

LOSS PREVENTION AND THE GREENING OF THE FINANCIAL PLANNING PROFESSION

By Bayard Bigelow, III, MBA, CPA

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Standardization -- the Two Edged Sword. The financial planning profession is at a cross roads -- on the one hand, an ever growing number of voices clamor in support of increased levels of government regulation. As is nearly always the case, the cry for increased levels of government regulation has arisen because of highly publicized abuses. Government regulation, however, has a sledge hammer like quality to it. The response by the profession, appropriately and predictably, has been to launch efforts at self regulation with renewed vigor -- who better, after all, to promulgate and enforce appropriate standards of professional behavior than those knowledgeable of the profession itself. Any corrective action, whether imposed from within or from without, will also have the effect of reducing risk to the client base of the financial planning profession, while simultaneously stemming the erosion of confidence felt by the public in general and by would be regulators in particular.

But there's a fly in the ointment, as those of other professions have come to realize over long periods of time -- the standardization of the "rules" of professional conduct and practice has eased the burden of proof that must be sustained by the plaintiff's bar. To be convinced of the validity of this premise we need only look at changes in the accounting profession over the last decade. Rates for professional liability coverage for CPAs are some 400% higher than they were in 1985. Rates increased because the insurance industry grossly underestimated the number and severity of claims which might

reasonably be expected against members of the profession. Claims increased, in turn, not only because of inroads made by the plaintiff's bar, but also because of the rather sharp increase in the level of self policing activities undertaken by the accounting profession. One need only look at the number of FASB and SAS opinions published in the last decade.

In any professional negligence case, the plaintiff must be able to credibly demonstrate that there existed a generally accepted standard of professional conduct which the defendant failed to meet, resulting in harm to the plaintiff. As with all other professions, the financial planning profession has eased the burden of proof to the plaintiff by taking the necessary step of promulgating standards of professional conduct and practice. But with published standards, the plaintiff will no longer have to demonstrate that a standard exists. A standard will exist, *de facto*. Will this result in increased claims activity and therefore increased hazard to the profession? It's inevitable.

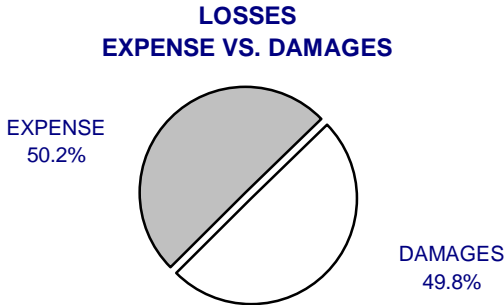
The Implications. With increased levels of litigiousness, and the resultant increase in the level of risk associated with being a financial planner, the obvious question is what can be done to manage and / or control that risk. Before answering this question, however, we need to know something about what risks the practitioner faces.

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 good

indicator of where the land mines are.

Message # 1 -- Expenses Are The Exposure.

Nearly all professional liability insurance policies will cover the costs of both defending and settling a claim. It is therefore illustrative to examine the split between the cost of defending a claim, and the cost of settling a claim, 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 are non-meritorious claims.

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 otherwise -- an equally valid reason for buying professional liability insurance is to protect against the expense of providing a defense for a claim that 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 lawsuit.

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:

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

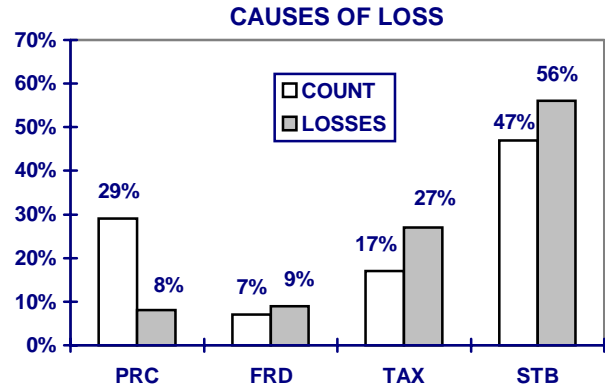
FRD -- Fraudulent activity;

TAX -- Tax errors;

SUITABILITY (STB) -- 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 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.

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? There are several:

- Adhere to conservative investment principles.
- As the Orange County and Barings collapses so clearly demonstrate, employ only those investment instruments which you understand.
- 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. 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.

- If appropriate, use loss limitation techniques such as using a stop loss for publicly traded securities.
- 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.
- Pick your clients with care, avoiding clients with unrealistic expectations or whose integrity appears questionable.

The Loss Prevention Imperatives -- Lessons From The Other Professions. In this article, we have zeroed in on the defense cost component of losses and the causes of losses. While we cannot draw statistically robust conclusions about how loss prevention should be approached for financial planning professionals, we can look to the experience of other professions to determine why emphasis needs to be placed on loss prevention / risk management and where and how to apply such efforts.

Loss Prevention - So What? The why of loss prevention is simple -- while insurance may provide you with protection from the financial consequences of a dispute with your client, protracted litigation can be personally and professionally damaging and draining, as any professional who has been sued for negligence in the conduct of his or her professional activities knows all too well. A law suit drains away time and effort which might otherwise be applied to the management of your practice. As if that weren't enough, the mere accusation of professional misconduct is often personally and psychologically devastating to the professional, no matter how unfounded the accusation.

Ambrose Bierce, American satirist and humorist, writing in *The Devil's Dictionary* in 1906, took a somewhat humorous view of a lawsuit:

"Lawsuit: a machine which you go into as a

pig and come out of as a sausage"

On a more somber note, Charles Dickens, writing over 150 years ago, understood well how devastating a lawsuit could be:

"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."

In short, a claim is to be avoided at all reasonable costs through defensive practices.

The What of Loss Prevention. It is outside of the scope of this article to elaborate on all the nuances of loss prevention / risk management as applied to the financial planning profession -- that will be covered in subsequent articles and through other professional publications. The lessons of the other professions are, however, notable because of their simplicity. I think of the following as laws, for any profession:

- 20% of your clients will generate 80% of your liability exposure. Exercise care in selecting clients.
- It is prudent to periodically review client retention practices and to shed uncooperative or litigation minded clients, or those whose expectations are consistently unrealistic.
- Your profession is complex -- concentrate in areas where you are professionally advantaged and that you understand.
- Establish sound procedures and stick to them, making sure that they are changed only as professional circumstances and requirements warrant.

Under promise and over deliver.

- Engaging documents should fully identify client expectations and objectives, as well as the manner of payment and the scope of services to be provided.

- Consistently over disclose, in understandable language, as you would wish similar treatment were your position with your client reversed.
- Report claims or incidents to your insurer at the earliest moment. If you wait until all parties are gathered on the steps of the courthouse, ready to do battle, it's too late. Early intervention is vastly preferable, as opinion on either side of the dispute has not yet solidified.

Summary. The management of a successful, prosperous financial planning practice is a complex undertaking requiring attention to areas other than the traditional management tasks. In an era of codification of acceptable standards of professional conduct, volatility of the financial markets, and increasing litigiousness, loss prevention and risk management assume new importance. If your training as a professional financial planner didn't prepare you for these new realities, get prepared -- it won't become any easier in the future. While liability exposure is a new variable requiring management attention, the good news is that the experience of many closely aligned professions applies to the financial planning profession.

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