ERRORS & OMISSIONS

PROFESSIONAL LIABILITY

The Impact of M&A on Insurance Agents & Brokers Professional Liability

Mergers & Acquisitions (M&A) among North American insurance agencies soared to an all-time high in 2017. While the trend has slowed slightly for 2018, the first quarter of 2018 still produced the third highest M&A activity of all time, demonstrating that M&A activity is still in high gear for agents & brokers. Much of this is attributed to an influx of private equity capital.

As the buyer or seller of an insurance agency, there are many factors that need to be considered. The transactional structure, valuation, due diligence, and terms of the contract are among the top priorities.[1]

BY THE NUMBERS

- Insurance Agency M&A activity increased to 604 deals in 2017, up 31% from 461 deals in 2016 [2]
- Q1 2018 produced the third highest M&A activity of all time (behind Q3 2017 and Q4 2017) [3]
- Private Equity/hybrid buyers accounted for 63% of the 2017 transactions, up from 56% in 2016.[4]

With so much to focus on, one critical aspect easily overlooked is the impact of the purchase and sale on the respective insurance agents & brokers professional liability (IAE&O) policies. A merger or acquisition can result in significant changes within an agency. The potential for new staff to train, the blending of systems, workflows, and cultures can all contribute to an increased chance of errors and omissions. Failure to properly vet and structure the IAE&O coverage on both sides of the transaction could lead to coverage gaps during a critical time.

IAE&O Considerations for the Buyer

When considering acquiring a book of business or an agency, along with the typical due diligence and drafting of the purchase agreement terms and conditions, a careful review of both the buyer's and seller's IAE&O policies should be conducted with the buyer's insurance agent or broker. Below are some of the key coverage points critical to protecting the buyer's IAE&O exposure post-acquisition:

1. **Acquisition Thresholds:** Many policies have language that provides an acquisition threshold, which is typically based on assets or revenue. Commonly, the threshold will be around 15-20% of the acquiring entity's revenue as of their most recent financial statement, but can vary per policy.

   In most IAE&O policies, acquisitions under the threshold are generally covered automatically by the policy with no changes in terms or conditions. If an acquisition *exceeds* the threshold, the insurance carrier has the right to re-underwrite the new exposure and potentially charge additional premium or make coverage changes.

   For acquisitions over the threshold percentage, IAE&O policies will typically cover the acquired company for a short period of time (generally 30-60 days from the acquisition date). This coverage is solely for wrongful acts committed after the acquisition date, and is subject to notification and underwriting as outlined above. The buyer's policy should be reviewed to ensure all notification requirements are followed and any necessary underwriting or coverage changes are made to address the acquisition.

2. **Professional Services:** IAE&O policies cover specific named professional services or professions. When acquiring a new entity, it is important to review all of the professional services the acquired entity is providing, to ensure that all exposures are accurately covered under the buyer's going forward policy.

   Any discrepancies between the services provided and the coverage in the IAE&O policy should be identified and included. For example, let's imagine that a property & casualty agency purchases a benefits (life, accident & health) agency. Typically, LA&H agents may provide additional services, such as benefits administration, human resources consulting, captive management or reinsurance/stop-loss placements. These services might not be covered under the buyer's existing IAE&O policy.

3. **Additional Insureds:** If the seller's policy includes coverage for subsidiaries or additional insureds, it is important that those insureds be carried forward to the buyer's policy. This can get

CONTINUED >

tricky if the buyer is not purchasing all of the subsidiaries, or if some of the prior subsidiaries have been dissolved or are no longer in operation. In this circumstance, it is imperative that the purchase agreement is specific as to which entities' liabilities will be the responsibility of the buyer vs. the seller going forward.

4. **Extended Reporting Period/Prior Acts Coverage:** As the majority of IAE&O policies are written on a claims-made basis, one of the most important factors in protecting the buyer's IAE&O coverage during a merger or acquisition is how coverage for prior acts will be addressed.

   If the acquisition is an asset only purchase, typically the seller will retain all of the exposure for the prior acts committed by the seller's agency/staff. This is done via the seller's purchase of an extended reporting period (ERP) also known as a run-off or discovery period, generally from their current IAE&O carrier. The ERP will provide coverage for the errors or omissions committed prior to sale of the agency, and the buyer's going forward IAE&O policy will provide coverage for errors or omissions on or after the acquisition date.

   If the acquisition includes liabilities, then the responsibility for the prior acts exposure is typically addressed in the purchase agreement. In some cases, the seller entity is still required to purchase an ERP on their policy, and the buyer will pick up the going forward wrongful acts coverage.

   In this situation, where the buyer is taking on liabilities and the seller will be purchasing the prior acts coverage, it is particularly important to review the terms and conditions of the seller's IAE&O policy and ERP. The coverage terms and conditions built into the expiring policy will be carried into the ERP. Most policies offer an automatic ERP for 60 days after the acquisition, with additional options for purchase. The most common terms start at 1 year and typically go up to 6 years.

   The coverage provided in the policy and the length of the ERP can have a direct impact on the buyer's IAE&O exposure. There may be cases where the seller's ERP does not provide coverage for certain claims due to exclusions or policy conditions, or where the ERP has expired. In these cases, if a claim comes in the buyer may be the only party with insurance coverage, thus becoming the "deep pocket" and the target of the plaintiff's attorneys.

   In some acquisitions, the acquiring entity will take on the prior acts exposure by asking their IAE&O carrier to add the new entity(s) to the going-forward policy with prior acts coverage included. In this case, a coverage review is necessary to ensure that the buyer's policy is equally as broad as the seller's prior policy to avoid any potential gaps in coverage. The IAE&O carrier will typically do a full underwriting of the agency being acquired, and may ask for the expiring policy, applications, loss runs, etc. for the seller's agency – and charge additional premium.

   In both asset only purchases and asset/liability deals, it is critical that the buying agency has complete details on the seller's claims history. If the buyer's agency is relatively claims free, and the seller's agency has a claims frequency or severity issue, this could negatively impact the carrier's underwriting view of the going forward combined agency.

   Not only should reported claims be reviewed, but the buyer should conduct due diligence and obtain appropriate representations and warranties and/or disclosures in the purchase agreement relating to any circumstances which could reasonably give rise to a claim but which have not yet been reported. If the seller is aware of any such potential claims, those should be reported to the seller's IAE&O/ERP carrier prior to the acquisition effective date, to avoid any potential gaps in coverage during the transition.

5. **Risk Management:** If the buyer will be acquiring staff and/or office locations, a review of the seller's existing policies and procedures is critical to mitigate potential losses moving forward.

   Ideally, the buyer should implement consistent best practices for risk management and computer systems across all locations. All staff should also receive training so that everyone is on the same page. For example, if an agency can point to good records or file documentation, they stand a better chance of avoiding or prevailing in litigation. If the buyer has clear and thorough file documentation protocols, but the acquired agency(s)' staff is not properly trained, the buyer runs the risk of being exposed to more costly litigation.[5]

   Simply implementing the procedures may not be enough to prevent these sorts of claims post-transaction. Carrie Campi, Vice President of Allied World North American Claims Group states, "When a buyer acquires an agency, there is inevitably a transitional time period during which the acquired entity must implement the systems, policies and procedures of the acquiring agency. During this transitional period, it is critical that the acquiring agency intensely scrutinize the acquired entity's adoption to ensure compliance. The scrutiny may relax as the comfort level increases and full acceptance and adoption of the new system, policies and procedures is observed. However, the acquiring agency should do a periodic review to ensure that the compliance continues, possibly through periodic audits."

CONTINUED >

IAE&O Considerations for the Seller

The primary IAE&O consideration for the seller will be prior acts coverage for the errors and omissions made by the seller agency prior to the sale date. Failure to procure adequate prior acts coverage can leave the seller exposed long after the deal is done.

Most IAE&O policies include a clause that states that ***if the agency is acquired or merged and is not the surviving entity,*** then the policy will go into an automatic ERP anywhere from 30 days to the natural expiration date of the policy. This means that only errors or omissions committed by the seller agency *prior* to the acquisition date will be covered.

If the seller is only selling a portion of the assets or certain entities but will remain in business after the sale, it is important to balance the need for going-forward IAE&O coverage with the need for the prior acts coverage on the sold portion of the business.

If the entire company will be sold or merged, then a plan must be put into place to address the prior acts exposure for the professional services provided by the seller agency prior to the acquisition date.

If the seller company will be responsible for purchasing an ERP, they should discuss the terms of the ERP with their agent or broker to determine the length of the ERP required to protect their business. Most IAE&O policies require that the Insured notify the carrier and pay for any ERP within 60 days of the acquisition closing date (timeframes vary per product). Failure to timely purchase and pay for the ERP could result in the coverage/option being withdrawn, creating a subsequent gap in prior acts coverage.

As mentioned above, extended reporting periods are generally available from 1 to 6 years. The decision on which option to buy is important. Assuming the seller has retained the liabilities as outlined in the purchase agreement, once the ERP expires the seller could be left with uninsured exposure.

Typically the ERP is purchased from the same carrier that writes the seller's current IAE&O policy. They amend the policy to convert it into an ERP, leaving the terms and conditions of the original policy as is. This provides continuity, meaning the seller will not have to fill out any updated warranty statements or report potential claims in order to purchase the ERP, and the policy will continue to provide coverage for wrongful acts back to the policy retro date.

Moving the ERP coverage to a new carrier is risky, particularly if the new carrier requires updated claims warranties or has a retro date or prior & pending litigation date that is later than the incumbent carrier's retro/P&P date. This could result in a gap in coverage.

If the buyer will be rolling the prior acts coverage into their policy, and the seller will not be purchasing an ERP, the policy requirements for the buyer's IAE&O insurance should be spelled out in the purchase agreement. For example, if the buyer adds the seller entity(s) on to their policy as of the transaction date with prior acts coverage, but then removes them or deletes that prior acts coverage, or perhaps goes out of business and does not purchase an ERP themselves, then the seller could be left with no coverage or protection for those prior acts.

In Conclusion

Each M&A transaction is unique. Any time you are entering into an asset sale, merger or acquisition as either the buyer or the seller it is critical to reach out to your insurance agent or broker as early as possible to address the coverage needs and risk management required for a successful transition.

References

[1] Bill Schoeffler and Catherine Oak, Oak & Associates (2005). "Seven Steps in Selling Your Agency" [Online.] Available: https://www.insurancejournal.com/magazines/mag-features/2005/08/22/59448.htm [2018, September]

[2] Optis Partners, LLC (January 17, 2018). "Agent & Broker 2017 Merger & Acquisition Update." [Online.] https://www.agencyequity.com/news/2620-agent-broker-2017-merger-acquisition-update#.W2SC0Y2WyUI [2018, September]

[3] Daniel Menzer, Optis Partners, LLC (April 16, 2018). "Q1-2018 Merger & Acquisition Update." [Online.] http://optisins.com/wp/2018/04/q1-2018-ma-report/ [2018, September]

[4] Optis Partners, LLC (January 17, 2018). "Agent & Broker 2017 Merger & Acquisition Update."

[5] Edward Donohue III, Hinshaw & Culbertson, LLP, 01/29/2015, *The Importance of the Client File in Agent Risk Management* (available through Allied World IAE&O Risk Management)

ABOUT THE AUTHOR

Michelle Girardin Freimuth

Vice President, Insurance Agent E&O Practice Lead

Allied World North American E&O Division

QUESTIONS? Contact Michelle at michelle.freimuth@awac.com