Cluster Tips
By Chris Burand

An agency owner called me the other day and asked about doing a cluster. I asked if I might take a guess at what his accountant or attorney had advised regarding how best to create a cluster contract. My guess was that the accountant or attorney advised they set up a shell LLC to hold/own all the company contracts with all the money passing through this holding company to the individual agencies, with profit sharing to be determined by some prearranged formula probably involving premium per company. He said, “Yes. How did you know?”

I further suggested his accountant or attorney probably failed to mention any governance requirements for the individual agencies, buy-sell covenants, trust fund/money covenants, or dissolution provisions.

I could see his face of disbelief through 1,300 miles of telephone lines, as he said, “How did you know? Am I ever glad I called today because we were about to sign the papers and no one ever even mentioned these key points.”

I have reviewed dozens of cluster contracts and have yet to find one written by an attorney who understood insurance agencies well enough to write a proper cluster contract. Cluster contracts between individual agencies or groups of agencies (not necessarily the major cluster type agency organizations) are almost always grossly inadequate. For example, what happens in a three-agency cluster where one member cannot pay their companies? Most cluster contracts de facto make the other two liable, with no recourse. The contracts almost never require members to maintain certain financial requirements or include checks for financial condition. Considering that 40%-50% of agencies are out of trust (they have a trust ratio less than 1.0), this is a huge issue.

Another example is protecting the other members if something happens to one. Even if a buy/sell clause is included, are the terms feasible? With most cluster contracts, they are not. Similarly, if a retiring member wants to retire, can they without being held hostage by the other members?

Clusters are ripe for mismanagement and having one member take advantage of other members. A simple example of this is when one member practices poor up-front underwriting causing everyone’s contingencies to plummet.

Even without mismanagement and unfair play, cluster contracts are generally fixed in concrete. They are written as if circumstances never change, that no one retires, dies, becomes ill, or gets a divorce. They are often so fixed that even voluntarily changing carriers is not feasible. Nor is changing partners.

Cluster contracts are also written as if nothing will ever go wrong. We are in insurance. The only reason insurance exists is because we know things will go wrong.

It is interesting to see how virtually every attorney and accountant that designs clusters designs them wrong in the same way. If you are considering joining or forming a cluster, you need someone that intimately knows insurance and someone that can consult with your CPA & attorney to design a contract that makes sense. Fixing a broken cluster or de-clustering agencies when things go wrong, which is inevitable, is one of the most expensive projects any agency will ever undertake, especially if any party is disgruntled.

If you are participating in a cluster or thinking of joining/forming one, do it right and hire people that know how to do it right. Doing it right is an investment that most certainly succeeds.

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