

What E&O Limit Should You Purchase?

By Bayard Bigelow, III, MBA, CPA

Policyholders frequently ask us what E&O insurance limits their practices should carry. Because this is a complex question, centered in the values of the owner of the practice, this is an issue which you must decide yourself. However, we are able to offer direction.

Your Exposure

The immediate, but we believe incorrect, measure of the maximum exposure your practice faces is the portfolio size of your largest client. Why do we believe this answer is incorrect? A number of years ago, we insured both RIAs and smaller broker dealers. A NYSE company, Towers Financial Corporation, filed for bankruptcy. There were virtually no early warning signs of the pending collapse of the company. Within two weeks, five claims, each made against a different registered representative of the same broker dealer, were reported. Over the course of the next year or so these claims were all settled.

The insight that this series of claims provided was that the maximum exposure that a policyholder faces is the largest single holding of a given security, including stocks, bonds, and various funds. It is, after all, much more likely that a single security will decline significantly in value than that a well diversified portfolio of a single client will head south overnight.

Put differently, your worst nightmare is to pick up the newspaper tomorrow morning and learn that your favorite investment, which you have recommended and purchased more frequently than any other, has just tanked. From this insight, it follows that not only must you diversify exposure for each portfolio, but you also need to diversify across the entire practice so that the decline of a single security will not take your practice along with it.

Defense Costs v. Indemnity

All policies of which we are aware will cover both defense costs and the payment of losses. Insureds, however, tend to think in terms of the maximum loss they may incur. While the NASD no longer publishes data on arbitration awards, the most recently available data shows that average damage awards alone are in the range of \$150,000 to \$200,000. The rough insurance rule of thumb, which is mirrored in our claims experience, is that defense costs approximate damages. Thus, no matter what you consider your exposure to be, double it to cover not only the loss itself but also the cost of providing a defense.

Your Priorities

Start-up practices are frequently ruled by a single concern – cash is king, because anyone who has started a business knows that the start-up period can be a rough ride, usually down several miles of bad road. On the other hand, sitting behind a practice started as a second career, or one with a lengthy history, is an owner with a net worth which he or she wishes to preserve. In this case, the need for limits may differ considerably from that of a practice started up out of the back of the owner's VW microbus.

Thus, the second question you must deal with is whether you want to eat well or to sleep well. We prefer to sleep well, as we have devoted many years of our professional careers to building our business. Many in the profession share this belief.

Is No Insurance an Answer?

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”. The latter group actually does carry insurance, albeit in an unconventional form – their house is their insurance policy. You can and will be held personally liable in the event a claim heads south. While anything we may assert about the advisability of buying insurance is self serving, self serving statements are frequently true.

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 client 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.

So, What Limit?

We now come to the major issue – what limit should you buy. Apart from considering your exposures and your personal needs, we will also provide you with the benefit of the answers your peers have come up with when they vote with their feet and their checkbooks. The most frequently purchased limits are for a per claim limit of \$1,000,000.

We advise prospects and policyholders that we believe there are three reasons for this pattern:

1. \$1,000,000 is a nice round number.
This is not a defensible reason.
2. A limit of \$1,000,000 is the lowest limit policy which would completely cover all but one, in our view a clear aberration, of the hundreds of claims we have had over the years. Further, occasionally claims have exhausted the per claim limit of below \$1,000,000. Absent meaningful tort reform, which we do not expect to occur until well after our children have chosen a very sumptuous rest home in which we will live out our years, we may expect that the averages will continue upward.
3. As the profession matures, it is highly probable that institutional product vendors and others with whom you have a professional relationship will require that you carry E&O insurance. While we believe that the majority of professionals continue to be self-insured, increasingly institutions are demanding that an adviser who represents them carry E&O insurance. This also extends to principal agent relationships of those to whom you may refer or receive referral business, lawyers or actuaries for example.

We operate in the property-casualty insurance industry which by any measure is mature. Every insurer that we are aware of requires that its agents (and brokers as well) carry E&O insurance. In fact, the industry standard is so well entrenched that it is generally accepted that an insurance agent or broker must carry at least \$1,000,000 of limit to be in conformity with industry standards and the requirements of the majority, if not all, property-casualty insurers.

Limits – Another View

Finally, we will give you our personal view on this issue of limits. You 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. Thus, the purchase of a certain limit is in reality the choice along a continuum, balancing affordability with the ability to fend off a Katrina like financial catastrophe. Because this 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, the limit which you purchase today may be the limit which applies to a claim reported several years hence. Our best advice to all of these issues is to buy as much limit as you can afford.

Summary

The limits question is a difficult one and you should consider:

1. Your own exposure as measured appropriately;
2. Defense costs as well as damages;
3. What you are trying to protect;
4. Going bare is a bad answer; and
5. The most frequently purchased per claim limit is \$1,000,000, we believe, primarily due to the influence of institutions.
6. Buy as much limit as you can reasonably afford.

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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