

PERSPECTIVES

An attorney's guide to insurance and risk management

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The Right Amount of Coverage

*As insurance professionals specializing in lawyers professional liability, we know it is challenging to determine the appropriate limits for your firm's professional liability insurance policy. The following article, from the January 1996 issue of the **ABA Journal**, offers a clear and useful description of the factors to consider when selecting the appropriate amount of coverage for your firm.*

The question of how much professional liability insurance coverage a law firm should purchase is easier to ask than answer. There is, unfortunately, no one generally applicable answer, given the variations that make each law firm distinct. But there are factors to consider in estimating reasonably adequate coverage limits. Five key areas are: severity of claims, frequency of claims, risk "tail," defense costs and policy aggregate limits.

Claims Severity

A law firm must know the monetary value of matters it handles to determine appropriate malpractice insurance limits. However, average dollar value can be misleading as there is no guarantee that a loss payment will never exceed the average value of a firm's representations. Malpractice liability coverage, like most other insurance, should be purchased to protect against catastrophic loss. Accordingly, the most costly potential loss must be given more weight in determining limits than the average exposure.

Claims Frequency

Since all areas of practice do not have the same probability of claim occurrence, claim severity considerations may be modified by the frequency factor. Nearly all loss experience studies identify real estate and plaintiff's personal injury as areas with the highest frequency of claims. The next tier, with a significantly lower claims probability, includes estate planning and family and commercial law. All other practice areas have relatively low claim probabilities.

An offsetting statistic, however, shows that devoting small amounts of time to a number of relatively claims-free areas can result in greater exposure than concentrating in areas with higher claims frequencies. This "dabbling multiplier" should not be ignored when applying the frequency factor.

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Risk “Tail”

The risk tail, or time between an occurrence and the claim arising from it, for various areas of practice can have a significant bearing on malpractice insurance limits. Real estate claims, for example, typically have a long risk tail since the incidents that give rise to them often go undiscovered until properties are resold years later. As the time period lengthens between an act, error or omission and a claim that arises from it, the probability grows that a loss payment will be increased by inflation.

Defense Costs

To ignore defense costs could be financially fatal. One guide is to double the calculated potential loss payment exposure if defense costs are charged against policy limits.

Policy Aggregate Limits

The policy aggregate limit determines the total amount of coverage available for all loss payments (and, possibly, defense costs) during the policy year, regardless of the number of claims. Typically, frequency of claims increases with the number of

lawyers in a firm. Thus, the aggregate limit in a policy can be as critical as the limit per claim.

The aggregate is also an important factor in decisions on the purchase of an extended reporting endorsement (tail coverage). That endorsement must provide sufficient total protection during the entire risk tail period, which usually is longer than the one-year time frame for which the aggregate limit on the predecessor practicing policy was determined.

It is therefore important to review coverage well in advance of a renewal deadline. The review should analyze the adequacy of ongoing practice limits and consider increasing the occurrence and aggregate limits in the year prior to the anticipated purchase of an extended reporting endorsement. A law firm can reach a reasonable comfort level for limits on its insurance only by analyzing its malpractice exposures annually.

But be wary of looking for false savings. If a law firm tries to save a few dollars in premium costs by reducing limits, it is likely to be substantially underinsured, a risk that could lead to devastating financial loss.

*The above article, “The Right Amount of Coverage: Taking Inventory of Risks Helps Determine Malpractice Insurance Limits” was written by Duke Nordlinger Stern and appeared in the January 1996 issue of the ABA Journal. © 1996 American Bar Association. Reprinted with permission of the ABA Journal. **

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