

Legal Primer for Independent Consultants

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Prepared for:
Succeed in Actuarial Consulting:
Legal and Business Tools for the Solo & Small Firm Actuary

Society of Actuaries 2007 Annual Meeting
Washington, D.C.

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Many of the materials included in these materials first appeared in or are adapted from the Independent Consultant Newsletter, published by the Entrepreneurial Actuary Section. The newsletter is a great resource for an actuary who must depend on him or herself to succeed, and subscriptions are free for members.

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I. Choosing an Entity

A. The LLC Is the Entity of Choice

If you are forming an entity through which to conduct a consulting practice, you will probably want to set up a limited liability company or LLC. Like a corporation, the owners of a LLC are not personally liable for the obligations of the entity. Unlike a corporation, however, there is no income tax payable at the entity level. All the income and other tax attributes flow through to the owners like it was a partnership. Also, unlike in the past, a LLC can offer as generous retirement benefits as a corporation. Depending on the ethics rules that apply to the area of consulting in which you are operating, you may need to set up a limited liability partnership, which is the same as a LLC except that liabilities for each owner's professional malpractice flow through to that owner. Other liabilities of the entity, however, remain with the entity.

B. What about a sole proprietorship?

If you have a small part-time consulting practice, you may think you need to set up a corporation or limited liability company. Anyone who spends more than five to ten hours a week consulting, or who has a partner, should take the plunge and set up an entity. But what if you have a client or two? What are the benefits and drawbacks of setting up a business entity?

The pros and cons of various entities are discussed below, but for purposes of this section, we'll assume you would set up a limited liability company, or LLC. LLCs give the protection from personal liability of an entity, but are taxed on a pass-through basis like a partnership. The factors we will be discussing, however, generally apply to all types of business entities.

- Cost to establish. Setting up an LLC is usually not expensive. In Connecticut, it costs \$60. You probably do not need a lawyer if you are setting up a single member LLC.
- Continuing Costs. In Connecticut, there is an annual tax of \$250 - \$300 for most business entities. Annual or biennial reports, along with a \$75 annual fee, are also required. Your state probably has similar fees.
- Taxes. Setting up an LLC will also bring you to the attention of the state and local taxing authorities. You can expect that the agency that administers any sales tax in your state will contact you shortly after you form the entity. We do not advise dodging sales tax when you know it is due. The issue of sales tax on professional services is frequently a disputed question, though. If you have a good faith argument that your services are not subject to sales tax, it makes sense to avoid even having a discussion of the issue if you can avoid it.

- Limitations on Personal Liability. The primary benefit of an LLC over a sole proprietorship is that it shields you from personal liability for the obligations of the entity. This may not be a benefit to most casual consultants. Liability for professional malpractice in most states is usually personal, even if performed through an entity. Also, if you don't have an office that the public visits, or any open accounts with suppliers or service providers, there are unlikely to be other liabilities from which you would need protection. If you lease any office space or equipment, it is highly likely you will be required to give a personal guarantee anyway.
- Using a Trade Name. A trade name is a business name other than your own name. For instance, "Business Excellence" is a trade name; "The Offices of Roger Wilco, Consultant," is not. You can use an LLC to operate under a trade name. In most states, however, you can achieve the same thing by establishing a "doing business as" or a d/b/a. In Connecticut, you can do this by filing a Fictitious Name Certificate with the local land records office. If you have concerns about giving out your social security number out for tax identification purposes, you can get a tax identification number for a d/b/a separate from your personal social security number by filing a Form SS-4 with the IRS.

Creating more paper and complexity by setting up an LLC is not always necessary. Consultants who have a small practice, working for a few clients or less than ten or fifteen hours a week out of their home, may not need to set up any sort of entity.

II. Get the Deal You Expect: What You Need to Know About Contracts

A. Client Contracts

1. Business Issues

This topic covers the agreements you will enter into with your clients. These issues are relevant as well to those with an established practice, but in starting out, it is important to know what to look for when you are presented with a form contract by a future client.

Statement of Work. This is the guts of the agreement. If the statement of work is right, you are far along the path of making sure the agreement will work for you. Do you know exactly what you need to do at each stage of the project, and what the client is obligated to pay you at each stage? If the client terminates the agreement early, do you have the right to be paid for the work you have done at cancellation? What are the consequences of missing a delivery date? If there are firm due dates for deliverables, are there similarly firm dates for payment? If you are being paid at an hourly rate, does the agreement specify whether travel or any overhead expenses are covered? If travel expenses are to be reimbursed, is pre-approval of expenses required, and what type of back up is required? Does the statement of work incorporate all material terms of any correspondence regarding the deal? It is likely that once you sign a formal agreement, any agreements in correspondence or made in

conversations are likely to be unenforceable, so make sure everything is included in the statement of work or scope of work provisions.

Non-Competition and Non-Solicitation. Non-competition agreements restrict your ability to compete with your client. Non-solicitation agreements restrict your ability to sell to or service your client's customers. If you are performing consulting services directly for a client, no such clause would be appropriate, since it's unlikely that you will be competing with clients in this area. Such agreements are commonly included in boilerplate contracts, so they may be in the agreement even if they are not appropriate. If you are being hired as a contractor by a firm to provide services to its clients, you can expect such a provision.

If the client won't remove it or there are potential issues of non-competition, you need to determine whether it is going to be enforceable. Each state's laws vary, but such provisions are enforceable in most states, depending on their terms. Non-solicitation clauses are more likely to be upheld than non-competition clauses, particularly if they last only for the term of the agreement. Even if the provisions are probably not enforceable, the threat of even a baseless lawsuit can give your client an advantage in negotiating a resolution to any dispute, and can deter potential clients from doing business with you. The greater the restrictions on your right to do other business, either during the term of the agreement or on expiration of the term, the higher compensation you should receive to compensate you for any loss resulting from such restrictions.

Intellectual Property. If you are hired to create a deliverable, make sure that you will own it, and not the client, when the job is done. If the client "owns" it, you will have no further rights in the deliverable, and the company will be able to modify it, sell it or license it to others at will. If the contract states explicitly that the project is a "work for hire," then everything you produce will belong to the client. If the term "work for hire" is not used, you have a good argument that the client does not own the work.

If you don't intend for the client to own the work, and you hope to use it for future clients, make sure this is explicit, and that the words "work for hire" are not used. If the client won't own the product, you may have to negotiate a license and define the company's right to modify your product, sell it, or transfer it. Also, the agreement should set forth in an exhibit any existing intellectual property that is similar or related to the product you are developing for the client. You want to make sure that the client does not claim later that it is part of the "work for hire." If any of your preexisting intellectual property is used in the deliverable, you should expect to grant the company a non-exclusive, paid-up, perpetual and irrevocable license to use the intellectual property. You may want to try negotiating additional compensation to reflect the fact that the client is getting the use of this pre-existing intellectual property without having to pay for its development.

Choice of law and arbitration clauses. If the agreement has a choice of law provision that states that the law of another state will apply to the agreement, or that any dispute must be decided in a court of a distant jurisdiction, your cost to enforce the agreement will be much higher than if local law and courts will govern. If the agreement provides for arbitration of

disputes, try to have the arbitration be local, and decided by a single arbitrator. The initial costs of initiating arbitration are much higher than starting a lawsuit, so you want to try to keep the expenses as low as possible.

Term of the Agreement. Does the term of the agreement automatically renew unless notice is given prior to the conclusion of the term? What are your obligations and the client's obligations upon the expiration of the term of the agreement? If you will incur upfront costs, such as obtaining equipment or making financial commitments to other contractors, you should try to negotiate an upset payment if the client exercises a right to cancel the agreement early in the term.

Use of Contractors. If you are going to subcontract some of the work, the agreement may require that the company approve the contractor. If the subcontractor will be working at the company's site, you can expect to be required to provide evidence of liability insurance. Some clients may require that you have workers' compensation insurance, which is generally not difficult to obtain, but can be expensive for a new employer, depending on the state.

2. Professional Responsibility Issues

Introduction

By: David S. Rintoul

One of the most important ways to avoid professional responsibility and ethical issues is to use detailed engagement letters, which can be part of the client contract or a separate letter. Below is an article by Anna Rappaport and Lauren Bloom discussing issues that an engagement letter should address.

Engagement Letters to Help Run Your Practice Well

By Anna Rappaport and Lauren Bloom, ©2007 Lauren Bloom

The Basics

An important part of a successful consulting practice is having a clear understanding between the consultant and client about what is expected by both parties. Using an engagement letter is often an excellent way to document that understanding. This article will provide some information about what might be included in an engagement letter and suggestions on how to negotiate them with your clients.

The Code of Professional Conduct (Code) sets forth requirements with regard to Actuarial Services performed by an actuary and governs the relationship between the Actuary and Principal (the client or employer). The core of a typical engagement letter is a clear definition of what it is that the actuary plans to do for the client, how the compensation will be determined, and what the responsibilities of each party are. The description of the scope of the engagement is important so that both parties are clear on what they have agreed on. The Code sets forth some guidance as to how the actuary shall conduct the assignment.

While the guidance in the Code need not be repeated here, the actuary should comply with the Code whenever the actuary provides professional services to a client.

Compensation and scope are usually related. Compensation may be an hourly rate, a retainer, a fixed fee for a specific project, or some other basis. Where the compensation is on a retainer basis or a fixed fee, it is normally very important to include in the letter what is included in that fixed fee so that the client will understand exactly what the actuary will and will not do. It's also a good idea to specify any additional fees that will be associated with the engagement, for example, reimbursement of travel expenses, copying costs, or the cost of outside peer review. In addition to the type of work and additional fees involved, the actuary might wish to include items such as: how many drafts of the work will be provided within the fixed fee or retainer for review and comments. Anna usually provides for one or two drafts with revisions when writing something that the client will give input to, and then makes additional drafts available for an added charge. This can be particularly important if you are working on something that may get public distribution, especially if the client tends to provide many comments. Anna has had some past experiences where clients give multiple comments, sometimes asking her to include material and then asking her later why it was there. (Lauren has had similar experiences, and finds that providing drafts with tracked, dated changes identified by their author can help manage the editing process.) The actuary also may want to specify how many meetings (either in person or by conference call) are included for the fee provided, so that additional meetings beyond those anticipated when the project began would then involve an added charge.

The Nature of the Work – Actuarial or Non-actuarial?

An assignment might require the actuary to issue a formal actuarial opinion, or it might not. Standards apply to actuarial opinions that do not apply to other types of advice the actuary may provide. If the actuary is writing a report or doing research for publication, the client may be providing editorial services. Anna's approach is to make clear that she expects that kind of editorial support. Lauren agrees that it's often a good idea to have editorial services available to support actuarial work, especially if it is anticipated that the work will be published. The actuary can ask the client to provide editorial support, or retain an editor and pay for the editorial services or build them into the price of the engagement. Where something is going to be published with the actuary's name on it, it is important for the actuary to retain final sign-off of the version to be published. Where something is published, is not an actuarial opinion, and does not have her name on it, Anna provides input but the client may decide what they want to publish. Lauren would caution, however, that if the actuary is concerned about the accuracy or completeness of the client's version, the actuary may want to reserve the right to withdraw from the engagement prior to publication.

Timing and Communication

The engagement letter also usually includes a schedule for when the work is to be done. If the work requires exchange of information between the parties, the actuary may wish to specify the completion date in terms of elapsed time after the actuary gets information rather than a fixed date. It's also often a good idea to include some idea about milestones within a project plan so that both parties can see how things are going along. If a project involves asking for information/asking questions along the way, the actuary may want to provide a normal response time (one day vs. three days, etc.)

Another critical part of the scope is how the actuary and the client expect to communicate with one another. Anna recommends that, if work is mostly going to be transmitted by e-mail and there are not going to be in-person meetings, this be specified up-front. It is nice to meet people face-to-face, but often they may be far away and in-person meetings can be time-consuming and expensive. Lauren thinks it is usually wise for the engagement letter to specifically describe the level of reliance on the client that the actuary expects and to require the client to identify a contact person to whom the actuary can go with questions and requests for information. It may also be advisable to state in the letter that the actuary may not be able to complete the engagement without the client's full support. If the actuary is working cooperatively with the client and the client's attorney, or with the client and another actuary, the engagement letter usually should address the cooperative relationship and explain how the actuary expects to proceed. If the actuary expects to be able to contact the prior actuary, the engagement letter is a good place to state that expectation. It is probably also prudent to identify who will receive the work product on the client's behalf. If the actuary wishes to reserve the right to meet or speak with a specific individual or entity (for example, the President or Board of Directors of a client company), the engagement letter is a good place to make that desire clear.

Are You an Expert or a Vendor?

Larger organizations hire a variety of outside people, some of whom are considered experts and others who are considered vendors. They often have purchasing departments who deal with vendors and have standard contracts that apply very poorly to your situation. At times they may provisions that you can not or are unwilling to meet in these standard vendor contracts including broad indemnification, requirements for large amounts and various types of insurance, etc. While the adverse consequences that are possible under these indemnification clauses are often very remote, they create risk for the actuary if he or she accepts them.

For the individual practicing on their own, these conditions may be unacceptable. It is important in such situations to be viewed as an expert, or it may be very difficult to reach agreement.

Matching the letter to the assignment

It would be nice to have a standard letter that could be used regardless of the situation. However, there are very different situations including the following:

- Working for an individual vs. working for a plan sponsor vs. working for an insurance company vs. working for a professional association, or working as a subcontractor
- Providing a statement of actuarial opinion
- Doing calculations where the client supplies the data
- Doing research/calculations where all information comes from public sources or third party sources
- Giving a speech
- Writing an article for publication
- Providing peer review of someone else's work

- Serving as an expert witness
- Providing advice on a research project where you are not the primary researcher

The description of work in the engagement letter usually should be tailored to the specific nature of the engagement and expected work product. Lauren observes, however, that the actuary may choose to keep the more general provisions of the actuary's engagement letters essentially identical.

Other things to think about

To keep life simple, it would be easy to stop with the core of the engagement letter. However there are other issues that the actuary is usually wise to consider. Some of the issues to think about are:

- How professional liability is managed in the actuary's practice
- If speech material being written can be posted on the actuary's website
- Whether there are any restrictions with regard to working for competitors
- Who will do the work and whether the actuary might be partnering with someone
- Who, other than the client, will see the actuary's work? To what extent will third parties foreseeably rely on the actuary's work product? Is the client willing to indemnify the actuary against third-party claims?
- Is the actuary's work such that it can only be relied on in its entirety? If not, to what extent is the actuary comfortable with having the work excerpted?
- Will outside peer review be necessary? If so, who will pay for it?
- What happens if the client decides to switch to another actuary? Will the actuary want to refuse to cooperate from the successor actuary until outstanding fees are paid? (Under the Code, an actuary can only refuse to cooperate with a successor actuary based on the client's non-payment of fees if the actuary has an agreement in effect with the client before the client switches to the new actuary)
- If the actuary has to rely upon another expert who also serves the client (e.g., an auditor, attorney, accountant), will the client agree to indemnify the actuary against any error on the part of the other expert?

Management of professional liability

Some small actuarial firms have chosen not to buy liability insurance, often basing the decision on a perception that clients may be less likely to sue if the actuary has no insurance to offer a "deep pocket." Most consultants, however, have such insurance, although the level of coverage may or may not be sufficient to make a client whole if the actuary makes a mistake. Regardless of whether the actuary has errors and omissions insurance, there are various strategies that the actuary may wish to use to limit liability:

- Only accept assignments that are low risk, and do not have potential for significant harm. Anna has chosen not to accept assignments requiring calculations. This is, of course, an individual decision that depends tremendously on the individual actuary's tolerance for risk.
- Get indemnified by the party you are working with (see above). This may be an appropriate strategy where, for example, you are hired as an expert witness.
- Agree to limits of liability so as to define your maximum liability

- Obtain client signoff on key methods and assumptions or even final signoff on the work
- Add extra layers of quality control.

Each of these points will usually need to be individually negotiated with the client. Once decided, the actuary will normally wish to include these points in the engagement letter.

What others say

Other professionals have similar issues. For example, a review of the standards for Chartered Financial Planners certification provides guidance on the standards that apply to CFPs. For the CFP professional, a written letter is required in advance of the engagement setting forth the following:

“Specific parties to the engagement, including details of any legal and agency relationships which may exist;

Assurance of protection of client confidentiality;

Specific personal financial planning services to be provided;

Attestation that any assumptions used in the planning will be disclosed in writing;

Duration of the engagement including frequency of contact, which may include subsequent reviews;

The CFPs compensation arrangements with respect to this engagement;

Existing conflicts of interest and agreement to disclose subsequent conflicts of interest if or when they do occur;

An explanation of qualifications, licenses and experience of individuals who will work with the client;

Client’s responsibilities, including the full and timely disclosure of information;

The CFP professional’s responsibilities, and

Procedures for resolution of client claims and complaints with the firm.”

(Source, page 31, CFP Certification Standards, 2006, Financial Standards Planning Board)

The legal profession also requires its members to use engagement letters. The required content of such letters varies from state to state, but generally includes a clear description of the services to be provided, the fees to be charged, the schedule for completion of services, and disclosure of any real or apparent conflicts of interest.

Within the actuarial profession, the Code speaks to some of the issues referenced by the CFP, including conflict of interest, confidentiality, actuarial communications, and disclosure of assumptions.

Small assignments

For the individual actuary and actuaries practicing in small firms, much of the work may be small assignments. Neither the actuary nor the client can usually afford to spend huge amounts of time coming to agreements about what the actuary will do, so it's usually preferable for the actuary to keep the engagement letters reasonably simple. This can be challenging. Lauren suggests that it may be beneficial to start from a "standard" engagement letter that is then adapted to the circumstances of a particular assignment. Even if a fair bit of editing is required to conform the letter to the assignment at hand, it is still usually simpler to edit an existing letter than to prepare one from scratch.

Pitfalls to be avoided

Each actuarial assignment is different, but some pitfalls appear more frequently than others.

For example:

- If a lawsuit is filed based on the actuary's work, the client may claim that the actuary promised results upon which the client relied, then failed to deliver them. A clear statement in the engagement letter to the effect that the actuary will produce projections but that actual events will likely unfold different from the projections can make it more difficult for the client to succeed with this argument.
- The client may claim that the actuary made promises outside the scope of the assignment. A clear description of the scope in the engagement letter, accompanied by a statement that the engagement letter represents the actuary's entire understanding with respect to the engagement can help defeat this claim.
- The client may not understand exactly what the actuary expects to do. Again, a clear statement of the scope of work and description of expected deliverables can resolve any misunderstandings.
- The client may not be willing to let the actuary contact the predecessor actuary because the client is trying to conceal facts from the actuary. If the actuary reserves the right to contact the predecessor actuary in the engagement letter, that will quickly bring the client's intent to the surface.
- If the actuary does not reserve the right to refuse to cooperate with a successor actuary in the engagement letter or other agreement with the client, Precept 10 will require the actuary to cooperate with any successor even if the actuary's fees have not been paid.

The engagement letter is a valuable tool, both to define the terms of an engagement and to provide a vehicle for resolving outstanding issues with the client. Consulting actuaries are wise to use them.

Appendix

Check List — Remember to think about

What will be done

What you will deliver

When will it be done

Timing

How you will communicate and with whom

What will you be paid and when

Managing liability
Intellectual property issues
Confidentiality
Any agreements about rights to work for others
Where you will get data
What client is responsible for and what you are responsible for

B. Contracts & Agreements with Partners and Peers

1. Ad Hoc – Single Projects

Working on a project with another independent consultant? Congratulations. You may have just formed a general partnership.

Joining with a peer to do a project is a great way to handle a project that would otherwise be too big, or for which you do not have all the expertise required. It can also relieve some of the professional isolation a solo or small-firm consultant can feel. To make sure that you get what you expect out of the deal, you need to keep some legal issues in mind, though. Many issues are similar to those addressed in the articles in these materials. You will need to address issues such as ownership of any intellectual property created for the project, and non-solicitation of clients and possibly a non-compete. Take a look at the other section of this primer for more background on these issues.

Some legal issues are unique when working on a project with a peer. You may see the relationship with your peer as a one time, non-exclusive project. Each of you remains free to seek other work without having to share any of the work or revenue from these other projects with the others. Your expectations may be defeated if your peer or a court finds that you didn't just form a one-off deal, but instead have established a new business entity. This can happen as a result of the law of partnerships.

If two individuals join together to do business, the law generally considers the individuals to have formed a general partnership under common law. You don't have to file any form, make any elections, put initials after the name of the entity, or even have a name at all. A partnership can arise simply from the fact that two or more individuals and companies are working together. Whether a partnership is formed, the scope of its business, and how long it will last depend on the intent of the parties. If this intent is not in writing, however, one of the "partners" may claim a different understanding of what you all intended when you started working together, particularly if participation in a lucrative and prestigious contract is at stake.

The consequences of a court finding that you are operating as a partnership can be far-reaching. Partners in a partnership owe their fellow partners strict duties of loyalty. In a famous statement of the duties partners owe to each other, Justice Benjamin Cardozo stated:

Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a

workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. . . . Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.

The words are grand, but the consequences of partnership status are concrete. If a partnership exists, you have a duty to give your partner a chance to participate in future business opportunities that are within the scope of the business of the partnership. If you don't have something in writing setting forth the scope of the joint business, you open yourself up to a claim from a former "partner" that he should have the chance to participate in the project, or that you breached your duty to him by not first offering the business opportunity to the "partnership."

Avoiding an unintentional partnership can be easy. A simple letter signed by each participant that each has the right to pursue other business during and after the specific joint project without first offering the project to any or all of the other participants can be enough. Once any part of a deal gets in writing, though, there is a tendency to put everything in writing. The more writing there is, the more important it is to have legal counsel involved to make sure that everyone's expectations are fulfilled.

2. You Have a Partner: Now, What is the Deal?

(a) What Do you Need to Consider in Making a Deal?

Going into business with another person is an attractive idea, and is a great way to really build a business with more value and equity than merely your willingness to work hard. It is however, one of the biggest areas where people err by not bringing a business lawyer into the process. People tend to go to a lawyer to set up the entity, which is in fact easy enough for most people to do by themselves, and not see a lawyer about documenting the deal between the participants. A few hours of lawyer time at the beginning, however, can save much expense and heartache later.

Choice of Entity: There is little debate regarding the best type of business entity for small consulting firms: a limited liability company, or "LLC," is the best choice. Like a corporation, it protects its "members" or owners from individual liability for the obligations of the entity. Unlike a corporation, however, the members can decide how it will be taxed, whether as a corporation, S-corporation or as a partnership, which most LLCs choose to avoid entity-level taxation. See section 1(a) above.

How Will Your Company Be Run? The choice of entity is just the start of figuring out how your business will be run, who's going to run it, and what rights and obligations each owner will have. This article discusses some of these factors, particularly whether you should enter into an operating agreement regarding your LLC. An operating agreement is simply a written agreement among the members regarding how the LLC will be managed on a day-to-day basis and what the members' rights and obligations are. An operating agreement is optional; the LLC is formed when you file the form with the appropriate state agency, usually the Secretary of State.

When do you need an operating agreement? The decision to enter into an operating agreement can be significant. You will incur \$750 to \$3000 in legal fees, depending on how active the negotiations are. Costs will be higher if some or all the members hire their own attorneys, which may be necessary depending on how contentious the negotiations become. Negotiating an operating agreement also tends to bring any simmering tensions among the members to the surface, as the members discuss who deserved to get what when. Entering into an operating agreement, however, provides a sound basis for the business to move forward, with every member having a better idea of what his or her rights and obligations are, and provide a structure for avoiding disputes, and resolving them promptly if they do arise.

To be able to discuss this topic in a short article, I have made some assumptions: all the members of the LLC will be employees of the Company, or otherwise actively involved in the management and business of the Company; and that you chose the “member-managed” LLC, where, like a partnership, all members are basically peers. The other form of LLC, the “manager-managed” LLC, is closer to the corporate model, with one or more CEO-types running the company with other members as passive shareholder-type owners or otherwise not involved in management. State laws vary widely on some important points regarding governance of LLCs, so you need to consult with a lawyer in your state before deciding what to do.

If you don't have an operating agreement, the LLC will be managed as provided in the LLC statutes. The statutory provisions which govern in the absence of an agreement among the members basically create a partnership where the majority rules. This article will discuss some of the areas in which you may wish to alter the statutory scheme.

Majority Rules: Under the statute, the majority rules, either the majority of members, or the holders of the majority of the percentage interests in the LLC, depending on the state. The majority, therefore, could increase their own salary, sell all or any part of the company's assets, dissolve the company, fire another member, enter into contracts and admit new members, depending on the state. The only exception to majority rules, depending on the state, is a merger or consolidation, amendment to the written operating agreement or taking an action that contravenes a written operating agreement. These require either unanimous approval or approval by two-thirds of the member interests, depending on the state.

If you want to limit these powers in a meaningful way, you need to have a written operating agreement. In deciding who will vote on what, you may want some major decisions, such as whether to sell the company or fire a member from employment, to be voted on by each member having one vote, regardless of their respective percentage interests.

Even without an operating agreement, there are some limits on what a majority can do. They are subject to fiduciary duties to the other members not to unreasonably exploit their position for their personal benefit and to the detriment of the company. The scope of the duties and how they apply to specific circumstances is uncertain. Better to deal with it in the operating agreement than trying to guess what a court is going to order once a dispute arises.

Below this is a section dealing explicitly with issues regarding a minority ownership interest.

Individual Power: In a member-managed LLC, each member has the right on his or her own to conduct all ordinary business activities of the company, such as signing contracts, buying equipment, hiring employees, etc. If you want to require consent by more than one member for significant actions or expenditures in excess of certain amounts, you need to have a written operating agreement.

Distributions: Share and Share Alike: Under the statute, each member has an equal right to share in any distributions from the LLC in proportion to the value of their capital contributions to the company. If the members want compensation to be determined by some other factor, such as hours billed, business originated, or revenue generated, this needs to be dealt with in the operating agreement.

Withdrawal:

Voluntary: A member has a right voluntarily to withdraw from an LLC, though the withdrawing member may have to pay damages to the LLC if the withdrawal violates the operating agreement. Some states provide that a withdrawing member is entitled to be paid the fair market value of his or her interest, while in others like Connecticut, the withdrawing member is not entitled to be paid anything for the member's interest unless the company dissolves or otherwise makes a distribution to members. You therefore cannot force the person out as a member, even if they no longer work for the company. An operating agreement can provide for a compulsory buy out.

Involuntary: A member cannot be expelled involuntarily from an LLC unless the member is insolvent, unless the operating agreement provides otherwise. If you want the right to remove a non-productive member, you need to put that in the operating agreement. For instance, you could provide for a forced expulsion and buyout with the vote of all the members but the affected member.

Buyout Price: When the statute gives a withdrawing member the right to be bought out, or if the members decide to provide for a buyout, how will the buyout price be determined? By the withdrawing member's capital account? The member's proportionate share of the book value of the company? Will the value of goodwill and receivables be included? Will the value be discounted for lack of marketability or for being a minority interest? Unless you deal with this in the operating agreement, a court will decide these issues.

Competition: If a member successfully withdraws from the company, the former member may be able to compete with the company so long as the former member can show that he or she is not using company secrets. If you want to restrict competition post-withdrawal, you need a written operating agreement.

Other Businesses: In some LLCs, the members envision that the company will be their full-time occupation. They expect that each member will devote his or her full time and energy to the company, and if any member becomes aware of a potential business opportunity, the member will give the company the option to pursue it before pursuing it by him or herself. Alternatively, other LLCs are set up with the idea that they will only be one of many of the business activities of the members. No one expects that business opportunities will be offered to the company first, and may even be willing to have the members compete with the company. If you don't address these issues in the operating agreement, the common law corporate business opportunity doctrine will apply, with all the uncertainty and expense involved in getting a court to make a decision.

Arbitration: If you want any intra-company disputes to be arbitrated, rather than in court, you have to have a written operating agreement.

(b) What About a Minority Interest?

What's the most important fact in common among the following?

- A friend, who owns 100% of a consulting firm company, approaches you about investing \$50,000 in the company to bring new software to market in return for a 30% interest in the company;
- A 100% owner of a firm you've been consulting for on an hourly basis offers you 20% of the equity in the firm in return for working at 25% of your usual hourly rate;
- You have accumulated a 10% stake in your current employer, but you want to go out on your own, possibly competing with your current employer. The principal of the firm owns a 60% stake in the company.

Since actuaries are reading this article, I assume you have all figured out which numbers are the most important. The most important fact common to all these scenarios is that you will have a minority stake in a company where one person owns a majority interest. Do you understand the consequences of such a distribution of ownership?

Rights of a Minority Owner

In the absence of an agreement to the contrary, what rights do you have as a minority shareholder, assuming that there is no written shareholder or operating agreement addressing these issues? In the absence of an agreement to the contrary, you basically have the following rights as a minority owner:

- If the company is sold or dissolved, you get your proportionate share of the proceeds remaining after all debts are paid;
- If there is a distribution of profits, you are entitled to a share of the distribution;
- You have the right to demand an accounting, which is a limited right to examine the books and financial records of the company; and
- You have the right to sue for breach of fiduciary duty if the majority owner engages in bad misconduct.

This article will not address the last situation, involving issues tantamount to fraud. If you believe the majority owner is defrauding you, see a lawyer immediately, and be prepared to spend some real money. Nor will this article address issues involving several people going into business together with equal interests when all the owners will work for the company, which I've addressed in several prior articles. This article deals with the more quotidian issues that confront a minority owner when someone else has majority control.

What Issues Do Minority Owners Confront?

What are the consequences of your bundle of rights as a minority owner when addressing day-to-day business issues?

- As a practical matter, your right to demand current distributions from an operating business is limited. A majority owner, if she is committed to avoiding any distributions to a minority owner, can usually avoid making any distributions of profits. By establishing generous reserves for future expenses, paying a salary to herself or her relatives at the high range of what is reasonable, pre-paying expenses, investing in new business or new equipment, leasing expensive cars, etc., a majority owner can spend enough that there are rarely any profits to be distributed. So long as the expenses are not grossly unreasonable, you probably won't be able to force the company to allow you to share in any of the current income of the company.
- You have no right to participate in any management decisions of the company. The majority owner may make a decision that you think is bad and puts your interest in the company at risk. You may see the majority owner running the company into the ground. You can try to convince him that it is the wrong decision, but he doesn't have to take your calls.
- You have limited rights, if any, to have your interest bought out. You may want to cash out your interest and do other things with the money. State law may give you the right to force the company to buy you out, but these rights are limited.
- While you would be entitled to a share of any profits on sale of the entire business, a sale can be structured in a way to avoid any payout to minority owners, such as a sale of assets over time with the proceeds reinvested in another business.

How Can You Owner Protect Yourself?

The law of corporations and limited liability companies gives owners almost unlimited discretion in deciding how a company will be run and what rights any of the owners, majority or minority, may have. To address the three scenarios I discussed at the beginning of the article:

- The investor may want to contribute only \$10,000 in equity for his 30% interest, and have the other \$40,000 be a loan secured by the assets of the business and a personal guarantee of the majority owner.
- The consultant working at a discount rate may require that he have a personal ownership interest in the software.
- The employee leaving the company would be in better shape if the agreement provided for some mandatory buyout. He would, however, have to expect to take a sharp discount from the proportionate value of the interest in the company.

The provisions regarding management of a company and protection of minority owners are limited only by the creativity of the owners and their counsel, and a complete discussion of the possibilities is beyond the scope of the article. When considering a minority stake in a company, think carefully about your expectations regarding the following:

- Involvement in day-to-day management;
- Involvement in decisions about fundamental corporate changes such as sale of the company;
- Payments on your equity from current operations;
- When you will be able to sell or be bought out; and
- Distributions on sale or dissolution of the company.

Discuss these with your prospective business partners to make sure everyone shares basically the same expectations. Then, you can go to a lawyer to have this understanding reduced to writing.

While going to a lawyer to get an agreement will cost some money, it will be **much** less money that litigating problems once they arise. For instance, I ask for a \$500 - \$1,000 retainer to draft an operating agreement; I require a minimum \$10,000 retainer to start a lawsuit among partners. One last issue to consider in hiring a lawyer to draft an agreement is whether each partner should have their own lawyer, or if one lawyer can draft the agreement for everyone. If all the partners will be equal owners, are equally sophisticated, and are bringing in roughly equivalent business, one lawyer should be able to draft the agreement. The more unequal the partners, though, the more you should consider having more than one lawyer participate in negotiation of the agreement.

Conclusion: Think First.

Many times, a minority interest is worthwhile and valuable, particularly when a business is sold. A minority stake certainly does not mean that you inevitably will be shut out from any financial gain. If, however, the majority owner is not cooperative and no written shareholder or operating agreement exists, your minority interest in the company may not be worth much in any practical sense. In the absence of an agreement, you should realize that your ability to financially benefit from a minority interest depends to a great degree on the good faith of the majority owner. Before you invest time and money in a minority stake in a business, think about whether trusting the majority owner is enough, or do you want to get your agreement in writing to make sure that everyone's expectations are fulfilled.

C. Agreements with Contractors

Many new businesses hire independent contractors when they need help to avoid the long-term commitment of hiring an employee. You need to be careful, however, to avoid unintentionally “employing” someone you thought was a contractor, and to make sure that you protect yourself.

Intellectual Property Issues

You need to consider IP issues to protect your own intellectual property, and to make sure you are buying the rights to the contractor’s work that will allow you to fulfill your commitments to the client. Make sure the contractor acknowledges that any materials he will access during the assignment are your intellectual property, and that he agrees to keep it confidential. If the contractor’s knowledge of the information would give the contractor a leg up in competing with you, then the agreement should contain a tightly drafted non-compete limiting the contractor’s ability to offer a competing product or service for six months to a year. The contract should provide that any work by the contractor is “work for hire,” which means that his work product belongs to you. If the contractor retains ownership rights in his work product, then the agreement has to provide that he grants you an irrevocable fully paid license to sell the IP as a part of your product and service and to grant similar licenses to your customers.

Non-Competition / Non-Solicitation

You also want to make sure that your contractor does not divert the client or other future business opportunities from you in the future. These agreements can take two forms: a non-solicitation clause that restricts the contractor’s right to do business with a specific client, or a non-compete clause, which restricts the contractor’s right to do business in a certain sector in a certain geographical area for a period of time. A non-solicitation clause should provide that the contractor may not do any business with the client for six months to a year. Areas of flexibility are making the non-solicitation apply only to a certain division, if the client is large, or allowing the contractor to provide non-competitive services to the client. Allowing the latter, however, risks diluting your contacts with the client. If you become aware of an opportunity to provide service to the client that is not in your area, you probably want to reserve the ability to either subcontract out the work, or at least be able to hand a plum assignment to someone who might be able to return the favor in the future.

There are two theories in drafting non-compete agreements: either draft a very broad non-compete in hopes that it will be enforced to the full extent the law allows, or narrowly draft the non-compete specifically to protect your materials interests. In the context of dealing with a fellow-professional in a short-term assignment, the latter theory is preferable. You do not want your profit on the deal eaten up in re-negotiating a draconian non-compete to reach a result that will be acceptable to your contractor. Spend some time thinking about how to define the business you want to protect, and the actual geographical area in which you do business. You will end up with an agreement is less likely to sour the relationship with your contractor, while making it more likely that a court will enforce it.

Employee vs. Contractor

One of the most important issues to address in the agreement, especially one that is longer term, is to make sure that the contractor will not be considered an employee. Employee status means potential liability for unemployment, worker's compensation, employment taxes and employee benefits such health insurance if you have a group plan. So long as you only have one employee, you generally don't have to worry about statutory employment laws like discrimination and employee-benefit statutes. There are twenty factors that go into determining whether someone is an employee or a contractor.¹ One factor not listed is that a contractor is less likely to be considered to be an employee if payment is contingent on the payment to the prime contractor. All the factors do not have to be present, but you should structure the transaction, and have the agreement contain acknowledgments, that establish as many as possible. These factors are weighed differently in different situations, and it can be quite difficult to determine ahead of time how a court or the Department of Labor will rule in a specific instance. Keep these issues in mind and try to address as many as you can, and you will probably be okay.

Payment Terms

If the contract is an hourly contract, it is appropriate to pay the contractor less than the rate you are billing to your client. Like a placement firm, you should be compensated for the benefit the contractor is getting from your sales and marketing expenses. One of the more controversial issues with payment terms is whether the contractor gets paid only when you get paid on the prime contract. Guaranteeing payment does increase the chance the contractor would be classified as an employee, so if it is a close case, you may want to insist on payment to the contractor depending on you getting paid. One way to address the issue is to separate the compensation into two parts: one portion paid hourly and guaranteed, and the rest being some form of profit sharing paid upon completion of the project. If you do have some type of profit sharing, make sure the agreement provides that profit is determined after direct and indirect expenses on the contract are deducted, including some portion of your fixed overhead.

With attention to a few of the legal issues noted here, you can successfully use contractors to create just the right virtual firm to handle a wide variety of projects that you could not handle on your own, but without shouldering the burdens of full-time employment.

D. Agreements with Employees

Many of the issues you need to address with employees are the same as with contractors: compensation, non-competition agreements and intellectual property.

What's the Employment Contract. You have to be careful in your discussions with a prospective employee. Statements made during the hiring process, such as "You'll have a job so long as you do a good job," or "We'll give you an annual bonus of 10% of your

¹ If you Google "twenty factors" and "independent contractor," you will come up with many lists of these factors. As of April 2, 2007, the following web site has a good list:
http://www.wachovia.com/small_biz/page/0,,447_972_1695_1945_1956.00.html

income” or a statement that the person will have a particular level of secretarial support, can all be construed as legally enforceable contracts in some instances. The safest way to deal with this is make sure your offer letter accurately states that commitments you intend to make, and to include language in the letter such as the following:

You acknowledge that this letter sets forth the terms of your employment with us. In signing and returning this letter to us, you acknowledge that you have relied on no prior oral or written statements in accepting this job. You acknowledge that your employment is ‘at-will,’ and either of us can terminate the relationship at any time for any reason.

Compensation: Any compensation arrangement should reflect the reality that in most cases, proven ability to bring in business is more valuable than any particular skill. Splitting revenue with an employee is a great way to encourage employees to have a more entrepreneurial view of their job. However, any split should be made **after** deduction is made for a fair share of overhead and any direct sales expenses, such as travel. A fair split might be from one-third to one-half of the net proceeds to the employer. Further, if you are paying a bonus, the bonus plan should require that the employee be employed as of the date the bonus is paid. You don’t want to be financing your former employee’s competing business.

Non-competition Clauses: Under most state laws, it is not illegal for a former employee to go into competition immediately with a former employer, and to contact the former employee’s customers, so long as the employee did not misappropriate a customer list. Further, unless an employer invests resources in developing the customer list, and keeps it internally confidential, many states do not consider customer lists to be protectable trade secrets.

If you want to keep a former employee from soliciting your clients, you are probably going to need to have the employee sign a non-competition agreement, where the employee agrees not to compete with you for a certain after his employment ends and in a certain geographical area, or a non-solicitation agreement, where the employee agrees not to solicit your customers for a certain period of time. Drafting a non-compete is **not** something to do without an attorney. States have varying laws on non-competes: in California, a non-compete is generally invalid, while non-solicitation agreements are allowed. Even in states like Connecticut where non-competition agreements are enforceable, they have to be narrowly drafted to be enforceable. Also, in many states, you have to be careful when having existing employees sign a non-compete. In Connecticut, you have to give existing employees new consideration, such as a cash payment, bonus, or promotion, to have an enforceable agreement. If a non-compete is important to you, and in most cases it should be, hire an attorney.

Intellectual Property: Generally, anything that an employee develops using company resources belongs to company. The employment agreement should state that whatever the employee produces is a “work for hire,” which should result in your owning any intellectual property created by the employee. To avoid arguments about whether an employee developed particular intellectual property prior to being employed, you can include an

exhibit to the offer letter in which the employee can list any existing intellectual property. If your company has any valuable intellectual property, such as computer programs or proprietary methods of analysis, or if you are hiring an employee specifically to develop intellectual property, you do not want to do this on your own. Hire a lawyer to draft the confidentiality and intellectual property agreement.

III. Other Issues in Establishing a Practice

A. Competing with a Former Employer

Many new businesses start when someone leaves a current employer to start a firm, maybe in the same city and in the same practice area as the former employer. This can result in a cooperative relationship in which the former employer helps you get established and is your ally in developing your firm. Other times, everyone ends up in court. This article will address some of the issues you should consider to increase the chance that you will create an ally, and not an enemy, when you form your new firm.

Will You tell you Employer Beforehand? Whether to tell your employer before you leave to compete is perhaps the most fundamental question to answer. Whether to do so depends primarily on two things: the personality of your boss, and the competitive threat you pose. The latter question is largely beyond the scope of this article, but you should have a pretty good idea of how litigious your boss is based on the time you have been employed and what's happened before when an employee left to compete. The former question depends on a realistic determination of the effect of your leaving on the employer's practice. Aside from the obvious question of how many clients you think you will take and the proportion of the firm's revenues they represent, ask yourself the following:

- Could the employer give you contract work after you leave, or even office space, if you talk beforehand?
- Is it worth agreeing not to go after certain clients or agree not to accept work from them to secure your employer's cooperation in setting up your new practice?
- Can you define an initial area of practice that you can do economically on your own that the employer is intending to drop or deemphasize because it cannot?

This is an important issue to get right, as the consequences of getting it wrong are serious. For instance:

- If you tell your boss ahead of time in hopes of gaining his cooperation, he or she may fire you right away. It may take you months to get up to speed so you can compete, without the pay you were counting on from your now-former employer. In the meantime, your former employer will be giving great service to the clients that you thought you could pick up because they were unhappy. Even if you are not fired, you are giving your employer a chance to lock in its relationship with its clients, while you cannot solicit them for your new business due to the duty of loyalty, discussed below.
- If you don't tell your boss ahead of time, you may lose the chance to do contract work or receive referrals from your former firm. A potential ally can turn into an enemy. If you quit and set up a new firm the next day, your former employer may

be suspicious that you are using its proprietary customer list or other intellectual property, or that you violated your duty of loyalty by contacting its clients while still employed. This could result in the employer suing to obtain an injunction to stop you from doing business.

The above parade of horrors happens rarely. The consequences of things going bad are serious, however, so you should spend significant time considering this question at an early stage in your planning.

Do You Have a Non-Compete? If you are subject to a non-compete, you should consult with a lawyer about what effect it may have on your business plan. A non-compete or covenant not to compete is an agreement not to compete with your employer in a certain practice and geographical area. Other articles I've posted on the web site deal with them in more detail. You have to individually agree to a non-compete, which are almost always in writing, so review anything you signed when you joined the employer. If you are not sure you signed to a non-compete, ask to review your personnel file. If you are subject to a non-compete, consult with a lawyer familiar with your state's laws of non-competition. State laws on this issue vary widely, so you need to know what the law is in your state. The situation is even more complex if you live in one state and your employer is in another.

As you may learn from your lawyer, the existence of a non-compete is only the beginning of the issue. The agreement may not be enforceable, in whole or in part. There may be a viable market niche not covered by the non-compete in which you can confine your practice for the duration of the non-compete. You may be able to negotiate a relaxation of the non-compete with your former employer. You may decide that it is so unlikely that the employer will enforce it that you will open your practice anyway. This is an issue to address early, however, with qualified legal help.

What Can I Do For my Business While Employed? This is another area where you need to check on your own state's laws. The following discussion reflects principles of Connecticut and general law, but this is another area where you should consult with a lawyer in your state.

As an employee, you generally owe a duty of loyalty to your employer not to compete with it while employed. You can prepare to compete, however. You can sign a lease, form an entity, reserve a name, buy advertisements to run after you leave, have announcements printed, and do anything else other than actually starting to do deal with the public. Do not take any customer lists, as these can be trade secrets. Also, avoid taking any documents from your employer, even your own work product, to avoid an intellectual property fight. You can talk with co-workers with whom you may want to go into business. You can probably talk to other employees about coming to work for you as an employee, though this is an area that touches on your duty of loyalty to your employer.

You generally cannot tell existing clients that you are going into business for yourself and ask if they will come with you. You can try to scoot around the edges of what is allowed by making general enquiries about whether they are happy with your employer, but you have to be careful with asking these questions.

As soon as you are no longer an employee, and so long as you are not subject to a non-compete, you are free to compete. You can quit first thing in the morning, and start calling clients right away.

Conclusion: You Can Do This. The purpose of this article is not to scare you out of forming a firm to compete with your employer. Most transitions to a new firm happen seamlessly, and develop into mutually beneficial relationships. In the series of articles I've written for our web site, I have discussed many issues that you can handle on your own, without a lawyer. Setting out to compete with your former employer, however, is generally not one of these. A visit to a lawyer early in the planning process can save a lot of money and anxiety compared to seeing one after you get served with a lawsuit. With early planning with experienced counsel, you can have a much better chance that you will be one of the fortunate ones who former employer is your ally and not your enemy.

B. Office Leases

Most consultants setting up their own consulting business will rent office space. Different leases for commercial space can have significantly different provisions: despite what the landlord tells you, there is no "standard lease form" for commercial property. If the lease is for more than a few thousand square feet, has a term in excess of five years or involves considerable construction and renovation or if you are contributing to the cost of the construction, you should certainly retain a lawyer to negotiate the lease. Whether you are reviewing the lease on your own or with counsel, you should consider the following issues;

- **Definition of the Space.** Check the plan of the premises that is commonly attached as an exhibit to the lease to make sure you are getting the property you expect, and that the space is sufficient. Most office building measure space according to the standards of the Building Owners and Managers Association, or "BOMA." They allow landlord to include a portion of the common areas in the leasable space of the tenant, which result in your paying for up to 20% more space than you actually use. This makes a big difference in your per square foot of usable space you are paying for, and something you need to take in to account when comparing a lease of space measured according to BOMA, and lease that uses the actual square footage of the space. Does the landlord have the right to move you within the building if he wants to lease the space to someone else? If so, how much notice are you entitled to, and does the landlord have to pay for the expenses of moving and other incidental costs, such as changing letterhead or business cards?
- **Rent.** What are the grace periods for payment of rent? Short and infrequent grace periods, such a two five day grace periods during the term of the lease, are common for payment of rent. Grace periods for other defaults should be at least thirty days after written notice by the landlord. This is important if you have an option to extend or a right of first refusal on other space that is terminated if you are in default under the lease.

- **Options to Extend:** Options to extend the term of the lease are valuable for the tenant. If a lease term is concluding and there is no option to extend, the landlord has substantial bargaining power since he knows the tenant will have to go through the expense and difficulty of moving if there is no agreement on a renewal. Issues you need to consider:
 - Leases commonly require that a tenant exercise an option to extend the term of the lease within a certain time, usually sixty to ninety days before the conclusion of the current term. These provisions are generally interpreted strictly by the courts. **Make sure** you do not forget these dates by dairying the date by which you must exercise the option.
 - Some leases provide that tenant loses the option if there was ever a default under the lease, even if the default has been cured. Insist on a provision that you can exercise the option so long as there is no **outstanding** default under the lease at the time of exercise of the option.

- **Rent Escalations.** Leases with options to renew or leases for terms in excess of five years commonly have provisions for increased rent due. It is preferable to have the rent increased according to the actual increase in expense of operating the building, rather than to an index such as the consumer price index.

- **Build Out.** It is common in a new lease that the landlord will agree to make some renovations to the space, or will build new space. If so, a work letter should be an exhibit to the lease, precisely stating what the landlord is obligated to do.
 - The more build out you request, the longer the term the landlord will require so he can amortize the cost of the renovation. If he is building new walls and doors, expect to sign a five year lease. If he is doing some painting and replacing some carpet, you can probably get a three year lease. If you are starting a new business, a shorter lease term is critical: if you really succeed, you will need more space; and if you decide to close up shop, you do not want a long-term rent obligation to continue. If you are willing to take space totally “as-is” that has been vacant for a substantial time, you may be able to get a lease as short as a year.
 - If the space is in a building under construction, make sure you have a right to get out of the lease if possession is not delivered by a certain date so you are not hung out to dry if construction is delayed. Also, the obligation to pay rent should not commence until a certificate of occupancy is issued.

- **Expense Pass-Throughs.** You can expect that an office in regular office building will be on a triple net basis, the shorthand for which is “NNN.” That means that the landlord’s expense for common area maintenance or “CAM” (snow shoveling, cleaning etc.), liability insurance and real estate taxes will be passed through to the tenant. Issues to consider in these provisions:
 - Has the landlord represented what the first year pass through will be? Is it on a base year basis, where you just pay for increases in expenses from the

first year of the lease, or do you pay an additional common area charge from the beginning?

- Does the list of items included in CAM exclude all capital items? Roof repair is okay, but replacement of the roof, or the HVAC systems, is not.
 - Do you have the right to audit the landlord's records to determine if the CAM calculations are correct? Is there a limitation on the time after you get a statement of common charges to contest it? A 30 to 60 day objection period is too short. Ask for six months.
 - You should carefully check the pass-through statement you get each year. They are frequently wrong, either including unauthorized expenses or getting the percentage wrong.
 - Is the percentage you are being charged equal to your actual percentage of space in the building?
 - Is the landlord allowed to charge a management fee, or are pass-throughs limited to payments to third parties? Is there any limit on the percentage of the other expense that can be charged for the management fee?
- **Insurance.** Many leases require that the tenant carry liability and fire insurance. Send the insurance provisions to your insurance agent so you know how much it will cost you. The lease may also provide that the tenant has to indemnify the landlord for damage to the building. Make sure the indemnity obligation is limited to harm caused by the tenant within the leased premises. Show an indemnity provision to your insurance agent as well to make sure you are covered for any liability.
 - **Subletting.** The right to sublet the premises is important if you need to get out of lease for any reason. The lease should allow subletting the space for any use permitted by applicable zoning or the other leases of the premises, but could exclude retail, sex-related businesses, etc. The landlord may insist on the right to approve a subtenant, but the lease should provide that such consent will not be unreasonably withheld. Landlords, in arguing against such a provision, frequently claim that they have to make sure a subtenant is financially responsible. Tenants who sublease space are generally still liable under the lease, so this is not a valid reason to resist such a provision.

C. Tax Registrations

You will have to obtain a federal tax identification number in order to open a bank account. You will need a state tax identification number by the time you file your state tax return. If you have employees, you will also have to register with the unemployment compensation department. There may be other registrations that you have to make in your state. Check the web sites of your state's departments of labor, revenue, and worker's compensation.

IV. You've Set It Up; Now Succeed and Prosper!

A. Networking:

Introduction:

By David Rintoul

Leaders in every professional occupation over the last twenty years, starting with accountants, and then moving to lawyers and now to actuaries, have realized that technical excellence and responsive client service, while necessary for success, are no longer sufficient. Marketing and networking have to be a part of your plan. Below is a great way to implement this newer way of doing business, developed by Emily Neustadt. While this is a difficult and sometimes unwelcome realization for professionals that have spent a life time developing a defined expertise, embracing the necessity for marketing can provide you with material success and the choice to take only the work that you most enjoy.

A comprehensive marketing program including advertising, direct mail, and publications, is beyond the scope of this seminar. You can, however, get an introduction to the most effective method of marketing a solo or small consulting firm: relationship networking. The following materials were prepared by Emily Neustadt, whose biography is at the end of these materials. She is a business coach who has had great success in making introverted technicians into effective and relaxed networkers. Completing this form will give you an introduction to what you need to do to move towards success.

Elegant Networking

By Emily Neustadt

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Do it well: do it gently. Find your own personal way of networking. We don't want to treat people as products, opportunities or commodities, something we use and throw out. We want to treat them as people.

When you see an opportunity to offer your services, remember that the potential client has something to gain. And when you ask for or offer something, always leave room for no. No is a fine answer. If you get a no, you're one ask closer to the yes. Find the people for whom your service is appealing.

Be gentle and yet unstoppable in your personal goals. Be clear about your goals for each week. How many real conversations do you need to have with prospective clients in order to meet your monthly goal for revenues? How are you going to make those meetings happen with all the other things you need to do each week? What can you do to systematize this process as much as possible and make it as engaging as possible?

Your company has something to offer. What is that offering and can you describe it please in one sentence?

Get feedback from a trusted colleague on this sentence. Is it clear? Does it center on the solution your offer? Do you say it with ease? Practice this one sentence with as many people as possible.

Who needs the services/solutions/skills/products/talent that you have to offer? Think as expansively as you can, don't list specific companies or people here, list qualities, business situations, unique types of clients you most love to help.

The reality of opportunity is that it is everywhere. Business is built on relationships. With whom do you want to create a business relationship? Who's your ideal client? Who's the ideal client for your firm? Is that different?

1. Who are the people that you admire because of their expressed views, plans or ideas on some aspect of business?
2. Who are the people of influence, ease and intelligence who have expressed an interest in you and your career?
3. What contact have you had with those people recently? (people in Q#1 and 2)
Read their books, articles; Worked for them; Attended their seminars, training sessions; Saw their video, website, TV show; Had lunch; Wrote them a letter, postcard, email, thank you letter.

What kind of contact would you like to have with them?

Have lunch/coffee/dinner with them once, 1/month, 1/quarter. Exchange information with them. Attend a seminar/ public appearance given by them. Post on their website. Attend a public speaking engagement or networking event with them. (Most people love to have company when going to a professional organizational meeting.)

I think we need to get in front of the people we like and admire. In our work, we don't always get the opportunity to choose who we're surrounded by. We need to take an active stance in this and reach out to those people, go see them speak, read their books or articles. It keeps us fresh and in touch with our core values. It energizes us and gives us examples of other ways to express ourselves, talk about our work, etc.

4. What is an appropriate rhythm of contact with people who may be able to use your services or may be able to refer you to someone who could? Look at each person as an individual. Decide on what the rhythm should be and get some feedback.

“I got a lot out of today’s lunch. 1) Would you like to do this again in the fall?” 2) Could I give you call again in the fall and check in with you then? 3) I’d like to email you in a couple of weeks and let you know what I’m looking at then. Would that be ok?”

5. What kind of system of reminders are you working with? Plot these contact calls/letters/emails/v-mails in your calendar. Manage your promises. If you said you’d follow up in six weeks, do it. It’s easy to convince yourself you don’t want to pester someone, but the truth is they may be looking forward to your call.
6. What kind of support do you have around questions of etiquette, form and grammar? Join forces with someone whose taste you admire. Ask them for the exact kind of support you need. 1) Help you find the right sentences and phrases before you make certain phone calls or write certain letters. 2) Proof your letters, resumes, etc. before you send them. 3) “Book end” your calls and letters. In other words, you call your friend to tell them you are about to call your contact. Then make the call. Then call your friend and tell him/her that you did it. It keeps you honest, on track and gives you a forum to voice your fears, woes and embarrassments.
7. Who can use your consulting services? What types of businesses?
8. What size company would you like to work for? (Translate that to clients, market, and population.)
9. What companies (clients, market, and population) specifically meet those requirements?
10. Who do you know that works in these companies? Ask three people this week who they know from those companies.)
11. Who do you need to know? Who do you want to know?
12. How can you make those connections?
Do you need to write a letter, join a professional organizations, attend a public appearance, visit a website? How often, and yes, is it in your calendar yet?
13. What are you doing now to gently increase your network?
You don’t need to treat people like commodities, but it is important to recognize opportunities that are right in front of you. As long as you don’t exert any undue pressure on anyone, most people are delighted to participate in your search in some

comfortable way. The key is to sense what's comfortable. Be explicit about your desire to treat them well. Who do you think might need my services? Would you mind if I called X and let him know you suggested I call?

14. What is stopping you from moving forward with any of this?

15. What support do you need?

This is where the rubber hits the road. Many people say they're too introverted or too humble or are just not good at networking. They feel that it's beyond them or beneath them. They feel that the marketing or sales department should be separate. (There are people in one-person companies that feel like that!) But the truth is that networking, marketing and sales is everybody's job.) Being an effective networker means getting the support you need to keep on track with your goals.

Here are some suggestions:

- Get a coach. Call Emily Neustadt or email her at en@neustadtconsulting.com.
- Make a deal with a trusted friend or colleague who is a good networker. Meet with them once a week. Share your goals, your concerns, your plans. Get their feedback. Have them share their goals, concerns and plans. Provide some very soft accountability for each other.
- Write your goals and plans on a small card. Post it at your desk and mark in your calendar all the small steps that lead you toward your goal.
- Take yourself out to lunch to a very nice place where you can really relax and think big. A fancy restaurant or a nice mountain picnic. Bring along your calendar and your goals. Project out for at least a quarter, the activities you need to engage in to meet your goals. Be strategic, think big, and plot it all out in your calendar. When you get back from your lunch, tell someone about your plans. Sign up for the events you've decided to attend, RSVP, offer to speak etc. Spend the whole afternoon on this and then call it a day. Set yourself up for success.

B. Liability Protection

Introduction

By: David S. Rintoul

Professional liability insurance is the most basic step in protecting yourself and your business. Below is an article prepared by Paul Dorroh and Mary Whisenand, used by permission, that explains one of the more important aspects of liability insurance: that almost all professional liability insurance is "claims-made" rather than "occurrence based." Understanding this distinction is crucial to making sure that you are protected at all times from professional liability claims, no matter what changes you make in your career.

Understanding Your Claims-Made Professional Liability Insurance Policy

By Paul Dorroh and Mary E. Whisenand

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Introduction

Until the 1970s, almost all liability insurance policies, including professional malpractice policies, were written on "occurrence" policy forms. Under such a policy form, the event, which creates the insured's liability, is also the event which triggers the insurer's contractual obligation to indemnify the insured. That event was variously defined, depending on the type of liability insurance involved, and in the case of professionals was typically defined as any act, error or omission in the rendering of, or failure to render, "professional services" as defined in the policy. In other words, the professional's mistake was the covered event, and the policy imposed no time limit for reporting claims which might arise; once the "occurrence" happened, the insurer became perpetually obligated to indemnify the insured.

In the 1970s, insurers writing professional liability insurance experienced a dramatic upswing in late-reported claims, along with an increase in the average cost of claims that reflected the high inflation of the times, as well as other growth in costs reflecting numerous broad social trends. The industry was faced with a basic inability to accurately

set the price for the occurrence policy form, because most of the claims arising out of any given year's professional services would not be reported, and thus, could not be evaluated, until well after the insurer had accepted a fixed price for an open-ended promise to indemnify. Many insurers ceased writing this kind of insurance, and others decided to charge prices they deemed high enough to protect against the uncertainties of their future obligations. For many professionals, such prices were simply unaffordable.

The Modern Claims-Made Policy

As a result of these developments, virtually all insurers writing professional liability insurance switched from the occurrence policy form to the claims-made form. While this form had existed for many years, its use was generally limited to coverage for specific events or projects where any claims would become known immediately. Under a claims-made policy, the event that triggers the insurer's duty is the reporting of a claim within the

policy period arising from an occurrence within the same policy period. Since the insurer's liability is not open-ended, costs can be predicted more accurately and high charges for uncertainty can be reduced.

From the insured's point of view, the claims-made form presents some problems, since it is precisely the open-ended aspect of professional liability that causes most professionals to carry insurance. While the cost of a claims-made policy would be less, thus enabling the professional to carry some type of protection, the coverage would also be less, since the annual payment bought protection for only one year, not for eternity.

Further, the claims-made form was not well suited to protecting an ongoing business or professional practice in which coverage would be renewed from year to year and protection would be required to continue indefinitely. In response to these problems the insurance industry (including, by this time, a number of captive insurers formed by the professionals themselves) made a number of adaptations to the basic claims-made policy form, in order to make it more responsive to the needs of the particular profession. For professionals today, while each company's policy form is unique in some respects, it is also true that there are basic features and issues that are common to all such policies. What follows is a brief discussion of some key topics to assist in understanding the modern claims-made form for professional liability insurance in general.

Prior Acts and Tail Coverage

When the insurance industry began converting from the occurrence to the claims-made form in the late 1970s, few professionals had to confront the issue of coverage for prior acts, errors or omissions, since their old occurrence policies provided eternal protection (at least up to their often inadequate limits of liability). When the professional purchased his first claims-made policy, that policy contained a specific date on which coverage began (commonly known as the "retroactive date"), and provided no coverage for claims arising out of occurrences that took place prior to the retroactive date. However, with each succeeding renewal of the policy, its coverage expanded to include claims arising out of occurrences during the prior periods covered under the same policy. In other words, the retroactive date remained the same, rather than moving forward with each renewal to encompass only one year's activity, as would be the traditional claims-made approach.

While this adaptation dealt reasonably well with the open-ended aspect of professional liability, it did not solve the problems which arise when insureds switch from one claims-made insurer to another. In this situation the issue is determining which company would be responsible for which claims, in cases where the occurrence took place under the earlier policy but the claim was reported under the latter policy.

The industry's initial response was to offer, for a considerable extra charge, an endorsement providing so-called "tail" coverage (adopting industry jargon describing the lag between occurrence and report of claim as the "long tail" of professional liability business). This endorsement provides an additional period of time (either limited or unlimited) in which the insured can report claims which arise from occurrences while insured with the

first company. Of course, for as long as the insured continues to renew with the same company there is no need for this endorsement, for with each succeeding renewal the policy expands in terms of the number of years of practice exposure it is covering. But, when the insured switches insurers, or retires or changes the practice setting, it may become necessary to secure this endorsement. Depending on the number of years of additional reporting time that the particular insurer is willing to offer, the combination of claims-made policy with tail coverage endorsement becomes more like the old occurrence form. If the insurer offers an unlimited period of additional reporting time, then the combination is functionally the equivalent of an occurrence policy for the years covered.

Over time the industry also developed another approach, under which the new company would accept liability for claims based on occurrences under the old policy. This feature has become known as "prior acts coverage." Under this approach, the new insurer writes a policy, which either includes the retroactive date established under the earlier policy, or provides coverage for claims arising out of prior acts without any specific time limitation in the past. The latter coverage is commonly referred to as "full prior acts" coverage. For professionals today, the prior acts coverage approach is far more common than the tail coverage approach as a means of allocating responsibility for claims between the new and the old insurer. This approach leaves the old insurer responsible only for claims which were actually reported while the old policy was in effect; the new insurer assumes responsibility for all unknown claims arising out of occurrences within the prior acts period, as well as all claims arising from occurrences in the current policy period. This approach has two benefits. First, it eliminates some disputes about which insurer is responsible for a claim. Second, it encourages the early reporting of claims, thus eliminating other possible disputes and, at least in the opinion of many experts, at the same time reduces the cost of claims and enables the insurer to price its product more equitably.

It is important to know, when switching claims-made insurers, exactly what is the scope of prior acts coverage being afforded, if any. First, it should be understood that the insurer is not legally obliged to offer any prior acts coverage when an insured first takes out a policy. Most companies will not offer any prior acts coverage in the following situations:

- The insured has not continuously carried professional liability insurance in the recent past;
- The insured has purchased a tail coverage endorsement from its prior carrier;
- The insured is leaving a firm to establish a new practice.

In addition, many companies will offer only limited prior acts coverage (i.e. with a stated retroactive date sometime in the past) in the following circumstances:

- The insured purchased or otherwise obtained tail coverage at some time in the recent past;
- The insured had a gap in coverage at sometime in the recent past;
- The insured's current professional liability policy contains a retroactive date;
- The insured's past practice exhibited risk characteristics deemed unacceptable by the insurer, but the current and prospective practice is deemed insurable.

Pricing Aspects of the Claims-Made Policy

When the insured obtains claims-made coverage for the very first time, the premium will be much lower than would be the cost of an occurrence policy providing the same coverage, since the former is providing coverage for only one year and only as to claims arising and reported in that same year - a much smaller obligation than is assumed under the occurrence policy. However, when the policy is renewed for a second year, the claims-made insurer's liability has grown to include claims reported arising out of occurrences in two years of practice. It is obvious in a common sense way that the insurer should charge more in the second year than in the first, all other things being equal, since the scope of its liability has expanded.

In determining how to price the first year of coverage and succeeding renewals, the claims-made insurers' actuaries closely monitor statistical data reflecting the lag time between occurrences which create liability and the reporting of claims arising out of those occurrences. In addition, they study the impact of various economic factors on the value of claims during this lag time. From this data they derive conclusions about the number of years likely to elapse before all of the claims arising out of any one "occurrence year" are reported and settled and the ultimate cost of defending and settling those claims. Depending on the profession, territory, and numerous other considerations, they then use these conclusions to establish rating factors to determine the cost of a claims-made policy as it renews each year. These rating factors are commonly referred to as "step rates" because they evolve in a stair-step pattern.

To use a simplified example, assume that with respect to the "occurrence year" 2000, the statistical analysis suggests that claims arising out of occurrences in that year will be reported in the following pattern:

Year reported	Percent Reported	Cumulative Percent Reported
2000	30%	30%
2001	25%	55%
2002	15%	70%
2003	10%	80%
2004	10%	90%
2005	5%	95%
2006	5%	100%

This table would then provide a basis for calculating the premium for each year's renewal policy. The 2000 policy would, of course, be priced to reflect the 30 percent of claims expected to be reported in that year. The 2001 policy would reflect not only the 30 percent of expected claims attributable to the 2001 occurrence year, but also the additional 25 percent expected to be reported in 2001 for the 2000 occurrence year. The process would continue for each renewal until that for the 2007 occurrence year. At that point, under these assumptions, there are no more residual claims relating to 2000 occurrences, so no charge is made for them. At this point, for premium rating purposes, the policy is considered "mature"

with respect to the 2000 occurrence year and premiums will be calculated for future renewals on the basis of a rolling seven-year period of exposure. For coverage purposes, of course, claims arising out of 2000 are still covered.

For many professionals, these aspects of pricing are more theoretical than practical issues. This is because many professionals have maintained claims-made coverage for many years, and when they switch insurers they are granted full prior acts coverage, meaning their premium rate is already mature. However, for some insureds, the early years of claims-made coverage will include significant built-in cost increases due to these step factors. Among those commonly affected are the following:

- Insureds who had no prior coverage;
- Insureds who became covered with a retroactive date that reflects less than the full number of years covered by step rates;
- Insureds who have obtained tail coverage with a prior carrier.

Claims-made insurance has sometimes been described as "pay as you go" coverage, since it is premised on paying premium in relation to the claims expected to be reported in a limited period of time, rather than all claims whenever reported in the future. The step-rate feature is consistent with this description.

It is important to remember that at any given point in the process of renewing a claims-made policy, the insured has a mix of mature and immature years being covered. When, eventually, the claims-made policy is no longer renewed, but terminates, the insured will still have a need to either obtain prior acts coverage from a new carrier, if continuing in practice, or to obtain tail coverage from the existing carrier. In general, the cost of tail coverage will be related roughly to the expected cost of future claims arising out of unreported occurrences in the immature years of the policy. Some companies promise to offer tail coverage upon termination (with certain exceptions) at a premium that is guaranteed in the policy as a percentage of the premium for the last year of coverage. Other companies promise to offer tail coverage but do not specify the price. There are also differences in the number of additional years of reporting time that may be purchased.

Limits of Liability

As experience with the modern claims-made policy has grown, one of the little noticed benefits of the claims-made form has emerged.

While the old occurrence form did provide perpetual protection, it did so only for the limits of liability purchased for the year of the occurrence. That protection may be more theoretical than practical if the amount of coverage has been eroded by inflation and social trends as reflected in the costs of defense and the ultimate value of judgments and settlements. The fact that a consultant carried \$50,000 of occurrence coverage in 1970 may be of little comfort if the claim is reported and must be defended in 2007.

Under the modern claims-made policy, the limits of liability in effect at the time the claim is reported apply, even if the occurrence took place earlier and the limits were then lower. In the above example, if the consultant had carried \$50,000 of claims-made coverage in 1970, and gradually increased his limits over the years in pace with changes in the environment, then his 1970 occurrence would probably be covered by adequate limits.

Considerations for the Individual Consultant

For those consultants in solo practice, the above discussion should prove generally accurate without further elaboration. Today, however, many consultants practice in firms of two or more, and there is increasing mobility between firms and practice settings. These consultants need to be aware of some special issues affecting their coverage for professional liability claims.

In all professional liability policies, the named insured is the firm. In the case of a sole practitioner, of course, the firm and the consultant are identical. With two or more consultants, however, the case is different. It is the firm which holds the rights and duties of the named insured under the policy, with respect to such matters as payment of premium, giving and receiving notices and exercising various options which may be available. Thus, while individual consultants may be protected under the policy, many of them know little about it because the matter is handled by others at the firm. Thus, consultants often have little idea who, if anyone, is providing their professional liability coverage, either currently or for prior acts, nor do they understand the scope of protection being afforded to them personally.

Regardless of the practice setting and any contemplated changes, take the time to know what professional liability coverage exists to protect you and your firm against claims. The following checklist may assist in better understanding these issues and avoiding unintended gaps or deficiencies in coverage:

Try to recreate for your personal records a "Personal Insurance History" going back to the day you began private practice.

If you are leaving one firm either to join another, or go into sole practice, request a copy of the old firm's current professional liability policy, as well as a summary of prior coverage while you were there. This will provide you with basic information you will need to obtain insurance on your own, as well as the ability to avoid gaps in coverage as you continue your practice elsewhere.

If you are joining a new firm, be sure to determine the scope of prior acts coverage being afforded to you, and satisfy yourself that, when taken together with prior and continuing coverage from your old firm, the new firm's policy provides you with continuous protection for your entire practice. Generally, so long as your old firm continuously renews claims-made coverage, its policy would respond to claims against you based on your practice there. However, in some cases your new firm's policy may also provide you with prior acts coverage – an important consideration if our old firm should disband or merge into another

without obtaining adequate tail coverage, or without notifying you of the change. There are also cases where your prior firm's tail coverage only applies to former members of the firm who are no longer engaged in private practice, not covering those who leave for another firm or to start their own practice.

If your firm is dissolving, and there is no clear successor firm, investigate the available options for tail coverage, since you may find limited availability of prior acts coverage regardless of whether you establish your own practice or join another firm. One advantage of obtaining tail coverage is that your future practice (if you are establishing one) would normally be covered under a first-year claims-made rate, which will be much lower than the premium you would have to pay if your new insurance had to cover prior acts. One possible drawback is that the tail coverage for the dissolving firm may only provide a limited additional period of time to report claims arising from the dissolved firm's practice. The available policies vary in how much additional time they will offer, how much you have to pay for various time periods (although in some cases the policy does not guarantee the price for tail coverage), and what you must do to exercise your tail coverage options.

When purchasing or renewing a policy for yourself or your firm, it is important to provide the carrier with all the relevant information to help them give you the best pricing possible. Keep in mind:

A complete claim history is important. Reporting potential matters and claims to your carrier in a timely manner not only protects your coverage rights; it provides the carrier with the information needed to help you manage the situation. And it is not true that turning in a potential claim will automatically increase your insurance rates. A main function of the underwriter is to determine what situations are valid and which ones may only be nuisance cases. Obviously if there is a pattern within a firm's potential claims an underwriter may choose to recommend risk control procedures or take rating action.

Provide information on your internal systems and processes. Even if you have provided this information on past applications, let the carrier know what improvements you have made. For an underwriter, knowing a firm's internal procedures can make a definite impact on how the overall risk is viewed.

Retirement

Special considerations exist for professionals who are retiring from practice, or entirely ceasing private practice due to health considerations, to pursue another occupation or for other reasons. Although no longer actively practicing, such professionals do need continuing insurance protection for claims that may be asserted after retirement based on occurrences while still in private practice.

For professionals retiring or withdrawing from a firm that continues to carry professional liability insurance for the ongoing practice, coverage is usually afforded automatically under the policy of the firm, so long as it continues to be renewed. Even if the firm switches carriers, the retired professional is usually covered so long as the new carrier is providing prior acts coverage. The retired professional shares in the coverage afforded the firm with respect to limits of liability and deductibles.

Such an arrangement is often satisfactory where the continuing firm is stable and well established, and can clearly afford to continue carrying coverage. The retiring professional should, however, consider the following factors:

- What is the likelihood that the firm would ever discontinue carrying professional liability insurance?
- If the firm no longer carried a policy protecting the retired professional, would other sources of coverage be available?
- Does the firm's policy provide retiring professionals the option to purchase on an individual basis an extended reporting period endorsement? (Some policies do provide this option, which would continue the coverage as to the retired professional regardless of the firm's discontinuance of the policy.)

C. **Managing Risk**

Small Firms, Big Challenges:

Managing Litigation Risk in Small Actuarial Firms

By Lauren M. Bloom

Practicing actuaries face a number of risks, including the risk that their work will be challenged in court. When working in-house as employees of insurance companies, pension plans or government agencies, actuaries normally run little risk that they will be individually sued. Consulting actuaries are more likely to be the target of litigation, however, perhaps because clients are less reluctant to sue consultants with whom they have an arm's-length business relationship than employers are to sue their employees

For actuaries working in small firms, the risks of litigation can be particularly severe. Large actuarial firms typically devote substantial resources to litigation risk management, using standardized client contracts and disclaimer language, adopting policies to supplement the profession's standards, appointing compliance officers and peer reviewers and engaging outside attorneys to help design and implement their litigation risk management programs. Actuaries working in smaller firms usually cannot devote the same resources to litigation risk management that large firms do. However, the professional services that actuaries provide to their clients involve such large sums of money that a single successful lawsuit can put a small firm out of business.

Fortunately, smaller firms can reduce their litigation risk without unreasonable difficulty or expense. This article, and one to come in the next issue, will offer ideas on how actuaries in small firms can address their litigation risk in rational, cost-effective ways.

Client Selection, Education and Management

The first step in reducing litigation risk is to think twice about taking on the "high risk" client. Unsophisticated clients who do not understand exactly what the actuary can and cannot do are likely to resort to the courts if they rely too broadly on the actuary's work.

Clients who want work done at the eleventh hour, without opportunity for peer review or based on critically flawed data, may be withholding essential information. Clients who will not commit to providing the actuary with necessary information and support may be looking for a scapegoat, not a business advisor. Clients with a history of suing previous consultants may be especially prone to resort to litigation over future disagreements.

Even high-risk clients can be effectively served if the actuary actively manages the client relationship. It is usually wise to educate clients about the scope and nature of actuarial work and relevant facts and circumstances not only at the beginning, but throughout the relationship. Litigious, uncooperative or uncommunicative clients may require the actuary to go to greater lengths to document the scope of the assignment and exactly “who said what to whom and how” as a project goes forward. Thoughtful communication can reduce the risk of misunderstanding or client dissatisfaction, in turn reducing the risk that the client will bring suit against the actuary. Contracts, engagement letters, correspondence and even e-mail can be used by the small plan actuary to educate the client, clarify the scope of the assignment and document the course of communications.

Scope of Assignment

Another effective means to mitigate litigation risk can be carefully delineating the scope of the assignment. Assignments for which the profession has developed accepted practices are likely to be less risky than those in emerging areas where fewer outside resources are available to help the actuary do a professional job. A small firm actuary may find it helpful to use techniques, processes and tools like computer software that have been thoroughly tested and are widely used. Some assignments (for example, mergers and acquisitions or negotiations between an employer and a union) are inherently more risky than others, and may be more than some small firm practitioners can comfortably take on. Another way to mitigate litigation risk can be for the small firm actuary to develop a “niche” specialty in which he or she excels, reducing litigation risk accordingly.

Compliance with Professional Standards

Lawsuits against consulting actuaries usually allege malpractice, i.e., failure of the actuary to engage in “generally accepted” practice. The standards set by the U.S. actuarial profession in its Code of Professional Conduct, Actuarial Standards of Practice (ASOPs) and Qualification Standards are compelling evidence of “generally accepted” practice, a fact that the Actuarial Standards Board has explicitly recognized in the Introduction to the ASOPs. Consequently, the small firm actuary is wise to review the standards that apply to each assignment, comply with them, and then document compliance.

Precept 2 of the Code of Professional Conduct requires the actuary, before taking on each assignment, to determine that he or she is qualified by virtue of basic and continuing education and experience to do the work. (The actuary should also be mindful of the Qualification Standards, which establish basic and continuing education and experience requirements for certain actuarial assignments.) This can be a challenge for small firm actuaries, particularly if they are being asked to work in a new area. Teaming up with

another actuary who has complementary qualifications can help the small firm actuary meet this requirement, as can obtaining peer review from a qualified colleague. Limiting the scope of the assignment to the actuary's area of expertise can also be effective. The small firm actuary may find continuing education to be particularly valuable as a way to obtain the skills needed to move into new fields.

Large actuarial firms often have "standards compliance officers" who are responsible for ensuring that actuaries in the firm are aware of and in compliance with new ASOPs; small firms rarely have that luxury. Small firm actuaries are still required to satisfy applicable ASOPs, however, so it becomes incumbent upon them to find ways to keep current as the ASOPs evolve. The Actuarial Standards Board's Web site provides the most current version of each ASOP and information about when the ASOPs are being added to or revised. If the actuary is unsure which ASOPs apply in a particular setting, the American Academy of Actuaries' Web site features the "Applicability Guidelines for Actuarial Standards of Practice," a list of commonly-performed actuarial tasks, organized by practice area, and the ASOPs that usually apply. Regular use of the Applicability Guidelines can help the small firm actuary satisfy applicable ASOPs when performing particular tasks.

Two ASOPs almost always apply to actuarial assignments. ASOP No. 23, Data Quality, addresses actuaries' use of data and how to deal with common data problems. ASOP No. 41, Actuarial Communications, addresses actuaries' communications with their principals. Both ASOPs provide invaluable guidance to the actuary on areas that are particularly likely to become an issue in litigation. An actuary's failure to appropriately address flaws in data, or to communicate clearly and effectively with a client, is something a plaintiff's attorney can readily explain to a court. Compliance with ASOP Nos. 23 and 41 can help the small firm actuary avoid those litigation pitfalls.

Getting Review

Large actuarial firms usually have an internal peer review process; again, small firms are less likely to have a formal program. However, peer review can significantly reduce the actuary's litigation risk. Peer review often brings to the surface problems or questions concerning the work product that may not have been apparent to the actuary, offering an invaluable opportunity to correct errors and clarify uncertainties before the client relies on the work. The small firm actuary can point to his or her having obtained peer review as evidence of due diligence in performing the assignment. Obtaining peer review can also increase the small firm actuary's confidence that the work satisfies applicable professional standards.

Some small firm actuaries contract with colleagues to "swap" peer review services, while others engage peer reviewers only for larger or more complicated projects. Less formal review of the small firm actuary's work can also be helpful. Simple proofreading can catch mathematical and other errors. Especially when dealing with unsophisticated clients, the actuary may find it beneficial to have a non-actuary examine a work product for completeness and general comprehensibility. When engaging any reviewer, however, the

actuary should bear in mind the confidentiality requirements of the Code of Professional Conduct.

The American Academy of Actuaries' Council on Professionalism has published a paper on peer review, a terrific resource for the small firm actuary who is interested in creating a peer review program. The Conference of Consulting Actuaries has also published guidelines for peer review; more information is available online at their Web site.

Document, Document, Document

It can be tempting for any professional to think the job is finished when the work goes out the door. To reduce litigation risk, however, the small firm is wise to consider what documents to keep and what to discard. Large firms usually have carefully considered document-retention policies. Small firm actuaries often operate more informally, and may neglect to consider this important issue.

Document retention could be the subject of another whole article, but following a few simple "rules of thumb" can improve small firm actuaries' documentation without significantly increasing their effort or expense. The profession requires actuaries to maintain sufficiently detailed work papers such that another qualified actuary could evaluate the reasonableness of the actuary's work. In most instances, the work papers would include documentation of processes used as well as assumptions and conclusions; documenting processes can help the small firm actuary demonstrate adherence to generally accepted practice. The ASOPs contain specific documentation requirements that should be satisfied. Copies of all documents that the actuary sends to the client should usually be retained, even if the version that went to the client was marked "draft." Rough drafts, preliminary calculations and other "raw" materials should be incorporated into the actuary's work papers as appropriate, and then discarded. E-mail can be particularly tricky; although it seems informal, e-mail is as permanent a form of communication as a letter or memorandum, and should be handled with comparable care. Its apparent informality has one important advantage, however; when carefully used, e-mail can be especially useful to prove that a client was given information or asked an important question at a particular point in time.

When it comes to document retention, consistency is key. A qualified attorney can help a small firm actuary develop a document retention policy that is suitable to the actuary's practice. Once the policy is in place, consistent compliance can reduce the risk that the actuary will be embarrassed (or worse) in litigation by having to produce damaging documentation.

Conclusion

Managing litigation risk is an important element of a successful professional practice. By thinking carefully about litigation risk and putting preventive practices in place, small firm actuaries can enjoy their work without excessive concern about the litigation risks associated with it.

Biographies of Contributors



David S. Rintoul. David S. Rintoul has a diverse business and litigation practice, practicing in the law firm of Brown, Paindiris & Scott in Glastonbury and Hartford Connecticut. He advises and represents many entrepreneurs and independent consultants on business and legal issues. He advises employers and employees regarding non-competition agreements and employment agreements. He advises and represents employees in a wide variety of employment matters as well.

David has substantial litigation experience, having handled trials and appeals in state and federal court, and administrative hearings before many state agencies. He has been class counsel in national and statewide class actions, and has been appointed by the United States District Court as a Special Master in the area of employment law. In 2006, he was recognized by his peers as one of the top business litigators in Connecticut in Connecticut Magazine's Super Lawyer listing.

David regularly lectures and writes on a variety of areas. He has taught seminars in a broad range of employment and employee benefit matters for bar organizations and continuing legal education organizations. He has lectured nationally on business and legal issues involved with professional and consulting practices.

David is admitted to practice in Connecticut, and is a member of the Connecticut Bar Association. He is on the Executive Committee of the Labor & Employment Section of the Connecticut Bar Association, and is Co- Chair of its Employee Benefits and ERISA subcommittee. He is a graduate of The Johns Hopkins University (B.A. 1983), School of International Advanced Studies, Bologna, Italy (diploma, 1981-1982) and the University of Connecticut School of Law (J.D., with high honors, 1986).



Lauren Bloom. Lauren M. Bloom is the founder and CEO of Elegant Solutions Consulting, a firm dedicated to helping professionals, business executives and association management build trust with their clients, customers and members by "walking the ethics talk" in their daily practices. She is currently working on a book titled, Elegant Solutions: A Practical Approach to Resolving Ethical Dilemmas While Preserving Your Professional and Personal Relationships.

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An internationally-recognized expert on professional ethics and governance, Ms. Bloom has appeared as a keynote speaker and on panels across North America and in Europe, bringing a practical, humorous approach to the serious business of developing and maintaining high ethical standards in a post-Enron world. Her paper on the development of processes to set and enforce ethical standards within professions was recently published in the Proceedings of the 2006 International Actuarial Congress in Paris, France.

Lauren graduated from Yale College with a B.A. in English in 1979. In 1985, she received a J.D. from the Columbus School of Law, Catholic University of America, where she was valedictorian of her graduating class. She also holds an advanced degree in Labor Law with distinction from Georgetown Law Center.

Lauren began her legal career at the Justice Department as a trial attorney, soon moving into private practice and specializing in standard-setting and enforcement and governance for nonprofit associations.

Beginning in 1992, Lauren spent more than fourteen years as General Counsel of the American Academy of Actuaries, where her practice focused on teaching professionals how to incorporate high ethical standards and principles of good governance into their professional activities. Lauren played a pivotal role in the development and enforcement of the U.S. actuarial profession's code of conduct and standards of qualification and practice. She also consulted with the International Actuarial Association on its project to develop the first international standards of practice for actuaries. She is widely published in the actuarial profession's publications, and continues to speak to actuarial firms and association meetings around the United States. Lauren provides consulting services to actuarial firms, focusing on professionalism, standards compliance, and malpractice risk mitigation.

In addition to her work at Elegant Solutions Consulting, Lauren currently serves as General Counsel to a mutual aid association. She can be contacted at laurenmbloom@aol.com.

Paul Dorroh is Senior Vice President of Marsh Affinity Group Services, a Service of Seabury & Smith, Inc., responsible for professional association insurance programs in the western United States, including programs of lawyers' professional liability insurance sponsored by The State Bar of California and The Hawaii State Bar Association.

Mr. Dorroh has been active in the professional liability insurance industry for over 20 years, prior to which he was in the private practice of law with the firm of Pillsbury, Madison & Sutro (now Pillsbury Winthrop LLP) in California. He is a graduate of The University of California, Berkeley, and of the Boalt Hall school of law, and is currently a member of The State Bar of California and the Professional Liability Underwriting Society.



Photo: Rich Lee

Emily Neustadt. Emily Neustadt is a business focused executive coach and senior consultant with 15 years experience working in Fortune 500 companies. She works with organizations, teams and individuals on issues of leadership development, strategic planning, influencing and communication for better management.

Her programs are customized to the client's strengths and the organization's needs. She is pragmatic and action-oriented, facilitating short and long-term change. Emily's specialty is in strategic planning and delivering feedback in a way that motivates professionals and clarifies the next needed step. She teaches these skills to individuals and teams, leading off-sites, facilitating discussions and providing executive coaching. Her systems-centered perspective grounds the experience in the reality of the organization's business and political environment, enabling clients to achieve exceptional results, utilizing their gifts and talents.