INSURING YOUR FINANCIAL PLANNING PRACTICE

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E&O professional liability insurance for financial planners and RIAs is sold by insurers operating is the excess and surplus lines market, or the E&S market as it is known in the insurance industry. Its characteristics differ from the more established market in which insurance is marketed, which is known as the admitted market. This article, in addition to addressing what policies are available to the planning professional will also address what the professional needs to know about E&O insurance with particular emphasis on the E&S market.

The Issues

Because of the characteristics of the E&S market, insurance products sold within in it, unlike other policies such as private passenger automobile, homeowners insurance as well as many commercial coverages, are ***not*** commodities. The professional facing the decision of how to evaluate various policies, therefore, needs answers to the following questions:

- What is the E&S market?
- How do the two markets differ?
- How important is the carriers financial strength, as well as other considerations, in the E&S market?
- Given regulatory controls, what other program characteristics are important to the professional?

The E&S Market

Many types of widely available insurance policies are sold in the so called admitted market. In this market, the policy's language and key provisions, as well as the way in which premium is calculated and the underwriting rules, are approved in advance by the state insurance department in each state. In fact, the coverage provisions are highly standardized precisely because the market includes thousands or even millions of potential customers with similar insurance needs - faced with such a large number of potential insureds the industry actually works cooperatively in developing a common policy and coverage provisions.

While the admitted market is used when there are large numbers of potential insureds with similar risk characteristics, the E&S market is used when the insured group is relatively small or the risk characteristics are not similar. Indeed both characteristics are true of the financial planning profession - the number of potential insureds is relatively small and the risk characteristics are non-uniform. Just look at the numbers - the American Bar Association has over 600 thousand members and the AICPA some 300 thousand members. The largest of the associations for financial planners has less than 30 thousand members. Further, the profession itself is highly diverse and encompasses life insurance agents, registered representatives of broker / dealers, financial planners, asset managers, investment management consultants, mutual fund managers, registered investment advisors and several professional designations. These characteristics strongly suggest that a high degree of tailoring of coverage is required to meet the diverse insurance needs of the profession. It is possible to provide such a tailored approach only in the E&S market.

How Do the Two Markets Differ

The E&S market has two characteristics of which the professional should be aware:

- With the exception of New Jersey, insureds cannot access the State's Guaranty fund in the event of a carrier insolvency; and
- While coverage can be tailored, it is equally true that the policy form is unregulated and may contain provisions that would not be acceptable to the State Insurance Department in the admitted market.

These characteristics have some important implications for the professional.

The Carrier's Financial Strength

Carrier insolvencies are relatively rare events. In such an event the insured or the claimant may look to the state's insurance guaranty fund to provide limited relief. In the E&S market, however, no such assurance exists expect in the State of New Jersey where the insurance department has set up a separate guaranty fund for the E&S market.

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Most states require that a surplus lines policy bear a warning which appears on the policy jacket. In some states, the warning must be printed in large print, while in others it must be printed using red ink. The warning language required in California is among the most complete:

1. *The insurance policy that you have purchased is being issued by an insurance company that is not licensed by the state of California. These companies are called "nonadmitted" or "surplus lines" insurers.*

2. *The insurance company is not subject to the financial solvency regulation and enforcement which applies to California licensed companies.*

3. *The insurance company does not participate in any of the insurance guarantee funds created by California law. Therefore, these funds will not pay your claims or protect your assets if the insurance company becomes insolvent and is unable to make payments as promised.*

4. *For additional information about the insurance company you should ask questions of your insurance agent, broker, or "surplus lines" broker or you may contact the California Department of Insurance.*

Here's the point - for most of the insurance you buy, the carrier's financial strength is of only marginal importance because the State guaranty fund effectively neutralizes its impact by acting as the ultimate guarantor of the insurer's obligations.

Practical Hint #1 *When buying insurance in the E&S market, make sure that you find out the ratings of the insurer How high should they be - the higher the better. Remember that the financial strength of the carrier, while always an important consideration, is a much more important part of the buying decision in the E&S market than it is in the admitted market.*

Other Considerations - Coverage

In the admitted market, a carrier must file policy language with the State Insurance Department before it can be approved for use. Once approved it must be used without change. The review process also provides the insured with the comfort that the coverage provisions comply with the state's insurance statutes. A surplus lines policy, by contrast, is neither filed with nor approved by the state insurance department of the state in which the policy is sold. Accordingly the policy does not have to meet the same standards that an admitted policy must meet, nor is the carrier required to offer the same policy from year to year.

While the coverage offered in the E&S market is not approved by your insurance department, that does not mean that you should accept what the carrier offers without question. Rather, just the opposite is true - in this, the "buyer beware" market, it is all the more important that you make an informed choice and select a carrier and a policy which provides you with the appropriate insurance protection.

But how should you go about understanding what after all is a complex contract. Apart from financial security, the consumer should look at several leading indicators as to the insurers reputation, commitment and experience with this, a highly specialized and technical profession:

- What experience do the underwriters and / or the insurer have with the profession?
- Have any of the professional associations reviewed and/or endorsed the policy for use by its members?
- Were professional financial planners involved in the development of the policy?
- How long has the policy been in effect unchanged? If the policy has changed in the last year, what changes were made and what prompted these changes?
- What is the carrier's presence in the professional liability lines, particularly with closely related professions.

Practical Hint #2 *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 answers to these and other questions about the carrier's seriousness of purpose – an uncommitted carrier that no longer writes the coverage which you purchased from them is hardly likely to be responsive in handling a claim on your behalf.*

The Coverage Issues

An insurance product is complex and technical – even the shortest policy will take 15 or more pages and thousands of words to define the conditions under which coverage may, or may not, apply. While it is unlikely that the layman will be able to understand all of the nuances of coverage, it is possible to evaluate the appropriateness of different policies and insurance programs.

Practical Hint # 3 *When you buy an insurance policy make sure that you understand its key provisions. This is particularly important in this, the "buyer beware" market.*

The Coverage Issues. The principal coverage issues are relatively easily stated:

- ***Scope of Coverage*** Does the policy cover the services which you provide through your practice?
- ***Defense Provisions*** The right versus the Duty to defend
- ***Claims Reporting and Recognition*** The incident versus the written demand coverage trigger
- ***Tail Coverage*** Contractual rights to purchase an Extended Reporting Period Endorsement

Scope Of Coverage Different insurers will define the risks that they wish to write in different ways, dependent upon their definition of their "target market". A group program with a broker dealer, for example, might typically only cover securities products which have been traded through the broker dealer. The first element of coverage that you need to understand, therefore, is how the policy defines professional services and what exclusions apply to coverage. These provisions are located, respectively in the Definitions section and the Exclusions section of any professional liability policy.

Defense Provisions Although it is not generally recognized outside of the insurance industry, it is typical for an insurer to pay, on average, at least 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. The broadest form of coverage available is termed "the right and duty to defend". Some polices, however, may contain the language "the right ***but not*** the duty to defend". Such contractual provisions mean that a defense is provided to the insured at the carrier's option – you should avoid such coverage.

Claims Reporting and Recognition Under some contracts, the carrier's coverage obligation commences once the insured has reported a set of events likely to lead to a claim – in other words an incident. With other contracts, however, it does not commence until the insured actually receives and reports a demand for monetary damages; while in still other contracts, coverage does not apply until actual suit is brought against the insured. If you have anything other than the first type of policy and you change carriers, you may find yourself in the unfortunate position of having no coverage when you receive a demand for monetary damages or when suit is brought -- the carrier issuing replacement coverage will always exclude coverage for matters reported to a previous carrier; and the carrier which issued the expiring carrier will deny coverage unless the policy issued calls for the application of coverage with the report of an incident.

Availability of Tail Coverage For a variety of reasons including practice dissolution, retirement, permanent disability, or other reasons, you may need to purchase what is know as tail coverage. A policy tail enables you to report claims after the policy has expired. Your contractual right to purchase such coverage, which would be referred to in the policy as an Extended Reporting Period Endorsement, should be identifiable in the Conditions Section of the policy. If the policy is silent on such rights, you may assume that they are not conveyed in the policy.

Summary

Because of the relatively small number of professionals in the financial planning profession, as well as their diverse insurance needs, the E&S market is ideally suited to the meeting of these needs. But in the same breath, this very same market presents risk to the uninformed. Ask the right questions and make sure you get answers that are clear and which you understand before buying any insurance policy.