



Cookson Walker Consulting

Starting Fresh

Seven Broker's Resolutions for the New Year

By John Garner and Eric Walker

As an owner of an insurance brokerage firm, you may be quite happy with the way things have gone in 2004. Even with the definite signs of softening in certain lines, growth may have been substantial and operating ratios nicely controlled, giving you a healthy bottom line.

But if you are like a good number of principals, while things have gone well in the past few years, you are aware that issues exist that must be addressed. You have put off dealing with them because you have not had the time and, frankly, had hoped that they would somehow resolve themselves or be looked after by somebody else. On reflection, you know this is wishful thinking and that if you do not deal with them now they could hurt the firm or you as a shareholder in the future.

Subscribing to the maxim that you should not leave for tomorrow what you can do today, you should take time to list those issues that need to be addressed. They could include those thoughts that may have nagged at you during your recent planning session, or that incident in the office a few months ago that made you realize something was being missed on the personnel side of things. You may have retired a senior shareholder and were bothered by parts of the shareholders' agreement that came into play for the first time, or it may have struck you that the significant shareholders are in their late forties or early fifties yet there are no plans preparing for their eventual retirement. A partner's response that "if all else fails, we could always sell the firm" just does not sit well with you.

The fact is that even the best companies have issues. But one of the distinguishing features of these companies is that they deal with them before they become major problems.

The checklist that follows is derived from situations we have run into in the recent past in what we consider to be well-run brokerage firms. Some may have no application to you, but hopefully they will at least trigger you to look at those aspects of your business that you do not necessarily think about on a regular basis and either satisfy yourself that everything is in good order or note those matters that may not be and resolve to address them in the coming year.

Shareholders' agreement

Too often, problems with the details of a shareholders' agreement are only discovered when a situation has to be dealt with. If you have not yet had to resort to your shareholders' agreement, you should take the time to review it in detail to make sure that it appears to be complete and that its provisions are practical, reasonable, and free from ambiguity.

One of the primary reasons for a shareholders' agreement is to set down the rules for the valuation and payment for a departing or deceased shareholder's shares. For this purpose, the definition of value is critical. Typically, the shareholders intend that it will be "fair market value," but this is not always the case. For example, they may recognize that even though fair market value may differ, they are prepared to fix the value as a set multiple of commission income as

adjusted for balance sheet items. In addition, they may acknowledge that the multiple is “below market,” internal succession or the future involvement of family members being a more important consideration. (Clearly, if the set multiple is intended to approximate “fair market value” it should be reviewed regularly in light of market conditions and any changes in the composition of the firm’s business or circumstances.)

If your shareholders’ agreement provides that shares are to be valued by a professional (for example, a chartered business valuator), the definition of value must be provided, even if it is stated to be “fair market value,” so that there are no misunderstandings. Your financial adviser can assist you with this.

The effective date of the valuation must also be stated. This would generally be on the date that triggered the need for the valuation (for example, the date of the shareholder’s resignation, retirement, termination or death), or as at the last day of the most recently completed fiscal year preceding the triggering date.

If a professional valuation is called for, the shareholders’ agreement must provide enough time for the valuation to be completed. To be realistic, at least 60 days are required because of the amount of preparation and research required even if the valuator is immediately available to do the work. Some agreements also provide that the departing shareholder has the option of obtaining a second valuation, with the ultimate valuation being the mid-point of the two. If this is the case, he will need some time to make the decision after obtaining and reviewing the first valuation. Then, if he decides to go for the second opinion, another 60 days have to be provided. We are already looking at close to five months of delay, and these valuations are not inexpensive (how these costs are to be allocated should be clearly stated, too).

Some agreements further provide that the remaining shareholders have the option, following receipt of the second valuation, to call for a third, with the three to be averaged or the middle value selected. We are now verging on seven to eight months of waiting to complete just the first step! In these cases, it would seem far better if the shareholders agreed from the beginning that the firm’s value will be established by a professional valuator from a specified firm, with the proviso that in the event the specified firm cannot be used -- because of unavailability or conflict of interest, for instance -- then another firm may be selected from a list they have included in the shareholders’ agreement.

Even though a definition of value has been established, consideration should be given to having this value discounted in certain circumstances. The amount of the discount may vary depending on the severity of the situation: Retirement without proper notice is one thing but termination for cause is another. Clearly, there are a variety of situations where some form of discounting could be justified.

Once the departing shareholder’s shares have been valued, time will probably be needed to obtain the funds necessary to purchase those shares. If they are to be redeemed by the firm, bank financing may be required. If the other shareholders have a pro rata right (based on their respective shareholdings) to purchase, they have to decide if they want to do this, and then make the financial arrangements if they do. Sufficient time has to be allowed for each of these steps, particularly if the shareholders have first rights but, if they decline to purchase the shares or do not subscribe for all of them, then the shares are to be redeemed by the firm. All of these steps, by the way, have various income tax advantages and disadvantages, depending on how they are structured, so you need to involve your financial adviser.

Some of the preceding considerations will depend on what the payment terms are. These may also vary according to the nature of the triggering event. You may decide that a deceased shareholder's shares should be purchased or redeemed outright (and may have key man life insurance in place for this), and that this should also be the case when a shareholder retires upon giving proper notice. In other instances, a deferred payout may be appropriate. No matter what the situation, however, if the firm is required to redeem or fund the purchase of the shares, it should be with the caveat that while best efforts will be used to do this in accordance with the stated payment terms for the particular triggering event if, as determined by the directors, the firm's solvency could or would be adversely affected by making a scheduled payment, then the directors have the right to direct that payments will be deferred until this issue no longer exists.

Other matters that you should consider in a triggering event situation include the whole area of non-competition, non-piracy of accounts and non-solicitation of staff. With the assistance of legal counsel, you should determine whether, in certain circumstances, the continuity of payments to a departed shareholder should depend on his subsequent activities.

Some shareholders' agreements also deal extensively with corporate governance matters such as the composition of the board of directors and how they are elected, the appointment of officers, and whether certain actions must be approved by a super-majority (66 per cent or 75 per cent, for example) of the directors or shareholders. These should be thought through too.

Resolve that you will review your shareholders' agreement and discuss any concerns that you may have with your partners and professional advisers. And, if you determine that changes are appropriate, and you have the agreement of your partners (or the necessary majority), resolve to have your legal counsel make the amendments as soon as possible.

Succession planning

Some experts argue that you should commence your succession planning 20 years before your planned retirement date. While you may consider this extreme, arrangements should definitely be in place for any partners over the age of 50, particularly if they have significant roles in the firm or are major shareholders. Not only does their orderly retirement have to be considered, but also the possibility of an unexpected early withdrawal because of health or other reasons.

One often finds significant shareholders aged within a narrow range. Once this average age is over 45, the shareholders should already have some form of consensus as to whether they want the firm to continue as an independent entity (over which its shareholders, including future appointments, have control) or are open to its eventually being acquired or merged into a larger, controlling entity. If their inclination is to the latter, it is not necessarily critical to have younger, capable individuals in the second tier. The converse applies to those shareholders who want to perpetuate the firm. They must have individuals on staff who can be groomed to successfully take over the reins. Only in this manner can it be ensured that the firm has the financial wherewithal to fund the obligations incurred to redeem or acquire the retiring principals' shareholdings and at the same time generate sufficient surplus cash flow to permit the firm's continuing growth and development.

It must be recognized that neither of the preceding routes is without risk. There is no guarantee that willing buyers will be in the wings when the shareholders decide it's time to be acquired or absorbed by another firm. To mitigate this risk, a game plan and timelines are needed, and the shareholders must be prepared to change course in the event of unexpected developments within the firm, the trading region or the industry.

Likewise, if the shareholders decide they want to perpetuate the firm, they cannot assume that they will be immediately successful in finding eligible candidates for their succession. They also have to be very clear on the necessary attributes of their successors, and responsibilities have to be assigned for the mentoring of these individuals. The chances of this process going relatively smoothly will be significantly enhanced if it is properly thought through and managed in the manner appropriate for the major endeavour it is.

If a shareholder would like his or her child to be considered as a possible future shareholder, the conditions have to be established now for the stages the offspring will have to go through to prove he or she is appropriately qualified to be a successor. This proving ground should be at least as rigorous as it would be for any other candidates, even if the parent is the controlling shareholder. Resolve that if you are in a situation as described above, you will address the matter of succession planning with your partners in the coming year.

Strategic planning

In 1990, while at Trivest Insurance Network, John Belyea (now the executive vice president of Creighton & Company, an insurance brokerage in Mississauga, Ont.) wrote what is probably still the most lucid article on strategic planning for brokers. Belyea started his article with a quote from the Koran: "If you don't know where you are going, all roads will take you there." From this he built his case.

A firm cannot be successful if the major shareholders do not have a reasonably clear and consistent idea of where they are going (their mission), their primary goals and objectives for at least the next five years, and what must be done to achieve them. This being said, unless events have occurred in the interim that significantly affect these strategic plans, they probably do not have to be formally reviewed and reassessed more often than every three years or so.

What has to be avoided at all costs is the perversion of the strategic planning process into a perfunctory annual exercise where wordsmithing of the mission statement or "our values" takes up most of the time. This just results in frustration and people questioning the benefits derived from the time, effort and costs involved. The last thing you need is the participants losing sight of the purpose of strategic planning, no matter how good the output looks on paper.

Resolve to sit down with your partners in the coming year to review your approach to strategic planning, with your goal being to ensure that, when they are held, the sessions encompass the intense and wide-ranging thought, debate, reasoning and reflection that is essential to making them worthwhile.

Annual planning and budgeting

If not managed properly, annual planning and budgeting sessions can be a major source of frustration for the participants. Rather than address all aspects of the annual planning process, the following identifies those parts where issues often arise:

- Attendees should be selected wisely. Participants should be those responsible for the key aspects of the firm's operations. They should not necessarily be limited to shareholders. Conversely, not all shareholders necessarily need to participate. In addition, the larger the size of the group, the less effective it generally becomes.
- This process should be considered the annual expression of your strategic plans. This means that the participants should review and think about the strategic plans prior to attending the session. Otherwise, you run the risk of people operating out of context.

- The budget for the coming year should be drafted prior to the planning session at a depth where each meaningful profit and expense centre (e.g., IT and finance and administration) is separately identified. The focus should be on revenue and direct costs, but any reasonable attempt at allocating indirect costs (overhead) would improve the process significantly. Without a feel for how profitable (or expensive) each department is, the participants are at risk of making the wrong decisions.
- The major assumptions used in preparing the draft budget should be clearly noted so they can be considered and debated at the planning session. These should be supported by historic information and recent trends (that is, prior years' numbers and year-to-date results compared with budget and the same period last year). Erroneous assumptions do not result in good plans.
- The draft budget should be reviewed in the context of the strategic objectives. If targets have been set for rates of growth and profitability, then the gaps have to be identified up front so that the necessary action plans are developed. Coming up with the idea of making an acquisition to fill the gap is not sufficient unless this was always a strategic objective that has been clearly thought through (i.e., target firms have been identified or profiles established).
- The output of the planning session should be clearly documented to avoid future misunderstandings or failed memories. Action plans should be organized by area of responsibility, persons responsible and in order of agreed time lines (completion dates). The progress of each action item should then be monitored at regular accountability sessions. You otherwise risk finding the same items in next year's plans and a widening gap between where you are and where you want to be.
- There is nothing worse than the player who was "too busy" to perform his part of the agreed action plans. He or she should not have accepted the responsibilities in the first place or should have had them assigned by the CEO (or the senior officer responsible for implementation) to somebody else. Accountabilities have to be very clear, acknowledged, taken very seriously and enforced. No excuse should be acceptable.
- The final budget should reflect the decisions that were made in the planning session including, where appropriate, the anticipated costs and benefits of the various action plans. With actual and prior year-to-date results, these budgets should be an integral part of the review against plan at the regular accountability sessions

Resolve to address any issues with your annual planning process and execution of the action plans in the coming year.

Organization structure

In the 1980s, Hales & Associates, one of the premier consulting firms to the U.S. brokerage industry at that time (Reagan Consulting, an offshoot, and of Best Practices fame, has continued this tradition), came up with what they termed the "plateau theory." They had observed that once a firm achieved a certain size it either had to make changes to its management structure or risk plateauing at that size. A typical situation handled successfully in a smaller firm would see a senior shareholder best focussed on production and business development but encumbered by internal responsibilities having these functions assumed by a general manager. At later stages, accountants would be replaced by controllers, then vice presidents of finance and chief financial officers, and all non-sales, business development and

marketing responsibilities would be devolved to a chief operating officer (COO). Marketing and personnel officers also come into play. (Hales talked too of eventually bringing in a professional chief executive officer, but this part is not so clear, especially if the firm has a strong COO.)

Shareholders need to think about the plateau theory. It is not unusual to find good firms operating sub-optimally because of a reluctance on the part of the shareholders to take (or give) away responsibilities now handled by one or more of them. Time and again, one reads about smaller businesses (in the global context) following the path of the life cycle: Growing, maturing, coasting for a while on their momentum, and then fading away or having to be sold. The plateau theory posits that with growth comes the need for more professional management and a greater specialization of duties. By taking the necessary action, the shareholders can shift the firm's life cycle into a new phase from which it can continue to grow.

If you notice any of the following developments, resolve to meet with your partners to debate whether your firm has hit a critical juncture in its growth, and act accordingly.

- People are being pulled in many directions and have assumed responsibilities for which they do not have a strong background, causing you to worry that things are being missed, not getting the attention they need or being handled ineffectively.
- You have a number of product-line departments in your firm, but have no easy way of monitoring their individual progress and profitability because the financial information you are receiving is not detailed enough.
- Departmental income statements, revenue per employee statistics, or operating ratios (if this information is available) indicate performance problems, but nobody has the time (nor really the skill) to look into them.
- Personnel issues keep cropping up. Each department seems to have its own set of rules and staff members are complaining. Ad hoc decisions are being made because nobody really wants to spend the time to deal with the issues and establish consistent practices.
- Staff training on your broker management system is inadequate, and procedures are not properly documented. Your accountant does an admirable job of managing the technology, although there have been recent issues. Even though the consultant you retained seemed to improve the situation, you are still convinced your staff could be using the system more productively,
- You have run into unexpected cash flow crunches that you know were avoidable. Accounts receivable seem high, as do some expenses. You worry about the lack of controls.
- Your companies are starting to complain about certain producers, be it the quality of their submissions or unreasonable demands on underwriters. You tried to establish standard practices but nobody is monitoring them.

Employee performance appraisals

Performance appraisals provide management and senior staff with the opportunity to sit down with employees to discuss their strengths and weaknesses, goals, aspirations, areas for personal improvement and their professional development. They allow action plans to be

established that, by assisting the employees to enhance their performance, also directly beneficial to the firm.

These positive results are contingent on performance appraisals being conducted effectively, with appropriate guidance, preparation, execution and follow-through. Unfortunately, because they are so busy, people may not see the process in this context. For them, it becomes a have-to-do and, as a consequence, much of the value is lost. The impact on the firm may be gradual but if this attitude is not changed the repercussions from the loss of proper direction can be significant.

People must sometimes be reminded how critical the appraisal process is to the continuing success of the firm -- and the individuals who work there. If you have any concerns about how well your firm is performing in this area, resolve to discuss them with your personnel manager and your partners and ensure that everybody recognizes the value that can be derived from this investment of time.

Self-help groups

In the October 2004 issue of *Canadian Insurance*, Cookson Walker wrote about the "lonely broker" syndrome. Perhaps we should have called it the "lonely brokerage" syndrome, because it often applies to all partners in a firm who realize they do not have a ready means for discussing and debating the various aspects of running and owning a successful firm with anybody else, or at least with people who really understand their business.

The beauty of self-help groups is that they permit open and honest dialogue with peers who, because they are not direct competitors, have no reason not to discuss a broad range of matters in depth. These groups permit their members to build on each other, share experiences and insights, establish their own benchmarks and, occasionally, share the cost of resources that will benefit them all.

If your firm is not now a member of a self-help group, resolve to discuss the idea with your partners, have them read the October article if they have not done so already, and look into joining or forming a group in the coming year.

Hopefully, the foregoing examples will inspire you to think deeply about your operations and arrangements with your partners. If you have recently completed your business plans for the coming year, you may have already identified a number of issues and established action plans to deal with them. But other items may not have come up, particularly shareholder issues and the way you conduct your planning process. Note these and resolve to address them in the coming year. In time, you will be glad you made the effort.

Eric Walker is a partner and John Garner is an associate at the Cookson Walker Consulting Group. Eric can be reached at (416) 368-7900 or at ewalker@cooksonwalker.on.ca.