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Opinion

Four Potential Holes in Your E&O Coverage

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Navigating the nooks and crannies of errors and omissions insurance can be exhausting. Many advisors buy whatever policy seems simplest to understand and figure they're protected. But mere coverage is not sufficient to avoid liability, and wealth managers should check the language of each policy for gaps that may expose them to legal risks. Below are four issues that insurance brokers often overlook when explaining coverage and premium options to advisors.

Policy may not cover regulatory investigations. Insurers often say a policy will cover legal costs associated with a formal regulatory investigation. However, in many cases, the policy language makes no mention of expenses stemming from such probes. Also, some policies will cover them only if the investigation was initiated by a client complaint — creating a hurdle that sometimes can't be overcome. For example, what if the **SEC**, during a routine inspection, stumbles upon something that leads to a formal investigation? Or what if the firm is involved in an event governed by the Whistleblower Protection Act, in which the complainant is an employee, not an investor? Overall, the best approach is to obtain coverage for regulatory investigations and litigation that is not restricted to client complaints.

Policy may not cover broad corporate errors. Senior executives may believe they are covered because their job title is included in the definition of insured individuals. However, E&O policies are typically triggered only by a written demand from a client, whereas a chief compliance officer may be dealing with an issue that stems from a broad operations breakdown. Therefore, issues involving the CCO may not be covered. As a solution, advisors should purchase directors and officers (D&O) liability insurance designed to protect executives against claims arising out of business decisions rather than investment decisions. Again, make sure the policy doesn't exclude regulatory investigations.

Policies may not cover trading errors. Advisors may think their policy automatically covers trading errors, but most do not. Firms need to add coverage for such errors. Further, advisors should be familiar with policy

provisions stipulating when and how the trading error must be reported to the carrier and whether the policy provides for reimbursement. It's worth remembering that most trading errors are discovered by the financial advisor or custodian before the client learns about them.

Carrier may not defend the advisor. Advisors quite often feel their insurer would rather settle a claim to keep its own expense down than fight to protect the advice firm's reputation. Advisors should check for "duty to defend" language in the policy that spells out the carrier's obligations to provide a proper legal defense. "Duty to defend" language can be inconsistent, so insurance brokers should make advisors aware of any gaps, based on the brokers' experience with individual carriers.

Another important issue here is the settlement clause, also known as the "hammer clause." It states that the insurer's obligation ends at the amount for which they can settle with the plaintiff or at the policy's given limit of liability. The clause also says if the advisor fails to consent, any expenses incurred above the suggested settlement amount are the advisor's own responsibility. The remedy is to remove the hammer clause from the policy or come up with a predetermined negotiated compromise with the carrier prior to securing coverage. Importantly, advisors should confirm that they can select the attorney who will defend them. Typically, there will be increased pressure to settle if the carrier appoints the defense.

The more familiarity advisors have with these themes, the better positioned they will be to identify weaknesses in their E&O coverage. Such due diligence is a crucial task for advisors serious about navigating legal risk and gaining peace of mind about their firm's future.

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