Practice Note No. 7-

Merger & Acquisitions- Professional Indemnity Insurance Implications

CAAV Practice Note No. 7

In this issue, we once again highlight a topic of key importance to those considering merger and acquisition activity, including where this might form part of succession planning.

Don’t Leave It Late!

The purchase or sale of a professional Practice is a major financial and commercial transaction for all concerned, and considerable time and effort will be spent on “due diligence”, particularly by the potential purchaser and its advisers, to ensure that both parties understand as much as possible about the financial, commercial and personal consequences of the proposed deal.

Unfortunately, the issue of Professional Indemnity Insurance (PII) or, indeed, the management of professional risk – is often not addressed until very late in the day, when most of the terms of the proposed deal have already been agreed, and someone then remembers that “we ought to tell our insurers”.

This is a mistake: the consequences of not considering the PII implications of a sale or acquisition can often be disastrous, as this is one of the problematic areas of PII cover.

As specialist Insurance Brokers, we can assist you through this process and provide you with practical advice before, during and after the completion of the legal contract, in order to ensure that your interests are best protected.

The notes that follow are intended to be a general guide only. Each transaction has its own unique features, and you would need to discuss with us, the details of any specific/proposed deal.

The Basic Starting Point: A Change in Insurance Risk

When a PI Insurer agrees to insure your practice, they are assessing the risk and basing their terms on the details you have provided (through your broker) of the history of your firm, its present and past activities and risk profile, its fee income and its claim record.

In simple terms, it follows therefore, that the acquisition of another business means that the underwriter has to re-assess the risk.

Insurers may conclude that there is very little change in risk and that no extra premium or terms are required; on the other hand, it may be decided that the risk has changed so fundamentally, that cover can no longer be provided.

In practice, most acquisitions will fall somewhere between these two extremes.

Before The Deal: PII and Professional Risk Due Diligence.

When a professional Practice is considering making an offer for another firm, it should explore what effect the acquisition might have on its own PII terms, its future PII claims record and, last but not least, its professional reputation.

The practice needs to undertake some detailed due diligence regarding the PII history and arrangements of the potential vendor, together with an exploration of its professional risk management and profile and then discuss further with its own PII Brokers.

Key information to request should include the following:

- A full copy of the current PII policy (or policies);
- A full copy of the last completed PII proposal form on which policy terms were based.
- A full history of the firm's ownership, including details of any previous acquisitions and who was responsible for the past liabilities of those acquired firms.
- A full and detailed claims record of the firm and its predecessors in business.
- Confirmation that all potential claims matters been notified to the current Insurers.
- Ensure you understand both the full range of the professional activities currently provided by the firm, as well as details of other activities that may have been carried out in the past and are not ascertainable from the information on the PII proposal form (if you are likely to be responsible for past liabilities as part of the deal).
- Details of the firm's current professional risk management procedures, including such key points as how work is allocated and supervised, agreement and recording of the client brief, ongoing file documentation and client reporting, peer reviews and complaints procedures.

Negotiating the Terms of the Deal: PII Implications

One of the key terms which impacts on the future PII insurance arrangements is determining who is responsible for the past liabilities of the acquired firm. This is a decision that should not be taken lightly: the assumption of past liabilities increases the purchaser's PI exposure going forward and it impacts directly on the future premiums you pay!

In all cases you should ideally send a draft copy of the sale and purchase agreement to your PII Broker as soon as you are able and ask for advice regarding the PII implications. If the purchaser is only acquiring the assets and goodwill of the other firm, then responsibility for past work usually remains with the vendor, who will need to arrange run-off PII cover for a reasonable period of time. *

A minimum of six years run-off is usually recommended, since this is the standard limitation period for a client to bring a claim against a professional firm under contract; however, longer periods of run-off cover may be more appropriate in some instances (e.g. construction related Appointments by Deed in particular): do consult on this.

*The RICS Approved Minimum Wording does afford an element of compulsory run-off PII cover (there may be additional cost) though this is very limited and will be of little benefit to most CAAV members' Practices.

Run-off cover is usually only available from the Insurer who is insuring the vendor firm at the time of the sale and then only on an annually renewable basis. On the other hand, if the purchaser is acquiring the liabilities of the vendor business, as well as its assets, it will need to insure the PI run-off.

This can be done in two principal ways:

- cover can be incorporated into the purchaser's own existing PII arrangements for an additional premium,
- alternatively, the purchaser can take over the vendor's existing PII policy and keep the run-off insured separately.

The latter option is generally more expensive over the period of the run-off, but it does have the advantage of ring-fencing the acquired firm's past liability exposure. This may be useful if the terms of the deal include a requirement for the vendor to pay for the cost of the run-off cover.

Sometimes the terms of the sale and purchase agreement are rather vague about responsibilities for past liabilities and their insurance; e.g. the terms may make the purchaser responsible for arranging the run-off cover even though the past liabilities are not being assumed legally.

Armed with the key information highlighted in the 'Before The Deal' section, together with a copy of the sale and purchase agreement and the parties' intentions regarding the insurance of the past liabilities, the PII Broker will be able to obtain premium indications from the current Insurers and to make recommendations for the handling of your PII affairs going forward, prior to the final sealing of the deal between the two parties.

Completing the Deal: Tell the Insurers and Monitor the Position

Once the sale or purchase has been agreed, both parties will need to tell their PII Broker/Insurers in order to give immediate effect to the legal agreement and to protect the appropriate interests. Do this before absolute finalisation of the deal – don't risk a gap in cover.

Obligations to keep ongoing or run-off PI cover in force should be properly monitored to ensure compliance with the terms of the agreement.

Is your renewal due shortly?

To review your existing insurance and see how our facility could benefit you, please get in touch to schedule an introductory call.

Not ready for your renewal?

Simply drop us a quick email with your renewal month and we will be in touch closer to the time.

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