coverstory

The newsletter of Hammond Professional Indemnity Consultants

Focus on run-off | **two**

Like any other business, professional practices are subject to change. When that change leads to a closure of the practice, professional indemnity insurance cover is crucial to protect against claims which may continue to arise after the practice has ceased trading. This is particularly important when the principals or partners go on to form other businesses, or when one partnership merges with another. Here, we take a look at the run-off cover options.

run-off to move on

Run-off cover is a professional indemnity insurance policy which comes into effect when the insured stops trading, and any claims made under it relate to work carried out before the policy was incepted.

When a business closes fully, a run-off policy is generally the only way to cover the liabilities that ensue post-closure. Where a business ceases trading for another reason, such as the dissolution of a partnership or the merger of the business with another, partners or directors will often continue to require cover for their new business activities, and this is when other options may need to be considered in detail.

It is always important to ensure that the correct type and level of cover is put in place as a failure to act could leave individuals open to personal loss.

Hammond PI regularly advises clients involved in the closure of businesses on how best to proceed, and a number of run-off options are summarised overleaf.

What **are** the options?

In this fictitious example used to illustrate possible alternatives, ABC Partnership merges with XYZ Ltd to form Alphabet Consultancy Ltd. ABC Partnership has no claims history. However, a claim was made against XYZ Ltd a few years ago. In this and similar situations, there are essentially three options to consider:

Option 1

Either of the two established businesses could ask its existing insurer to amend its policy to cover the new business. In this case, the policy previously held by XYZ Ltd is chosen to provide cover for XYZ Ltd and Alphabet Consultancy Ltd. ABC Partnership continues with its policy until renewal but then asks the Alphabet Consultancy insurers to provide partners' previous business cover for the partners of ABC Partnership going forward. This would be pre-agreed by the insurers of XYZ Ltd at the point of amending their policy to include Alphabet Consultancy Ltd.

Option 2

Each of the two merging companies inform their respective insurers that they have formed a new business and that they wish their polices to be placed into run-off. Their policies will then continue until renewal providing cover for work undertaken prior to the run-off date. Run-off cover would be maintained by each party through the continued renewal of the policies in run-off for the desired period, generally six years. Alphabet Consultancy Ltd would then take out a new policy providing cover for all work undertaken by that business only.

Option 3

This is a combination of the first two options. If XYZ Ltd was the predatory company merging ABC Partnership into its business as an acquisition, it may not wish to risk inheriting claims relating to work carried out in the past by ABC Partnership. In this case XYZ Ltd would simply advise its insurers of the change of name, the introduction of the new directors and the change to the firm's business activities and fees. The policy would be amended accordingly and a mid-term premium increase may be requested to reflect the inevitable increase in the firm's turnover.

The insurer may also ask for more premium if the activities of the business become a higher risk as a result of the merger. In this instance ABC Partnership would advise its insurers to go into run-off and would maintain this run-off policy for six years or more.

Pros and Cons

An advantage of the first option is that it is likely to be the cheapest, largely because all elements are combined. On the other hand, an insurer may judge that the claims history of one of XYZ Ltd warrants a premium loading, which could impact on the cost of cover for the new consultancy.

If a claim is made against Alphabet Consultancy Ltd in respect of work undertaken by one of the previous companies prior to the merger, the resulting increase in premiums will impact on the new business. This may not be desirable as far as the directors of the previous business are concerned.

It is worth noting that a partner's previous business insurance extension is not the ideal way to deal with a previous exposure to claims, particularly where a number of partners may have dispersed. If previous partners fail to maintain their own run-off cover, the whole liability could fall on a partner who does. As this is clearly not the basis on which the insurer would have underwritten the risk, insurers tend to be very wary of such extensions.

Option two is the cleanest way to proceed, however the cost could be high, while the third option would certainly suit the predatory company - particularly if, as part of the merger, it was negotiated that the principals of the acquired business paid for the run-off premium for that business. This would mean that the directors of XYZ Ltd (now directors of Alphabet Consultancy), need not concern themselves over bringing a history of claims. The use of a single premium six year policy can be beneficial in this instance.

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