-binding Indication	• No cost to obtain conceptual proposal
	Review of Marketing Results & Carrier Selection	
(5-7 Days)	Payment of Underwriting Fee	• Fees typically range from \$35k to \$50k (depending on nature and complexity of risk)
	Underwriting Process	• High level review of diligence process • Access to legal, financial tax and other due diligence reports • Underwriting call with deal team and third party advisors
	Policy Negotiations	• Concurrent with underwriting process • Work closely with outside counsel
	Bind Coverage	

Process Points

Timing of Coverage

- With a staggered sign and close, policies can be bound at signing and then take effect at closing or for the period prior to signing and then the period after closing (interim breaches not covered if known).
  - Avoids the need for a closing condition re: coverage;
  - Buyer pays 10% of the premium up-front, and has coverage for breaches of signing date reps;
  - Excludes matters that become known to the buyer during the interim period and relate to events first arising during the interim period.

Diligence

- Like lenders, underwriters will use Buyer’s diligence (on a non-reliance basis) as the basis for it’s diligence review; review of memo and diligence calls
- Consider industry and specialist third-party diligence that may need to be conducted (i.e,. environmental, cyber, GmP and FDA regulatory compliance, etc.)
- Provide all information to Underwriter (and have records of what was shared)
- Provide Quality of Earnings Report often required to get coverage for financial statements
- Consider the different dynamic re: risk allocation
- Diligence call with Underwriter

Executive Liability

Brief Overview

Directors and Officers Insurance (D&O)

Affords coverage to board members and leaders of the company for, defense costs, settlements, and judgements that arise from claims alleging various wrongful acts including, but not limited to:

- Mismanagement or misuse of funds
- Inaccurate or inadequate disclosure
- Conflicts of interest
- Unwarranted compensation
- Misleading financial reporting
- Breach of duty to shareholders
- Decisions regarding mergers or acquisitions
- Shareholder derivative claims

Employment Practices Liability Insurance

Affords coverage to the entity, directors and officers, and/or employees for, defense costs, settlements, and judgements for actual or alleged employment wrongful acts, which include but are not limited to:

- Wrongful termination, failure to employ/promote, deprivation of career opportunity, wrongful demotion
- Discrimination
- Harassment
- Retaliation
- Employment-related libel, slander, defamation, invasion of privacy

Fiduciary Liability

Affords coverage to the plan sponsor, the plan itself, and plan fiduciaries for, defense costs, settlements, and judgements that arise from allegations of breach of fiduciary duty to the plan and/or errors in the administration of the plan:

- Actual or alleged ERISA violations
- Breach of ERISA fiduciary duties
- Excess Fee cases
- Negligent administration of benefit plans
- Civil penalties of inadvertent violations of key ERISA sections
- Fiduciary mismanagement
- Administrative Errors and Omissions
- Terminated, sold or merged plans
- Settlor capacity coverage

Cyber Liability

Brief Overview

Cyber liability: **Affords coverage for financial loss related to:**

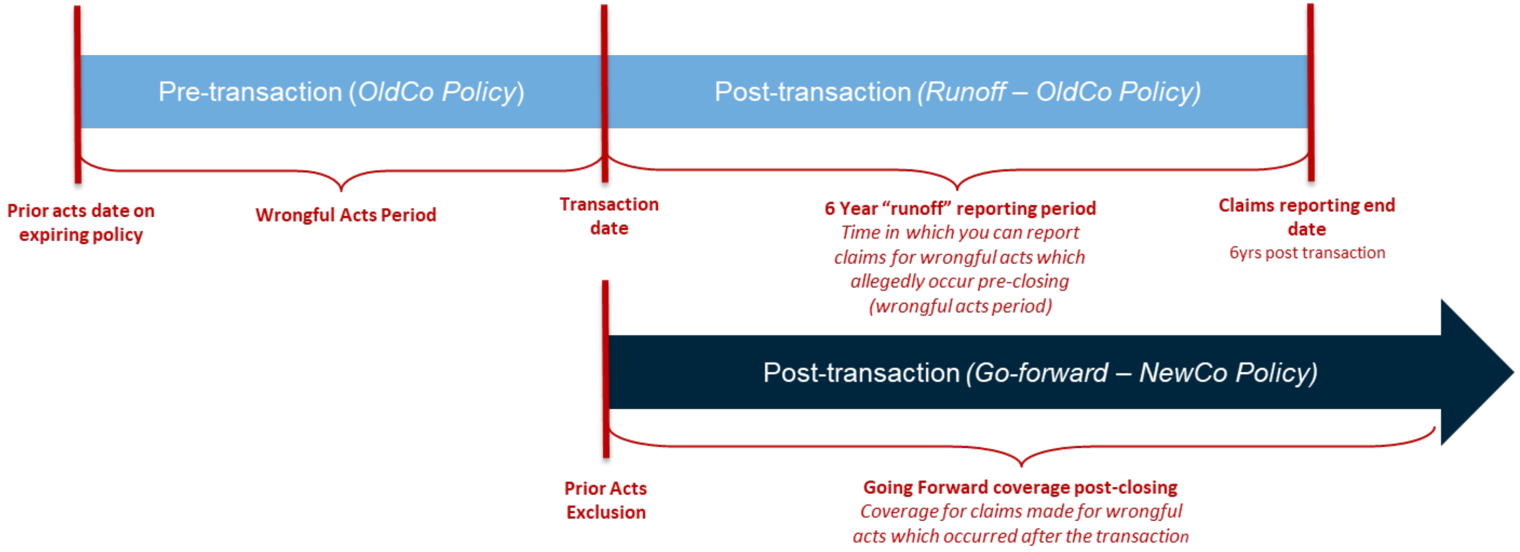
- Network intrusions/hacks/malware viruses
- Lost/missing/stolen electronic assets
- Phishing/spear phishing attacks
- Mishaps due to broken business practices
- Rogue employees
- Unauthorized access through improper disposal of data

Cyber insurance is an exceptionally broad policy which affords coverage for numerous incidents. We like to pool them into four buckets

- Third Party Liability: An organization's liability because of a lawsuit , regulatory proceeding or demand for money
- First Party Breach Response: Allows the policyholder access to best-in-class vendors and service providers, to mitigate and investigate any breach. The costs to use these best-in-class providers and vendors are covered. They include legal fees, cyber forensic teams, Public Relations specialists, etc.
- First Party Operational Costs: Provides indemnification for any negative operational impact to the organization as a result of a breach or privacy incident. Such as loss of income.
- Cyber Crime: Affords coverage for theft of funds through business email, unauthorized access or theft of telephone services

Runoff Coverage

Structure and Process



- Run-off policy(ies) ensure there is dedicated insurance solely to address the D&O, EPL, and Fiduciary Liabilities of the OldCo which would otherwise go uninsured by the NewCo insurance program. The run-off policies stay in-force for three (3) to six (6) years and addresses claims/litigations which are made against the company after the transaction but allege pre-transaction wrongful acts.
- Run-off is necessary as the coverages being placed for NewCo will specifically exclude any liabilities arising from OldCo operations. Having both a run-off program and go-forward program in place provides a seamless transition of insurance protection and creates a clean separation of liabilities from Oldco and Newco. i.e. Oldco matters **do not affect NewCo insurance.**
- **Moreover, RWI insurers will likely require this structure, as an RWI policy is not intended to replace other commercially available insurance. A proper insurance program put into runoff allows for the broadest terms and conditions on an RWI Policy**

Team Member Biographies

Gallagher

Dylan Psotka, RPLU

Area Senior Vice President, Gallagher Specialty Products
(847) 501-0943 • Email: dylan_psotka@ajg.com

- Mr. Psotka leads the Management & Professional Liability insurance offerings within Gallagher's Equity M&A practice group and offers transactional advice, diligence review and negotiation of coverage for both financial sponsors as well as their portfolio companies. Mr. Psotka has over 17 years of experience structuring coverage and policy terms & conditions within the transactional risk marketplace.

Education and Professional Designations

- University of Kansas – BS (Finance)
- Registered Professional Liability Underwriter (RPLU)

Affiliations

- Professional Liability Underwriting Society (PLUS)

Aaron M. Zeid, Esq.

Senior Area Vice President, Gallagher Specialty Products
(847) 624-1747 • Email: aaron_zeid@ajg.com

- Mr. Zeid provides leadership and subject matter expertise to the Transactional Risk team and is a specialist in the area of Representations and Warranties Coverage, Tax Liability, and Contingent Liability. Mr. Zeid has over fifteen years of technical legal expertise in advising clients on and handling corporate and commercial transactional matters.
- Prior to joining Gallagher, Mr. Zeid worked as outside counsel and in-house counsel (both as an employee and as an owner of an insurance company).

Education and Professional Designations

- University of Colorado-Boulder, Bachelor of Arts (Political Science)
- Chicago-Kent College of Law, Juris Doctor
- Stuart School of Business, Masters Business Administration

Affiliations

- American Bar Association
- Alliance of M&A Advisors, Chicago Chapter Board Member
- PLUS Transactional Risk Board Member

Lee Newmark

Area Executive Vice President, Senior Director | Healthcare Practice
(630) 694-5375 • Email: lee_newmark@ajg.com

- Lee is a senior director for Gallagher's Healthcare Practice and is responsible for helping to expand the practice's presence in the healthcare space. He is focused on providing medical professional liability risk solutions for healthcare providers nationwide. This includes a strong focus in the sectors of healthcare services, specifically with an expertise in physician practice management. He also helps to lead the healthcare specific efforts for Gallagher's Equity and M&A Practice.

Education and Professional Designations

- University of Illinois, Urbana-Champaign, B.A., Communications and Business

Affiliations

- Member of PRIMA, Public Risk Management Association
- Risk & Insurance Power Broker Award, Healthcare - 2014, 2015, 2016, 2017, 2018
- Insurance Business America 5-Star Professional Liability Award, 2022
- Gallagher's President Club Honors

Jun Won Kim

Partner
McDermott Will & Emery LLP
Email: jwkim@mwe.com

- Mr. Kim advises private equity sponsors and their portfolio companies, as well as public and private strategic companies, in a wide range of domestic and cross-border transactions, including mergers, acquisitions, sales, consortium investments, minority investments, joint ventures, restructurings, carve-outs, dispositions and other corporate governance matters.
- Previously, Mr. Kim was with Simpson Thacher & Bartlett in their corporate, M&A group. Mr. Kim has been recognized by Best Lawyers in America as a "One to Watch" in Mergers and Acquisitions Law.

Education and Professional Designations

- Northwestern University School of Law, JD
- New York University, BA

Nate Wolfe

Partner
McDermott Will & Emery LLP
Email: nwolfe@mwe.com

- Mr. Wolfe focuses his practice on complex domestic and cross-border transactional matters. He represents private equity firms, family offices and strategic investors in the structuring and negotiation of a full range of corporate transactions and financings, including leveraged buyouts, mergers, stock and asset acquisitions, joint ventures, growth equity and venture capital investments, minority investments, corporate carve-outs, reorganizations, divestitures and other transactions. Mr. Wolfe also regularly represents private equity clients in all aspects of their investments in portfolio companies, from acquisition through exit, and provides general corporate counseling to portfolio companies and other clients on day-to-day matters such as corporate governance and federal securities laws, employment, commercial contracts, financing and incentive equity.
- Mr. Wolfe has experience across a variety of industries, including healthcare, life sciences, energy, IT services, automotive, telecommunications, sports and entertainment, manufacturing and business services.

Education and Professional Designations

- Georgetown University, JD
- University of Arkansas, BA