Anatomy of a merger

By Paul J. Di Stefano, CPA, CPCU

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True agency mergers, where the principals of both agencies continue as shareholders, have always been one of the toughest transactions to structure. By looking at some of the elements of a true merger, an observer can immediately detect problem areas. The first area that needs to be addressed is the division of equity in the combined agency. To address equity allocation, typically both agencies are appraised at fair market valuation, i.e., the price that a third party would pay for these agencies. Just as in the normal appraisal process, the owner compensation is eliminated when determining fair market value. But this can immediately become one of the sticking points since, in a true merger, agency principals are not looking to reduce compensation but in fact just the opposite. When consulting with the principals of prospective merger partners, one of the more difficult tasks for Harbor Capital Advisors is determining what part of current remuneration is actually owner compensation. We have found that industry compensation standards can be an important element in addressing the management component.

An example of the ways in which compensation can differ is shown by a recent merger in which Harbor Capital was the intermediary. Principals of one agency had historically been compensated based upon a percentage of commission books of business serviced, in addition to set compensation for management roles performed within the agency. Compensation of principals of the other agency—in that case being family members—was based on historical salary precedents rather than actual responsibilities and books of business. In a merger like this, the goal should be to keep compensation at current levels by defining duties in a manner that is rational and at the same time generates a total compensation package in line with current levels.

The compensation issue is further complicated by the issue of defining the operating roles of the principals going forward. In many cases, we find that there is duplication in the roles performed by the principals of both agencies, especially in the areas of carrier relationships, financial oversight, operational management, and sales management. The challenge is to determine which of the principals will continue in current roles and which principals will assume new roles and responsibilities. Although this may seem like a sensitive area to deal with, we have found that on many occasions principals are more than glad to give up certain responsibilities which they consider burdensome while at the same time they welcome the opportunity to refocus their natural talents in other areas.
The reality is that with the additional intellectual resources of the combined agency, many areas of opportunity can now be more effectively addressed, such as sales management and individual production. In merger discussions everyone needs to keep an eye on the prize. One of the driving forces for any merger is the business leverage to be gained by reducing duplication of effort while at the same time proactively focusing on new challenges.

Work should be done on creating a vision for the merged entity with a detailed operating plan so that the combined operating staff can effectively assist with the merger transition plan. After the principals have agreed to their roles and responsibilities, the staff must be critically evaluated. While it goes without saying that the best individuals in both organizations should be chosen to fill roles going forward, this exercise will be a collaborative effort. Redundant individuals should be considered for transition roles such as system integration. It has been our experience that individuals initially considered redundant may well find a role before any transition is complete.

In a merger, corporate governance can be another thorny area. Going from a closely held agency where one or more principals have effective majority control to a minority position is a hard pill to swallow for many principals when it comes to signing on the bottom line. To avoid the control issue from becoming a potential deal breaker, Harbor Capital has in the past recommended that the new shareholders' agreement include super majority voting requirements to approve specific initiatives including the following:

- sale of the agency;
- termination of a principal;
- change in compensation for a principal;
- major corporate expenditure;
- acquisitions or divestitures;
- debt commitments; and
- increase in staffing levels.

Super majority voting requirements can mean anything over 51 percent. The dynamics of super majority requirements vary depending on the distribution of equity among the agency shareholders. In the case where the smallest shareholder owns 25 percent, the super majority may be 76 percent to give a minority equity owner veto power. In the case of a natural voting block, such as a family, the super majority could enable that block to veto an action. Super majority requirements can also vary depending upon the action contemplated.

In the case of a merger where all principals are currently minority owners, it is usually easier for the individual shareholders to get comfortable with the concept of a merger since historically there was no voting control. The reality is that even if super majority requirements are in effect, the best way to run an organization is to build consensus rather than hold formal votes.

While corporate governance is an important element of the shareholders’ agreement, another element that requires attention is the buy/sell provisions. When merging, agency principals are giving up some liquidity since, while owning their own agency, the decision to sell can be made at any time. When merging, that decision may become more limited. Thus the critical questions are at what price, under what terms, and under what circumstances can a principal be bought out. Obviously, a balance has to be struck between the needs of a selling shareholder and the financial resources of the merged agency because although selling shareholders like to receive as much cash as possible upfront, the agency may be limited in its ability to fund the purchase of stock. When
constructing the buy/sell agreement, additional thought should be given to the future likely timing of shareholder sales.

Another element in the buy/sell agreement is the related question: Who has the right to purchase the selling shareholders stock? In certain cases, family members may want the right of first refusal. In the case that the right is not exercised, the merged agency would purchase those shares. One should keep in mind that there are different tax consequences depending on how the shares are purchased.

In summary, agency mergers can be a dynamic force for growth. In negotiating a transaction, some of the key problematic areas should be addressed early in the process before they take on a life of their own. Agency perpetuation through the merger process instills the discipline necessary for future agency growth because it focuses the principals on operating the agency on a more institutional basis.

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