Scary Story

By Janet Arrowood

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A registered rep in Utah did everything right by his elderly clients. He even recommended long-term care insurance as an asset-preservation tool but they had turned him down. Later, when their son sued him after both parents tragically suffered from dementia and began ringing up incredible medical bills, the advisor assumed he was covered by his errors-and-omissions insurance. He was so confident, in fact, that he didn't keep a record of his advice, which would have likely helped him immensely in the suit.

Unfortunately, his confidence was misplaced. While his actions routinely covered him from a suit by his clients, it did not protect him from their son acting on their behalf. His ignorance of the fine print cost him dearly: He had to pay $600,000, plus any legal fees incurred, to the son.

Although his penalty was exceptional, his mistake was all too common. Errors-and-omissions insurance, or E&O as it is generally known, is a fundamental part of an advisor's life that is too often taken for granted. When interviewed, wirehouse representatives at Morgan Stanley, A.G. Edwards and Merrill Lynch, as well as the chief executive of a Denver-based financial-services firm, showed a nearly complete ignorance of their coverage. They didn't know any details of their deductibles, limits and exclusions, and all assumed they were covered for everything, though that was not the case.

In a world where financial lawsuits regularly make headlines, advisors that ignore their E&O coverage do so at great risk to their careers and their pocket books. Legal fees alone can crater a wallet. The average cost for defendants, says Jerry Reiter, founder of Financial Advisor Legal Association and a former financial advisor, is in excess of $42,000, and they are stuck paying the deductible, even if they win.

Even if they never get sued, it behooves advisors to know what their coverage is and how it compares to other policies, because they frequently must pay for some or all of it — an amount that can run thousands of dollars annually. The information may come in handy when comparison shopping for a new job or, if staying put, lobbying for changes in the policy so that it fits particular needs.

What's in It for Advisors?

A boilerplate policy, says Z. Jane Riley, compliance officer of The Leaders Group, a broker/dealer based in Littleton, Colo., will pay damages up to a limit:

- Typically the deductible is anywhere from $2,500 to $10,000 per incident, with a coverage limit of $1 million to $5 million per claim.
- The firm usually has a separate E&O policy with higher deductibles and higher limits.
- Once the firm's aggregate limit is reached, its advisors may not have any E&O coverage.
- "Preferred" insurance companies may have a lower deductible than other insurance companies.

Whatever the deductibles, there are some things that most policies will not even cover. For example, in the case of the Utah rep, his policy may have helped protect him against the insured, but did not protect him from someone acting on the insureds' behalf. This is a fairly common exclusion, and advisors should be on guard against it since, according to Riley, the plaintiffs in a majority of suits are related to the clients (i.e., not the actual client).

There is also the possibility that advisors may be covered for some things and not others, like when they are a fiduciary but not when they are a trustee — or the opposite. Also, a policy may or may not provide "past acts" coverage for "claims made" (i.e., things you did in the past, at another b/d and/or under a previous E&O policy).

The Paper Trail

As important as it is to know what's in an E&O policy, even more important is for advisors to keep good records of everything they do so they can provide any supporting documentation in case they are sued or taken to arbitration.

In the Utah case, once again, the advisor didn't have a paper trail or e-trail of his advice to his clients. Had he done so, the son would have likely had no case against the representative and the type of coverage the representative had would not have mattered much. In fact, there was a similar case where, after much digging, the rep found a copy of a letter he had sent to clients in an analogous situation and the client's attorneys squashed the suit before it got under way.

Just how important is a paper trail? Client's lawsuits, say most compliance and E&O specialists, are almost always taken on a contingency-fee basis. If you can produce paperwork to show you did act properly, the client's lawyers will almost always require the client to pay a large retainer, because the likelihood of winning is much lower when you have a paper trail. At that point, most clients drop thoughts of winning big bucks from a lawsuit or settlement and the case goes away.

Bruce Kantor, president of Kantor & Associates, in Charlotte, N.C., agrees wholeheartedly with the need to document every client and prospect conversation, especially conversations where the person declines to take recommended actions.

Taking Into Account Change

Even advisors well-versed in their E&O coverage shouldn't just file their policies away in a drawer. They need to review their policy at least once a year, says Rick Eldridge, CEO of Intuitive Insurance in Castle Rock, Colo., especially if they change plans, retire or change b/ds.

Advisors who retire or leave their firm normally will sign an "exit agreement," "severance contract" or a similar document, and they need to make sure this document includes a "hold harmless" agreement in defense against claims that result from their employment.

This agreement should provide ongoing legal defense and coverage, as if the E&O were still in force, for the advisor's actions while he was an employee. After all, as Yogi Berra might say, it should be over when it's over.

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