

## Mergers, Acquisitions, and Dissolutions

The business context for the delivery of professional services is constantly evolving. Perhaps one constant form of change is the purchase (**acquisition**) of an ongoing practice, the consolidation (**merger**) of firms, or the “winding down” (**dissolution**) of a practice. Often, decisions on the techniques used to accomplish such changes ignore possible professional liability exposures and the role of professional liability insurance in protecting the parties involved.

Mergers and acquisitions typically include legal agreements that take into consideration the consequences of professional liability issues. As some firms rush into vertical integration and others seek diversification as survival techniques in an increasingly competitive environment, insurance coverage and claims history are often overlooked until deals are being finalized. Firms may seek greater absolute size, broader capabilities, a stronger competitive position, and greater potential for long-term profitability, but they may also assume unrecognized and unmanaged risks.

### Insurance Concerns in Mergers and Acquisitions

Any purchase or merger is a complicated process. The structure of the acquisition results in new tax consequences and liability—especially professional liability—for the buyers and sellers. Unless care is taken,

there may be assumption of liabilities by the new entity for which there may not be coverage. A professional liability insurance company only assumes those liabilities to which it has specifically agreed. In the absence of an insurer’s agreement, the successor firm will have no insurance coverage for any of the tort liabilities of the predecessor.

Insurance companies base premiums on known situations: the exposure of firms is based on size, revenues, disciplines, loss records, and other attributes. The basic rule is that an insurer will not accept risk without the opportunity to review and approve the situation and make any necessary changes in its underwriting. Although the CNA policy includes automatic coverage for new subsidiaries during the first 90 days following an acquisition or formation, that coverage is only interim protection while coverage options are explored.

Principals of the firms involved in the merger or sale, as well as their legal counsel, should be extremely careful to consult with brokers and insurance carriers to determine how best to make certain that no party is without the coverage intended, expected, and needed. Proper planning in the beginning can help avoid major problems at the end of a deal.

### Mergers, Acquisitions, and Consolidations

Although terms for combining companies are often used interchangeably, there are distinctions. A **merger** is a

combining of two businesses in which one survives and the other loses all or part of its identity. An **acquisition** generally comes about when one firm gains effective control of another firm through a financial transaction.

**Consolidation** is the complete fusion of two or more entities into a new company.

In instances where one firm expressly agrees to assume the debts and liabilities of another, or when the successor implies that it will pay the debts of the predecessor under the contract of sale or merger, the insurance policies of the successor firm do not cover the additional assumed liability unless the insurer issues an endorsement for the successor's policy. And if the predecessor firm's policy is transferred to the successor firm, a court will hold that the successor intended to assume the predecessor's tort liability. Courts, however, will give full effect to a contract provision that clearly negates the assumption of liability.

When a successor firm is a mere continuation of a practice, courts will infer a *de facto* merger. This is often evidenced by retention of the same management, personnel, assets, and physical location. Indeed, if the seller yields the right to use its name to a successor firm, a court probably will find a continuation. In addition, if services are continued—for instance, if a successor firm continues the construction phase services of a project designed by the predecessor firm—the successor may be found to only be a continuation of the predecessor and responsible for its liabilities. A transfer of cash rather than a transfer of stock for assets usually indicates that a continuation is not intended.

The merger of firms is often implied if the selling firm discontinues its existence. However, if a selling firm retains a sufficient sum to cover the costs of contingent liability, it is unlikely that a court could construe the sale to be a *de facto* merger. Thus, both parties to an acquisition may want the original firm to continue professional liability insurance coverage during a longer period of dissolution.

Most corporate acquisitions involve either the purchase of the target company's stock—in which case the buyer assumes all of the assets and liabilities—or the purchase of selected assets. Again, due diligence is necessary to uncover hidden risks and structure purchase agreements to properly judge the cost of contingent liabilities, such as professional liability claims. The only way to acquire a sole proprietorship is through an asset purchase arrangement, but this does not necessarily mean the transfer of liabilities. Again, the advice of insurance and legal counsel before the transaction is arranged is vital to bring the maximum value to both parties in the deal.

The most common and efficient method of accommodating the combined risks is through a single policy. Some details of the policy are imperative. For instance, all predecessor firms should be named, along with the continuing entity, to provide coverage for their services and, parenthetically, their principals and employees. Other important policy details are discussed below.

- **Limits of Liability Insurance Coverage:** In a situation where a prior firm is not legally terminated, the potential exposure to be covered by the operating policy after the merger or acquisition is greater than the exposure under either of the individual policies. The limits of coverage should be increased in light of the increased potential liability arising out of combining not only the individual prior acts, but the increased risk arising out of the combined present and future exposures.
- **Deductible Obligations:** The deductible for the ongoing practice needs to be sized to accommodate the prior acts of both firms involved. Consideration needs to be given to the impact of the deductible obligation on not only the current combined practice, but also on the expanded practice of the united firms. There is also an increased potential for claims from the prior practices of each.
- **Prior Acts:** With claims-made insurance coverage, a policy must be in effect at the time when the wrongful act was committed and at the time the claim was made. Therefore, prior acts consideration is one of the most important negotiation issues to be addressed. These are the specific issues needing resolution with the assistance of insurance counsel and underwriting expertise:
  - › **Deductible:** Once the union is accomplished, any claim arising out of services rendered prior to the merger or acquisition becomes an obligation of the new entity. The merger or acquisition agreement should accommodate and define this issue.
  - › **Cost:** The cost of prior acts coverage within the ongoing entity's policy will depend on circumstances that can vary significantly. From an underwriter's perspective, a simple rule of thumb is to consider what would be done if the united firm submitted a new business application.
  - › **Claims:** When combining two separate practices under a single policy, the underwriter will need a five- to ten-year claims history to assess the additional risk being assumed by the merger or acquisition. This is no different from what would be required of a new business submittal.

Even though it may be more economical and efficient to have a single policy, the unified firm may wish to keep several policies in effect. An alternative to a single policy or the continuation of separate policies when one of the entities has been absorbed is a “retired partners” policy. This policy focuses on the continuing exposure of a firm no longer in active practice. It may be the most effective way to prevent the prior acts of one firm from being a burden on the continuing practice of the combined firms.

## Other Considerations

While there are many common considerations, there will also be some unique circumstances, such as:

- **Retiring Principals:** 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. This five-year renewable policy is not a problem if all predecessor firms are named. It may also be that the agreement requires notice to the retiring principals in the event of cancellation, non-renewal, or reduction of limits by endorsement. Another option is to purchase a separate policy to cover the continuing exposures of the retiring principal. In the merger agreement, a five-year policy may be purchased to cover the services provided by the retiring principal while at the merged firm. These policies for past services are renewable.
- **Potential Claims or Circumstances:** In all cases, the parties should be made aware of the importance of giving notice to their existing carrier of facts or circumstances that may give rise to a future claim. The merger or acquisition frequently places a potential claim burden on the entity continuing in practice. The notice and acknowledgement by the existing carrier must be accomplished before canceling the policy. Any claims or potential claims that are known at the time coverage is moved to another policy would not be covered by the new policy.
- **Services in Progress:** The merger or acquisition agreement should spell out who assumes the legal liability for services in progress. Clients need to be notified of and acquiesce in the arrangement.
- **Services Performed on the Same Project:** Mergers and acquisitions frequently involve firms of different



professional disciplines. It may be that both firms have rendered services on the same project. After the firms are united and covered by a single policy, they will no longer have coverage for claims of one against the other. If, for example, they had had cross-indemnity agreements that were otherwise within the scope of coverage, those agreements would no longer have coverage under the policy for the consolidated firm.

## Dissolutions

If professionals are providing services through business corporations, the dissolution of the corporation does not end the professional liability exposure. Professional liability may be attributed to the licensed owners 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 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.

- **Winding Down a Partnership Practice:** The activities of the partners after the dissolution must be examined. If all partners intend to retire and cease practice, then there are two distinct possibilities: the purchase of “retired partners” coverage, or 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. These policies cover the principals and any former employees.

- › Continuing the existing practice policy on a minimum premium basis will also protect any employee for the covered acts, errors, or omissions committed in the performance of professional services on behalf of the dissolved firm.

- **Separating a Partnership into Ongoing Practices:** Often in partnership dissolutions, the individuals constituting the partnership intend to continue practicing separately. Dissolutions in this scenario can be amicable or quite antagonistic. If amicable, the question of coverage for prior acts can be easily managed by one or another 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 practices. These new policies can cover their individual exposures from the previous firm. To maintain coverage for claims arising out of the services performed by the partnership, the principals can agree on a specific list of projects for which each is willing to respond. To operate efficiently, such list must be clear and all-inclusive.

In an antagonistic dissolution of a partnership, special care must be taken to recognize and accommodate the continuing professional liability risks for past services.

### Summary

Whether by merger, acquisition or dissolution, if there is a change in ownership or operation, the involved firms must consider how the change will impact their professional liability coverage. And that consideration is best accomplished by advance planning rather than as the deal is being settled.

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Victor Insurance Managers Inc. (fka Victor O. Schinnerer & Company, Inc.) recently filed in all U.S. jurisdictions to re-brand and change its name. This name change has become effective in almost all states while still pending in several states, which we expect will complete their approval processes shortly.

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