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Coping with the Inevitable Firm Transitions

Every firm has a life-cycle. Professionals leave firms to practice individually or to join another firm; a firm might dissolve as a business entity or be acquired by or merge with another firm; or, firm owners may retire or be unable to continue providing professional services. These changes require special protection, and they should be discussed with a firm's professional liability insurance broker or agent to determine how best to proceed.

All professional liability insurance available to design firms is written on a claims-made basis. For a claim to be covered, the claim has to be first made against the policyholder *and* reported to the insurance company during the policy period (claims-made and reported coverage). If a policy expires, and a claim is thereafter made, the individual professional and the firm will not have coverage under that policy. Some policies will provide coverage for claims related to negligent performance during the policy period – provided that the claim is reported within a set and limited time after the policy expiration date. Coverage is provided for claims made and reported after the expiration of a claims-made policy only if such claims arose from acts or omissions occurring during an insured period of time and reported before the extended reporting period ends. For instance, the CNA policy offered through Schinnerer includes an automatic 60-day reporting period after the policy is terminated.

This coverage carried by design professionals is sometimes referred to as a "long-tail" line of insurance. A negligent act or omission may take place today, but harm arising from that act or omission may not be discovered or a claim made against the design firm or the individual professional (who by signing and sealing the design documents took responsibility for the project under state licensure laws) for a considerable period of time. In most states, this period is cut off by the applicable statute of repose. In other states and in those where the statute of repose only encompasses improvements to real property, the risk could be in perpetuity because of the obligation placed on the professional and the professional's firm by the state.

To extend the coverage of a professional liability policy beyond its policy term, it's possible to purchase reporting coverage through an "Extended Reporting Period" or "ERP." The extended reporting period is the time during which a claim arising from an act or omission occurring prior to the inception date of the ERP can (in most cases) be reported and covered, subject to the policy's terms and conditions. Most professional liability policies provide an insured with options to purchase ERPs of varying length. The insured typically may purchase the ERP for a period of one year, three years, five years, and, under some policies, a ten-year time period. The cost is generally a multiple of the last annual policy premium and depends upon the length of time selected for the extended reporting period.

Changes That Require Attention

A continuation of coverage or the purchase of an extended reporting period is important to design professionals and their design firms when significant changes occur. The following scenarios offer five examples of why a design professional would purchase "tail" coverage.

1. A Professional Changes Firms or Decides to Open a Separate Practice

When an individual leaves one firm to start a new firm or for other employment, the professional should be concerned that, as an individual, the professional remains covered for services performed while working for the prior practice.

If the original firm remains an ongoing entity, the professional is usually covered as a former member or employee of the firm for claims arising from services rendered while the professional was with the firm. This, however, assumes that the firm retains its claims-made coverage, including prior acts coverage. If the firm divides or dissolves at some point thereafter and does not maintain professional liability coverage for the firm upon its termination, then all coverage will cease and there will be no coverage for the professional who left the firm or for the professionals who were with the firm at the termination for any claim made after the termination date of the professional liability insurance policy.

If a professional leaves one firm and joins another, it is usually not possible for the individual to purchase coverage for acts or omissions that occurred prior to joining the new firm. In most cases, the new firm's insurance policy will cover only the professional's performance on behalf of the new firm. Most firms and their insurance carriers will not agree to provide coverage for claims arising from acts or omissions of the professional *prior* to joining the firm. It is highly unlikely that the individual will be able to cover prior acts or omissions by purchasing an extended reporting period when leaving a firm since the option for an individual ERP is not normally available.

2. A Professional Decides to Leave a Firm, but Performs Limited Services in a Solo Practice

There may be several options for a partner or other principal of a firm to secure coverage for prior acts in this particular circumstance. As the professional's prior firm remains covered under a typical claims-made policy, the professional will have coverage for claims arising from services performed while at that firm. A design professional leaving a firm and going solo may be able to purchase a new policy to cover the professional's solo activities with some form of prior acts coverage in connection with the earlier services. Not all insurers will provide prior acts coverage in these cases if the prior firm is still in business. And it is highly unusual that an insurer will offer a policy to part-time professionals who are performing a limited amount of services while retired from active practice. In some cases, a retired professional who is performing design services or providing other construction-related professional services can purchase a separate policy covering the services going forward, especially if the services are not related to design for construction. For instance, forensic services, sustainability advice, or other consulting services might be covered under a separate policy.

3. A Design Firm Merges with Another Firm through a Purchase of Firm Assets

Firms merging with other firms often face unrecognized exposures. Insurance coverage for all parties involved in this type of transaction is most effective when contemplated as part of a pre-merger, due diligence strategy. Such a strategy includes a well-drafted buy/sell agreement that attempts to protect the acquiring firm from claims arising out of successor liability and the purchased or merging firm from future litigation.

The buy/sell agreement should clearly evaluate the assets and exposures of both firms and assign the appropriate risks to either party. The structure of each company's insurance policy may determine who is going to be responsible should a professional liability claim arise. The successor company—prior to the completion of the acquisition—should use prudent risk management measures either to avoid claims from acts of the predecessor firm or to be prepared to address claims through insurance coverage. The firm closing out its practice needs to understand its ongoing risks and provide coverage even after the acquisition has taken place. It is important that the allocation of responsibilities between the parties be compatible and contemporary with the insurance coverage in place.

If the selling firm still has projects in process, that exposure should be addressed. If all projects have not been completed, a policy just to cover the discovery period for projects finished by the selling firm will not be effective. The acquiring firm can, however, assume the risk and responsibility for the incomplete projects. This would allow the selling firm to close up its operations and buy "tail" coverage for claims during the discovery period on its completed projects. A policy for this continuing exposure can be paid for as part of the terms of the merger or acquisition, or the selling firm could set up a separate, continuing entity to finish off the remaining projects. The selling firm's policy would have to remain in place until all the projects are completed, after which time a "tail" policy could be instituted. Many firms pay for this continuation and tail coverage through an escrow account set up at the time of the sale of the firm's assets.

The acquiring firm may choose to insure the risks of projects that are not completed by the selling firm. To cover the risks associated with these projects, they would have to be specifically endorsed onto the policy of the acquiring firm. As an alternative, these projects could be specifically excluded from the coverage of the acquiring firm. If these projects are added later, additional premium will be charged for this increased exposure. This can leave a gap in coverage: the selling firm will be closed and the only available insurance coverage will be for claims resulting from completed projects. The acquiring firm will have no coverage for projects not yet completed. And if the projects are specifically excluded, there will be no coverage for future claims involving the projects. In essence, they will remain uninsured projects.

Mergers or acquisitions often happen as a result of principals wishing to retire and using their ownership in a firm as a means to fund that retirement. Recognizing the personal exposure professionals have for their professional acts, the merger or acquisition agreement may require the ongoing entity to maintain coverage for the retiring principals.

4. The Owners of the Professional Service Firm Decide to Dissolve the Firm

Professional liability may be attributed to the owners of design firms and those who took responsibility for the licensed services throughout the period of the statute of repose as dissolution does not extinguish the potential for claims. There is a need to maintain insurance coverage for potential exposure to personal liability that attaches to professional practice.

Within the professional services area, dissolutions most frequently occur in partnerships. The liability of partners is, almost without exception, joint and several. Thus, either one or both partners can be held liable for the wrongful acts, errors, or omissions arising out of the partnership practice. The questions that need to be addressed and answered are much the same as in mergers and acquisitions. Often in partnership dissolutions, the individuals constituting the partnership intend to continue practicing separately. The question of coverage for prior acts can be easily managed by one of the following:

- One of the individuals continuing in practice can simply name the dissolved partnership on its new policy. Any deductible obligation for claims arising out of services performed by the dissolved partnership will now become the obligation of the former partner's firm continuing coverage in its own name.

- The individual principals of the dissolved partnership can each purchase policies for their respective new practices. These new policies can cover their individual exposures from the previous firm through prior acts coverage. In some situations, a professional liability insurer might allow the individuals to maintain coverage for claims arising out of the services performed by the partnership if the principals can agree on a specific list of projects for which each is willing to respond. In order to operate efficiently, any such list must be clear, all-inclusive, and evaluated in the insuring process. Anything not disclosed would not be covered by either policy.

5. The Owner of the Firm Retires from Practice or Permanently Leaves Practice

If all owners intend to retire and cease practice, some insurance carriers offer two distinct possibilities: the purchase of "retired partners" coverage or, for qualified firms, the continuation of the policy in existence at the time of the dissolution on a minimum premium basis.

Purchasing retired partners policies secures protection from claims arising out of the partners' past performance of professional services. This is true regardless of how the practice is organized (e.g., sole proprietorship, partnership, corporation, or other entity). This type of policy can protect financial interests by covering the residual risks associated with the firm's prior practice. This protection is extended to both the retired owners and any employees for the covered acts committed in the performance of services on behalf of the dissolved firm. For the purchase of a retired partners policy, most carriers mandate that all projects must be completed through construction and any claims from past projects must be closed. Often a carrier will require that the firm have a record with the carrier of at least three years of continuous coverage.

A retired partners policy is often discouraged by carriers who would rather have the coverage ended and an extended reporting period purchased. The cost of a retired partners policy is usually based on a multiple of the cost of firm's three-year average premium. So a retired partners policy often is an expensed way for a firm to wind down a practice.

Carrying a policy at a minimum premium – basically reporting zero billings for services but continuing the policy – might be available from some carriers but is usually discouraged. Often an independent insurance broker serving the firm will recommend that the practice wind down by reporting zero billings, renew the policy at the minimum premium for a few years, and then buy an extended reporting period which is based on the prior billings for a period of years. The extended reporting period is then less expensive since it is partially based on the zero billings years. Many carriers, however, will not allow this practice because it prevents them from accurately capturing an adequate premium for the exposure of past projects that would be carried over into the extended reporting period.

Options Require Discussion and Consultation

Any design professional anticipating a change in practice or the termination of practice needs to carefully examine the options available with the professional's insurance advisor and, through the insurance advisor, with the underwriter who provides coverage for the firm. Design professionals who work through their independent insurance broker can explore your policy options available through your design professionals program. Often, multiple options that can address most of the concerns of retiring professionals and those transferring their practices to others are available, you just need to discuss with your insurance advisors to find the options best for you and your firm.

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