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PROFESSIONAL LIABILITY DEFENSE QUARTERLY

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LAW FIRM MERGERS: ETHICS/INSURANCE COVERAGE CONSIDERATIONS, BY: JODY HARRIS, R.P.L.U., ALICE M. SHERREN, ESQ., AND DONALD PATRICK ECKLER, ESQ.

The merger of two or more law firms can be exciting and hopeful. However, merging firms should not ignore the potential for increased legal malpractice and ethical risks that may come along with the new endeavor. If your firm is considering joining forces with another, here are some pointers to help keep your risk in check.

Why Firms Merge

Generally speaking, the larger the firm, the higher the revenue per lawyer and profit per partner. Many suppose this is because clients believe, whether rightly or wrongly, that bigger firms have superior talent and that the reputation of a "BigLaw" firm will give the client an advantage over a comparatively unknown solo practitioner or small firm. In addition, many clients seek out firms with a presence in more than one geographic area so they can use the same law firm regardless of jurisdiction.

With this in mind, firms often seek to merge with other established firms to expand their client base, breadth of services offered, or locations in which they can provide service. For some, the perfect merger would be with a firm that already provides similar expertise; the goal is to increase the size of the firm. For others, merging complimentary practices is the goal; a transactional firm merged with a litigation firm would mean neither would need to refer work outside the firm. For still others, the motivation for a merger is the opportunity to provide service to current clients in a city or area where the larger firm does not currently provide service.

When Merging Firms and Malpractice Meet: Conflicts

Once a firm has merged, however, it is not just the profits that may increase. Merged firms may face higher malpractice risks in part because of increased conflicts. Conflicts are among the most common basis for legal malpractice claims. Some firms may attempt to minimize potential conflicts to ease the merger or to avoid losing important clients. Failing to investigate, ignoring altogether, or overlooking by conducting an inadequate conflict check can lead to costly malpractice claims as a result of actual or potential conflicts.

It is imperative that lawyers and law firms who seek to merge with others fully and honestly identify actual and

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potential conflicts and obtain informed waivers from all affected or potentially affected clients. Consulting with outside professional liability counsel to determine whether a particular situation is a conflict under the Rules and whether a waiver is required may be a prudent step to both identify conflicts and properly resolve those that exist.

If conflicts are too great, the merger may not be in anyone's best interest. For example, even if concurrent representation of certain clients does not rise to the level of an actual conflict, perceived conflicts if a merged firm now represents clients who are business competitors, or who are on opposite ends of a public issue, can also increase the risk of malpractice or ethical complaints being brought against the firm. The "business conflict" can be almost as problematic in terms of client relations as can be actual conflicts barred by the Rules.

In the insurance defense firm context, some firms take the position that they will never represent insureds in coverage disputes or plaintiffs in personal injury suits, whereas others take on such work if the chance of success is sufficiently high and worth the investment and risk to other aspects of their business. Each firm's philosophy in handling such work should be considered during merger discussions as it relates to future work for some partners who have made that work an important part of their practice. In addition, the interests of clients who may have to be referred to other lawyers should be central to those discussions between the firms considering merger.

Firm Organization

In addition to addressing conflict issues, from a practical perspective, merging lawyers and firms need to ask and answer the hard questions, and not assume that everything will work out in the end. Will existing partners in the merging firms continue to be partners in the merged firm? Who will be the equity or capital partners? How will the partnership be structured? Will it be an LLC, a PLLC, a corporation, or a partnership? What are the book of business requirements for existing and new partners, and who gets to decide on profit sharing? How will new partners be admitted to the firm? If certain partners or associates opt out of the merger, how will their client files be transferred, assuming their book of business chooses to go with them? How will money owed for leases or utilities be handled going forward? If the firm will have income from a number of states, how will state income tax be handled if there is profit sharing among the partners?

Defense and Insurance Considerations of a Merger

It is also essential that the merged firm has appropriate malpractice insurance given the changes in number of attorneys, practice areas, and size and sophistication of cases. Merging firms should be certain to discuss their newly formed firm with their respective malpractice carriers and brokers. A change in the type of work being done, the jurisdiction in which it is being done, and the loss history of the attorneys doing the work all could affect the appetite of certain insurers for the risk and the premium to be charged. The firms should also discuss the procedure the newly conceived firm will employ for determining if claims have been made or if potential claims have been advanced. Make sure questions related to potential claims are identified in applications for insurance to put the firm in the best position to have coverage and to avoid rescission of the policy.

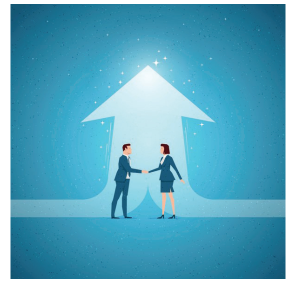
There may be several options of malpractice insurance coverage available to firms. The first step is deciding which firm's insurance broker is the one to vet those options for a firm and be the broker for the new firm. It may be the acquiring firm's broker who performs that function, but it doesn't have to be. Many factors can be considered in making this decision, such as which broker is better suited for the job due to professional liability insurance expertise, market relations and leverage and firm business relationships. Once the merged firm's broker is chosen, discussions of the options for insurance coverage have to be discussed.

Acquired Firm Purchases an Extended Reporting Period

The cleanest option, but what may be an expensive one, is for the firm being acquired to purchase the Extended Reporting Period (ERP) on their policy. An ERP extends the insurance policy currently in place for whatever terms of ERP are available on the policy and the firm decides to purchase. If the acquired firm is covered on an ERP, then the acquiring firm transfers the risk for malpractice claims from legal services before the firms were merged to the insurance carrier, subject to the limitations of the coverage available. This way the acquiring firm does not have as much risk for legal services they did not provide or control.

There are different types of ERP's or "tails" on policies (as commonly referred to in the insurance industry). A unilateral tail is only available if the insurer cancels or non-renews the policy. A bilateral tail is available if either the insurer or the insured cancels or non-renews the policy. The Extended Reporting Period usually allows the firm to cancel their policy and secure a return premium for the unearned portion of the policy period, minus a short rate premium penalty for cancellation by the insured.

Unfortunately, many times firms don't place enough importance on the Extended Reporting Period's options on their policy until they need them. These terms cannot be renegotiated mid-term on a policy, so it is wise for firms to understand them before they bind



> "The cleanest option … is for the firm being acquired to purchase the Extended Reporting Period (ERP) on their [malpractice] policy."

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coverage with a carrier.

Another feature of ERP's is the term and cost and which firm will pay for it. Several questions have to be asked to determine if it is adequate. Will the ERP term (length of time available to extend the policy) for the acquired firm cover the statute of limitations for legal malpractice for the states where the legal services were provided? Do the statutes of limitation in those states run from date of discovery of the wrongful act or from when the wrongful act occurred? Does the work provided include a long discovery period, such as estate work?

Often times insurance policies include notice provisions to carriers for when a firm acquires a new firm or group of attorneys from another firm or the number of attorneys at the firm changes in a material way. Understanding these terms of a firm's policy and complying with them is also critical in maintaining appropriate coverage.

It should be considered whether the ERP available has been eroded by claims that have been made and closed or is subject to erosion or exhaustion by claims that have not been resolved or potential claims reported on the policy. In some insurance policies the limit of liability on the ERP is partially or fully reinstated when purchased, but most often the ERP limit does not reinstate. The terms of the actually policy have to be considered as well as the claims/potential claims reported on the policy.

Normally policy limits are for a one year period, another consideration is what limit is available on the ERP is that the limit is spread over a time period of one year to an unlimited period, depending on the terms available on the policy.

When the acquired firm purchases an ERP, they then should be added to the merged firm's policy based on date of hire to the firm. If individual underwriting is performed on a firm, the premium for the new attorneys would be at its lowest point because the insurance company is not picking up any exposure for prior legal services. The premium charge for these attorneys will increase however, as the exposure for legal services increases for the firm.

Finally, in the current marketplace, the firm may also be able to purchase a clean limit of liability on a standalone ERP from a different insurance carrier. It is worth the time to explore options in the marketplace to compete with terms available on the firm's insurance policy.

Acquiring Firm Adds of Prior Acts Coverage for Acquired Firm

The acquiring firm's insurance carrier may be amenable to adding the prior acts of the acquired firm to the merged firm's policy. How much they will charge for this increased exposure will depend on individual carrier.

When choosing this option, it is important that firms appreciate they may be taking on risks beyond increased premium costs. The risk of taking on the liability on their policy of legal services performed outside their control need to be considered. What about the legal services of attorneys who are no longer with the firm? Was there a "problem" lawyer who is no longer with the current firm, but whose prior acts will be picked up as well? Policies cover the prior acts of current and "past" attorneys, so consider how many attorneys were at the firm prior to the merger and who they were when making this decision. Also think about whether there were prior areas of practice that increase the risk for severe claims.

A firm should understand not only the terms of the ERP on their insurance policy, but the following important definitions: Named Insured, Insured, Predecessor Firm, Successor Firm. These definitions and others are important in determining coverage. If an acquired firm does not meet the definition of Predecessor firm on the policy for example, it may be necessary to specifically add the prior firm entity by endorsement. Coverage language will determine who is covered and who isn't.

It is vital for the combining firms to obtain clarity regarding: 1) how existing malpractice or ethics claims will be covered once the firms merge, 2) how malpractice or ethics claims which arise out of legal services provided prior to the merger, but which are made after the merger, will be covered, and 3) who is responsible for deductibles and premiums. Some legal malpractice insurance policies specifically provide that any lawyer insured by the policy is individually responsible for the deductible. Others simply state that "the firm" is responsible for any deductible. Be certain that you know what your legal malpractice insurance policy states, and that everyone in your firm understands the risk they may have for deductibles both as a firm and as an individual.

There might also be arrangements between the combining firms to defend and indemnify the partners of the other in the event that a claim that arises out of work that occurred prior to the merger. The advantage of such an arrangement is that it prevents the pointing of fingers in the malpractice litigation that would principally benefit the underlying plaintiff. Should there be an adverse outcome or a settlement on the underlying lawsuit, the firms could then resolve apportionment in subsequent litigation or arbitration. Any arrangement of this sort would have to be pre-approved by insurance underwriters and claim personnel.

Other Concerns

The effective date of merger affects conflicts, tax obligations, insurance coverage, pension and retirement

PLDQ's Winter 2018 Issue

We encourage member submission of articles pertinent to professional liability claims administration, defense trial advocacy, or professional liability substantive law. The manuscript deadline for the next issue is:

February 1, 2018.

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obligations, and other legal obligations. All involved lawyers should be certain that they have obtained and maintained appropriate insurance for both pre- and post-merger acts.

If technological and administrative systems are changing, be certain everyone understands how the current system works to avoid calendaring mistakes or missed deadlines. This may involve a change in firm name or substitution of counsel being filed in a given case. Failure to ensure all lawyers and staff are properly trained on the system can lead to increased risk for ethical and legal malpractice issues.

Clients of the new firm should also be contacted and advised of the merger. As engagement letters are generally not transferable, new engagement letters likely need to be executed so that it is clear to the client who is representing them. In the insurance defense context, insurer clients will need to be advised and billing procedures will need to be addressed to make sure that bills in conformity with guidelines are issued moving forward.

Trust account administration is an issue that must be paid special attention to. Bar regulators look closely at trust accounts to make sure that client funds are properly accounted for and protected. How any retainers are to be handled by the combined firm should be closely monitored by the lawyers responsible for the matters in which retainers have been paid.

Conclusion

The optimism that rightfully accompanies a merger should not obscure the critical and fundamental issues that should be addressed when consummating a merger. Mitigating the risks of conflicts, appropriately handling insurance issues to address specific risks, and administrative issues to preclude simple errors can be the difference between a successful merger and an unsuccessful one.

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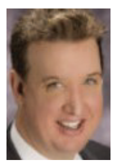

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"[J]uries submit to hindsight bias when they find doctors liable for failing to notice the presence of a condition that would have been very difficult to notice [at the time]."