

Errors & Omissions Insurance: The Experience of States with Mandatory Programs for Real Estate Licensees

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Abstract. Empirical and survey data collected from parties in states that require real estate licensees to have errors and omissions insurance is presented and analyzed. Satisfaction with the mandatory system was expressed by 68% of licensees and 89% of regulators. Variables that are significantly related to licensee satisfaction are identified. Perhaps most importantly, licensees who have operated under both voluntary and mandatory systems are more satisfied than those who have operated exclusively under a mandatory system. Motivations for mandating errors and omissions insurance include the desire to provide consumer and licensee protection, and affordable premiums for licensees. Recommendations for regulators considering mandating E&O insurance are presented.

Introduction

Errors and omissions (E&O) insurance is the functional equivalent of the professional liability insurance carried by physicians, attorneys, architects, and other professionals. This type of insurance provides a means to indemnify clients and customers who are financially damaged by an honest mistake or negligent error made by a real estate licensee, which, in turn, protects the licensee because a claim filed against a licensee without E&O insurance can be both financially and professionally disastrous. Claims filed against real estate licensees run the gambit from failure to negotiate a sale to misrepresentation of a property's physical condition, but according to Evans (2000), 80% of lawsuits against brokers are brought by buyers, and two-thirds of those have to do with the condition of the property.

Currently, real estate licensees in thirty-eight states may voluntarily obtain E&O insurance, but coverage is mandatory in twelve states. Proponents of mandatory coverage assert that a mandatory program helps ensure that consumers will be protected because all, not just some, licensees have coverage. Like other types of insurance, the E&O insurance market has experienced substantial tightening in recent years. Many insurance companies have stopped writing E&O policies or have greatly increased premiums, making it difficult for some licensees to obtain coverage. Some real estate commissioners at the 2003 ARELLO Annual Meeting reported that they could not find an insurance provider willing to quote coverage at any price. However, states that have mandated coverage arrange for a group policy for their licensees, and based on the comments received from licensees and regulators in the present study, it is apparent that the availability of these group programs helps to make E&O insurance available at affordable rates.

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The National Association of REALTORS® (2003) provides evidence that most agents and brokers have an appreciation of E&O insurance. NAR's survey data indicates that nationwide 83% of all agents and 73% of all brokers have coverage. Stitz (2004) provides insights into why some REALTORS are not covered in states where coverage is voluntary. He reports that approximately 8% of all members of the Ohio Association of REALTORS® do not have E&O insurance; 3% indicated coverage was too expensive, 1.8% stated that they did not believe it was necessary, 1.3% indicated that they intended to obtain coverage but had not yet done so and 0.4% stated that they cannot obtain coverage due to previous claims. The relatively low premium available through the group program in mandatory states may be attractive to many licensees in voluntary states who already have coverage, as well as those who claim the reason they lack coverage is due to high premiums. Mandatory coverage would also likely be motivational for licensees who are procrastinating in obtaining coverage, good news for those who assert that they are uninsurable and resisted by those who believe coverage is unnecessary.

The purpose of this study is twofold; the first is to present information that may be useful to state policymakers contemplating a mandatory E&O insurance program for their real estate licensees. To accomplish this objective, the experience of parties in states with existing mandatory programs is investigated using survey data collected from both real estate regulators and licensees operating in mandated states, and empirical data collected from the preeminent mandatory E&O insurance contract administrator. Despite the importance of E&O insurance, a search of both the real estate and insurance literature revealed no published academic papers that address this topic. Therefore, the second purpose of this paper is to start filling this gap in the literature.¹

The remainder of the paper is organized as follows. In the next section, the states that have a mandatory E&O insurance program are identified. Survey data collected from licensees in the mandatory states is presented in the third section and is analyzed in the fourth section. In the fifth section, information obtained from the insurance industry and state real estate regulators is presented. The sixth section contains recommendations for regulators contemplating the implementation of a mandatory E&O insurance program, and a conclusion is presented in the last section.

States with Mandatory E&O Programs

The twelve states listed in the first column of Exhibit 1 currently require their active real estate licensees to have E&O insurance. Examination of the second column of Exhibit 1 reveals that Kentucky, in 1987, was the first to implement a mandatory E&O insurance program, and that New Mexico and North Dakota, in 2002, are the most recent states to do so.² Also shown in Exhibit 1 are data on each state's population, number of real estate licensees and the number of licensees as a percentage of population. The smallest state with a mandatory E&O program in terms of both population and number of licensees is North Dakota. The most populous state with a

Exhibit 1
Twelve States with Mandatory E&O

State	E&O Mandatory Since	2004 Active Licensees	2004 Estimated State Population	% of Active Licensees to Population
Colorado	1-1-1998	31,963	4,550,688	0.70
Idaho	12-31-1993	6,005	1,366,332	0.44
Iowa	7-1-1991	7,899	2,944,062	0.27
Kentucky	4-1-1987	24,848	4,117,827	0.60
Louisiana	1-1-1990	14,324	4,496,334	0.32
Mississippi	7-1-1994	8,005	2,881,281	0.28
Nebraska	1-1-1993	7,363	1,739,291	0.42
New Mexico	1-1-2002	9,650 ^a	1,874,614	0.51
North Dakota	1-1-2002	1,750	633,837	0.28
Rhode Island	7-12-1990	6,223	1,076,164	0.58
South Dakota	8-16-1993	2,649	764,309	0.35
Tennessee	12-31-1990	30,339	5,841,748	0.52

Note:

^aTotal licensees: the licensing official at the New Mexico REC did not know the number of inactive licensees in this total.

mandatory program is Tennessee and the state with the most licensees is Colorado. Iowa (Colorado) has the lowest (highest) percentage of licensees to population.

The Licensee Survey

A survey was delivered via email to 1,069 REALTORS licensed in one of the twelve states that require E&O insurance.³ The names of the licensees to whom the survey was emailed were obtained using a “find a REALTOR®” search engine available on the NAR website.⁴ To be eligible to receive the survey, the licensee was required to have an individual (rather than a company) email address. The results should be viewed with some caution because of the relatively small sample size and because it is unclear what bias, if any, the data source and/or the “individual email address” requirement introduces. The results are interesting nonetheless.

Two hundred one responses were received, an overall response rate of 18.8%.⁵ In an attempt to enhance the response rate, the survey was kept brief (eight questions). The only demographic information collected on the survey was the number of years the respondent had worked in real estate. Respondent gender was identified from a variety of Internet sources.⁶ Approximately 48% of the respondents were female and 52% were male. Examination of the data in Exhibit 2, where respondent tenure in real

Exhibit 2
Licensee Years in Real Estate

State	<i>N</i>	Mean	Low	High	Std. Dev.
Colorado	9	19.8	7	35	9.9
Idaho	26	12.5	1	30	9.3
Iowa	6	17.8	8	35	10.3
Kentucky	12	17.3	6	35	10.2
Louisiana	11	17.3	6	33	9.9
Mississippi	20	18.3	6	32	9.5
Nebraska	7	22.3	7	42	12.6
New Mexico	19	15.3	3	33	11.2
North Dakota	23	15.3	1	34	10.1
Rhode Island	21	13.9	1	33	10.3
South Dakota	21	17.6	1	35	11.0
Tennessee	26	18.5	9	30	8.0
Total	201	16.4	1	42	10.0

estate is detailed, reveals that as a group the respondents have substantial real estate experience; their average tenure in real estate is 16.4 years.⁷

The licensee survey contained (among others) the following three questions:

- Did you obtain your current E&O policy through your state-sponsored program?
- If E&O insurance was not mandatory and you could continue to obtain it at the same premium you are currently paying, would you continue to be covered?
- Who pays your E&O premium? (with the following choices: You, Your broker, and Shared by you and your broker).

Examination of Exhibit 3, where the responses to these questions are detailed, reveals that 72% of respondents obtained their E&O coverage through their state-sponsored provider while 28% obtained their coverage independently.⁸ The majority (92.4%) of the respondents indicated that they would continue to carry insurance even if it were not mandatory while 7.6% indicated that they would not. It is not uncommon for sales associates to shoulder much of the cost of conducting business. Therefore, it is not surprising that 83.1% indicated that they pay for their E&O coverage. However, 11.4% reported that their broker paid the premium and 5.5% indicated that the cost was shared between them and their broker.

Survey participants were also asked: "How many claims have been filed against your E&O policy? Examination of Exhibit 4, where the results are detailed, reveals that

Exhibit 3
Licensee Response to Three Survey Questions

State	E&O Coverage Thru State Plan		Would Continue Coverage Even if Not Mandatory		Who Pays E&O Premium		
	Yes	No	Yes	No	Licensee	Licensee's Broker	Shared between Licensee and Broker
Colorado	8	1	6	3	9	0	0 ^b
Idaho	17	9	25	1	21	4	1
Iowa	2	4	5	0 ^a	2	3	1
Kentucky	10	2	11	1	12	0	0
Louisiana	8	3	9	2	8	2	1
Mississippi	17	2 ^a	19	0 ^a	18	1	1
Nebraska	6	1	7	0	6	1	0
New Mexico	16	3	18	0 ^a	13	3	3
North Dakota	12	11	20	2 ^a	15	6	2
Rhode Island	8	13	17	4	18	1	2
South Dakota	19	2	20	1	21	0	0
Tennessee	21	5	25	1	24	2	0
Total	144	56	182	15	167	23	11
% of Total	72.0	28.0	92.4	7.6	83.1	11.4	5.5

Notes:

^aOne respondent did not respond to question.^bColorado has a single-class licensee system.

85.1% of the respondents indicated that they had never had an E&O claim filed against them. However, 14.9% indicated that one or more claims had been filed against them. Given information presented later in this paper concerning the total number of claims in each state, it is not surprising that the majority of the respondents have not been involved in a claim. On the other hand, licensees with a claims history may be overrepresented in the sample, but this facilitates a subsequent comparison of the two groups.

Licensees were asked to respond to the following question: "How satisfied are you with your experience with mandatory E&O insurance coverage?" Possible responses included: "very satisfied," "satisfied," "neutral," "dissatisfied" and "very dissatisfied." Examination of Exhibit 5, where the results are detailed, reveals that the mandatory programs have been fairly well received by respondents: 23.5% reported being very satisfied, 44.5% were satisfied, 29% were neutral and 3% were dissatisfied. None indicated that they were very dissatisfied. Note that 68% of the respondents were at least satisfied. This figure is significantly higher than exists in at least one

Exhibit 4
Number of E&O Claims Filed Against Respondents

State	Zero	One	Two	Three	Four or More
Colorado	8	1	0	0	0
Idaho	23	1	1	1	0
Iowa	5	1	0	0	0
Kentucky	11	1	0	0	0
Louisiana	9	1	0	0	1
Mississippi	15	5	0	0	0
Nebraska	6	0	1	0	0
New Mexico	16	3	0	0	0
North Dakota	19	4	0	0	0
Rhode Island	18	3	0	0	0
South Dakota	18	3	0	0	0
Tennessee	23	3	0	0	0
Total	171	26	2	1	1

Exhibit 5
Licensee Satisfaction with Mandatory E&O

State	Very Satisfied	Satisfied	Neutral	Dissatisfied	Very Dissatisfied	Total
Colorado	2	5	1	1	0	9
Idaho	2	11	12	1	0	26
Iowa	0	5	1	0	0	6
Kentucky	7	2	3	0	0	12
Louisiana	4	3	3	1	0	11
Mississippi	5	10	5	0	0	20
Nebraska	2	4	1	0	0	7
New Mexico	4	7	6	1	0	18 ^a
North Dakota	5	14	4	0	0	23
Rhode Island	4	7	8	2	0	21
South Dakota	5	8	8	0	0	21
Tennessee	7	13	6	0	0	26
Total	47	89	58	6	0	200
% of Total	23.5	44.5	29.0	3.0	0	100.0

Note:

^aOne respondent did not to respond to this question.

voluntary state. Overall REALTOR satisfaction with E&O insurance in Ohio was 40.5% as reported by Stitz (2004).

Finally, the survey gave participants the opportunity to make any comments that they wished about E&O insurance; 41 individuals, from 9 states, elected to do so. Examination of their comments, which are available at www.wright.edu/~joseph.coleman, reveals several recurring themes: (1) an appreciation of the low premium due to group purchasing power; (2) concern that claim limits are too low to be effective, (3) concern that having E&O coverage increases the probability that the licensee will be subjected to a frivolous lawsuit (although this would apply whether or not coverage was mandatory); and (4) concern that a good claims record does not result in a reduced premium.⁹

Analysis of Licensee Survey Data

The results of tests conducted to identify variables that are significantly related to licensee satisfaction with mandatory E&O insurance are reported in this section. Two preliminary tests are conducted: one to investigate whether state survey response rates are related to average satisfaction level for licensees in each state, the other to determine if there is a difference in average satisfaction levels by state. It would be problematic if either result is significant. A Pearson correlation test, however, indicates that the former relationship is insignificant (correlation coefficient (r) is .338 with a p value = .28), and ANOVA results indicate the latter relationship is also insignificant (p value = .21). The results of these two preliminary tests indicate that it is appropriate to conduct the following tests on all respondents as a single group.

A t -test is used to determine if satisfaction levels differ significantly for the following seven variables. First: between licensees who pay for their own coverage and those whose broker pays, or shares, the premium cost. A priori, it seems logical that not being responsible for the premium payment might result in greater satisfaction with a mandatory system. Second: between licensees who have, and have not, experienced an E&O insurance claim. A priori, it seems logical that a person who has gone through the claims process might be more favorably inclined toward a mandatory system (although this may depend upon how effectively the claim was handled) because the licensee has first-hand knowledge of the financial protection E&O insurance provides. A licensee who has never had a claim filed against them may view E&O insurance in general as unneeded, and, therefore, consider a mandatory system as a vehicle that forces them to carry the "unneeded" coverage. Third: between licensees who obtained E&O coverage through the state-sponsored provider and those who obtained coverage independently. It is possible that one who opposes a mandated program would signal dissatisfaction by refusing to obtain coverage with the state-sponsored carrier. Fourth: between licensees who would continue to carry E&O insurance even if it were not mandatory and those who would not. It is intuitive that a licensee who indicated that he/she would not carry E&O insurance if it were not required is unlikely to be satisfied with a program that mandates coverage. Fifth: between licensees who have operated under both a voluntary and a mandatory system and those who have only experienced a mandatory program because licensees who have operated under both

systems may be in a better position to evaluate the advantages and disadvantages of a mandatory system (*e.g.*, premiums, claim limits). Licensees in the sample are divided into these two groups by comparing their tenure in real estate to the number of years that coverage had been mandatory in the state in which the licensee operates. Sixth: between licensees located in a state with a real estate recovery fund and those located in a state without a recovery fund. Eight of the mandatory E&O insurance states have a real estate recovery fund, including: Colorado, Idaho, Kentucky, Louisiana, North Dakota, Rhode Island, South Dakota and Tennessee. Recovery funds, normally funded by fees levied on licensees, may provide consumers with additional protection because the funds can be used to indemnify consumers that have been financially damaged in a transaction that is excluded by the E&O policy or a claim that exceeds the E&O policy claim limit. Despite this, it is possible that licensees in a state with a recovery fund view the two programs as redundant, and, therefore, hold E&O insurance in lower regard. Seventh: between male and female licensees. There is little reason to suggest that satisfaction levels should differ by licensee gender, but the gender issue is examined here because other real estate and insurance studies have identified differences based upon this criteria.¹⁰

To address the above issues, the mean satisfaction level for the two groups in each of the seven cases is calculated. The mean value is obtained by assigning a numerical value to each respondent's reported satisfaction level: 1 for very satisfied, 2 for satisfied, 3 for neutral and 4 for dissatisfied (*i.e.*, the lower the mean value, the higher the satisfaction level). Then a two-tailed *t*-test is applied. Finally, both a one-factor ANOVA and a Tukey–Kramer multiple comparison test are employed to test whether licensee tenure in real estate (dependent variable) is significantly related to licensee satisfaction with mandatory E&O insurance. A priori, it is plausible that the more experience a licensee gains the more he/she realizes the importance of E&O insurance and, therefore, the more likely the licensee is to be satisfied with mandatory coverage.

Examination of Exhibit 6, where the results of the *t*-tests are presented, reveals that three variables are highly significantly related to satisfaction. Specifically, satisfaction is higher for licensees with an E&O claims history compared to those with no claims history; for licensees who have worked under both a voluntary and mandatory E&O coverage system compared to those who had worked only under a mandatory system and, not surprisingly, for licensees who stated that they would continue coverage even if E&O insurance were not mandatory compared to those who stated that they would not.

Examination of Exhibit 6 also reveals the four variables found not to be significantly related to satisfaction. Specifically, no difference in satisfaction is discovered between licensees that pay for their own coverage and those who pay only some, or none, of the premium; between licensees who obtained coverage through their state plan and those who obtained coverage independently; between licensees located in states with and without a recovery fund; and no difference in satisfaction levels is discovered between the females and males in the sample.

The ANOVA results indicate a significant difference between satisfaction with mandatory E&O insurance and the number of years of experience possessed by a

Exhibit 6
t-test Results: Licensee Satisfaction

Group	Variable	N	Mean Satisfaction Level: Group 1	Mean Satisfaction Level: Group 2	t-Statistic	p Value
1	Who pays E&O premium					
2	Pay own	166	2.108	2.147	0.25	.797
2	Pay none or share cost	34				
1	E&O claim history					
2	none	170	2.170	1.800	2.38*	.018
2	One or more	30				
1	E&O carrier					
2	State-sponsored	143	2.105	2.140	0.28	.777
2	Independent	57				
1	Would continue coverage					
2	Yes	181	2.044	2.789	4.02**	<.0001
2	No	19				
1	Work experience with					
2	Mandatory & voluntary	137	1.985	2.397	3.49**	.0006
2	Mandatory system only	63				
1	State has recovery fund					
2	Yes	158	2.096	2.062	0.25	.810
2	No	42				
1	Gender					
2	Male	104	2.086	2.146	0.52	.600
2	Female	96				

Notes: In all cases but one, the folded F-test showed the population variances for each subgroup should be assumed to be equal and the pooled t-test was used. For the variable "work experience with," the folded F-test indicated that the population variances should be assumed to be unequal and the Satterthwaite test was used.

*Significant at the 5% confidence level.

**Significance at the 1% confidence level.

licensee ($p < .0001$). In order to more precisely identify the differences, a Tukey–Kramer multiple comparison test was performed. The test results indicate that the mean number of years in business for the respondents who were very satisfied (21.5 years) is significantly higher than both the mean number of years in business for the respondents that are satisfied (16.2 years) and those who are neutral (12.2 years). There is, however, no significant difference in the mean values between the very satisfied respondents and the respondents who are dissatisfied (20.5 years). All other multiple comparisons are not significantly different. Although the difference between the satisfied and neutral groups is not statistically significant, the magnitudes of the length of service tend to support the a priori hypothesis. The magnitude for the dissatisfied group with those of the other groups may be due to confounding variables outside the scope of this study (e.g., negative experience with insurance companies).

The Regulator's Survey

This section presents information gathered by survey from the Real Estate Commission (REC) in nine of the twelve states where E&O insurance is mandatory.¹¹ The responding RECs are almost unanimous in their opinion of mandatory coverage. Eight of nine respondents reported that they were very satisfied with mandatory E&O insurance and one reported being neutral (with possible responses: very satisfied, satisfied, neutral, dissatisfied and very dissatisfied). The results of a two-tailed *t*-test (*p* value < .0001) verify that the regulator's mean satisfaction level is significantly higher than the licensee's mean satisfaction level. Such a high satisfaction level clearly indicates that regulators believe that the mandatory program has achieved the desired results. The near consensus response, however, prevents statistical analysis of differences in satisfaction levels for RECs as was done for licensees. The RECs response to other survey questions, however, provides a wealth of valuable information. For expository expedience, the information is divided into five groups. First, the motivations behind the implementation of mandatory E&O insurance are reviewed. Next, the advantages and disadvantages of mandatory programs are presented. Third, the focus is on program administrative costs. Fourth, some insurance policy details and related regulations are examined. Finally, data on the recent E&O insurance claims history of each mandatory E&O state is presented.

Motivations for Mandatory E&O

In an open-end question, REC participants were asked to enumerate the motivations for instituting mandatory E&O insurance. Seven of the nine respondents specifically mentioned the need to maintain or increase consumer protection; three mentioned the need to provide affordable insurance coverage to licensees; and three mentioned the need to maintain or increase licensee protection.

The actions of some state legislatures have provided added incentive for real estate officials to recommend mandatory coverage. In Colorado, the REC became concerned about (then) recently-passed legislation that empowered the state to transfer money from funds such as the real estate recovery fund into the general fund. The possibility that the public could be left unprotected motivated the Colorado REC to recommend mandatory E&O legislation, which became effective in 1998. Subsequently, in 2003, funds were appropriated from the Colorado recovery fund, dropping the fund balance well below the statutory minimum. This episode may give real estate officials in other states with recovery funds pause for concern.¹²

In most states, regulators initiated the move to mandatory E&O insurance. For example, the REC in Nebraska (which had no real estate recovery fund before, or after, mandating E&O insurance) wanted to provide real estate consumers with some financial protection and was considering establishing a recovery fund. During its investigation the Nebraska regulators learned of the Kentucky E&O program, decided a mandatory E&O program would require less administrative time, and helped develop legislation which was enacted into law. In Iowa, however, the move to mandatory E&O insurance was initiated by the state Association of REALTORS®. According to

the Iowa REC, before E&O insurance was mandated, “coverage was difficult to obtain and the premiums were staggering. Premiums would go up, or the policy would be cancelled without claims or cause leaving the licensee without coverage.”

Advantages and Disadvantages of Mandatory E&O

In this section, the advantages and disadvantages of mandatory E&O insurance programs, mentioned by insurance industry officials and state RECs are presented. Some are more subtle than others, and no guarantee is given that either list is complete.¹³

First, the advantages:

Coverage Availability. Many insurance companies have recently stopped writing E&O policies for real estate licensees, or have greatly increased the premiums. This makes it difficult for some real estate practitioners to obtain coverage. The group program in each mandated state helps to make this important insurance available to all licensees at affordable rates.

Affordability. E&O insurance in the voluntary market is costly. Premiums for individuals often range from \$300 to \$500 or more, depending on the type of real estate activities performed. However, policies are generally only sold on a firm basis (*i.e.*, the entire firm must purchase a policy and individual licensees do not have the option to obtain insurance). Minimum premiums for firm policies are in the range of \$1,500 to \$2,000. Many small companies may not be able to afford the minimum premium, so go without any E&O insurance coverage. Group plans under mandatory E&O insurance programs are designed to bring down the cost of coverage (*i.e.*, lower premiums and lower deductibles).

Portable Coverage. Mandatory E&O insurance programs alleviate problems relating to individual coverage. Since E&O policies in voluntary states are generally available to firms only, an individual who changes firms may find that he/she is not covered by the new firm’s policy. Also, most firm policies cover claims against members of the firm for acts of a licensee only while the licensee is employed by that firm. For example, if an employee of Firm A is sued for an act that occurred while the licensee was working for Firm B, Firm A’s insurance may not cover this act. Many licensees may find themselves in this situation. Larsen and Coleman (2003) report substantial licensee movement between brokerage firms. In addition, because some firms do not carry insurance, a licensee working for an uninsured firm may be unable to obtain individual coverage. Group policies under mandatory programs are designed to provide individual coverage that will follow the licensee even if the individual changes firms.

Coverage for Prior Acts. Under mandatory E&O programs, claims made during the policy period resulting from “prior acts” (a claim resulting from a transaction in a previous policy period, but where notice is not received until a subsequent policy period) are covered if the licensee has been in the

group plan continuously from the date of the alleged error to the effective date of the claim.¹⁴ Prior acts coverage is also available in the voluntary market, but would not apply if the licensee switched insurance carriers between the transaction date and the claim date.

Consumer Protection. The purchase of a home is the largest investment most consumers make in a lifetime. An undisclosed problem or misrepresentation will likely have an adverse effect on that consumer and, if the real estate licensee who caused the damages is uninsured, the consumer may be without recourse. Mandatory E&O insurance increases consumer protection from honest mistakes and omissions by licensees because all licensees, not just some, are insured.

And, the disadvantages:

Mistake Prone Licensees Can be Problematic. At least two problems result from the fact that insurance underwriters base the mandatory E&O policy premium upon the weighted average risk of all licensees within the state. First, the inclusion of high risk individuals increases the premium for all licensees and licensees with a good claims record tend to resent the fact that the premium they pay does not reflect their personal claim record. Second, the insurance provider must rely on the REC to police licensees because existing programs require that the state-sponsored policy be offered to every licensee at the same price, with no right on the part of the insurance provider to cancel an individual's coverage. This is true, even if a licensee has a lot of previous claims and cannot obtain coverage on their own outside the group program. Therefore, to protect the financial integrity of the program, the REC may be required to discipline problem licensees (even revoke an individual's license in the event such action is justified) because there are only two ways the insurance provider can stop covering a problem licensee: (1) stop writing the entire group program, or (2) for the problem licensee to no longer qualify as a member of the group (*i.e.*, the individual no longer has a valid license). If the REC does not adequately monitor its licensees, the group program may be put at risk.

Additional REC Administrative Responsibilities. With a mandatory E&O insurance program, the REC will incur some additional administrative responsibilities. In most cases, the REC must devote time and resources to the program to help ensure that it is operated effectively. This effort will involve coordinating the activities of REC officials and staff with members of the state insurance and legal departments, which, in turn, will require these departments to also devote time and resources.

Few Insurance Providers. RECs in mandatory E&O insurance states are concerned by the low number of insurance companies currently underwriting policies. This limits competition and opens the possibility that even with a group plan, premiums may escalate or, at the extreme, threaten the existence of the group program. In 2003, Alabama became the first (and to date only) state to repeal its mandatory E&O requirement. The issue surfaced in 2002

when the Alabama REC conducted a review of their E&O group program and found that it had been four years since an insurance carrier had been under contract (due in part to the high number of E&O claims filed against licensees in the program). Alabama statutes provided that if the REC was unable to contract with an insurer to cover all licensees who choose to participate in the program, the requirement of E&O coverage was void during the applicable contract period. Today, the Alabama REC encourages licensees to seek E&O coverage on the open market.

Program Administration Costs

REC survey participants were asked: “How much does it cost annually to administer the state mandatory E&O program?” The responses suggest that some RECs may either not have a good grasp on this issue, consider administration costs to be too small to measure, or consider these costs to be a part of their overhead (five states gave no response for this question). With few exceptions (*i.e.*, the three states where the REC still collects the E&O premiums), the majority of administrative duties have been transferred to the external program administrator.¹⁵ The primary duties maintained by the states in administering their mandatory E&O insurance program are: (1) issuing requests for proposals (RFP’s) for new contracts; (2) reviewing bids; (3) negotiating final contracts; and (4) ensuring licensee compliance.¹⁶ Of those RECs that did respond to the question, the estimated costs of administering the E&O program ranged from zero to \$5,000 annually. One state estimated the annual hours devoted to administrating the E&O program to be 350 hours by the staff with an additional 100 hours by management.

Special circumstances may shift administrative costs up or down. For example, in Kentucky there is a tax on insurance premiums that varies by county, so in collecting the E&O premium the REC must verify the licensee’s county of residence to ensure that the correct amount of tax is collected. On the other hand, Rhode Island cut administrative costs to bare bones in recent years by operating their program without a contract with an insurance provider. Rhode Island had a contract with Rice Insurance Services Company (RISC) from 1992 through 2000. But, primarily because of the low number of E&O claims filed on licensees in the state, decided in 2000 to let RISC handle almost all of the program administrative details (RISC agreed to do so because Rhode Island’s program loss experience was deemed acceptable). This decreased the RECs administrative costs because it removed it from the administrative process, but licensees can still benefit through a low group rate. Of course the Rhode Island REC remains ultimately responsible for ensuring that each of its licensees has E&O coverage.

Policy Terms and Associated Regulations

Examination of the information presented in Exhibit 7 reveals considerable variation between states regarding E&O policy terms and associated requirements. While the maximum coverage per claim, shown in the second column, is \$100,000 in every state; the total claim limit, shown in the third column, ranges from \$100,000 in Iowa

Exhibit 7
Mandated E&O Program Policy Details: November 1, 2004

State	Coverage Limit Per Claim	Total Coverage Limit	Deductible	Maximum Annual Premium	Premium 2004 (2005)	Who Collects Premium
Colorado	\$100,000	\$300,000	\$0 defense \$1,000 damages	None	\$230 (\$215)	RISC
Idaho	\$100,000	\$300,000	\$0 defense \$1,000 damages	\$140	\$135 (\$135)	RISC
Iowa	\$100,000	\$100,000	\$0 defense \$0 damages	None	\$123 (\$134)	RISC
Kentucky	\$100,000	\$1,000,000	\$0 defense \$0 damages	\$125	\$123 (\$123)	REC
Louisiana	\$100,000	\$300,000	\$0 defense \$1,000 damages	\$500	\$217 (\$217)	REC
Mississippi	\$100,000	\$500,000	\$1,000 defense \$1,000 damages	\$150	\$146 (\$148)	RISC
Nebraska	\$100,000	\$300,000	\$0 defense \$1,000 damages	\$500	\$150 (\$150)	RISC
New Mexico	\$100,000	\$500,000	\$0 defense \$1,000 damages	\$150	\$146 (\$146)	RISC
North Dakota	\$100,000	\$500,000	\$1,000 defense \$1,000 damages	\$125	\$125 (\$125)	RISC
Rhode Island	\$100,000	\$500,000	\$1,000 defense \$1,000 damages	None	\$148/2 year (\$160/2 yr.)	RISC
South Dakota	\$100,000	\$500,000	\$500 defense \$1,000 damages	None	\$140 (\$140)	REC
Tennessee	\$100,000	\$300,000	\$0 defense \$1,000 damages	"Reasonable" as determined by Real Estate Commission	\$260/2 year (\$306/2 year)	RISC

Note: The sources are Rice Insurance Services Company and various state RECs.

to \$1,000,000 in Kentucky.¹⁷ The deductible amount per claim, shown in the fourth column, ranges from zero in Iowa and Kentucky to \$2,000 in Mississippi, North Dakota and Rhode Island.

Seven states have statutes or rules, shown in the fifth column of Exhibit 7, which set an upper limit on the annual premium amount. The limit ranges from \$125 in Kentucky and North Dakota to \$500 in Louisiana and Nebraska. In the past, such limits have presented a problem in some states as market conditions drove premiums above the previously set limit. This problem cannot occur in the five states that have not set a premium limit. Actual premiums charged in 2004 and 2005 are shown in the sixth column. The annual premium for 2004 ranges from \$80 in Rhode Island (where claims have been incredibly low, see Exhibit 8) to \$230 in Colorado. The

**Exhibit 8
Annual E&O Claim Information: 2001–2003**

	Colorado	Idaho	Iowa	Kentucky	Louisiana	Mississippi	Nebraska	New Mexico	North Dakota	South Dakota	Rhode Island	Tennessee
2001 Claims												
No payment or reserve	370	7	49	32	NA	29	NA	NM	NM	9	2	87
With payment or reserve	228	11	42	40	NA	35	NA	NM	NM	13	6	84
Total claims	598	18	91	72	NA	64	74	NM	NM	22	8	171
Average claim amount for claims with payment or reserve	\$18,509	\$8,054	\$6,791	\$8,990	NA	\$18,426	\$5,427	NM	NM	\$13,167	\$14,917	\$10,497
2002 Claims												
No payment or reserve	343	23	62	34	NA	32	NA	NA	5	6	8	72
With payment or reserve	238	16	50	42	NA	31	NA	NA	1	10	5	93
Total claims	581	39	112	76	NA	63	61	NA	6	16	13	165
Average claim amount for claims with payment or reserve	\$18,778	\$11,540	\$12,957	\$8,713	NA	\$15,245	\$4,705	NA	\$16,723	\$6,186	\$2,981	\$8,809
2003 Claims												
No payment or reserve	401	19	41	35	63	30	NA	NA	6	2	12	62
With payment or reserve	162	25	61	83	99	38	NA	NA	3	2	11	123
Total claims	563	44	102	118	162	68	43	NA	9	4	23	185
Average claim amount for claims with payment or reserve	\$20,963	\$11,255	\$6,895	\$8,549	\$11,220	\$11,145	\$8,782	NA	\$13,616	\$11,835	\$7,334	\$9,918

Notes: The sources are Rice Insurance Services Company and various state RECs.

NA = Not available

NM = Program not mandated this year

rightmost column in Exhibit 7 shows that the state REC collects the premium in three states: Kentucky, Louisiana and South Dakota. RISC collects the premium in the other nine states. In all cases, the state REC is responsible for ensuring that each licensee is in compliance with the mandatory E&O insurance requirement.

Policy premiums are a function of a number of variables, including: the number of individuals in the group, loss experience, deductible amounts and exclusions. Exclusions are not shown in Exhibit 7 because there are few (although some) differences between the subject states. Generally, the exclusions in mandatory program policies are similar to those in non-mandatory policies, and include transactions where the licensee had a personal interest, the claim was not submitted by the insured to the insurance company during the coverage period, fraud or a crime was involved, environmental conditions are involved, and where the licensee is alleged to have caused personal injury.

Many states have reciprocity agreements for their licensees with other states. Participants in existing state-sponsored E&O programs can obtain coverage in all states with which their state has reciprocity by paying a single \$15 endorsement. As long as the licensee's home state policy meets the minimum E&O requirements of the other state, the licensee is then covered for E&O claims in the other state.

As previously mentioned, some licensees believe that the E&O claim limits, detailed in Exhibit 7, are too low to be effective. However, the \$100,000 per claim limit that currently applies in all mandated states is more than fivefold the average paid claim amount shown in Exhibit 8.¹⁸ In some problem transactions, more than one licensee is involved. In cases where two (or more) licensees are liable, it is possible that the effective single-claim limit is actually \$200,000 (or higher), at least from the damaged party's perspective (*i.e.*, individual agent's claim limits are additive). In addition, because some licensees believe existing claim limits are too low, it is worth noting that the specified claim limits are minimums, not maximums, and a licensee can obtain additional coverage from the insurance provider. The premium for additional coverage depends on a number of factors including the amount of coverage, whether the applicant is a group or individual, and the claim history of the applicant (*i.e.*, policy details on coverage above state minimums are not covered by mandatory E&O insurance regulations).

Recent State-sponsored Plan Claim Activity

The E&O claim history for state mandated programs for the period 2001 through 2003 is summarized in Exhibit 8. During this period, the number of annual claims ranged from only 4 in South Dakota during 2003 to 598 in Colorado during 2001. The average claim amount paid ranged from \$4,705 in Nebraska during 2002 to \$20,963 in Colorado during 2003. When including all states, there is no clear trend in the number of claims filed over the time period examined or in the average claim amount paid.

Recommendations for Policymakers Considering Mandatory E&O Insurance

In this section, several recommendations for policymakers contemplating a mandatory E&O program are presented. First, it is best to keep statutory requirements as basic as possible because circumstances may change and it is sometimes problematic to amend legislation. To facilitate this effort, legislation from states with mandatory programs (which vary in the amount of detail) should be examined when formulating proposed legislation. Most state statutes provide that the REC shall determine the terms and conditions of coverage, including the minimum policy limits, permissible deductible and permissible exclusions through rules and regulations. This is an effective method that may ease program administration if future changes in these items are required. Rules and regulations tend to be easier to modify compared to statutes.

Second, despite the fact that the statutes of most states with mandatory E&O insurance specify a maximum policy premium (Exhibit 7), such a specification is not recommended. A statutory price limit can create problems in the event the maximum premium amount becomes unrealistic due to changes in market conditions. In fact, this problem has already occurred in more than one state, necessitating an amendment to the statutes. Again, greater flexibility is available when the statute gives the REC the authority to set a maximum price, which can be adjusted to account for inflation or a change in market conditions.

Third, specifying a minimum A.M. Best rating requirement by statute is not recommended. There are often only one or two bidders for mandated E&O insurance programs and restrictive rating requirements in the statute may further limit competition. In an effort to ensure financial stability of its insurance carrier, two states established a minimum A.M. Best rating requirement by statute (as did Alabama). Most states, however, do not include this item in their statutes. Instead their legislation allows the REC to either establish the minimum rating requirement in the RFP specifications or to consider the company's rating as a factor when evaluating bid proposals.

Fourth, if the state has a real estate recovery fund in place, it is recommended that the recovery fund be maintained to protect the public for legitimate claims that either exceed E&O policy limits or claims that are excluded by the E&O policy. However, at the time mandatory E&O insurance is being contemplated, it is important to consider the interaction of allowable claims and claim limits for both the recovery fund and E&O program. Upon implementation of mandatory E&O insurance, several states in the sample modified their recovery fund claim limits or criteria.

Fifth, licensees should be given the option to obtain coverage independently so long as the coverage at least meets state requirements. Sixth, mandatory E&O should only apply to active licensees. All states with mandatory E&O follow both of these prescriptions. Without the later, licensees considering temporarily leaving the business would have an incentive to drop their license rather than transferring to inactive status.

Seventh, in all phases of the process (*e.g.*, drafting legislation, formulating rules and regulations and drafting RFPs), a good resource is the state's risk manager. As an expert on insurance issues, the risk manager can help establish reasonable coverage terms and conditions, and later assist in an evaluation of the financial strength of bidding companies. Finally, during the program investigation phase, regulators should make it clear to all parties exactly why the change is being contemplated (*e.g.*, lower premiums, consumer protection). In addition, regulators should encourage, and seriously consider, licensee input on the proposal.

Conclusion

E&O insurance provides important financial protection for the public and real estate licensees, but tightening in the insurance market is reflected in increasing premiums. The group insurance policies offered in conjunction with mandatory E&O insurance state programs offer a vehicle to help control these costs. Twelve states currently require their active real estate licensees to have E&O insurance: Colorado, Idaho, Iowa, Kentucky, Louisiana, Mississippi, Nebraska, New Mexico, North Dakota, Rhode Island, South Dakota and Tennessee. An impressive 68% of REALTORS and eight of nine regulators from these states who responded to the survey expressed satisfaction with mandatory E&O insurance. Licensee respondents did, however, express concern that having E&O insurance makes them a target for frivolous lawsuits, and also that policy claim limits are too low. The former concern may (or may not) be true regardless of whether coverage is mandatory. Regarding the later concern, it was shown that the \$100,000 per claim limit that currently applies in all mandated E&O group policies is fivefold the average amount paid per claim over the 2001–2003 timeframe, and additional coverage can be obtained by licensees unwilling to assume the risk that they will not be the subject of a successful claim in excess of the limit.

Analysis of the survey data indicates that licensee satisfaction with mandatory E&O insurance is significantly related to four of eight variables tested. Licensees with a claims history are more satisfied than those with no claims history. Licensees who stated that they would continue coverage even if coverage was not mandatory are more satisfied than those who stated that they would not. Licensee satisfaction is also positively related to the number of years of experience possessed by a licensee. Perhaps most importantly, licensees who have worked under both a voluntary and mandatory E&O system are more satisfied with mandatory E&O insurance compared to those who had worked only under a mandatory system.

Licensee satisfaction with mandatory E&O programs was found to not be related to the other variables tested. No significant difference in satisfaction was discovered between licensees who pay for their own coverage and those who pay only some, or none, of the premium; licensees who obtained coverage through their state-sponsored plan and those who obtained coverage independently; and licensees located in a state with a recovery fund and those located in a state without a recovery fund. In addition, no significant difference in satisfaction was discovered between females and males.

Survey responses from state real estate regulators provide a wealth of valuable information. Motivations for instituting a mandatory E&O insurance program include

the desire to maintain or increase consumer and licensee protection, and to provide licensees with affordable insurance coverage. The former motivation is especially compelling in certain cases because some state governments are now (or are contemplating) raiding real estate recovery funds to supplement their general fund.

When contemplating a mandatory E&O insurance program, policymakers should consider the advantages, disadvantages and costs of such programs. Advantages include coverage availability, relatively low premiums, portable coverage, coverage for prior acts and consumer protection. Disadvantages include the fact that licensees with a bad claims history will increase the premium charged to all licensees, additional administrative responsibilities for the REC and other state agencies and (currently) the low number of insurance companies underwriting E&O group policies. Regulators' estimates of mandatory E&O program administration costs are nominal. The maximum dollar estimate of annual administrative costs offered by any respondent was \$5,000. Some states have reduced costs by transferring duties to the external program administrator. Special circumstances, however, may increase or decrease administrative costs.

Comments made by real estate regulators also suggest several recommendations for policymakers contemplating a mandatory E&O insurance program. Statutory requirements should be kept as basic as possible because it can be problematic to amend legislation. Requirements specified in rules and regulations promulgated by the REC provide greater flexibility. States with a real estate recovery fund should continue it to protect the public for claims that are excluded by, or exceed claim limits in, the E&O insurance policy. Licensees should have the option to obtain coverage independently and the mandatory E&O insurance requirement should only apply to active licensees. Finally, during the program investigation phase, regulators should make it clear to all parties exactly why the change is being contemplated, and seriously consider licensee input on the proposal.

Endnotes

1. Several interesting nonacademic E&O insurance related articles are available on the Realty Times website (www.realtytimes.com).
 2. Alabama formerly had mandatory E&O insurance, but repealed the requirement on April 25, 2003. More details on this situation are provided later in the paper.
 3. The survey may be viewed in full at www.wright.edu/~joseph.coleman. One thousand two hundred emails were sent, but for reasons unknown (we suspect a combination of turnover in the brokerage industry and the foibles of the internet), only 1,069 emails were successfully delivered. The overall and state response rates (shown in Endnote 5) are based on the number of emails successfully delivered.
 4. Website at: realtor.org/rodesign.nsf/pages/RealtorDirectory?OpenDocument.
 5. Response numbers (rates) for individual states were: Colorado: 9 of 83 (10.8%); Idaho: 26 of 93 (28.0%); Iowa: 6 of 81 (7.4%); Kentucky: 12 of 84 (14.3%); Louisiana: 11 of 100 (11.0%); Mississippi: 20 of 92 (21.7%); Nebraska: 7 of 98 (7.1%); New Mexico: 19 of 90 (21.1%); North Dakota: 23 of 89 (25.8%); Rhode Island: 21 of 89 (23.6%); South Dakota: 21 of 79 (26.6%); and Tennessee: 26 of 91 (28.6%).
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6. For most respondents, we were able to determine gender from the NAR website. For three dozen with names like Chris and Terry, gender was determined by visiting their state association of REALTORS, firm, or personal website.
7. According to NAR (2003), in 2003, 52% of all REALTORS are female, and the typical NAR member had 13 years' experience in real estate.
8. As of October, 2004, the average participation rate in state-sponsored plans for active licensees in all twelve states is 71.7%. The participation rate for all active licensees in each state as of the same date are: Colorado 65.8%, Idaho 89.7%, Iowa 98.7%, Kentucky 51.6%, Louisiana 95.4%, Mississippi 70.0%, Nebraska 83.5%, New Mexico 65.3%, North Dakota 46.6%, Rhode Island 41.4%, South Dakota 67.8% and Tennessee 83.5%. A regression analysis was performed on participation rates and group premium amounts. The two variables are not significantly related (p value = .21).
9. The study includes some anecdotal evidence that is not inconsistent with the concern of increased lawsuits. Of the states that had a recovery fund at the time E&O insurance was mandated, the RECs unanimous response was that there was no significant difference in the number of recovery fund claims in the years before and after E&O insurance was mandated. However, we do not have access to the number claims against independently-obtained policies in the years surrounding the mandatory E&O insurance implementation dates.
10. For example, difference in male and female disclosure (of psychological stigma) behavior is documented in Larsen and Coleman (2001). In the health insurance industry, Feldman and Schultz (2004) find that compared to males, females have higher service quality expectations. These expectations can influence policyholder satisfaction as asserted by Kolodinsky (1996); however, she discovered no significant relationship between satisfaction and gender.
11. All twelve REC directors contacted by phone and asked if they would participate in a written survey agreed to do so. The survey and cover letter were then emailed to each. Nine responses were eventually received. Subsequently, the nine participating people were contacted by phone to gather some clarifying information. A copy of the survey may be viewed at: www.wright.edu/~joseph.coleman.
12. Similar legislation was passed in Rhode Island and Tennessee after E&O insurance was made mandatory. In Idaho, the legislature attempted, and failed, to pass such legislation. About \$1,000,000 has been transferred from the Kentucky real estate recovery fund to the general fund in the in the last two years without the benefit of enabling legislation.
13. Proponents and opponents of mandatory E&O insurance may believe that arguments for their viewpoint are missing. The researchers encourage anyone who has additional items for either list to contact them.
14. Officially, a claim is made when the insured first receives a written demand for money or services, or has received notification of a lawsuit or arbitration proceeding naming the insured.
15. In 2004, Rice Insurance Services Company, LLC of Louisville, Kentucky (RISC) was the exclusive contract administrator, servicing all states with mandatory E&O programs. In 2005, RISC is providing service to all states but Nebraska, which is switched to the Williams Underwriting Group.
16. The contracting process varies from state to state; however, in general, the REC with the assistance of the legal and/or the insurance departments issues an RFP for a contract administrator who will be responsible for obtaining an insurance carrier. The contract term may vary in most cases, from one to three years with options for extensions.

17. The limit on the number claims that may be filed on an insured licensee is a function on the dollar payments made on claims against the policy. For example, a single \$100,000 claim would exhaust the coverage of a licensee in Iowa, but twenty claims of \$5,000 each would be covered by another licensee in that state.
18. In making this observation, the researchers are aware of the story of the 6-foot tall man who drowned in a river with an average depth of two feet. In addition, Iowa's \$100,000 total claim limit may not provide adequate protection for multiple claims.

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