There Aren't Any Real Differences In Coverage Among Policies . . . Are there?

By Bayard Bigelow, III, MBA, CPA

Markel Cambridge Associates and its predecessors have been managing E&O professional liability programs for registered investment advisors since [1997]. That's over a decade of helping investment advisors select the best E&O policy for their circumstances. We also speak a lot, and will typically field a wide variety of questions from the audience. Whether by phone, in person, through correspondence, or from an audience, the questions don't vary a lot – and they underscore the degree to which investment advisors don't understand the policy choices they face.

The E&O professional liability polices available for financial advisors are ***not*** commodities, unlike other policies such as private passenger automobile, homeowners insurance and many commercial policies. The professional trying to evaluate various policies, therefore, needs a working understanding of their terms and conditions and how they will be administered in practice.

An insurance product that is tailored to fit a particular professional's needs will require choices to be made. While it is unlikely that the layman will be want to invest the time to understand all of the nuances of coverage, it is possible to evaluate the appropriateness of different policies and insurance programs. This article will attempt to highlight some of the key issues. Please note that the article addresses basic concepts of E&O policies, and the law in a particular state may be applied differently.

We all know one of life's unwritten rules — for every benefit there is an offsetting price to be paid. In other words, there really and truly is "no free lunch", also known as "The NFL Rule".

As the NFL Rule applies in this case, nearly all E&O policies available for investment advisors are written in an unregulated market. This is the market of choice because the profession is highly fractured and complex. Accordingly, any insurance product must meet the needs of a variety of different types of practices. Only in the unregulated market can coverage terms be tailored as circumstances dictate.

It also means that all policies will not be identical in terms of the coverages offered and their administration and that it is important for the buyer to appreciate the differences.

Defense Provisions

It is not unusual for an insurer to pay as much for the defense of claims as is paid in damages to claimants. In other words, the defense provisions of the policy are a critical part of the overall insurance policy.

There are two clauses commonly used in E&O policies. Under the first, the insurer has "the right and duty to defend". Under the second, the insurer has only "the right ***but not the duty*** to defend". While this difference may seem small, it can be significant.

Under a right and duty to defend policy, the carrier is required to provide a defense if only a single allegation potentially brings the case within the scope of coverage. Alternatively, if a claim alleges only acts that are excluded, the carrier can deny coverage for the entire claim.

In most complaints, a count of some form of ordinary negligence will be included, which will trigger coverage for the defendant. Failing to include at least one complaint of a covered act would appropriately result in a coverage denial of the claim by the defendant's insurer. Plaintiffs' attorneys generally would prefer not to see that result, since it eliminates a potential deep pocket for settlement and recovery purposes.

But if the insurer has no such duty to defend in the first place — that is, if its policy is a "right, but not a duty to defend" contract — the carrier may simply elect not to provide a defense. Thus, if a plaintiff alleges wrongdoing that is covered, the insurer under a "right but not the duty to defend" policy may elect not to provide a defense, leaving the policyholder to shoulder the considerable expense of a defense lawyer. If a buyer elects to purchase a policy written on this basis, he may be saving money in up-front premiums, but he may also be electing to self-insure for defense costs. Undertaking to do this is something that should be carefully thought through.

Punitive Damages

Punitive, exemplary or multiplied damages (as contrasted with compensatory damages) are intended to punish or to make an example of the defendant's conduct. Many courts do not allow insurance coverage for punitive damages, to discourage persons from engaging in the type of intentional or reckless conduct that punitive

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damages are designed to punish. This is the effect of case law in many states in which punitive damages are uninsurable. These states include the industrialized, heavily populated states such as California, Florida, Illinois, Massachusetts, New Jersey, New York, Ohio, Pennsylvania and others. (The Notes point to a more complete discussion of punitive damages by state [1]).

By their very nature, punitive damages can arise when the defendant's conduct is found reckless, willful or wanton or done with the knowledge that it was wrong. There is no perceived need to make a similar example of ordinary negligence.

But the typical professional liability policy will contain two exclusions, one pertaining to willful misconduct; and the other to harm that the insured expected or intended to cause.

When the policy contains these exclusions, it may also effectively exclude punitive damages, because the policy will cover only ordinary negligence allegations, upon which punitive damage awards may not be based. In other words, even if a policy does not expressly exclude punitive damages, its other exclusions may deny coverage for the types of conduct that give rise to punitive damage awards in the first place.

The Incident Trigger For Coverage

Losses arise most frequently from execution errors, best described as "dumb mistakes" – similar to what we all do every day as we muddle our way through the complexities of daily life. They are nearly always reported as an act which may reasonably be expected to give rise to a claim. A claim, by contrast is an actual demand for damages.

Execution errors share the following characteristics:

- There is typically little if any question of liability;
- Damages can be readily ascertained and are generally not significant;
- The error surfaces rapidly, usually within hours or days of its occurrence.

In short, if detected promptly and attended to quickly, incidents can be settled with minimal disruption to the relationship between the insurer and its policyholder or to that of the advisor and his or her client. And they can be settled without significant legal costs. The mantra for these incidents should be "Settle quickly and don't haggle a lot". Unlike fine wine, these claims do not get better with age.

The Law of Perverse Effects applies, however. If insureds expect to be treated in a punitive manner when they report an incident (as they are required to do under all E&O policies), then guess what – they'll engage in "self-help", by attempting to settle the matter quietly on the side. And with self-help comes the very real possibility of "claim implosion". To make matters worse, failing to report a claim as an incident may trigger a coverage denial for the entire matter, regardless of the nature of the claim, as the policyholder has not met his or her obligations under the insurance contract.

And yet we see it again and again and again – because a policy lacks provisions under which the carrier recognizes an incident before a demand is presented, the insured either goes the self-help route or, if he or she reports the matter without a demand having been made by the insured's client (as is always required), the insurer denies coverage. In the latter case, the insured goes to his or her client and informs him that without a demand there will be no coverage for the loss under the advisor's E&O policy. With that, the genie is out of the bottle, setting off an irreversible chain of events. The client, having been told that he must demand damages, or perhaps wondering what else he might be able to wring out of the claim, hires a lawyer. The lawyer then piles on everything he can think of. Voila, the magical transformation of a small incident into a large claim, similar to the Biblical miracle of the loaves and the fishes.

The Incident Trigger – Part II

Under some E&O insurance policies, the carrier's coverage obligation begins once the insured has reported an incident. With other policies, the carrier's duties do not commence until the insured actually receives and reports a demand for damages.

Consider what happens if a policyholder changes carriers. The (new) carrier issuing replacement coverage will always exclude coverage for matters known to exist at the inception of its coverage. Therefore, unless the expiring policy provides for coverage as of the date on which the incident was first reported (the first type of "claims made" coverage described above), there is usually no available coverage when a demand for damages is received or when suit is brought after the policyholder has changed carriers.

The Role and Importance of Price

There is one critical point here—***the premium should not be the primary consideration***. This product is about as far away form the commodity insurance lines as you can get. Whatever price differences exist at the time of quotation, they will be overwhelmed by the financial exposure arising from a mis-handled claim.

Sorting it all out

This line of insurance is one where a number of carriers have come – and gone – throughout the years. As the insurance relationship is long term in nature, you need to assess the carrier's commitment to the line of business. And the carrier's response to a claim is really the only measure of whether the coverage provided is or is not adequate.

To ascertain the insurer's seriousness of purpose, the most effective questions to ask center on just how committed, knowledgeable and experienced the carrier is with your profession. The simplest question is what experience do the underwriters and I or the insurer have with the profession? Another way to get at this same issue is to listen carefully to the way in which your questions are answered. You can pretty quickly tell if the broker or underwriter has a deep understanding of your profession by what they say (or don't say), and by how they say it.

Summary

Because of the relatively small number of professionals in the financial planning profession, as well as their diverse insurance needs, the unregulated market is ideally suited to the meeting of these needs. But it is also important to use this market intelligently and understand the choices you are making before buying any insurance policy.

[1] McCullough, Campbell & Lane,
The Insurability Of Punitive Damages
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