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COMMITTEE NEWS

Excess, Surplus Lines and Reinsurance

Insurance Agency Acquisitions Are Creating An E&O Claim Bubble

The last ten years have seen an explosive acceleration in consolidation among insurance agencies and brokerages. Before that, acquisitions were concentrated among the ten largest brokers, often called Alphabet Brokers, because of the industry practice of calling them by their initials. The new consolidators are private equity ("PE") firms and are responsible for a 1000% growth in acquisitions over the last ten years; from 100 per year in 2013 to 1,000 per year in 2021 and again in 2022. During that same period, traditional acquirers stayed the same.

Why have insurance brokers become so popular among PE firms when previously they were only marginally financeable by commercial banks? Because banks focused on hard assets such as plant equipment, inventory, and receivables, and these assets do not support an extensive lending base on a one-off basis. Private equity firms discovered that insurance brokerages had stable and growing customer bases, producing the financial magic of recurring revenues. Most insurance brokerages renew customers annually at rates ranging from 75-90% and some

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Robert M. Anderson, CPCU

Trusted by 32 of the Top 100 Insurance Law Firms, Bob began his career as a casualty underwriter for Pacific Indemnity Company (Chubb) and later for several Crum & Forster Group companies. Bob also served as president, chief executive officer, and board chairman of well-known Anderson & Anderson Insurance

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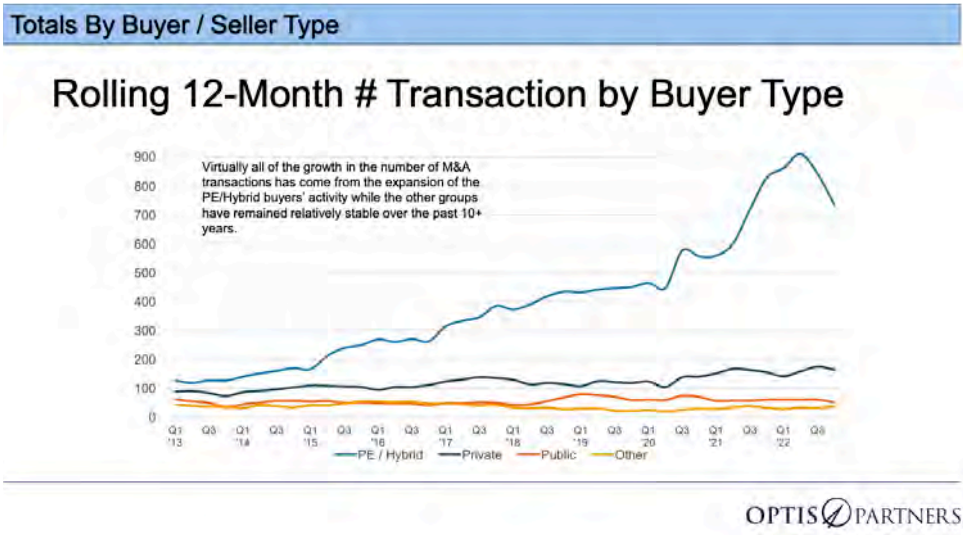

even as high as 95%. Thus – to the surprise of many otherwise financially savvy analysts – insurance brokers typically receive the same percentage of commissions in future years as they do in the first year of a client relationship.

While returns on other industry segments declined for the last few years, PE firm returns on insurance agencies and brokerages ranged from 20-40%. These returns were further juiced by the ability of PE firms to lay off 35-50% of the purchase price to loans with banks, a strategy not available to individual agencies or even many larger brokers trying to acquire small agencies. This was a winning financial strategy for PE firms in the sustained low-interest rate environment of the last few years. Only during the last part of 2022 has this strategy been muted as interest rates doubled from previous lows.

Given the increased popularity of insurance agencies as targets for PE acquisition, it is worthwhile to review what typically happens in the placement of Professional Liability Policies when an agency is acquired. When a larger brokerage acquires an agency, it is customary to acquire some tangible assets and most intangible assets, such as intellectual property, trade secrets, and client policies known as "books" of business, leaving a virtual shell of the prior entities. Acquired agencies ("Acquired(s)") are resistant to pledge their other assets or put their sales price at risk. But the acquiring private equity backed brokerage ("PEBB") does not want to incur undiscovered errors or omissions which could emerge as a claim against them after the sale is consummated. The solution requires the selling agency's professional liability carrier to issue a tail policy to cover future claims that emerge from the previous mistakes of the Acquireds. These extended reporting periods or "tails" provide a 1-6 year extension to cover future claims arising from "prior acts."

Brokers. Over nearly 30 years, he built Anderson & Anderson from a four-person company to the fifth-largest brokerage firm in California until its sale to AON Corporation. At Aon, Bob was the president of the Aon Advantage Group, advising 20 industry practice leaders such as the Hospitality Group, which insured Hotels, Resorts, and Casinos. Bob attended Harvard Business School's OPM program, which is similar to its MBA program. He earned his CPCU (Chartered Property Casualty Underwriter) designation from the American Institute for Property and Liability Underwriters, Inc. After leaving Aon; Bob was extensively involved in Insurtech, having been a co-founder of four separate insurance technology firms, three of which have been sold with one remaining firm focused on mid-sized employers.

Of course, these extensions are subject to the existing terms and conditions of the Acquireds' policy, including a retroactive date that puts an absolute limit on how far back an undiscovered error results in a future claim that the tail covers.

3 Year Tail Expires	Year Acquired	Number of Agencies Acquired	Exposure (in years)	Total Agencies Acquired	Total Years of Agency Exposure Under 3yr Tail
2023	2019	650	1950	650	1950
2024	2020	795	2385	1445	4335
2025	2021	1034	3102	2479	6787
2026	2022	987	2961	3466	8303

So, as the tail extensions expire (shown in Chart #2, above), which we projected as three-year extended reporting periods, the number of years of prior acts the acquiring company is exposed to is additive. For the approximately 50 PE-backed brokerages, it expands from 1950 agency years to 8303 agency years. Somewhat offsetting this exposure is that as time goes on, old undiscovered errors buried in client policies and agency files tend to produce fewer new claims, but not uniformly.

Recently we worked on a claim as expert witnesses where a business interruption ("BI") policy limit of $500,000 was left unchanged by the producer for nine years while the sales of the manufacturing company policyholder more than tripled. When the plant burned down, the claim for BI coverage was several million dollars. In this instance, Brokerage Company A ("BCA") acquired Brokerage Company B ("BCB"). BCB's E&O tail coverage can have a deductible between $25K and $100K, while BCA's current E&O policy has a deductible of up to a $1 million. Now, both policies are defending a claim. With two policies on the hook, it brings the agency policy and procedures manual of the BCA into discovery. Trying to blend two different workflows, agency technology systems, and operational cultures is very difficult.

Plaintiff attorneys are advancing new theories of recovery on E&O claims. One of them is Negligent Supervision. In our example above, regarding the inadequate BI limit, the policy period during which the fire occurred happened six months after BCB's acquisition and under the supervision of BCA. So, both the tail policy and the BCA's errors and omissions were in play, increasing attorney representation and posing problems of cost allocations between new and old carriers. With two pots of money to claim against, larger total settlements are problematic. And the motivations of PEBB, who controls the litigation, are different because of the differing deductibles and policy limits.

The plaintiff's attorney logically asks why his client should be held to the old agency's lower or nonexistent standards when he is told of the benefits of being

now serviced by a significant entity with more sophisticated services and control. How will defense and indemnity costs be split between the acquiring agency's E&O coverage and the tail policy? The limit of liability will assuredly be higher with BCA as well as the deductible. Since BCA essentially controls the litigation, wouldn't it be logical for them to prefer the smaller deductible of the tail policy in most cases to the possible detriment of the tail carrier? And, of course, after the tail policy's expiration, the buyer's E&O coverage will apply since the acquiring broker is the only one left to deal with the claim.

Other factors can stretch out the time periods even more. Insurance agency errors and omissions claims are a lagging indicator. This means that typically, a policyholder will first sue the insurance company, and if they come up short, then they will sue the broker. That can add years to the exposure and push the claim past the coverage of the tail policy period and into the Acquired's errors and omissions program. Also, major catastrophic events can change everything. To have a claim, you must first have an alleged error and omission or other exposure in the client's policy and some event that triggers the underlying claim.

When wildfires in California or hurricanes in Florida occur, multiple acquired agencies can have claims all at once, which can fall on the Acquired's errors and omissions policy. During such disasters, multiple claims are filed against the policy, which erodes the aggregate limit. Subsequently, once the tail extension is written, the limit on the original agency policy is locked in and cannot be increased. The PEBB might feel they have plenty of tail coverage only to see the limit diminished or eliminated by claims from the catastrophe and other claims of which they were not even aware.

New events are also changing previous patterns. The pandemic has changed behavior in all industries. One impact is that insurance agents rarely review insurance applications at their offices or clients' businesses to have the policyholder sign in person. Sadly, many agents sign the application on behalf of the insured, giving clients an out when dubious or incorrect information is what the carrier bases coverage and premium on. Then, the carrier denies a claim that otherwise would have been covered, and the broker is brought into the lawsuit. Also, brokers who commonly did "drive-bys" of client premises might not anymore.

And finally, the determination of whether the normal "order taker" standard of care prevails in defense of claims or if either the Acquired or PEBB has elevated it. Under the "order taker" standard in most states, the broker must make reasonable efforts to purchase the insurance the client requested. If he doesn't fulfill the client's request, he must promptly notify the insured so the insured can make other arrangements.

But if the standard of care is elevated, the broker takes on additional duties to advise. This increased duty is often brought about by the establishment of a "Special Relationship" in many states.

Making such a determination requires a thorough analysis of the Acquired's previous relationship's facts and the insured's promises and expectations from the PEBB. This analysis is most often the subject of an expert witness's opinion. In seeking such an opinion, it is desirable to have an experienced witness who was or is a brokerage participant, has been on both sides of transactions, and has dealt with traditional and private equity-backed acquirers. Most notable is the ability to convince a jury that they know the "nitty gritty" of how things happen in the real world.