

SURVIVING IN THE LIABILITY JUNGLE

by Bayard Bigelow, III, MBA, CPA

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About The Author

Bayard "Bud" Bigelow, III, MBA, CPA is President and Chief Executive Officer of The Cambridge Alliance, LLC, which represents an E&O program for Financial Planners and Registered Investment Advisors for First Specialty Insurance Company, one of the member companies of Employer's Reinsurance Corporation. This insurance program is exclusively endorsed by the ICFP for its members, and is exclusively recommended to the members of the IAFP.

Professionals interested in obtaining information about the program may contact:

**The Cambridge Alliance, LLC
P. O. Box 64998
Burlington, VT 05406
TEL: (800) 691-1515**

FAX: (802) 864-9369

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In response to the question "What is it about your practice that keeps you awake at night?" a CFP I spoke with recently replied, "Nothing. That's what I have insurance for." A more accurate answer -- for this particular professional -- would probably have been, "That's what I have *expensive* insurance for." The better answer is, "I don't stay awake at night because my firm scrupulously avoids high-risk situations."

Certainly insurance offers security. But it's no substitute for practicing defensively. And using insurance as your only safety net misses the point -- dealing with a claim is typically a major drain on both emotional and financial resources to any practitioner.

Unfortunately, ways of doing business that professionals regarded as "safe" 15 years ago are, in many cases, no longer safe. Society has changed the nature of the practice. The rate of litigation, the willingness to sue and the size of awards have grown exponentially, causing insurance companies to withdraw from the professional liability markets or raise rates exponentially. Indeed, in 1986, the shrinkage of available financial capacity to provide insurance for several of the professions created the "liability crisis" we have heard so much about. Extraordinary increases in the cost of insurance, in turn, caused those who could not pass on cost increases of this magnitude to practice without insurance.

Increased regulation of the financial planning profession, imposed from within or from without, is often cited as the solution for stemming the erosion of confidence in the financial planning profession. With the infamy surrounding the more well publicized breaches of professional conduct, all professionals feel the reverberations. It is no accident that the ICFP has, for the first time in its history, actively supported the promulgation of professional standards. Yet the number of voices supporting self-regulation as an alternative to government regulation continues to grow. Self-regulation is a vastly preferable alternative to government regulation. But if self-regulation is to work, it means not only adherence to the growing number of professional standards, it also means that each practitioner must manage his or her practice with the utmost degree of professional care *and follow procedures that have been proven to avoid losses*. This is true because, once the profession has adopted a set of standards of professional conduct, plaintiffs will now possess established standards of professional care against which to litigate.

It is more critical today than ever before that the operating fundamentals that contribute to running a safe practice be part of your mindset as you go about managing a business. We call this concept "loss prevention" or "risk management" in the insurance business. And we believe that, by looking at the nature of past claims against accountants, we can come up with increasingly better ways for practitioners to protect themselves.

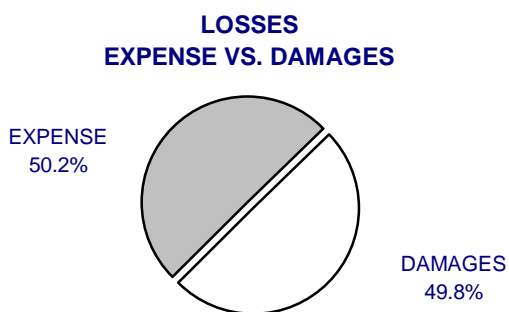
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Who's Suing? Not surprisingly there are certain types of activities that attract more claims than others. In general, these are the types of activities that have the potential to cost the client a large percentage of his or her resources. For example, a sizable corporation that loses \$5,000 in its investment accounts is unlikely to sue the financial planner for not identifying the problem. An individual client who loses \$5,000 very well may.

As the leading carrier providing E&O coverage for financial planners, our loss information spans some ten years of coverage. It is highly informative about the types of losses that practitioners experience, as well as those that are potentially severe.

Claims Experience. Our claims experience, which spans two carriers, is highly informative, but must be viewed with at least two caveats. These are that the experience is not statistically credible, both because of the number of claims and because of their lack of maturity; and, that the experience of carrier may not be the same as the policyholders' experience because of contractually imposed limitations on coverage. Nevertheless, the claims experience is a very strong indicator of where the land mines are.

Message # 1 – Defense Costs Are The Hidden Cost Of Settling Claims. 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:



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 law suit.

Message # 2 -- Loss Experience Will Tell Us Where Claims Are Likely To Arise. If we take another slice at the loss data, we can obtain valuable insights about where loss prevention efforts should be emphasized. The cause of loss data presented is divided into four categories as follows:

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

FRD -- Fraudulent activity;

TAX -- Tax errors;

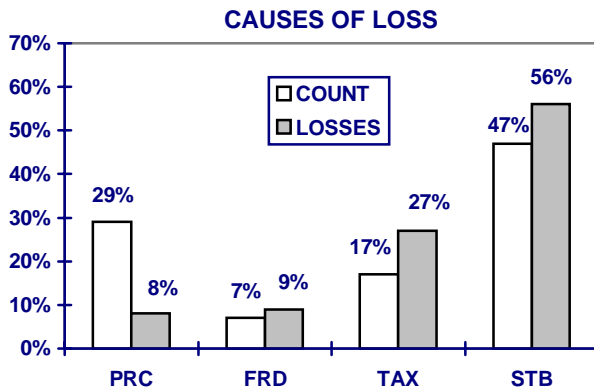
STB -- SUITABILITY -- Lack of suitability of investment;

The graph below depicts the number of claims as a percent of the total number of claims, and the dollars of loss as a percent of total loss

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amounts, arrayed by the cause of loss as described above.

CLAIMS EXPERIENCE 1989 -- 1994



Two important conclusions can be reached from this data:

- Procedural errors are a frequently cited cause of loss. Such claims, however, tend not to be particularly severe. Such claims represent 29% of the number of claims, but only 8% of losses.
- Suitability of investment claims, which are both the most frequently occurring and the most severe type of claim, tend to be expensive precisely because they are also difficult to sustain.

Let's examine each of these conclusions further.

PROCEDURAL ERRORS. We have classified as procedural errors those claims which arise out of some documentation error or incorrectly applied procedure. This would include, for example, claims which arise from penalties or taxes withheld from an improperly executed 401K / IRA rollover; or from failure to meet ERISA requirements; or from improperly executed client instructions; and other similar mistakes. They are a frequently arising source of claims. The good news, however, is that such claims tend not to be particularly severe, as the resolution of the dispute surrounding the claim is a fairly straight forward matter -- either the error occurred or it didn't; and the economic

damages associated with such claims tend to be either proscribed by law or are easily determined. The message, however, is clear -- before taking on activities involving procedural complexity, make sure your practice is procedurally well grounded. Also, stick to procedures known to work correctly and effectively once established.

Stick to the Knitting. A closely related message is what it always has been -- don't accept client assignments unless your firm has the knowledge to complete them in a professional manner -- the landscape is littered with the bodies of dead planners who have advised their client to invest in some new hot investment, only to have the client portfolio self-destruct several years down the road. Those high commissions sure seemed great at the time, however. As corollary, accepting a client assignment when you do have the expertise but not the available personnel, the necessary commitment, or the available systems resources is also dangerous. Stay in touch with the kind of work you want to do and that you do well. Build your marketing plan based on attracting more of that business.

The planner acts as a fiduciary with respect to the investment recommendations and decisions provided to clients. In this context, a fiduciary has the well established responsibility to put the interests of his or her clients before his own interests. There are those who argue that, at the right price, any client assignment is worth taking. In other words, if paid enough, you'd be willing to do almost anything. This ignores the psychic price a lawsuit can extract if something goes wrong. A lawsuit can run several years from the date of the initial problem to the time of the final verdict (not counting additional years for appeals).

As Charles Dickens once said with perhaps only a little exaggeration, "Becoming involved in a lawsuit is like being ground to bits in a slow mill; it's being roasted at a slow fire; it's being stung to death by single bees; it's being drowned by drops; it's going mad by grains."

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Get the point? Surely you don't want to lose several years of your life to turmoil, self-reproach, resentment, anger and anxiety, not to mention the time lost to defending yourself and the cost of the litigation, if you can avoid it. You *can* avoid it by accepting only work that you can do well.

SUITABILITY OF INVESTMENT. It is axiomatic that claims will not arise when an investment is doing well. When an investment has not performed as expected, however, clients tend to look to the financial professional to reimburse them for their loss. The good news is that claims of this nature tend to be difficult to sustain, absent bad faith on the part of the financial professional. The bad news is that you can go broke in defending yourself. What defensive measures are possible?

General Principles. There are several general principles that apply to nearly all investment situations:

Adhere to conservative investment principles, using loss limitation techniques such as using a stop loss for publicly traded securities.

As the Orange County and Barings collapses of a few years ago so clearly demonstrate, employ only those investment instruments which you understand.

Discretionary Authority. Avoid the temptation to assume discretionary investment authority. While the assumption of discretionary investment authority may ease the administrative burden, the risks are typically disproportionate to the rewards – the courts will assign a very high duty of care to the practitioner who possesses the authority granted by the client to invest on the client's behalf. By leaving authority with the client, the advisor is able to share risk with the client. This is a vastly preferable position if litigation ensues.

Document! Document! Document! Carefully document your client's investment objectives -- the higher the return objective, the more

carefully such objectives should be documented. Careful documentation tends to shift risk back to the client. The importance of adequate documentation of investment objectives and risk tolerance cannot be overemphasized. After all, the client is rarely in a position to refute your documentation, particularly if prepared at about the same time that the failed investment was made or when trouble first arose. Further, it is typical for a claim to arise several years after the investment is made – given such long time spans, one's memory can hardly be considered reliable.

Client Selection. According to the law developed by Italian economist Pareto (1848 - 1923), 80% of the results are generated by 20% of the events. This law can be applied in a positive sense, as in:

- 80% of your profit is generated by 20% of your clients, or
- 80% of the new business generated comes from 20% of your clients.

But look at the negative:

80% of the liability risks that you assume in your practice will come from 20% of your clients.

This argues for very careful client selection. Indeed, one of the simplest questions to ask of any new client is whether he or she has ever initiated litigation against a professional. While a positive response is not necessarily a reason to reject a new client, it certainly warrants further discussion with the potential client.

Careful client screening is not a one-shot responsibility, it is an ongoing responsibility. Your professional safety depends upon going through the process of seeing if anything has changed. New people? New procedures? New pressures in their business or personal lives?

In her book published in 1997, *Protecting Your Practice*, Katherine Vessenes refers to the

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practice of “graduating your client”, referring to a way of shedding difficult or troublesome clients:

*Whenever possible, "graduate" your difficult clients. Two planners from New Jersey have shared their wonderful method for detaching themselves from the difficult client. It goes like this: About a year in advance, they set the stage with a series of comments, such as "You know, about a year from now, we expect your portfolio will be in such good shape you probably won't need our services any longer." At the next meeting, they may say, "One way that we will be able to increase your income in retirement is to eliminate our fees. Once we get your affairs straightened out, you will be able to manage them on your own, without us." Another meeting might include the comment, "We are getting close to getting your portfolio on automatic pilot." The beauty of this system is the client is mentally prepared for the transition and feels comfortable with it. They can take pleasure in being graduated.*ⁱ

The Right Price. As yourself if you are still being properly compensated for the risk you bear, which may have changed. Market and competitive forces being what they are, pricing in today's market may not even include a profit above variable costs, let alone a markup for assuming a high degree of engagement risk.

Risk is a function of the degree of discretionary authority; the nature of the investments

managed; and the client's return expectations, as well as many special or unique circumstances. If risk is high for the work undertaken, either charge a premium rate, to compensate you for the implicit risk, or ask the client to find another firm.

The difficulty for the practitioner is that returns for some of their services today are being forced downward by the effects of competition. There's nothing wrong with competitive pricing, but you're only fooling yourself if you don't figure in the risk of the engagement when looking at the fixed and variable costs you'll incur. How do you assign a dollar amount to that risk? I suggest that you charge enough to make the client see the economic value of mending his or her ways. If the client won't change, then probably no amount of fee income is worth the risk you implicitly assume.

You might consider identifying the riskier parts of the engagement and saying to your client: "We'll charge you \$X for the engagement as defined this way, but if you change the engagement to reduce our risk, we'll reduce your fee by \$Y." This provides you with an excellent opportunity to discuss your concerns about professional liability with your client. All high-risk engagements should be reviewed by senior management annually. Those defending the engagement as good for the firm should be required to justify their position.

Clarify Expectations. The single document that, more than any other, governs expectations of both the client and practitioner is the client contract. Once you're comfortable with your client and the nature of the engagement, expend the energy to write down your understanding of what is to be done. Without an client contract, both client and practitioner alike are at the mercy of their own possibly very different interpretations of what the engagement should, or should not, accomplish.

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To be meaningful, the client contract should state as specifically as possible:

- the recipient,
- the entity for which services are to be rendered
- the services to be provided, as well as those which are not being provided
- the limitations of the services,
- transactional authority
- conditions of performance and other limitations of responsibility,
- the client's responsibilities during the engagement,
- client confidentiality
- disclosures
- billing and fees, commissions
- contract termination
- attorney review,
- client signature, and
- dispute resolution.

Surprisingly, although you may think these are obvious, they are not always included. And, when included, they often are unclear, confusing or inaccurate. Remember that the role of the plaintiff's attorney is to put you on the defensive. And imagine what a skilled courtroom ace could do with an client contract which is poorly drafted, ambiguous, or which assigns to the professional a broader level of responsibility, or responsibility without sensible limitations, than is intended. Further, what does an inadequate client contract imply about the level of care that this practitioner puts into its work?

The client contract is the first line of defense against professional liability claims. Use of an client contract is recommended for all engagements, and virtually required for any high-risk engagements, especially those with unusual or special circumstances. Use of a poorly crafted client contract, or a form client contract, will limit your defense options in the event of litigation. The legal presumption will be that you, as the author and expert, should have known what you were doing in drafting the contract's provisions. Mistakes set up the presumption that you care little about your work product, putting you immediately on the defensive.

Anticipate Trouble. Think about what could go wrong with the engagement before you even begin. You're not being negative, you're being pragmatic. Hire people who know what they're doing. Supervise inexperienced advisors closely. Check their work. Most importantly, keep accurate and detailed records of all conversations with clients – they are an invaluable source of information with which to refute the frequently faulty memories of those engaged in the heat of a dispute.

Avoid Suits For Fees. You've worked hard on an engagement and you deserve your fee. What do you do if a client refuses to pay? Sue for collection of fees? it's not recommended.

Unfortunately, suing for fees often triggers a counter suit alleging negligence, fraud or breach of contract. It's the worst kind of blackmail, in my opinion, impugning a person's professional reputation to avoid paying a bill. But it happens. And it can be prevented. If there is a dispute over the fees, then, in all likelihood, there is some disagreement over the nature or quality of the professional services rendered -- in other words an "expectation gap" exists. The time to discover the presence of an expectation gap is not when you present the bill, but rather when the engagement is negotiated and its scope identified in the first place. If you feel that collection is going to be a problem, consider billing and collecting in advance, making sure to collect next month's anticipated billings before completing this month's work. Trust your "gut feeling": if the client acts in an unprofessional or even manipulative manner based upon what you know of his or her history, you can expect the same. Think about doing an expected value analysis and passing up those clients who seem likely to balk at your invoice. Better to forego the business and the payment up front than do the work and find yourself foregoing the payment anyway!

Explore Alternative Dispute Resolution. Suppose all else fails and your client threatens a lawsuit? You have nothing to lose, and a lot to

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gain by exploring the techniques for solving the disputes that stop short of the courtroom.

These techniques, called “alternative dispute resolution” (ADR), are far less expensive than litigation. And using ADR offers a high likelihood of success since most claims, particularly modest ones, are likely to settle at the first serious attempt to do so.

We have had a great deal of success with mediation. The mediator brings the parties together and facilitates discussions. Options for solving the problem are almost endless. And if the problem can't be solved to everyone's satisfaction, there's no penalty -- you just try something else. Often, though, a mediated result can be obtained in a matter of days or weeks -- a far cry from the years required for litigation. Offered the opportunity to have their of the story heard, the clients can often be persuaded to settle for a much smaller sum than originally asked (especially when they've had the time to consider what a court case will cost them).

Arbitration is the other well-known ADR technique, and, indeed, most disputes involving securities will be submitted to NASD arbitration, as most broker / dealer client contracts contain a mandatory arbitration provisions. Arbitration has many of the same advantage of mediation, although, unlike mediation, the arbitrators will impose a solution from without, which neither party may find acceptable. Further, unlike litigation, the arbitrators have far more latitude to go beyond legal precedents. Further, the avenues for appeal are also limited.

Too Much Trouble? Do all these measures seem like a lot of trouble? Things that no one prepared you for in college? Get used to them. The truth is that, if you have not already done so, you are going to have to make a shift in perspective.

If you haven't had a major problem, you may still be thinking that you don't need to protect yourself, that a handshake will do as an agreement, that “we'll work that out later” will be the fine. Sometimes it will. But we don't live in the same world we used to.

Yes, insurance is expensive. And the best use for it is as a safety net to catch the unanticipated problems -- not the stumbling blocks the firm was too uninformed to address.

The answer to staying awake at night worrying about professional liability issues is not necessarily buying more insurance. The best way is following loss prevention guidelines taken from the unfortunate experience of other firms. They won't begrudge you the information. Because when you practice safely, you make the profession safer for everyone else.

ⁱ Vessennes, Katherine, *Protecting You Practice*, (Princeton, New Jersey,: The Bloomberg Press, 1997) pp. 230-231.