BEWARE OF THE URGE TO MERGE

Lawyers and insurance agents and brokers often share a similar belief that “bigger is better.” The first question a lawyer often asks upon meeting another lawyer is “How many lawyers in your firm?” Agents and brokers are often quick to compare with each other their agency and brokerage’s respective written premium. Prompted no doubt by much better reasoning than “bigger is better,” it goes without saying that mergers and acquisitions of insurance agencies and brokerages and/or purchases of books of insurance business have become an every-day occurrence in the past decade or so. While there are many important business and legal issues to consider when contemplating the “Urge to Merge,” one of the most important, but most often overlooked, is the potential for a significant increase in E&O exposure to the acquiring agency after the closing of the transaction. We will leave to accountants and attorneys of your choosing the corporate or tax consequences of buying and selling insurance agencies and brokerages. However, in this E&O Report, we will highlight the very practical and essential observations and recommendations that we have formulated over the many years in which our law practice has been devoted to representation of insurance agencies and brokerages in formulation of loss control strategies and in defense of E&O related litigation.

An acquiring entity has traditionally attempted to limit contractually its legal responsibility for negligent acts, errors or omissions committed by the selling agency before the date of the sale closing. We are often assured that the buyer acquired assets only and not liabilities of the selling agency. The acquiring agency often has required the selling agency to maintain adequate E&O limits to cover the seller for claims made after the sale that relate to negligent acts, errors, or omissions allegedly committed by the selling agency before the sale
closing (so-called tail coverage). Finally, acquiring agencies often insist upon indemnification language running from the selling agency to the buying agency which would, theoretically, protect the buyer from claims relating to negligence of the seller committed before the sale closing.

These traditional efforts at loss transference or control, in our opinion and experience, often miss the most fundamental area of exposure to the acquiring agency. The independent potential E&O liability of the acquiring agency that begins literally the first second after the purchase has closed. We refer, of course, to the potential liability implicitly assumed by the acquiring agency by reason of its own failure to cure any and all coverage deficiencies in the book of business that has become its own. We have said and written ad nauseam that we still do not know from a legal point of view how much time an acquiring agency or brokerage has to fix gaps or non-concurrences in coverage, inadequate liability and/or first-party limits and/or other potential coverage deficiencies in an acquired agency’s book of business. We do, however, know that an allegedly uncovered loss by an underlying insured shortly after the acquisition of its account by an acquiring agency, will create an E&O claim that will be difficult to defend successfully. The bottom line is that an acquiring agency must do careful and thorough due diligence before buying an agency, brokerage, or book of business. Most importantly, the acquiring agency must make absolutely certain that it has the necessary resources available to service the acquired accounts on a basis that is consistent with the level of service that is being provided to all customer-insureds of the newly expanded agency.

Because E&O exposure is an unfortunate fact of life in the insurance agency and
brokerage business today, the question of how to insure the E&O risk must receive prominent consideration in the minds of both selling and acquiring entities before closing. Ordinarily, a selling agency or brokerage will have no coverage under the E&O policy of the acquiring entity, for negligent acts, errors, or omissions that have occurred prior to the sale closing. In addition, there can often be complex issues relating to the coverage, if any, for the acquiring agency for negligent acts, errors, or omissions committed by the selling agency before the date of sale. Tail coverage should therefore be purchased by or on behalf of the selling insurance agency or brokerage for its own protection and for the protection of the acquiring agency or brokerage. In our experience, so-called tail coverage of at least three years and up to as much as seven years should be purchased, if possible, in order to protect the parties to the transaction.

Similarly, it is important for the acquiring agency or brokerage to make certain prior to the sale that the added errors and omissions risk will be acceptable to its current E&O insurer. Some E&O policies provide automatic coverage for an agency or brokerage that is acquired during the policy period. However, often this automatic coverage is only for a limited period of time; usually 90 days. Accordingly, it is prudent for the acquiring entity to first check with its E&O insurer before proceeding with the contemplated acquisition in order to confirm that coverage will be in place for the both existing and new business after the transaction has taken place.

Interestingly, the same thing that creates the potential for increased E&O exposure to the acquiring agency, a book of business that needs improvement in its coverage limits and overall quality, also provides the best reason for making the acquisition. In the new math as it also
applies to insurance agencies and brokerages, 1 + 1 can, indeed, often add up to 9 or 10, if the acquiring agency has the talent and the managerial strength to absorb meaningfully and quickly the acquired agency, its people, and its business. One of the most important indicators of whether an acquisition will ultimately prove beneficial is, in our opinion, a thorough investigation and analysis of why the agency for sale is, in fact, up for sale. If the selling agency’s business is gradually being lost to others, if its agency-company relationships are in jeopardy, if valued personnel have been leaving the agency, if the selling agency’s E&O premiums have been increasing disproportionately, and/or if there is recent frequency and severity of E&O claims against the selling agency, proceed, if at all, with great caution. Remind yourself of the six word title to this report, i.e. “BEWARE OF THE URGE TO MERGE.”

The question of “Why are you ready to sell?” should be addressed directly to the principals of the selling agency. If possible, the same question should be addressed to other producers and key employees at the selling agency. In addition, every effort should be made as discreetly as possible to tap outside contacts and sources relative to the strengths and weaknesses of the agency for sale. One additional after thought; if, shortly after your purchase of an agency or brokerage, key personnel of the acquired agency keep leaving your agency; you blew it! The E&O skeletons are getting ready to come out of your now combined agency’s closet.

We also believe in a form of due diligence when considering the purchase of an insurance agency or brokerage which often doesn’t get any attention at all. It is vital, not only for the obvious E&O coverage issues referred to above, but also for a more paramount reason, to obtain full disclosure about the selling agency’s experience with E&O incidents, claims, and suits. For
example, a claim relating to an alleged failure to follow-up with an underlying insured on a notice of cancellation for non payment of premium, can send a powerful signal that the selling agency may be vulnerable to other similar claims by virtue of this practice. A claim for failing to add a general contractor as an additional insured on the policy of a subcontractor may well illuminate a serious flaw in the selling agency’s method of adding additional insureds; one that will in all likelihood create additional E&O claims. Two lawsuits in two years over the sufficiency of limits written should clue you in to the fact that the selling agency may well have been less than aggressive with its customers in selling high enough limits. We have long believed that the overall health of an insurance agency or brokerage is directly related to how it performs on its E&O due diligence physical. We believe fervently that insurance sales are increased when the E&O loophole is closed. If a selling agency has existing unresolved E&O issues, it is a sure bet that it also hasn’t been writing all of the coverage that is should be writing for its customer base.

It goes without saying that full disclosure from a selling agency should also include delivery of all records pertaining to each and every account of the selling agency. In the defense of any E&O claim or suit, documentation is often the key to whether the claim or suit will ultimately be capable of successful defense. The documentation and file retention practices of the selling agency should be carefully reviewed before a decision is made to acquire the business of the selling agency. Finally, with no overt attempt to flatter our 900,000 brother and sister lawyers, some of whom are not entitled to flattery, the purchase and sale of an insurance agency or brokerage is potentially one of the best or worst business decisions that the seller or buyer will ever make. We have seen too many mergers, acquisitions, and sales of agencies and brokerages
take place with either no legal counsel for the seller and/or buyer or legal counsel with little or no experience in this type of transaction. While some cynical few consider the words “good lawyer” to be an oxymoron, we urge both buyers and sellers to work assiduously to find the most experienced lawyer possible to handle the purchase and sale of an insurance agency or brokerage. Not only will the financial promise of the deal be fulfilled for both sides, but also the E&O risk may well be reduced or eliminated when competent legal counsel is engaged at the earliest stage of the transaction.

A fact of life in the insurance agency and brokerage errors and omissions defense attorney’s world is that E&O exposure to the acquiring agency often increases dramatically after the purchase of an agency or brokerage. The reasons, some of which are overviewed in this report, are many and varied. We do not believe that the law of any state will allow any insured of an acquired agency or brokerage to be treated as what we call a “second-class citizen.” In our opinion, all of the insureds of the selling agency must be afforded the same service and benefits as the insureds of the buying agency. The practices and procedures of the agency or brokerage that has just been acquired must as soon as possible be made consistent with the practices and procedures of the acquiring agency. In short, there are enormous challenges associated with merging, acquiring, consolidating, and/or buying books of business which, if not thoroughly considered and resolved before the sale closing, become nightmares after the closing. Too often the nightmares have serious E&O overtones.

The natural evolution in the insurance agency and brokerage business will, no doubt, continue to be consolidation – less agencies and brokerages controlling more and more business.
An ounce of E&O loss control prevention before the sale and purchase of insurance agencies and brokerages in the future will be worth a ton of E&O cure in the days after completion of the transaction. The “Urge to Merge” can be a positive response to the ever-changing dynamic in the agency and brokerage business today or it can be only the next step toward a dismal record of errors and omissions frequency and severity. Careful consideration of some of the themes discussed in this report should enhance the likelihood that your agency or brokerage is in pursuit of sensible growth when the “Urge to Merge” occurs.

Submitted by Herbert J. Lustig