

## THE E&O CORNER

### THINGS TO CONSIDER WHEN AN INSURANCE AGENCY OR BROKERAGE PURCHASES ANOTHER AGENCY OR BROKERAGE OR A BOOK OF BUSINESS

The current market conditions present many opportunities for insurance agencies and brokerages with regard to the acquisition of other agencies or brokerages or books of business. We have seen a big increase in this activity during the past few years. There are various issues and concerns that must always be considered by both the selling and purchasing entities before and during any acquisition process. As we regularly handle these types of matters, in this issue of The E&O Report we will review some of the issues that should be considered when an agency or brokerage is looking to acquire or sell another agency or brokerage or a book of business.

#### Types of Purchasing Agreements:

The precise type of purchase agreement for a particular transaction will vary in specifics from transaction to transaction. However, there are basically two types of purchasing agreements that are used in connection with the purchase or sale of an agency or a brokerage: a stock purchase agreement, and an asset purchase agreement. There are substantial differences between those types of purchase/sale transactions. Obviously, when buying a book of business, the transaction is more akin to the purchase agreement.

(a) **Stock Purchases** – This type of transaction involves the purchase of the shares of stock of the selling stock corporation – in other words, a purchase of all of the business of the selling entity. There is no need to list the particular assets that are being purchased in this type of transaction, since by definition a stock purchase includes all assets owned in the name of the selling entity. One or more new stockholders are replacing the previous stockholders in the selling entity or a new entity can be created to purchase the stock.

However, along with the purchase of all of the assets of the selling entity in a stock transaction, the purchasing entity also assumes all of the liabilities of the selling entity. This includes any tax liability and any potential E & O Liability incurred by the entity being sold while still owned by the sellers, and any such liability will become the new owner's responsibility. Accordingly, the existing or contingent liabilities of the selling entity must be fully disclosed and carefully scrutinized by the purchaser in any such transaction. Appropriate indemnification provisions are important to protect the purchasers from future claims of liability which the sellers may have honestly overlooked or may have been unaware of at the time the agreement to sell was executed.

Tax considerations must also be addressed in advance of entering into a stock purchase agreement. Most, although not all, insurance agencies that are stock companies are Subchapter S corporations – meaning that they are “pass through” entities for tax purposes. The profits and losses realized by these companies are passed through to the owners in proportion to the percentage of ownership of each owner. Such entities file federal tax returns for informational purposes only and do not pay federal income tax. State tax rules differ from state-to-state.

(b) **Asset Purchase** - An Asset purchase is the more frequently used method for the purchase of an agency/brokerage or a book of business. By an asset purchase agreement, the purchaser is only purchasing a particular list of assets from the seller for a specific price. The sale need not include all of the selling entity's assets. Although variations exist, the purchaser in this type of transaction generally is not assuming any liabilities of the selling entity. There is still the need, however, to delineate the specific financial documents provided to the purchaser in connection with the transaction and also to include appropriate and complete indemnification language in the agreement for both the purchaser and the seller, depending upon the facts of a particular transaction. The same considerations come into play when purchasing a book of business since the book of business is the only asset being purchased.

Consideration will also have to be given as to the manner of payment for the assets. Payment can either be made in a lump sum, over a period of time, or a combination of the two. What is most appropriate depends upon the specific nature of the business being sold and the financial situations of both the purchaser and the seller.

A popular alternative to stock corporations is the limited liability company or LLC, which has been authorized by all states, including New York, Connecticut and Rhode Island. This entity combines the protection from liability to owners afforded in traditional stock corporations, while also allowing for simpler formation and treatment of income and losses. A purchaser may purchase the entire business of a selling

entity that is a limited liability company (along with all of the liabilities of the seller), or may buy all, or a portion of, the assets of the selling limited liability company.

Sometimes it is prudent for a purchaser to form a new entity for the purposes of purchasing the assets or business of a selling insurance agency. In such instances, it is most often appropriate to form an LLC for that specific purpose.

### **Other Considerations:**

The other considerations of a buy/sell transaction are numerous and varied, depending upon the particular transaction in question. Some issues to consider are the reactions of existing clients to the selling of the entity, and what may happen if a substantial portion of those clients transfer their business from the new owners. In addition, there may be issues with regard to the appointments of particular insurance carriers which should be addressed in connection with the sale.

### **Future Disputes Between the Parties**

No one enters into a buy/sell agreement anticipating that a dispute will develop in the future. However, disputes often arise no matter how carefully the buy/sell agreement has been drafted. It is for this reason that the agreement should contain provisions as to how and where any such future disputes will be handled, including whether to arbitrate those disputes or submit the disputes to the jurisdiction of a particular court for adjudication.

Although arbitration and alternative dispute resolutions have gained popularity in recent years, that mechanism of dispute resolution may not be the panacea arbitration proponents tout it to be. Our experience has shown that arbitration can often be much more expensive than anticipated by the parties, and sometimes not substantially faster than litigation in court. In addition, the arbitration clause must be carefully drafted in order to provide for payment of administrative and other expenses, and for the precise powers of the arbitrators. The decision as to whether or not to include an arbitration provision in the agreement should be jointly made by the parties and their counsel. It has been our recent experience that arbitration has become much more costly than merely litigating the matter in court. Thus, the decision to litigate in court or arbitrate must be weighed carefully. Another issue that the parties may want to consider is whether any dispute should be first submitted to mediation before any arbitration or litigation is commenced. Surprisingly, many disputes are settled during the mediation process.

### **Ancillary Agreements:**

No matter which type of purchase transaction is involved, there are often other agreements which the parties need to contemplate and possibly execute supplemental to the buy/sell transaction. Often the owner or owners of the selling entity will remain with the new owners as employees or as independent consultants. The preferred approach is to have such arrangements set forth in a separate agreement which contains all of the terms of the arrangement; that separate employment agreement should be referred to and incorporated into the buy/sell agreement.

### **Potential E&O Claims in Purchase or Sale of Agency**

With our vast experience in handling E&O matters, we would also like mention here that both the buyer and seller may have potential E&O exposure that must be managed. Obviously, some of the exposure will be managed by the indemnification clause in the agreements as discussed above. However, the seller should always seriously consider the purchase of tail coverage for any potential E&O claims that arose before the sale. The buyer must make sure that its E&O carrier is aware of the purchase and the acquired agency/brokerage must be added to their E&O policy.

### **Selecting the Right Counsel:**

Choosing the appropriate counsel can save substantial time and money in the purchase and sale of an insurance agency/brokerage or a book of business. Getting the lawyer involved earlier rather than later is always the prudent thing to do, and avoids the situation where the client believes that all necessary items have been agreed to, and that the only thing remaining is to "formalize" the agreement in writing – only to discover that counsel on both sides have raised additional questions and concerns for the protection of their respective clients. The clients then may be frustrated when they realize that the agreement they thought was all but completed still needs to be finalized. The involvement of an attorney at an early date will help avoid any misconception as to the realistic closing date for the transaction, and will actually save time and money by dealing with all issues up front.

The transactional team at KWC regularly handles transactions involving the purchases and sales of large and small agencies/brokerages and books of business. KWC also regularly litigates issues that arise in connection with these types of buy/sell agreements. Accordingly, KWC is cognizant of many of the potential pitfalls that may exist for the client in the drafting of the buy/sell documents. An insurance agency or brokerage that is contemplating a purchase of another agency or brokerage or a book of business should make certain that, whether it is KWC, or another law firm, the attorneys who handle the purchase or sale fully understand all of the issues that need to be addressed in order to fully protect the agency/brokerage in connection with the transaction. Doing so will help ensure that the transaction goes smoothly and the agency/brokerage can spend time focusing on its business.

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