STANDARDS AND THE CFP PRACTITIONER'S EXPOSURE TO LIABILITY

By Bayard Bigelow, III

The attached article is scheduled for publication in the October issue of *The Journal of Financial Planning* (ICFP). It grew out of a presentation made to the CFP Board of Standards in March, 1998. In preparation for that presentation, we were asked to present our views on the standards themselves and their likely impact on the liability climate that the profession faces.

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Standards And The CFP Practitioner's Exposure To Liability

By Bayard Bigelow, III

As we stand at the edge of the implementation of CFP Practice standards, much concern has been expressed about the impact of these newly drafted standards. At its most extreme, the opponents of standards have asserted, sometimes in strident tones, that these very standards will result in drastic changes in the liability climate in which the profession practices. The purpose of this article is to critically examine the issue of how these standards are likely to affect the profession, as well as to examine the validity of the views of the opponents of standards.

As we look at the draft standards, the drafters, the CFP Board of Practice Standards itself, appear to acknowledge the concerns of the practitioner that the standards implemented may result in a change in the liability climate. In Standard 1, the Board of Standards notes:

> *Conduct inconsistent with a standard in and of itself is not intended to give rise to a cause of action nor to create any presumption that a legal duty has been breached. The standards are designed to provide CFP designees a structure for identifying and implying expectations regarding the professional practice of personal financial planning. They are not designated to be a basis for legal liability.*

The Planner's Difference. We currently represent, as National Program Manager, a program which provides E&O Insurance for financial planners and RIA's. A number of years ago we also underwrote group E&O programs for broker / dealers. Consistently, and for several years, our claims experience for broker / dealers was considerably worse than that for financial planners.

The reasons for the differences in experience from these two similarly situated professions became clear to us with a series of claims reported in 1993. A NYSE company had filed for bankruptcy resulting from the misappropriation of funds by the officers of the Company. Within the first two weeks following the bankruptcy filing, four claims involving investments in the company were filed against four different registered reps of the same broker / dealer alleging lack of investment suitability. In no case was there a defensible assessment of the client's investment objectives or tolerance for risk. The claims could not be easily defended because there was little apparent justification of the choice of the investment in the first place.

Three years later, long after this series of four claims had been settled, we were having a discussion with a financial planner who had also recommended this same investment to his client. He patiently explained to us the efforts to document the client's objectives at the time that the investment had been made. He also pointed out that the client had, in the engaging documents, explicitly acknowledged the inherent risk that the client could not assume away, no matter how well or poorly an investment performed. As a result, the policyholder asserted that it was highly unlikely that a claim would be filed. No claim was ever filed. In later years we came to learn that several of our other policyholders had had a similar exposure to this same security. No other claim involving this investment was ever filed by those of our policyholders who were financial planners.

This series of claims, as well as the lack of any claims reported by those financial planners who had placed the identical investment, lead us to an important conclusion -- the difference between financial planners and other similarly situated financial advisory professionals was the process of financial planning itself, together with the resultant documents identifying the client's investment objectives, tolerance for risk and, most importantly, the meeting of the minds between professional and client. These three elements of documentation are all important when something goes wrong, as it surely always will. These same elements are the very subject of the standards soon to be implemented.

In defending a claim, the documents crucial to the providing of a defense include:

- Assessment of investment objectives;
- Assessment of client tolerance for risk; and
- File notes made contemporaneous to the alleged wrongful act

The existence of these documents, and in fact the financial planning process itself, already distinguish the financial planning professional from other financial advisory professionals. These standards serve to reflect practices already widely applied by many practitioners.

While the debate surrounding standards is far from over, we can at least hold it up to the light of day. In other words, when rational discourse breaks down, we can at least look at the facts.

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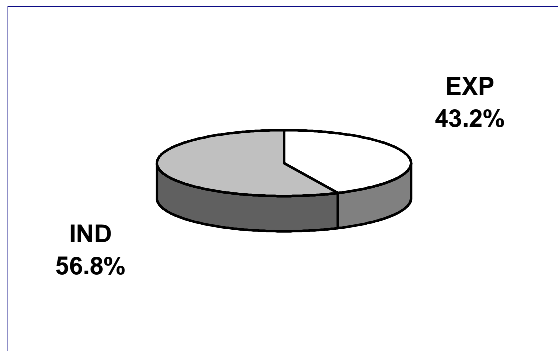
Message # 1 -- Defense Costs Represent Approximately Half Of An Insurer's Loss Payments. Nearly all professional liability insurance policies will cover the costs of both defending and settling a claim. We therefore need to look at the costs of defending the professional, across all claims. Here's our data:

LOSSES
EXPENSE VS. INDEMNITY
1988 - 1998



The abbreviations used in the graph have the following meaning:

EXP -- Refers to the expenses of investigating and defending a claim.

IND -- Refers to indemnity payments, or damages paid to bring about settlement.

Briefly stated, this data demonstrates that a very significant exposure against which the practitioner purchases insurance is to cover the expense of mounting a defense against what in many cases may turn out to be non-meritorious claims. Indeed, our loss experience demonstrates that well over half of all reported claims eventually close with only a small payment or no payment to the claimant.

This proposition runs somewhat counter to conventional wisdom. The insurance buying public tends to believe that it purchases insurance to protect accumulated assets against the erosion of some unanticipated adverse judgment. The data suggests that an equally valid reason for buying professional liability insurance is to protect against the expense of providing a defense for a claim that perhaps never should have been brought in the first place. While as a professional you may well assume that the quality of your practice is above reproach, you need not have been negligent to be named as a defendant in a lawsuit. The incidence of claims is a function of human dissatisfaction, not necessarily the result the defendant's negligence.

Message # 2 -- Loss Experience Will Tell Us Why Losses Arise. If we take another slice at the loss data, we can obtain valuable insights about the reasons that claims arise:

The cause of loss data presented is divided into five categories as follows:

DS -- DISCLOSURE -- Incomplete or misleading disclosures

FR -- FRAUD -- Fraudulent activity;

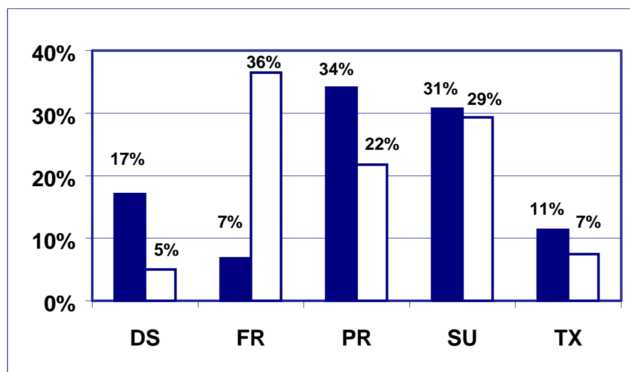
PR -- PROCEDURAL -- Procedural errors (e.g. in 401K or IRA rollovers);

SU -- SUITABILITY -- Lack of investment suitability;

TX -- TAX -- Tax errors;

The graph below depicts the number of claims as a percent of the total number of claims, and the dollars of losses as a percent of total loss amounts, displayed by the cause of loss as described above. The left shaded bar refers to the percentage of the total number of claims, while the right unshaded bar refers to the percentage of total paid losses.

CLAIMS EXPERIENCE
1989 -- 1998



As this data applies to standards, we can draw an important set of related conclusions:

Claims historically have arisen from several different causes of loss. Claims representing 69% of the number of claims and 71% of the loss amounts will be unaffected by the implementation of standards. *Causes of loss that will not be affected by standards include disclosure, fraud, procedural and tax claims, since such claims will continue to occur whether or not the standards are followed.*

Thus, approximately 1/3 of the numbers of claims and the amount of losses are attributable to allegations of lack of investment suitability. Either frequency or severity may or may not change as a consequence of soon to be implemented standards. We must look more deeply into the anatomy of a negligence claim in order to assess how standards will affect either the frequency or severity of such claims.

The Anatomy Of A Negligence Claim. In a negligence claim, the plaintiff must credibly demonstrate that:

- A generally accepted professional standard exists;
- The defendant failed to adhere to this same generally accepted professional standard;
- The resultant negligence on the defendant's part caused economic damage to the plaintiff; and
- The damages are measurable.

The allegation of negligence in a suitability claim generally surrounds the failure to recommend an investment consistent with the client's investment objectives; or tolerance for risk; or it may arise from an inappropriate allocation of assets.

The burden of proof on the plaintiff is a significant one, and absent willful misconduct on the part of the defendant, one that is very difficult to prove conclusively. Because a negligence claim is difficult to prove, it is equally difficult to defend. Thus, suitability claims are, on the one hand, expensive and defense intensive; and, on the other hand, tend to be settled either out of court or in a forum other than in formal litigation. But, as noted above, the starting point of such legal actions is to demonstrate both the existence of a professional standard, as well as the failure of the professional to meet that very standard, to the detriment of the plaintiff.

To conclude that the implementation of standards for CFP licensees will result in a change in the liability climate is tantamount to concluding that the standards represent a new level of professional rigor that the CFP has never before had to meet. There is virtually no evidence that this is the case.

It is generally accepted that the standards applied in any negligence claim can come from several sources. As standards apply to the CFP, the sources of standards might include SEC regulations, State Blue Sky Laws or other similar statutes, standards promulgated by other professional associations, the professional literature, as well as the "prudent man" rule of common law. Both plaintiffs and defendants are currently employing all of these sources of standards. Since it cannot be demonstrated that the standards soon to be implemented represent a significant shift in standards that are already being applied, and therefore constitute the body of knowledge that we have come to define as generally accepted practice, it cannot be concluded that a significant deterioration in the liability climate will follow.

A conclusion that is tempting is that the plaintiff's bar may employ these standards to make new legal inroads to the detriment of the profession. While that conclusion is tempting, it ignores two other issues:

Litigation is an expensive undertaking. While the popular business press dramatizes those cases where the legal system seems to have taken a wrong turn, resulting in a verdict significantly out of proportion to the damages sustained, such cases are rare. The day-to-day reality of the workings of the legal system is that it does not have the lottery like qualities that we so fear. Plaintiffs, or their attorneys if the case is accepted on contingency, must still face the stark reality of the economics of launching litigation, and against a most uncertain outcome. Who among us has not felt wronged only to have to face the chilling effect of the significant economic, emotional and psychological costs of litigation. These economics existed before standards and will continue to exist even when standards are put into effect.

Putting this first argument to the side for a moment, let us presume that the critics do have a point -- that is, that the existence of standards will cause plaintiffs to attempt to advance their respective causes that they otherwise would have somehow learned to live with. To believe that this will occur is to fail to believe in the advocacy system -- *if plaintiffs find it easier to litigate, likewise the defendant's burden will have been eased, as these very same standards are likely to be equally valuable to the defense.* This argument suggests that while there may be increased frequency of claims, it should be accompanied by a decrease in the average severity of all claims, and by a sharper decrease in the severity of negligence claims, including those alleging lack of investment suitability.

The Insurance Mechanism -- The Law of Large Numbers. One of the problems of determining the outcome of the standard setting process is that it involves trying to look into the future. It is always true that the future is unknowable, and the outcome may be quite different than what we can imagine knowing what we do today. Trying to assess the future in any meaningful way reminds me of the scene from The Wizard of Oz when the Wizard was discovered by Dorothy to be a mere man. "You're a very bad man," she said. The Wizard responded with, "No, actually, I am a very good man. I'm just a very bad wizard." I too admit to being a very bad wizard.

Enter the insurance mechanism. Through insurance, an unlikely but potentially catastrophic risk is spread among a large number of insureds. Thus, the theory holds that a policyholder willingly exchanges a small but certain payment of premium in exchange for reducing or eliminating entirely the risk of financial ruin resulting from a large claim. If enough such policyholders vote with their feet, then the risk of loss is spread among the pool of policyholders without having to be borne disproportionately by any single insured.

We are hard pressed to identify why it is felt that the implementation of standards will have a detrimental impact on the liability climate faced by the practitioner. However, this short lesson in the economics of insurance, as it applies to the issue of standards, implies that if we are wrong, the insurance mechanism will work to distribute what would be a large exposure to any single insured practitioner equally among all practitioners who are insured. Each insured will absorb a small incremental loss in the form of higher premiums. But no single insured will single-handedly absorb a high level of personal and financial risk.

Summary. The argument that standards will not dramatically change the legal climate for practitioners is a fairly straightforward one:

- Standards are very unlikely to have any effect on approximately 70% of the claims historically experienced by practitioners.
- The plaintiff's burden is already high for those wishing to bring a negligence claim.
- Since we already live in a standard based world, standards such as those proposed do not appear to represent a major change in the practitioner's exposure to liability.
- The economics of litigation do not change in a standards based world and should continue to operate as a further deterrent to frivolous litigation.
- While standards may increase the frequency of claims, they will correspondingly be likely to ease the defendant's burden, assuming that the licensee follows practice guidelines.
- If the profession's legal burden does increase, the insurance mechanism will spread the burden among those practitioners who are insured, making any singe practitioner's burden rather minor.

The Final Comments -- The Value Of Standards. Regardless of what any of us may think about standards, we have yet to mention that there is a very clear benefit to the implementation of standards. We started this article by citing the differences in claims experience among financial advisory professionals. It should be clear that the existence of these standards will have the effect of incrementally adding to the value of the CFP mark -- the public will have more confidence in both the profession and the processes it employs to discharge its professional responsibilities. This, in turn, should have the effect of increasing the demand for the services of the CFP practitioner, while decreasing the demand for services rendered by those who are not CFP practitioners.

We would also offer three pieces of loss prevention advice, born out by the claims made against our policyholders:

Document! Document! Document! In any claim, the quality of the practitioner's documentation is critical to providing an adequate defense. This is particularly true of both the documentation of investment objectives and tolerance for risk, and of file notes made contemporaneous to the services which gave rise to the claim -- typically, because the plaintiff will not have made file notes, those offered by the defendant will constitute "best evidence".

Choose Your Clients Prudently. Not every client is meant for you. Clients who have sued before, whose expectations are unrealistic or who present unusually difficult financial problems or special circumstances should generally be avoided.

Disclose Thoroughly. In a claim setting, the first document that is typically requested by the plaintiff is the RIA's Form ADV. Make sure that it accurately reflects your practice and is in compliance with appropriate regulations. You can count on the plaintiff's attorney showing no mercy if required disclosures are inaccurate or misleading.

We close with the following by Ambrose Bierce, American satirist and humorist, writing in *The Devil's Dictionary* in 1906, who took a somewhat humorous view of a lawsuit:

> *"Lawsuit: a machine which you go into as a pig and come out of as a sausage"*

Enough said!

About The Author

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