

Virginia

Regulatory Hot Tip 2011 –3

Professional Insurance Agents Association of Virginia and DC, Inc.

Diligence Pays Off

While some of you are considering enlarging your book of insurance business through acquisition, others are considering selling their insurance book of business. These latter folks are making plans to travel to far away places for their dream trip or spending more time hunting, golfing, boating, or whatever it is that you dream of doing after you sell the business.

Whether you're buying or selling, Due Diligence is a critical part of a business transaction. It should be handled by both parties in a spirit of cooperation and full disclosure. Although Due Diligence normally comes toward the end of the business transaction, and well after the euphoria and celebration that follows the initial handshake, it cannot be taken lightly. In essence, the Due Diligence process confirms that the seller has the assets claimed in the sales contract and has an unfettered right to convey them, and that the buyer has the funds to make the purchase. In other words, both parties to an agreement have their own Due Diligence responsibilities in the transaction.

Because Due Diligence is a critical component of a transaction, and because most folks don't go through a Due Diligence process very often, we normally use a check list to insure that nothing is missed. Due Diligence checklists are available for many different types of businesses on the internet and in books. The purpose of this article is not to offer a due diligence checklist, but to give you a brief overview of the Due Diligence process as a whole, and the areas of concentration that you need to focus on

*This regulatory hot tip is designed to provide accurate and authoritative information about the subject matter covered as of the date of this hot tip. The statutory authority and substantive information contained in this hot tip should be verified as it is subject to change with the passage of time. This hot tip is provided with the understanding that the author is not engaged in rendering legal, accounting or other professional advice or counsel. If legal advice or other expert assistance is required, the services of a competent professional should be secured. This publication is authored by JoAnne L. Nolte, JD, CIC, CPCU, FLMI, CLU, who practices at The Nolte Law Firm, P.C., 1427 W. Main Street, Richmond, VA 23220. NolteLaw offers **Solutions for Business –Large and Small** and can be reached at (804) 658-4518. Jo's practice is concentrated in matters of a general business nature as well as regulated industries and regulatory compliance (telecommunications, insurance, financial, water & sewer, energy related matters, and government relations). Jo has served as attorney for the Virginia State Corporation Commission and as in-house counsel to a privately owned national corporation. Non-traditionally, Jo owned and operated an insurance surplus lines brokerage agency and an insurance consulting business.*

in the Due Diligence process. Whether you are a buyer or a seller, these are areas that should be considered in evaluating the other party to your business transaction. Of course, the Due Diligence process should be considered only after appropriate non-disclosure, non-compete, non-solicitation agreements are in place, in addition to any letters of intent for which the parties may have contracted. Likewise, you need to consider whether this deal is exclusive for both parties and they are committed to inking a deal, or whether each is permitted to continue to court others while due diligence occurs.

All those disclaimers aside, Due Diligence can be broken down into several categories:

1. **Corporate Books & Records:** including tax filings, bank statements, income/expense items, entity formation, domicile and where the entity is doing business, ownership documentation and governing documents.
2. **Entity Culture or Personality:** how will the two business cultures fit together?
3. **Client, Prospects, Past Client, Vendor Lists:** or, in the case of insurance agents, are there insurance companies for which there are agreements, asset lists including intellectual property?
4. **Regulatory Matters:** whether there have been any state or federal investigations, orders, settlements, etc. and copies of same for each state in which the Seller does business.
5. **Employment Issues:** identification of key personnel, 401 (K) plans or other retirement or profit sharing plans, benefits currently provided to employees, any non-compete, non-solicitation or other types of employee agreements.
6. **Existing contracts:** May they be assigned? If so, have such been obtained?
7. **Miscellaneous:** considerations peculiar to the deal.

For purposes of this Hot Tip, we will briefly discuss each category and list at least one reason that this category is included. It may not be the only reason for its inclusion, but will generally let you know what is being sought and why.

One reason for a review of item number one, **Corporate Books & Records**, is to make sure that the entity is properly formed, has made all of the proper tax and licensing filings, learn who the owners are and to make sure that all governing documents have been followed.

One reason for learning about number 2, **Business Culture**, is to see whether the personality and business culture of the two entities match. Can they merge and

successfully operate as one entity? If your organizational culture is to be detailed, dotting all “I’s” and crossing all “T’s”, and the culture you are considering merging with is a fly-by-night sort of place, can you successfully take components of both business philosophies and work together as one? This is one of the most critical but often overlooked areas of Due Diligence review. Alternatively, if the cultures can’t merge, but you want to continue with the purchase, perhaps because you are getting an insurance market or client opportunity that you would not otherwise be able to procure, then how much time (and money) will it take you to move the entity over to your business philosophy, and what personnel will have to be sacked to get to the place you want to be. Make sure the price you are agreeing to pay takes these issues into account.

Lists and Existing Contracts are the parts of the Due Diligence review that are most guarded and also most important. You need to learn whether the larger client accounts have been serviced primarily through one sales person, the business owner or a CSR, and develop a strategy for retaining that business. Likewise, you need to review the insurer contracts to learn which markets are included that you currently don’t have access to and whether the contracts are assignable to you as a new buyer. Buying a book of business or agency to get access to a new market is frequently a major goal of an acquisition. Finding out after the deal has closed that the agency contract cannot be assigned could lead to real disappointment (to say the least!).

Not all purchases are between two regulated entities. If you are the buyer, you might want permission to speak with the **local regulators** and ascertain what kind of relationship the entity you are buying has with its local regulators. You will definitely need to determine what kind of orders, settlements, ongoing investigations, or prospective investigations might be known by them. Permission of the owner to speak with the regulators may need to be obtained.

The next to the last item, **Employment Issues**, is pretty self explanatory. If you don’t currently offer the same benefits as are offered to the target entity, then determine what you are going to do ongoing about benefits. Importantly, discuss with your legal advisor whether the increased number of employees (if there will be an increase) puts you into another classification for ADA compliance, family medical leave and other similar state and federal programs. Remember, after the deal closes, you cannot offer one set of benefits to the employees of your shop, and a different set to the employees of the entity you acquire. In my experience, getting benefit programs aligned is often a time consuming and challenging process. Don’t wait until after the closing to think about this issue. Due Diligence can provide the necessary data to deal with this issue.

The final item in our list is **Miscellaneous** and encompasses everything that is unique about your business transaction. This item could spill over into other categories, for example, perhaps the seller is nearing retirement age but still needs to continue with some health insurance for a year or two. Perhaps the purchaser has some medical issues which can not guarantee the seller that the purchaser will not become disabled down the road. Perhaps the seller is willing to finance this deal instead of going to a third party financier. Perhaps the seller owns the building from which business has been conducted and either (i) is willing to continue the lease for the new purchaser or (ii) wants that business out of the building. Have you made sure that there is a provision prohibiting the seller from letting another business entity with the same or similar business from renting that space for a couple of years? There are a myriad of miscellaneous items that could come up and need to be addressed. All of them will probably require individual negotiation and individual solutions.

This article has provided only a quick dash through items that should be considered and discussed in far more detail when you are the Seller or Purchaser of an entity. There are a host of other items that fit within each of these seven (7) categories, but this list is offered as a basic guide for your consideration.