No E&O? How Smart Is This?

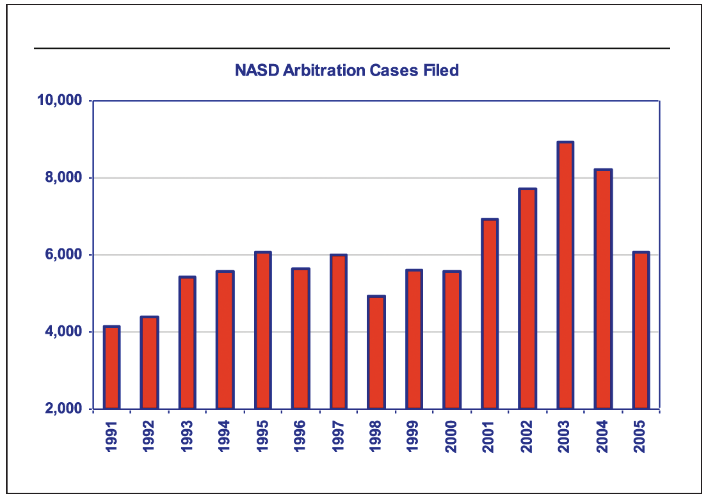
By Bayard Bigelow, III, MBA, CPA

There are two kinds of prospects and policyholders – those who would not dare practice without insurance and those who never believe they will have a claim and will argue, sometimes adamantly, that they will "self insure". Before rendering any response, however, I will completely disclose my biases and my vantage point so that readers can form their own opinion. I have been managing an E&O Program for RIAs since 1992 and, to the best of my belief, our name is well respected and well regarded in the marketplace. We frequently publish advice, in the form of articles and white papers to RIAs, since we know the issues which RIAs encounter well through decades of first hand experience. Put differently, while anything I may assert about buying insurance is self serving, self serving statements are sometimes true. At a minimum, ours are grounded in reality.

Scare Tactics

The insurance industry is from time to time accused of using "scare tactics" to convince prospects to buy insurance. For anyone to believe that "scare tactics" are promulgated by the industry to lure the uninitiated into buying insurance they do not need is simply ludicrous. We receive calls daily from advisors *who ask us* about claims we have experienced – they want to know, as a data point in their decision making process, what kinds of claims other advisors experience. My response is that the claims you might reasonably expect bear little resemblance to those which our policyholders actually experience, presumably because a smart advisor knowing that his client is unruly or uncooperative, would "fire the client". I could, from my experience, write a dissertation on unusual or unexpected claims – so called "frivolous claims".

But let me start with facts. Requests for arbitration or complaints of every imaginable stripe can occur through the NASD, the SEC, the civil court system, the American Arbitration Association, the New York Stock Exchange, the SROs and others. The NASD is the only forum which publishes statistics about dispute resolution involving securities. The graph below represents the number of arbitration claims filed with the NASD for the past fifteen years.



Source:
http://www.nasd.com/ArbitrationMediation/NASDDisputeResolution/Statistics/index.htm

It should be self evident from this simple graph that:

1. Beginning in 1995, only rarely has the number of filed NASD arbitration demands dipped below 6,000;
2. At its peak, following the market melt down of 2000 to 2003, the number of cases filed for NASD arbitration approached 9,000 cases; and
3. During this 15 year period, nearly 100,000 arbitration complaints were filed with the NASD.
4. No cases or complaints filed in venues other than the NASD are included in these statistics.

Between 2002 and 2004 NASD arbitration resulted in some $495 million in awards. This *does not include* the costs of defending these matters; nor does it include the settlement and defense costs of the 80% of filed arbitration cases which were settled by means other than formal arbitration, such as negotiation or mediation. If a case actually reaches an arbitration determination, representing about 20% of the total filings, about 50% of these cases are settled in favor of the plaintiff.

No matter how you choose to evaluate the liability climate, this hardly constitutes a nominal exposure to liability; and this is reality, whether or not characterized as "scare tactics". I would characterize those who ignore this hard evidence as "whistling by the graveyard".

At the risk of adding to the lore of the use of "scare tactics", I will recite issues underlying four different claims, all of which remain open and unresolved. These claims were first reported between February, 2004 and January, 2006. Nearly every day one or more of these claims yields new correspondence, a legal brief or two, discovery documents – in other words, the dollars attaching to these claims grow daily. It is difficult to estimate either how much it will ultimately cost to defend and settle these claims; or, the far greater emotional price that the advisor/defendant will pay along the way. My current estimate is that each will cost in excess of $100,000 to defend and the most significant among them will cost over $300,000 in defense costs alone. While we are confident that we will prevail in all cases because the plaintiff's cases appear so threadbare, litigation always carries the risk of an aberrant outcome, no matter how minimal that risk may appear.

Claim 1. The advisor, after inquiry of his client's employer advised him that his stock options were vested. This turned out not to be the case and, as a consequence, after changing employers, the plaintiff discovered that in order to preserve the value of the options, they had to be exercised immediately. This, in turn, resulted in a significant unexpected tax liability. The client expected that the advisor would pay these taxes.

It turned out that because the plaintiff was highly compensated, the early exercise of these options resulted in the remainder being taxed going forward at capital gains rates, rather than eventually being taxed, on a higher basis, at ordinary tax rates. Many advisors will recognize that if the amount of deferred compensation is large enough and the executive far enough away from the time when it must be withdrawn, and therefore taxed, an estate tax planning technique is to force the funds out of tax deferred status at an early point to lower the effective tax bracket. This is especially true with the decrease in the capital gains rate. In essence the plaintiff in this case has no damages, none.

Claim 2. At intake and at no other time had the client indicated that he held an annuity. The subject annuity was never included among the assets which the advisor managed and he never received either further information nor a penny of compensation from managing the annuity. In fact, other than a single reference in the intake documents, the advisor knew nothing about the annuity. The plaintiff, on the other hand, received monthly statements from the issuer and possessed full information about the annuity. The plaintiff sued the advisor. The substance of the complaint was that the advisor should have known about the annuity even though the plaintiff made no effort to inform him of its status.

Claim 3. In the late '90's, the plaintiff hired an executive assistant. The plaintiff, a former senior executive was intimately familiar with the importance of internal controls, in particular with the importance of segregation of duties to prevent embezzlement. During the course of her employment, spanning several years, the assistant embezzled multiple millions of dollars. It also turns that she had embezzled smaller amounts from her previous employer but the embezzlement was discovered after only a few months and her employment terminated.

During the course of the multiple year relationship, the plaintiff was advised on several occasions that he was jeopardizing attainment of his long term financial objectives because of excessive spending; the advisor offered to have a member of his staff review and help him better control his spending; and, the advisor also recommended that he hire a controller to oversee his financial holdings. None of these recommendations were accepted by the client.

Even though the advisor had no access to the plaintiff's checking account statements, the client alleged in the complaint that the advisor negligently failed to properly oversee his affairs, and detect the embezzlement. The advisor was responsible for overseeing the client's investments and not his personal spending habits.

Claim 4. In early 2000, the advisor accepted a new client and recommended that he invest in two high growth mutual funds which, while unseasoned, were being managed by well regarded fund managers. When the market headed south, these two funds performed particularly poorly. In late 2001, still holding these funds, the plaintiff terminated the relationship. In early 2002, the advisor reversed course and recommended to all clients that they cash out of these two funds. Because of the earlier termination of the relationship, the client never received this recommendation and continued to hold the investments, when the portfolio shift which the advisor recommended to her existing clients would have resulted in a substantial recovery of the amounts lost.

A thread which runs through the last three of these claims is that the advisor is being sued for events about which he or she knew nothing but, according to the plaintiff, this lack of knowledge was a major factor in asserting negligence. It is safe to characterize these claims as weak, unexpected and not susceptible to procedural shifts by the advisor which would have resulted in their avoidance. In other words, the use of consultants, as useful as they may be under certain circumstances to help tighten up procedures, would have been most unlikely to have resulted in their avoidance – these claims are rooted not in procedural deficiencies but in the desire of those who have lost money to recoup a portion from anyone who may be even vaguely connected to the loss. Procedures can always be improved – changing human nature is not quite as easy.

Our experience, over now nearly 15 years, is that the claims which are reported bear little resemblance to the claims one could imagine; the tried and true client is anything but; the most financially astute claimant will plead sudden onset Alzheimer's; and, when it comes to money, clients may depart radically from rationality. In other words, expect the unexpected.

It should also be noted that contrary to the popular myth that insurance is a "lightning rod" for claims activity, the existence or lack of insurance is a complete unknown when a claim is filed; and, in the majority of states, insurance is not discoverable. Not insuring your practice is not a sensible answer.

My Colors Don't Match!

A few years ago, a prospect called us about our E&O Program. Her request had some urgency to it. She had just met with a client. The client, in turns out, had been told by her psychic that her "colors didn't match with those of her financial advisor". We explained patiently that non-matching colors was not a covered act. In any event, her urgency emanated directly from her perception that the world was a lot less rational than she had thought and she best get insurance to protect herself. Her instincts were sound.

The New Realities

Relatively recently, the plaintiff's bar has begun to better organize itself. We discovered this in 2002 when for the first time multiple claims were made against a single advisor. Happily, gone are the days of the radio announcements from lawyers who claim, usually with no basis, that if you have lost money in the investment markets they can recover it for you. We believe, based upon the pattern of multiple claims against a single advisor, that the plaintiff's bar now systematically collects and shares information about who was sued, the outcome, who their insurer was and the settlement, if any.

A second reality, although hardly new, is cost increases associated with the defense and settlements. This has two parts. The plaintiff's bar plays a necessary advocacy role in our legal system. As such, they are continuously testing new theories of liability and damages. Sooner or later, some stick and become established legal precedent. That aside, just as the value of portfolios which you manage for your clients tends to go up over time, claims are susceptible to "social inflation" – verdicts rise over time, billing rates do as well, both of which in turn affect the cost of insurance.

The Reality of "Alternative Investments"

"Alternative investments" may be loosely characterized to include private placements, including private equity funds; hedge funds; derivatives, limited partnerships, and a wide variety of other types of investments. We will not insure them – this has not changed since we first examined the subject of alternative investments in 1994. Again, regardless of one's preference for these investments, they share several characteristics:

- They are illiquid;
- They are not systematically followed by the investment community;
- They are not regulated; and
- The clients placed in such investments typically have vast financial resources with which to pursue recovery in the event of loss. In the insurance industry, they are termed "formidable plaintiffs", and for good reason.

The show stopper for many advisors comes when we ask them a simple question "If you were sitting on the witness stand and an overbearing plaintiff's attorney were to ask you why you recommended these investments, as opposed to mutual funds of similar risk characteristics, how would you respond?" The usual answer is "Well, it seemed like a good idea at the time". Bad answer.

Insurers respond to such risks as they always have – either they will not insure them at all, which is what we have chosen to do; or, they will charge premiums which are commensurate with the perceived risk. As with investments in general, the higher the uncertainty, the greater the financial price charged by those who will assume such risks.

As a closer on the issue of hedge funds, we would suggest that you read an article published last fall on www.investopedia.com. We offer no comment on its content. The article can be found at: http://www.investopedia.com/articles/mutualfund/05/HedgeFundFailure.asp.

If you don't believe the principle of matching risk with reward operates in the insurance markets, simply ask your insurance broker to obtain quotes on property exposures in the Gulf Coast. But we need not even go that far to explain the high cost of insurance for high risk investments – the simple fact remains that for these investments there is simply no way to determine, short of underwriting every advisor's portfolio choices, whether the investments chosen are or are not prudent, because there is little publicly available information or scrutiny upon which to base such a determination. With such uncertainty comes a "risk premium" for your insurance; or terms which the average advisor finds unacceptable. In short, there is a measurable cost of placing clients in such investments and this cost should be weighed against the fees generated and the risk assumed.

Summary

Advisors operate in a profession in which claims are infrequent but severe; and they are highly unpredictable, as your best friend today may become your worst nightmare tomorrow. If you choose not to purchase an insurance policy, you actually do carry insurance, albeit in an unconventional form – your house is your insurance policy. You can and will be held personally liable in the event a claim heads south.

Thus, the purchase of E&O insurance is in reality the choice along a continuum, balancing affordability with the ability to fend off a Katrina like financial catastrophe; and you can control the price by controlling practice and investment risk. But risk per se is absolutely and unequivocally unavoidable. E&O insurance is a "long tail" insurance product, meaning that several years may elapse between the time the service is rendered and the resultant claim is reported. Our best advice to all of these issues is to buy as much insurance as you can afford.

Insurance is essentially a safeguard against financial catastrophe – this is as it always has been. I carry homeowner's insurance. I suspect that most people do, if for no other reason than the bank which holds their mortgage requires that they insure the value of their residence. I don't like paying the premium either, and in over 30 years my nominal losses have been much less than the premium I have paid. I also know of only one person among my many acquaintances who has ever had a house fire. But if my house burns to the ground tomorrow, I am going to be jumping for joy that I am properly insured. I also hope that I never get the opportunity to test out my insurance and that the premiums paid are wasted. This is what insurance is all about – the exchange of a small certain cost in the form of premium, for protection against a potentially larger and much more devastating financial catastrophe. I prefer sleeping well to eating well.

I choose to close with one of my favorite quotes, from one of my favorite authors, Benjamin Graham, the god-father of securities analysis. I studied under one of his protégées at Columbia University and he has had a great deal of influence on another one of my personal heroes, Warren Buffett. The quote is so relevant, even decades after it was first written, that I keep it tacked up on my bulletin board. "*The essence of investment management is the management of risks, not the management of returns*." The same principle applies to your practice and to insurance.

About the Author

Bayard "Bud" Bigelow, III, MBA, CPA is President and Chief Executive Officer of Markel Cambridge Alliance, which offers E&O for Financial Planners and Registered Investment Advisors. This insurance program has been continuously in operation since 1989 and is widely endorsed.

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