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## **A/E Firm Mergers & Acquisitions: Pitfalls to Avoid**

Navigating the complexities of Mergers and Acquisitions (M&A) involving design firms can often feel like trying to orchestrate a symphony amidst a pile of rubble. However, a beautiful symphony can be had with appropriate strategies and insights. It is of vital importance the firms involved have qualified legal and insurance assistance before beginning this journey. Not all lawyers nor all insurance agents possess such qualifications. This newsletter delves into the key insurance considerations of M&A and provides a guide to ensure smooth and successful transactions. Failure to properly address these issues can result in significant, uninsured losses.

### **Understanding the Basics**

#### **Key Terms:**

1. **Asset Purchase:** This involves acquiring some or all of a company's assets without taking on its liabilities. It's a way to gain valuable assets while avoiding potential legal and financial burdens.
2. **Stock Purchase:** In this type of acquisition, the buyer acquires all assets and liabilities of the purchased company. This method provides complete control over the acquired company but includes its existing obligations.
3. **Merger:** This occurs when two or more companies combine to form a new entity. Mergers can, if done correctly, create synergies and enhance market presence, but they do require careful integration planning. Failure to plan appropriately often can lead to disaster or, at best, a mediocre new firm.

### **The Stages of an M&A**

The M&A process can be broken down into several critical stages:

1. **Target Evaluation:** This initial stage involves identifying potential acquisition targets that align with the strategic goals of the acquiring company. Factors such as market position, financial health, and cultural fit are considered.

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2. **Due Diligence:** This is a thorough investigation conducted to verify the accuracy of the information provided by the target company. It involves reviewing financial records, legal documents, and operational data to identify any potential risks or liabilities.
3. **Valuation & Offer:** Once a target is identified and due diligence is completed, the next step is to determine its value. This involves financial analysis and due diligence to assess the target's worth. An offer is then made based on this valuation.
4. **Agreement:** After the offer is accepted, the terms of the acquisition are negotiated and finalized. This stage includes drafting and signing the purchase agreement.

## The Role of Insurance Brokers

Bringing in your insurance broker early in the process can significantly enhance sound decision-making and protect stakeholder interests. Experienced insurance brokers are no less integral to the firm's advisors than an experienced attorney. Their knowledge of insurance products and first-hand experience in M & A can mean the difference between success and failure.

- **Identifying Potential Risks:** Brokers help identify and assess risks associated with the acquisition, including financial, legal, and operational risks.
- **Mitigating Legal & Regulatory Risks:** They ensure compliance with relevant laws and regulations, helping to avoid legal pitfalls.
- **Preserving Value:** Brokers work to preserve the value of the acquisition by negotiating favorable terms and conditions.
- **Ensuring Smooth Integration:** They facilitate the integration process, ensuring that the acquired company is seamlessly incorporated into the acquiring company's operations.
- **Enhancing Decision-Making:** Brokers provide valuable insights and advice, helping decision-makers make informed choices.
- **Protecting Stakeholder Interests:** They ensure that the interests of all stakeholders, including shareholders, employees, and customers, are protected throughout the M&A process.

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## Risk Management

With a design professional M&A, handling policies with prior acts is crucial to ensure comprehensive coverage and mitigate potential liabilities. Prior acts coverage, often referred to as “Full Prior Acts,” allows the acquiring firm to assume responsibility for claims arising from services provided by the acquired firm before the acquisition date.

This is particularly important in the design industry, where projects can span several years and claims may arise long after the work is completed. To effectively manage this, the acquiring firm should integrate the acquired firm’s prior acts into their existing insurance policy, ensuring continuous coverage without gaps. This approach not only provides financial protection against historical claims but also facilitates a smoother integration by maintaining consistent insurance terms and limits. Additionally, it is often more cost-effective than purchasing an Extended Reporting Period (ERP) for the acquired firm’s previous policies. By carefully evaluating and incorporating prior acts coverage, design professionals can safeguard their merged entity against unforeseen liabilities and maintain a stable risk management framework. Effective risk management is essential in M&A transactions. Key areas to focus on include:

- **Professional Liability:** This insurance protects against claims of negligence or inadequate performance by professionals. It’s crucial for firms providing specialized services.
- **Directors & Officers (D&O) Liability:** This covers the personal liability of directors and officers for actions taken in their official capacity. It protects against claims related to mismanagement, breach of fiduciary duty, and other allegations.
- **Employment Practices Liability (EPLI):** This insurance protects against claims related to employment practices, such as wrongful termination, discrimination, and harassment. It’s important for maintaining a fair and compliant workplace.

## Insurance Considerations

Several types of insurance are involved in M&A transactions, particularly in tail coverage. It’s important to:

- **Obtain Copies of Current Policies:** Review the existing insurance policies of the target company, including professional, management, and business policies.

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- **Review Last Completed Applications:** Examine the most recent insurance applications to understand the coverage and any changes made.
- **Understand Any Losses in the Previous Five Years:** Assess the loss history to identify potential risks and liabilities.
- **Ensure Brokers Are Communicating Effectively:** Facilitate communication between brokers to ensure a smooth transition and integration of insurance coverage.

## Non-Disclosure Agreements (NDAs)

NDAs are critical in protecting sensitive information during the M&A process. Ensure that all parties involved have signed NDAs early in the process to maintain confidentiality and protect proprietary information.

## Extended Reporting Period (ERP) vs. Stand-Alone ERP

Understanding the differences between ERP and Stand-Alone ERP is crucial:

- **ERP:** The Extended Reporting Period (ERP) is an extension of the current policy limits, covering claims made for prior acts before the ERP was purchased. It typically lasts 1 to 3 years, with premiums determined by the carrier. ERP provides refreshed limits but usually does not include loss prevention measures.
- **Stand-Alone ERP:** This creates a new policy for coverage, separate from the existing policy. It covers claims made for prior acts before the tail coverage was purchased. Stand-Alone ERP is a separate policy with its own limits and premiums, often providing more comprehensive coverage.

## Work In Progress (WIP) – How do we handle WIP in the context of Tail Coverage?

Recommendation: Provide a list of WIP where the new policy picks up the WIP, from start to finish; old policy to exclude projects. Think about this: If there is a claim, do you want two carriers, policies, limits, and deductibles involved? Or just one?

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Handling WIP in the context of tail coverage requires careful consideration. It's recommended to provide a list of WIP where the new policy picks up the WIP from start to finish, excluding projects from the old policy. Key items to include are:

- Project Name and Number
- Total Contract Value
- When Services First Began

## Case Studies

The following examples, brief though they are, illustrate potential problems and how to successfully address them.

### Case Study #1: ERP Coverage

*Scenario:* An architectural firm opted for an ERP when canceling its policy. A year later, they were sued for alleged design flaws in a high-profile commercial building they had designed.

*Challenge:* The firm's professional liability insurance had ended when they closed the business, leaving them vulnerable to claims.

*Solution:* The ERP allowed them to report the claim during the extended period, ensuring that the lawsuit was addressed and avoiding potentially crippling out-of-pocket expenses.

*Fun Fact:* Most professional liability policies include an Automatic Extended Reporting Period that provides a short period of extended reporting (perhaps 30-60 days) for no additional premium if a policy is canceled or non-renewed by the carrier for reasons other than non-payment. Many firms will purchase a longer ERP than that provided in the policy, believing the additional fee is well worth the longer reporting period.

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## **Case Study #2: Stand-Alone ERP**

*Scenario:* An engineering firm secured a 3-year Runoff policy after merging with another design firm. Prior to the merger, they had incurred a significant loss, depleting a portion of their policy limit.

*Challenge:* A large claim was made two years after the merger, exceeding the remaining policy limits.

*Solution:* The Runoff policy refreshed its policy limits, allowing the carrier to respond to the full damages within the Runoff's policy limit.

*Fun Fact:* Availability of Runoff Coverage varies in the market, and carriers may be unlikely to offer this option, particularly if a firm has incurred substantial loss activity previously.

## **Case Study #3: Prior Acts Coverage**

*Scenario:* An architectural firm was acquired by another design firm via a stock purchase. Rather than purchasing an ERP, the acquired firm was added to the new firm's policy with Full Prior Acts coverage.

*Challenge:* A claim was made six years after the transaction, alleging negligence on a project completed seven years ago.

*Solution:* Full Prior Acts coverage ensured the availability of coverage for the older project work, addressing the allegations effectively.

*Fun Fact:* The cost to add a firm with Full Prior Acts can often be more cost-effective than purchasing an ERP.

## **Conclusion**

Tail coverage and ERPs are essential in providing protection against pre-acquisition liabilities. While assuming prior acts can be cheaper, it may also be more problematic. The goal is to mitigate financial risks long-term, ensure a smooth integration, and preserve the firm's reputation. Navigating the complexities of a successful M&A requires a strategic approach and a thorough understanding of the various elements involved, including legal and insurance. By focusing on risk management, effective use of brokers and legal counsel, and understanding the nuances of insurance coverage, firms can achieve a harmonious and successful merger or acquisition.