BROKER/DEALER E&O
CHANGING MARKET PLACE AND THE IMPORTANCE OF FACTS & CIRCUMSTANCES REPORTING

CARRIER CHANGES AND NEW COVERAGE RESTRICTIONS

Recently, several major underwriters of Professional Liability insurance have either exited the Broker/Dealer E&O space entirely, significantly changed their underwriting appetite, or dramatically restricted the coverage terms going forward. As a result, many firms have been forced to accept the more restrictive terms (read exclusions and retention level), or move the E&O program to a new carrier altogether. Both pose significant risk if not handled properly. Firms can and should utilize an often misunderstood provision contained in any quality E&O policy, known as Facts & Circumstances (F&C) Reporting. Failure to do so may result in an uncovered claim.

Case Study:

The carrier for ABC Securities is non-renewing the policy. While no claim has been received, the firm is aware of a potential issue that may give rise to one in the future. On the application for replacement coverage, the firm must answer the "warranty" question regarding any knowledge of incidents or circumstances. The circumstances surrounding any "yes" answers would be specifically excluded due to prior knowledge.

In an attempt to preserve coverage for a future claim, ABC Securities makes a detailed F&C report to the existing carrier, prior to policy expiration, including specific details regarding the known circumstances.

CLAIM VS. FACTS & CIRCUMSTANCES

What is the difference? In fact, a great deal. Generally, most E&O policies define "Claim" to mean a "written demand for monetary compensation" (see note). Facts & Circumstances, however, involve general knowledge of a potential problem without the existence of a formal "Claim".

A Broker/Dealer has the obligation to report a "Claim" under the policy in force at the time in which it is received. On the other hand, the firm has the right, but not the obligation, to report facts and circumstances. In the event such F&C report is made, and the report meets the criteria defined in the policy, a "Claim" later received will be considered to have been reported at the time of the F&C notice report. The provision is meant as a safety net of sorts to protect the BD when dealing with known events in the context of claims-made E&O policies.

WHEN TO USE F&C REPORTING

Examples of Facts & Circumstances include, but are not limited to:

- A severely distressed product or product sector
- A client complaining verbally, or in writing but not demanding monetary compensation
- An attorney request for records on an account with large losses or other issues
- A regulatory inquiry or investigation pertaining to a particular customer or group of customers

Note: The E&O policy should define "Claim" as a written demand. If this is not the case on your current policy, demand the change. Otherwise, any verbal demand can be considered a claim, and a claim can be denied for failure to report under the proper policy.

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Case Study:

ABC Securities has received a sweep letter from the SEC regarding the use of a 3rd party money manager. The money manager itself is under SEC investigation, has filed bankruptcy, and is liquidating the portfolio. ABC Securities has sizeable client assets in the portfolio, but no "claim" has been received from a customer.

Unrelated, ABC's E&O carrier has changed its target market and increased the claim retention level to an unreasonable $250,000. ABC Securities makes an F&C report prior to policy expiration, understanding that any claim related to the money manager would likely be excluded by a replacement E&O carrier due to prior knowledge.

A Note of Caution

While most policies allow for F&C reporting, some do not. Broker/Dealers should insist on the provision, or proceed at their own peril.

In addition, making an F&C report does not guarantee coverage for a future claim. E&O policies often contain very specific information requirements for F&C reporting, and the provision is certainly not meant to be catch-all protection. For example, a firm cannot simply send up an entire client database as notice of potential claim. For an F&C report to be valid, it must include specific, identifiable circumstances that may reasonably give rise to a claim, and firm-specific information must be provided relative to the potential exposure.

What Constitutes Prior Knowledge?

"If an Insured becomes aware of facts and circumstances which may reasonably give rise to a future claim…" This language is representative of that which is contained in most policies.

Again, great caution is advised here. It is best to error on the side of caution, making an F&C report, than to not make such a report and risk a future claim denial. In the latter case the firm is, at best, in a coverage dispute with the E&O carrier, and at worst, without E&O protection for a claim.

The issue of "prior knowledge" generally arises during the claim discovery process. Past correspondence between the client or client attorney and the firm or representative is often uncovered, indicating that the firm had, or should have had, prior knowledge of potential future claim.

Application Warranty Questions

For insurance renewal applications, the Broker/Dealer should not be required to answer a warranty question, as the E&O carrier is on the risk both prior to and after the renewal date. With new business applications, however, the question is compulsory.

In addition, firms should negotiate a policy amendment stipulating that only knowledge of the firm's officers will be imputed to the firm. As such, a representative's knowledge in the field, but which is not shared with the firm, is not grounds for denial of coverage to the firm.

Remember, most policies specifically state that the application becomes a part of the policy itself, raising the stakes regarding accurate completion.

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