DAC BEACHCROFT

Selling an insurance broker

Some common issues arising

Introduction

The insurance broker consolidation market has been extremely active in recent years, and that trend seems set to continue for the time being. There have been a number of factors behind this, including:

Succession planning – founders wish to retire and the next generation may not wish to continue with the business in its current form, or at all.

Compliance – regulatory compliance can impose a significant burden on smaller firms, whereas consolidators can typically deal with this centrally through a dedicated team, freeing the owners to get back to doing what they enjoy most.

Available buyers – at the moment, there are willing buyers for smaller insurance brokers, but this may not always be the case.

Future tax regime changes – changes in future to UK tax law may make sales subject to less advantageous tax treatment for sellers.

Greater size and scale – obvious benefits and "economies of scale" in being part of a larger business with more infrastructure, support and opportunities for cross-selling.

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First Steps and "Good Housekeeping"

Remember that a "consolidator" will probably be managing several deals at once, so will have a limited bandwidth for any particular deal. A seller who allows their negotiations to drag on too long, risks losing their deal.

Having a confidentiality agreement makes sense, but fighting too hard over the terms of a confidentiality agreement risks sending a buyer the wrong message about the legal process. A seller should be wary of handing over any "Crown jewels" to a potential buyer until the deal seems likely to proceed.

Whilst not usually legally binding, a "heads of terms" (also known as a "term sheet" or "memorandum of understanding") can be useful as a basis for the preparation of the legal documents and to brief regulators and funders. And the "moral effect" of heads of terms should not be underestimated either.

Time spent early on by a seller preparing due diligence materials for review is rarely wasted; not only does a slow response to a due diligence information request cause delay, it may also suggest that the business and its management are disorganised and not on top of everything.

02

Earn-outs

An earn-out is a common form of "deferred consideration", by which some of the price paid by the buyer is based upon the future performance of the business sold, perhaps over the course of several years. This can both address a buyer's concern about the risk of over-paying, and offer some upside to the seller. An earn-out works best when both sides' interests are aligned.

The seller needs to make sure it understands the trigger for payment of the earn-out and that proper provision is made for anything required from the buyer to facilitate achieving or exceeding that trigger. Buyers will usually accept some protections for the seller and the seller should consider what oversight it needs, especially if their day-to-day involvement will cease upon completion of the sale.

An alternative could be increased up-front consideration. The additional up-front payment may be less than the earn-out might have been, but at least the seller will receive something more. However, not all buyers will be willing to entertain such a request.

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Multiple Sellers

A key issue here is the extent of each seller's own liability for warranty and indemnity claims.

Sellers will typically wish to limit their liability just to the (cash) consideration they receive, and to their proportion only of any loss – so a 30% shareholder pays 30% of a claim. Often though a buyer will want to be able to recover the full amount from any seller – "joint and several liability" – in which case the sellers may enter into a so-called "contribution agreement" under which if one seller has to pay more than their specified share, the other sellers will reimburse them.

There is no "one size fits all" solution to this and it is typically a key negotiating matter. Ultimately, a seller will have to make a judgement whether they are comfortable with joint and several liability and trust the other sellers to make them whole if they have to pay out for a claim in full.

04

"Split" Signing and Completion

As an insurance broker will be FCA-authorised, a sale of 100% of the shares will constitute a "change of control" for which prior FCA approval is needed. The process of obtaining the FCA's approval can take several months.

There is nothing in principle to stop the parties to a transaction seeking FCA approval early on in the deal process, which would allow signing and completion to occur simultaneously. However, often there isn't time or the parties prefer to wait until an agreement has been signed before approaching the FCA.

This raises several issues:

- It is usual for the seller to accept restrictions on its conduct of the target business between signing and completion, but these should be reasonable and not unduly restrict "ordinary course" activities.
- The buyer should not be given any kind of "control", as the FCA hasn't approved this yet.
- Whilst it is usual to grant the buyer some access to the target business pending completion, the seller will not want to have given the buyer information which could be damaging to the seller's interests in the future.
- The seller will want to try to limit the scope of any termination rights the buyer seeks for the period pending completion.
- The buyer will usually want the seller to repeat the warranties immediately before completion. This will raise the question whether the seller should be permitted to deliver a second disclosure letter before completion. For the seller, it is usually worth raising this as part of the "heads of terms" discussions (see 1 above) as this can be a key focus in negotiations.

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Tax

Mistakes can be expensive and so it is advisable to take advice at a suitably early stage.

06

Life after Completion

Where the seller will remain in the business following completion, there are a couple of key issues to consider:

- **New employment agreement for the seller -** a key issue will obviously be the ability of the buyer to terminate, and of the seller to exit if they are unhappy with the new arrangements. The seller will need to be mindful of the restrictive covenant under the sale agreement as well as the restrictive covenant in any new employment agreement.
- **Seller becomes shareholder in the buyer –** as the value which the seller ultimately earns from the sale is now linked to the performance of the enlarged business over time, the seller should consider what, if any, due diligence it wants to carry out on the buyer and its plans. There are likely to be restrictions on sale of the "consideration shares".
- **Forced sale of seller shares -** if the seller and buyer part company before a planned "exit" has occurred, typically there is a forced sale and the value will depend on whether the seller is a "good leaver" or a "bad leaver". The seller should to be aware that, depending on their reason for leaving, the value at which the consideration shares are sold when they depart may be much lower than was anticipated either when the seller decided to take buyer shares instead of cash when selling their own business, or in comparison to what might in the future be achieved on an "exit" occurring.

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