

Accountability

Issue III

De-mergers and prior acts coverage.

There is an old proverb that “*all good things come to an end.*” This may also apply to an accounting firm. If a once successful partnership decides, for whatever reason, that it should dissolve, there are a variety of options available to the partners with respect to professional liability insurance for prior acts.

Generally the options available are as follows:

1. Wind-up the firm. Cancel the present insurance policy and go bare for claims arising from prior acts. This is the most hazardous course of action as it presents a situation where there is no coverage for claims made in the future (after the date the firm is dissolved) and consequently exposes the former partners to potential bankruptcy. Prior to the cancellation of coverage the partners must undertake a thorough evaluation of all files to identify any potential claims and this must be notified to the insurer. Coverage is always written on a *claims made* basis. Therefore all claims must be made to the insurer, including any incident that might give rise to a claim, while the policy is in force. This in itself presents another problem whereby the partners may need to justify that

the incident(s) notified are sufficient to qualify as a potential claim. Merely sending a list of former clients and dates of assignments may not be enough for the insurer to accept this as notification of a claim, which may result in a costly and protracted coverage dispute.

2. Purchase an extended reporting period [“Tail”] from the present carrier for all prior acts (work performed prior to the date the firm was dissolved). Certain insurers can provide a tail of up to 6 years for the date this is exercised. Thereafter, all partners purchase separate policies with no-prior acts coverage. This may be the cleanest solution, but potentially the most expensive, as the cost of a 6-year tail can be 200 percent of the last annual premium. Add to this the cost of the new individual policies.
3. In normal circumstances, only the successor firm in interest can “inherit” the prior acts coverage that is applicable to the former firm. It is very unusual for an insurer to grant full prior acts coverage to each former partner on an individual basis (when purchasing separate policies), although this may be available in the case of larger firms. Consequently, one the former partners opts to become the successor in interest to the former firm [“successor partner”] and names the former firm

as a *predecessor* for the purposes of professional liability insurance. An anomaly of professional liability insurance premium underwriting is that the successor partner's renewal premium will be calculated based upon the professional headcount and/or revenues of the new, downsized firm. However, because the policy contains coverage for former partners and staff of the firm, including predecessor firms, protection will be provided to the former partners and staff for prior acts. The former partners may then purchase new separate, individual policies with no prior acts coverage. The premium for this should be significantly less than the cost of individual full prior acts coverage.

If the de-merger is amicable, in this scenario an indemnity agreement may be agreed between the former partners in regard to claims for prior acts which contains the following provisions:

- I. The former partners may agree with the successor partner to contribute to the cost of any deductible incurred.
- II. The former partners may agree to contribute to the cost of any premium increase or claim premium loading applied to the successor partner's policy.
- III. The former partners may agree to contribute to the additional cost of full prior acts coverage (that is, the difference between full prior acts coverage and no prior acts coverage) incurred by the successor partner. This agreement can be for a period which tracks the step-rate

adjustments of a professional liability policy (usually six years) and the contribution may be reduced over that time.

It is imperative that the indemnity agreement is drafted by an appropriately qualified attorney. This may ensure there are no difficulties at a later date, and may form part of the de-merger agreement.

The third option seems to offer the most advantage. Overall, the cost is less and prior acts coverage for the former is maintained via the successor partner's policy. Whatever option selected, in the event of a de-merger it is important that the partners consider the exposure for prior acts and make appropriate arrangements for their protection.