Six Common Mistakes Advisers Make When Procuring Professional Liability Insurance And How To Address Them

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Investment advisers work hard to build their businesses, so it's vital to protect their firms from catastrophic losses that can arise from unexpected regulatory actions or lawsuits. Whether it's a trade error, an allegation of a breach of fiduciary duty, the failure to disclose important information to clients, or a formal regulatory investigation (like an SEC enforcement action), professional liability insurance (often called errors or omissions coverage or E&O insurance) is a vital tool used to cover costs and expenses associated with investigating, defending, and settling any such actions. Yet, an adviser's failure to adequately understand and properly negotiate the coverage being procured can lead to troublesome surprises down the road if a claim arises. In this article, we will highlight the six most common mistakes that advisers make when procuring E&O coverage and how to avoid such mistakes.

Mistake #1: The Failure to Adequately Understand and Negotiate What "Claims" are Covered Under the Policy

E&O insurance coverage is triggered when a coverable "claim" is brought to the attention of the insurer. However, the definition of a "Claim" varies from policy to policy. In most base policy forms, coverage is triggered upon a written demand for monetary damages, civil and criminal proceedings, and formal investigations (which include enforcement actions, administrative proceedings, or civil actions initiated by the SEC or another regulatory authority). However, advisers can incur significant costs even before any formal investigation is initiated as the SEC or another regulatory authority can conduct informal investigations (and require the production of significant information) prior to taking formal action against an adviser.

As such, if desired, advisers must consider whether they want the definition of a "claim" to include coverage prior to the initiation of a formal investigation. Such coverage can be procured and includes two flavors of coverage: pre-claim investigative coverage and informal investigation coverage. Pre-claim investigative coverage provides coverage for defense costs incurred during the investigative process before a formal investigation is initiated, but only if the informal investigation results in a formal investigation. Such coverage typically will not require the payment of an additional premium, although, this may vary from policy to policy. Informal investigation coverage is broader than pre-claim investigative coverage. Some insurers charge an additional premium or increase the retention for this enhanced coverage. When this coverage is granted, there is coverage early on in the investigative process and there is no requirement that the investigation becomes formal in order to trigger coverage.

It is important to note that routine examinations, sweep examinations, and inspections conducted by regulators and self-regulatory organizations are not considered informal investigations, and therefore, coverage is not provided in such situations.

Mistake #2: The Failure to Obtain Appropriate Cost of Corrections Coverage

Most investment advisers that manage client assets have dealt with at least one trade error over time. Yet, it may be surprising to know that not all E&O base policies cover such losses. That's why it's vital for an adviser to ensure that its E&O coverage includes "cost of corrections" coverage, which will cover the firm's losses where the firm makes an error (such as buying or selling the wrong security or number of shares for a client) and makes the client whole for the error. Cost of corrections coverage does not necessarily amend the definition of claim, but it does provide coverage for losses without the need of triggering the "claim" definition. In other words, the client does not have to bring a lawsuit against the insured firm for damages. In fact, the cost of corrections coverage was created to mitigate the need for a claimant to bring a lawsuit and incur the associated defense costs. Cost of corrections coverage is included in some insurers' base forms, but there are many insurers where this enhanced coverage must be endorsed, and therefore, it's critical for an adviser to ask about this coverage and not assume that it is included in the policy.

Mistake #3: Assuming That E&O Coverage Covers All of an Adviser's Services and Affiliates

E&O insurance can cover a wide variety of investment management and financial planning services. However, advisory businesses have proliferated to cover a wide range of other activities (such as trust services, bill payment services, family office services, brokerage services, and insurance-related services). E&O policies may or may not cover such activities, and it's critical for an adviser to work with its insurance broker to determine if all of its services are covered. Similarly, an adviser should clearly understand if entities controlling, controlled by, or under common control with the adviser are also covered by the policy.

Mistake #4: The Failure to Understand Coverage for Continuing Claims

Sometimes, actions or omissions when providing advisory services that took place prior to procuring E&O coverage (known as "prior acts") can lead to claims while the policy is in effect; advisers should seek to maximize coverage for claims arising out of such prior acts. However, E&O policies vary as to how and if they will cover claims related to such prior acts. As such, it's important for advisers to understand from their insurance brokers how, if at all, such policies will cover prior acts.

Even where insurers will provide coverage for claims arising out of prior acts, an insurer will want to know if the adviser or its personnel are aware of any actions that resulted in known losses or any actions that could give rise to potential claims - the adviser or its personnel must typically disclose these in the application process. If an adviser or its personnel fail to respond truthfully and thoroughly concerning knowledge of known losses or potential claims, an insurer can deny coverage for such claims. Therefore, an adviser should clearly communicate with its employees to understand if there are any circumstances that the employees are aware of that could lead to an insurance claim prior to procuring E&O coverage.

Mistake #5: The Failure to Procure Adequate Coverage

This is probably the most popular question we get when advisers are procuring E&O coverage, and, unfortunately, there is no single right answer given the different characteristics of each advisory firm and the services they offer. Yet, depending on the risk profile of an adviser's business, the failure to procure adequate coverage could potentially be catastrophic if an adviser has to cover uninsured costs using its own funds.

An adviser seeking to determine what amount of coverage to procure should speak with their insurance broker, their advisory firm peers, and other industry experts to understand what amount of coverage other similarly situated firms procure. Nonetheless, even with such "benchmarking" information, advisers should ultimately consider how much coverage is right given their individual circumstances. When evaluating appropriate coverage, an adviser should consider the number and types of clients they serve, the amounts of assets they manage, the riskiness of the investments they recommend, the riskiness of the services they offer, amongst other factors to determine how much coverage is desired.

Mistake #6: The Failure to Adequately Address Defense Costs

Most policies do not cover certain types of conduct, including illegal conduct or fraud. However, advisers seeking to defend these and other types of claims, regardless of how groundless, can incur significant expenses associated with defending the firm and its employees, particularly, if trials run long or if there are appeals filed during the lawsuit.

An adviser should arrange for any E&O policies to include language requiring the insurer to cover all defense costs until final (nonappealable) adjudication of the lawsuit. This ensures that the firm and its employees are covered for defense costs throughout the lifecycle of a lawsuit.

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