Accountability

Issue XX

RISK & INSURANCE IMPLICATIONS OF MERGERS & ACQUISITIONS

In the past few years we have received many requests from clients for advice on the insurance and risk management features of a merger with, or acquisition of, another firm.

Most of these transactions go through smoothly and to the satisfaction of all parties, but in the event that this is not the case there are a few pre-emptive steps that can be taken to reduce the possibility of a professional liability loss to your firm.

Pre-transaction

Obviously, before contemplating moving forward you must be satisfied that the practice you wish to acquire or merge with, achieves your firms objectives & practice growth, development of a new specialty, acquisition of a new product or service line, or the recruitment of certain key professionals. Much of this may be gleaned during the due diligence process or from the information provided by the professional liability coverage application. Once you are satisfied that the "target" firm is desirable in terms of practice growth you should consider how you might limit your firms exposure to claims arising from prior acts.

Your firm's attorneys will advise you on how best to structure the transaction. Popular today is an acquisition or transfer of the target firm's assets. This may mean that the corporate entity of the target firm remains intact (thereby becoming a form for any litigation for claims arising from the professional services of the target firm that took place before the transaction date).
The merger or acquisition agreement may also contain an indemnification clause that will allow your firm to seek a recovery from the former partners of the acquired or merged firm, in the event of a professional liability claim made against your firm after the transaction date but, which arises from their prior acts.

A problem with an indemnification provision is that if a claim is made and it must be exercised, the former entity or partners (who are now part of your firm) may be left personally responsible. This can place them under great financial and psychological strain, and ultimately inhibit the success of the transaction. There may also be residual liability from claims arising from services performed by retired or deceased partners.

In addition, prior to concluding the terms of the transaction, you may wish to involve both the target firm and your firm's professional liability insurance agent in assessing the exposure to claims from prior acts.

Borrowing liberally from the underwriting process you should ask the target firm and their agent some of the same questions that appear in a professional liability coverage application. For example:

a. Details of the breakdown of practice, e.g. any SEC Exposure.
b. A copy of the most recent Peer Review.
c. Disclosure of any client's going concern issues.
d. Details of any suit for fees.
e. Full disclosure of any claims made by the target firm or of any incidents that should be advised. *This may be supported by a Loss Run from an insurer.*

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f. Details of any lost clients or disputes with clients.
g. Details of the use of engagement letters for both new and existing clients.

Much of this can be obtained from E&O applications, and analysis of the responses will give you a good indication of the potential for future claims.

CPA*Gold*™ has developed a short-form questionnaire to assist you in this process which is available to policyholders; your insurance agent will be able to assist you.

<u>Limiting your exposure and transference of risk</u>

The exposure to claims for professional liability is faced by two distinct parties:

a. Your firm: Even if the transaction is structured in a way that limits your exposure to prior acts (e.g. an asset transfer), your firm may be joined in litigation due to the "holding out " exposure (your firm essentially holds itself out as a successor in interest to the target firm) and may incur substantial defense cost.
iv.
b. The former partners of the target firm: A claim for prior acts will be made against the target firm and the partners individually. In addition, the partners will need to make good on the indemnification provision as following a. above.

A well thought out merger or acquisition agreement should be supported by appropriate insurance coverage. There are two ways to achieve this:

a. Your firm's insurance policy should contain a coverage extension that automatically provides full (including prior acts) coverage to the target firm. (See below) In addition, the definition of the insured, under the policy should be broad enough to include predecessors. Of course, this means that your firm's limit and deductible, which may be different from the target firm, are exposed and therefore may be eroded by claims from the target firm's prior acts. Potentially, this could cause the availability and cost of your firm's professional liability to change in the future.
b. If the target firm previously arranged professional liability coverage there may be a right to an extending reporting period (often called a "tail" or discovery period). This effectively extends the time in which claims may be notified to the previous insurer for periods of one to five years, depending upon the insurer. Coverage provided is subject to the same limit, deductible and terms of the previous insurer's policy and is usually limited to an extension of the time period, but not the limit of liability of this policy. Costs for this vary from 90% to 250% of the last annual premium depending upon the time extension selected. For example the **CPA***Gold*™ policy states:

> *The additional premium for each Optional* ***Extended Reporting Period*** *Option below shall be calculated using the following percentages of the full expiring annual premium:*
>
> *90% for the One (1) Year Option;*
> *135% for the Three (3) Year Option;*
> *175% for the Five (5) Year Option; or*
> *225% for an Unlimited Option.*

It should be noted that this only provides coverage for claims made during the period of the extension that arise from professional services provided after the prior acts date and before the extension commences. This form of coverage extension is also often used if a firm dissolves or a sole practitioner retires.

<u>Protecting your assets</u>

As stated above, any asset transfer or indemnification provision should be supported by appropriate insurance coverage. The method used is entirely dependent upon your assessment of the target firm's claims exposure and your firm's tolerance for risk. In addition, the cost of insurance coverage and how this affects the transaction cost is also a factor.

Because of the possible differences in limits and (lower) deductible the best practice solution is to oblige the target firm to purchase an extended reporting period ["ERP'] from the former insurer.

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Additionally, there are a few other issues that should be considered:

a. Before exercising rights to an ERP see if it is possible to adjust the limit of liability under the target firm's policy, to a level that adequately reflects the claims exposure suggested during the due diligence.

b. Select an extended reporting period that is sufficiently long to give maximum protection in accordance with the various limitation statutes.

c. Request that your firm is added as a Named Insured before the ERP is requested. This may be limited to services performed by the target firm, but this should be enough to address any defense costs exposure, should your firm be named in a suit for prior acts brought against your firm.

d. Have the address and contact info changed to your firm's. You would wish to be in control of any subsequent claims.

On your firm's policy, add the target firm as a Named Insured or ensure that the policy provides automatic coverage. While this is a duplication of coverage, it may avoid a gap in insurance. By endorsement, this could be modified to difference in conditions/difference in limits coverage (a kind of umbrella coverage), which might mitigate coverage duplication whilst "plugging" any gaps and "topping-up" inadequate limits. This may also avoid different insurers invoking the *other insurance* clause in their policies. However, such action may be unusual because on ERP coverage is generally recognized as a more specific, and thereby primary, coverage.

This automatic coverage is usually not subject to an additional premium during the policy term, but the annual premium will be adjusted to reflect your firm's increased size at next renewal. Not all insurers do this, so you should check with your insurance agent.

In addition, it may be appropriate to add the target firm to your policy with a separate retroactive limitation date. This would provide protection for work in progress, but limit your firm's coverage to service performed after the date of the transaction. This should be coordinated with the purchase of the ERP for the target firm as described above.

Finally, and perhaps most importantly, if your due diligence reveals that a claim has been made against the target firm, you must ensure that this has been advised to and acknowledged by, the previous insurer. This is generally evidenced by a claim file reference number from the insurer.

Similarly, if due diligence reveals an incident that might give rise to a claim, this should be notified immediately to the target firm's insurer. This must be notified before the target firm's policy expires and before the effective date of the transaction. As above, this should evidence by a claim file reference number.

In conclusion, merging with or acquiring another firm is a tried and tested way to increase your practice, but it presents unique problems concerning the importation of professional liability claims risk. Best practice dictates that you should consider this exposure, involve your attorney and insurance agent at an early stage in proceedings and seek ways to minimize the risk and transfer any residual exposure to a financially sound and experienced insurer.

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