

Must-Have Insurance for the Lower Middle Market – and When It Should Join the Deal Conversation

Transaction Liability Private Enterprise (TLPE) has opened the door for thousands of lower middle market (LMM) deals priced from \$1M to \$30M to access the same risk transfer tool that 95%+ PE-driven M&A transactions currently enjoy, and at a fraction of the cost.

Just as Buy-Side Representations and Warranty (R&W) took a few years to gain traction, we're seeing momentum picking up in this developing market.

One recent case study shows just how effective this coverage is.

It involves the sale of a small Mexican restaurant chain to a regional restaurant group. But soon after the deal closed, the Buyer discovered that the Seller had neglected to mention several liabilities, including undisclosed equipment leases and labor law violations. Together, this resulted in close to a half-million dollars in damages.

With TLPE coverage in place, the insurer paid those damages, as well as legal defense costs. Talk about a clean exit for the Seller. And the Buyer was happy to be compensated without having to go after the Seller.

The benefits of TLPE are becoming clearer every day to savvy Buyers and Sellers.

The question I'm now getting is not whether TLPE is worth doing, but rather when is the best time to incorporate TLPE into our deal? After dozens of TLPE transactions, our experience shows the ideal time for introducing the concept of insurance is during the drafting of the Letter of Intent (LOI).

The LOI sets the framework for the transaction where potentially contentious subjects such as indemnification are first raised, which can immediately be offset by the introduction of insurance which will transfer the indemnity risk away from the Seller and over to an insurance company.

While one can secure TLPE insurance even after a purchase agreement is signed (subject to a signed and dated No Known Claims Warranty); however, getting in at the LOI stage has clear advantages in the early negotiations phase:

- First, the issue of whether insurance will be used to cover Seller indemnities can be established. In the event Buyers reject insurance, the Seller can still secure protection independently.
- Second, the question whether the insurance will replace or reduce the escrow can be decided. This results in more cash at closing for the Seller.
- Third, the choice on who will bear the cost of the insurance can be negotiated. I've seen deals where one party is willing to pay the entire costs, and in other cases, the parties agreed to share the cost (particularly where Buyers prefer larger Policy Limits than Sellers. At an average rate of \$15,000 per \$1M in Policy Limits, the amount of cost involved is manageable.

Given these negotiating points are addressed at the outset, the potentially contentious issue of indemnification is brought to light and a corresponding insurance solution is offered, thus removing a LOT of friction in the process. Watch how much faster and easier negotiations move after completing this process!

TLPE requires very little information for quoting, so establishing a budget can be readily available. That is one less "unknown" for the process.

I've seen LOI wording used on multiple transactions as simple as the following:

Representation and Warranty Insurance, Seller agrees to obtain Representation and Warranty Insurance ("RWI") in an amount equal or greater to the proposed purchase price with a bona fide RWI insurance provider acceptable to the Buyer. The cost of this policy will be borne fully by the Seller.

This wording serves as an example only and should not be considered legal advice. Please refer to counsel for specific contractual language.

If you're in the early stages of an M&A conversation and want to see how TLPE can apply to your deal, contact me at: pstroth@rubiconins.com 415-806-2356.

We can turnaround a proposal for TLPE coverage in two business days. And all we need to get the ball rolling is the application, the target's financial statements, and the LOI. Terms can be available for eligible deals in one or two days; two days if Underwriters need clarification on items.