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Accountants' Legal Responsibilities and Liability Insurance

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*Presented at the Accounting Study Conference,
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The title of this talk as described in the program is "Accountants' Liability Insurance". With your permission, however, I plan to expand the subject to include accountants' legal responsibilities as well, since the effectiveness and very existence of liability insurance must be based upon a broad understanding within the profession of its legal responsibilities.

No single characteristic distinguishes a profession from other vocations. The absence of the employer-employee relationship between the professional man (or firm) and his client, an attribute of every profession, is not unique to the professions. Highly developed skills, intellectual or physical, are not sufficient to identify the professional man. These characteristics, as well as high standards of educational training, are attributes of numerous lines of endeavor, some of which are not ordinarily described as professions.

There are, however, two characteristics which are common to all professions. The first of these is the existence of a self-enforceable code of professional conduct and acceptance of it by a substantial majority of the members of a profession. The ability of a profession to protect the general public against unqualified and insincere persons who attempt to exploit the standing and reputation of the profession is a distinguishing characteristic.

The second prerequisite of professional status relates to the very nature of the services performed. Professional service either facilitates the making of a decision by the client which affects his well-being, or it is intended to protect him against threats to, or invasions of, his personal well-being or his civil rights. The bases of such services, therefore, are (1) the rendering of an expert judgment, and (2) an action or a decision made in reliance on that judgment.

In the rendering of an expert judgment, the professional man assumes responsibilities commensurate with his expertness and with the economic significance of his judgment. He takes calculated risks in

the interest of effective service to his clients at reasonable fees. The first stages of professional maturity are marked by, among other things, formulation and acceptance by the profession of standards of competence, definition by the courts of responsibilities commensurate with these standards, and acceptance by the members of the profession of these responsibilities as calculated risks. A profession withers and dies if it refuses to accept the risks that attend responsibilities. That being so, a professional man has a responsibility to himself and to his profession to acquaint himself with professional liability developments, to observe the accepted standards of his profession, and to remain alert for ways and means of minimizing risks without diluting the effectiveness of his work.

Certified Public Accountants Meet the Tests of a "Profession"

Certified public accountants, individually and as a group, have accepted responsibilities presumed to be associated with professional skills and competence. As a group they meet all of the tests for professional standing. Our profession, in my opinion, has reached the early stages of maturity. To some people maturity implies vigor and balanced judgment; to others it means senility. The step from one to the other may be a short one, but a profession can avoid taking the step if its members seek continually to raise standards, thus improving the quality of their work.

Our profession is in such an early stage of maturity that its legal responsibilities are not comprehensively defined. However, certain characteristics are clear, and during the past few years they have been described in an excellent way in the literature. I commend to you Saul Levy's Accountants' Legal Responsibility, published last year by the American Institute of Accountants. In addition to a succinct discussion of the fundamental considerations relating to our legal responsibility, Mr. Levy's book reprints in full the most important court cases in this field.

I do not intend to analyze these cases or to discuss directly the various aspects of accountants' liability implicit in them. Mr. Levy has done this in an excellent manner.

Tenets of Legal Responsibility

It will, I believe, be helpful in this discussion to keep in mind two points made fairly clear by the courts:

Based upon the contractual relationship between the accountant and his client, the accountant may be held liable for negligence

in the performance of his engagement, negligence in this connection being something that is measured in the light of the skills and competence expected of a member of a publicly recognized profession.

As to parties, other than clients, who might have relied on the accountant's report, mere negligence probably is inadequate to make the accountant liable, unless the accountant knew that his report was for the primary benefit of the third party. Gross negligence on the part of the accountant may, however, be evidential of an inference of fraud and thus may become the basis of a liability to third parties.

Deliberate misrepresentation may not be necessary to establish fraud. An opinion by an expert may be found to be fraudulent if the grounds supporting it are so flimsy as to lead to the conclusion that there was no genuine belief back of it. Disregard of accepted professional standards may well lead to that conclusion. Mere negligence, gross negligence, and other such concepts, of course, embrace a range of conditions the limits of which are defined primarily by reference to auditing standards and accounting principles. The principal protection, therefore, against liability claims is the accountant's knowledge and observance of generally recognized auditing standards and generally accepted accounting principles.

Claims Against Professional Men Become More Numerous as the Profession Matures

As a profession matures, there is likely to be an increase in the number of claims brought against its members. This in no way is evidence of increasing laxity in the performance of professional services. It is attributable to two factors: (1) public awareness of the responsibilities of the profession's members widens as the profession matures, thus increasing the incidence of claims, and (2) points of law raised in one case become the basis of contentions in other claims.

The possibility that certified public accountants may be entering into a period when they will be exposed to an increasing number of claims should cause certified public accountants to consider carefully the steps that may be taken to minimize both the number and significance of such claims. No independent accountant can feel safe from such attacks.

"Avoidance of Misrepresentation"

In large measure, the basis of an accountant's legal responsi-

bilities is found in "avoidance of misrepresentation" sections of the various rules of professional conduct. The Institute rules relating to "avoidance of misrepresentation" read as follows:

"In expressing an opinion on representations in financial statements which he has examined, a member may be held guilty of an act discreditable to the profession if

- (a) he fails to disclose a material fact known to him which is not disclosed in the financial statements but disclosure of which is necessary to make the financial statements not misleading; or
- (b) he fails to report any material misstatement known to him to appear in the financial statement; or
- (c) he is materially negligent in the conduct of his examination or in making his report thereon; or
- (d) he fails to acquire sufficient information to warrant expression of an opinion, or his exceptions are sufficiently material to negate the expression of an opinion; or
- (e) he fails to direct attention to any material departure from generally accepted accounting principles or to disclose any material omission of generally accepted auditing procedure applicable in the circumstances."

Underlying, or standing behind these five admonitions is a great store of accounting literature, including recommendations issued by the various committees of the American Institute, such as the accounting research bulletins of the accounting procedure committee and the statements on auditing procedure issued by the committee on auditing procedure. Our clients have the right to assume that we observe the generally accepted standards of our profession, and we have the right to assume that the adequacy of our work will be judged by those same standards. Manifestly, our first responsibility is to have knowledge of the standards - this entails a great deal of continuing study by every certified public accountant. Let us take a closer look at the several ingredients of the "avoidance of misrepresentation" clause, remembering that our chief interest lies in acquainting ourselves with the legal hazards in our professional work.

A certified public accountant may be held guilty of an act discreditable to the profession if "he fails to disclose a material fact known to him which is not disclosed in the financial statements....." Two aspects of this rule are pertinent to the question of legal responsibility. First, is the matter of materiality. Materiality is, of course, mean-

ingful only as a relative concept. The basic criterion of materiality is the extent to which knowledge, or absence of knowledge, concerning the item in question would alter important decisions of those who read financial statements. Such a criterion, however, furnishes little assistance to the accountant in many of the cases where he assesses materiality. To the best of my knowledge, there is no all-purpose formula for judging materiality. In one set of circumstances the magnitude of the item in relation to net income may be significant; in another case either total assets or net assets or net sales or some other such factor may be the important measuring guide. Even the ratio which separates the immaterial from the material will vary with circumstances. I shall not dwell longer on the other judgment factors underlying materiality. I think, however, in addition to keeping up with the literature dealing with the views of our contemporaries on this subject, we must, from time to time, satisfy ourselves as to the practices of the profession in this connection by studying published financial statements. By careful study of such reports and the accountants' opinions included therein we can obtain indications of the range within which various items are considered to be material. Sound judgment as to materiality is, however, in the final analysis, nurtured by experience.

Standards of Disclosure

The second question is the matter of standards of disclosure, apart from the question of materiality. First, we must recognize that the position, style, and type of disclosure are important. A major deficiency in the body of the financial statements is not necessarily cured by footnote disclosure. For example, mention of all the pertinent details in a footnote might not satisfactorily cover the omission of a significant amount of inventory and the related liability from the balance sheet. A footnote is an integral part of the balance sheet and footnote disclosure is adequate in many instances; nevertheless, our standards view the footnotes as being only secondarily significant as compared with the basic structure of a financial statement.

Material Misstatement

Sub-section (b) of the "avoidance of misrepresentation" rule refers to "material misstatement known to him (the accountant) to appear in the financial statement" This proscription is so obvious as to its intent and reasonableness that it need not be discussed further.

Standards for Conducting an Audit

Sub-sections (c), (d), and (e), however, touch on the backbone of

our everyday activities. They are concerned with the scope of our examination, how it is conducted, and with our report, and the circumstances in which we must qualify or deny an opinion. They deserve our careful consideration from the point of view of both the hazards and the precautions which are necessary to make the risks bearable. Sub-section (c) states that an accountant may, in rendering an opinion on financial statements, be held guilty of an act discreditable to the profession if "he is materially negligent in the conduct of his examination or in making his report thereon." This is the tenet of responsibility that was invoked in the Ultramares case and was the basis for the precedent recognized in later cases of holding the accountant responsible to third parties (who rely on his report) for gross negligence. Substantially all claims against accountants have been based upon the grounds of negligence or gross negligence. Few have involved allegation of deliberate misrepresentation.

The first line of defense, and perhaps the most nearly impenetrable one, against claims that might be brought against the accountant for gross negligence in the performance of an engagement is his ability to demonstrate that the examination was made in accordance with generally accepted auditing standards and that recognition was given to generally accepted accounting principles. Our first duty to ourselves and our profession, therefore, is to acquaint ourselves with the standards of our profession and to remain abreast of developments in auditing and accounting as they occur, and to emphasize again and again that the accountant is not a "fact finder" but that he expresses a professional opinion as to the reasonableness of the representation of management, based upon tests and his judgment as to the effectiveness of internal control. A number of organizations are doing some fine work in reporting on studies in auditing and accounting, such as - to name only three - the American Institute of Accountants, the American Accounting Association, and the National Association of Cost Accountants. The literature of accounting is profuse, to say the least, and keeping up with it is no small task - but one that we must not neglect. It would be quite damaging to an accountant's position, I feel sure, if in defending himself he should show ignorance of the existence of publications of well-known professional organizations, particularly the publications dealing with the type of business relating to which the claim is being brought against the accountant. For example, if a claim should be brought against an accountant because of alleged negligence in conducting the examination

of a savings and loan association, he would be in a vulnerable position if he had no knowledge of the American Institute's publication on "Audits of Savings and Loan Associations".

Working-Paper Considerations

Assuming, therefore, that an accountant acquaints himself with the developments in the profession and assuming that he seeks to apply generally accepted principles and to observe generally accepted standards, what are some of the hazards that he might encounter in attempting to demonstrate that he did conduct his examination in accordance with generally accepted standards? First, there is the matter of the record that he makes of the scope of his work - his working papers.

You can be sure that if legal proceedings are instituted against an accountant he will be required to furnish the court with all working papers relating to the engagement. I have the impression in looking over the record of cases brought against accountants that, almost without exception, either information in the working papers or the absence of information from the working papers was the basis of the principal contentions of those who sought to hold the accountant responsible for negligence. Furthermore, I am of the opinion that more damaging evidence has been brought against accountants because of matters included in the working papers than because of matters not included. That does not mean that working papers should be less than adequate to demonstrate proper performance.

When the quality of our work is questioned, those who make the allegations and seek to show their credibility, have the full benefit of hindsight, and those who are called upon to judge us have, of course, the same retrospective advantage. The accountant's working papers, therefore, should show clearly the trail followed in performing the engagement, but at the same time, they need not show the deadends, if any, along the way, unless such side excursions are fully explained and do not contradict the accountant's opinion or cast a cloud of doubt over it. I am not recommending that an item be removed from the papers simply because there is a possibility, remote or otherwise, that it might be used against the accountant. I am saying, however, that there is little to be gained by leaving in the papers tentative, informal memorandums or other similar items that might, when considered apart from the oral discussions and the sequence of events before and after their preparation, be interpreted as evidence of wavering judgment underlying the report. Any such papers or memorandums as might remain in the

working papers should certainly be accompanied by an adequate explanation of any significant change in a point of view or course of action.

The final review of the working papers by the partner or principal supervising the engagement is the last line of defense against papers that might furnish damaging evidence against the accountants. Accordingly, such a review must be performed with full cognizance of the legal hazards and with a forward-looking view as to the inferences that might be drawn with the aid of hindsight. Such a perspective comes only from experience.

Apart from the matter of satisfying himself that the scope of the audit, the results of the tests, and requests for confirmation, and other inquiries are such as to support the opinion that is being expressed, the final reviewer of the working papers should be on the alert for open questions - questions raised by accountants during the course of the audit that have not been answered satisfactorily. He must watch for indications of things that should have aroused the suspicion of the accountants as they did their work. He must satisfy himself that the work done in studying the system of internal control, as described in the working papers, is adequate to support reasonably the conclusion reached as to its effectiveness and that the nature and scope of the audit work generally is adequate, having in mind weaknesses disclosed by the test of the effectiveness of the system of internal control. This final review is one of the most important steps, particularly from the standpoint of minimizing the risks of legal liability, in an audit engagement. It must not be done perfunctorily.

Accountants' Reports

The second feature of sub-section (c) of the "avoidance of misrepresentation" rule refers to material negligence in preparing the accountant's report; sub-sections (d) and (e) refer to the basis of the opinion and to the adequacy of disclosures in the accountant's report. Liability hazards relating to reports are more clearly defined and probably have received greater attention than the hazards in any other phase of the accountant's work. This is to be expected. After all, the report carries his opinion and his comments. The reader looks to the report for what the accountant has to say and how he says it. It provides the most readily available material upon which to base a claim.

The profession has, particularly during the past fifteen years, given a great deal of attention to the short-form report. The present form of that report (in unqualified form) is the result of a careful

weighing of words and combination of words. It purports to convey to an intelligent reader the limits of our responsibility as auditors. Because it is the product of such an orderly evolution, I think an accountant assumes an unnecessary risk if he departs from it in any material way. He assumes the risk attending departure from the only standards he has any right to be judged by. Literary variation per se has no place in the accountants' short-form report. Any variation from the standard wording is likely to be cause for an inference that it indicates something unusual. Therefore, by avoiding variations of such phrases as "present fairly," "accordingly included such tests," "in our opinion," "in conformity with," etc., we may well minimize the risk of being judged by standards imposed by a jury from its own interpretations rather than those developed by the profession.

Certificate Qualifications and Disclaimers

Qualifications and disclaimers in a short-form report cannot, however, be standardized. Hazards relating to certificate qualifications and disclaimers are, therefore, numerous and varied and troublesome because of the difficulty of determining that which is generally accepted. As you know, Auditing Statement No. 23 states that an auditor should, in rendering his report on financial statements, do one of three things: (1) express an unqualified opinion concerning such financial statements, (2) qualify his opinion, or (3) disclaim an opinion. The American Institute of Accountants has not incorporated the substance of Statement No. 23 in its rules of professional conduct; however, Institute committees have on several occasions considered the advisability of doing so. CPA societies and state boards of accountancy in a few states have incorporated the substance of Statement No. 23 in their rules of professional conduct.

We would do well to see that the language in certificate qualifications is such as to make unequivocal our intention to qualify, and it may be well to consider "except that (or for)" a standard phrase to introduce a certificate qualification. I can see circumstances in which, because of the uncertainty of future events and the results thereof on the financial statements, we might wish to introduce a qualification with "subject to". If we include in a short-form report information which is intended to be explanatory only, and not of a qualifying nature, we should, I think, avoid using "except for" - such a phrase should be used only for qualification.

Even though an accountant concludes that a matter is so signifi-

cant as to require a disclaimer as to a fair presentation of the overall financial position and results of operations, the standards of our profession permit him to express an opinion, if he deems it appropriate, as to any single item or group of items included in the financial statements. Such an opinion must be carefully worded so as not to contradict the denial of opinion relating to the financial statements taken as a whole. We must remember that frequent use and general knowledge of standard language may ascribe to a standard phrase a meaning which remains the same in any context. For example, "in conformity with generally accepted accounting principles" may be so well established in usage as to lead to the inference that it carries with it an assumption about overall financial position. The profession, in my opinion, will find it desirable to consider this matter further before too long.

Concurrent Issuance of Long-Form and Short-Form Reports

Whenever an accountant issues both a long-form report and a short-form report, there are special hazards. Generally such reports should bear the same date; otherwise, it may be inferred that the accountant has made at least some inquiries during the intervening period. The extent of an accountant's responsibility for events that occurred after the balance-sheet date, which events might have some relationship to a fair presentation on the balance-sheet date, is a subject that has received considerable attention in recent years and is the subject of the latest statement on auditing procedure issued by the Committee on Auditing Procedure of the American Institute. I shall not discuss this subject further, even though I consider it important to an accountant in assessing the limits of his legal responsibilities. Professional standards relating to subsequent happenings have taken shape rapidly in recent years. Any departure from such standards (as recited in Auditing Statement No. 25) is at best a calculated risk.

Perhaps I should point out here that there is still room for experimentation in accounting and auditing, my admonitions concerning the observance of standards, notwithstanding. The standards themselves, as you know, are broad enough to allow for variations in circumstances and definitive enough to furnish objective guides.

Concurrent issuance of a long-form report and a short-form report carries with it several other hazards which, perhaps, can be minimized by a final, independent review of the reports. By independent review at this point I mean a reading of the reports by a member of the firm (or an experienced accountant) who did not participate in the en-

agement in any other way. Among other purposes, such a review is intended to guard against cases in which the long-form report includes comments or supplemental information of such a nature as to cause the question to be raised that the short-form report should have been qualified. Comments on specific items may be so guarded, because they are directed to specific items, that a jury might decide that they cast some doubt on the fairness of the overall presentation.

Similarly, the review should be designed to weigh the disclosures and comments in the long-form report to ascertain whether or not any matters mentioned therein, and not mentioned in the short-form report, are so material as to make the latter report misleading.

Not infrequently, the long-form report includes statistical information not covered by the audit, such as department or territory analyses. We should guard against the possibility that our opinion will be construed as covering such material. It is important that the accountant's report be crystal-clear as to that part which is intended to be covered by the opinion and that which is intended to be outside the certificate.

Representation of Fact

One last admonition concerning reports. A claim against an accountant relating to a representation of fact in his report cannot be defended by demonstrating that the accountant believed it to be a fact. When an expert represents a fact as true to his knowledge he, in effect, warrants his knowledge. For example, if the report states that the financial statements are in accordance with the records, a fact is represented. It raises the question as to whether there were some records that the accountant did not see, and he probably cannot defend himself by arguing that he was unaware of the existence of other records. The combination of "in our opinion" and "present fairly" is intended, among other purposes, to guard against the inference that there is a representation of fact. We would do well to make even greater use of this pair of phrases, particularly in special-purpose reports.

C.I.T. CASE

The case of C.I.T. Financial Corp. v. P.W.R. Glover et al, which was mentioned in the August 1955 issue of The Journal of Accountancy, may well be one of the most important milestones in the development of legal concepts pertaining to accountants' liability. It involved a claim for substantial damages which was defended vigorously and successfully by the accountants in the United States District Court and, upon appeal,

in the United States Court of Appeals for the Second Circuit.

In addition to a remarkably clear and complete statement of the concepts of negligence and gross negligence as they apply to an accountant's work, Judge Sylvester J. Ryan's charge to the jury in the United States District Court (Southern District of New York) includes an instruction which covers a matter of considerable significance to accountants and which, as far as I know, is mentioned for the first time in legal proceedings. Judge Ryan said that "an accountant does not make factual representations as to the contents of financial statements; these are the statements of the management and unless the accountant expressly states to the contrary he does not assume responsibility for them, but he does assume responsibility for his own opinion and represents that in order to form such an opinion he has complied with generally accepted auditing standards."

Liability Insurance

Despite the best efforts of the individual accountant and of accounting firms to conduct their practice in such a way as to minimize the hazards, some risks remain. As mentioned previously, risks of some minimum degree are inherent in professional practice and we would in the long run probably be rendering a disservice to our clients if we sought to eliminate all such risks. Fortunately, liability insurance is available to protect the accountant against claims that might otherwise prove to be disastrous.

When a claim is brought against an accountant because of alleged deficiency in his work, whether or not the claim can be settled or disposed of without lengthy legal proceedings, the accountant may expect to suffer one or more types of measurable, monetary losses: settlement of the claim itself, payment of legal and other costs relating to the defense of the allegation, and loss of revenue resulting from lost time (this last factor may be the most significant one). Furthermore, and perhaps of greater long-range significance, is the possible damage to the accountant's reputation, particularly in situations where there is a public airing of the proceedings.

Liability insurance in its usual form provides for indemnification of the accountant for two of the monetary losses: (1) any amount paid in settling the claim and (2) any legal and other similar costs incurred in the defense of the claim. Large, small, and medium-sized firms alike can ill afford to be without professional indemnity insurance. No firm, by reason of its size or nature, is invulnerable against that one

claim which could spell economic disaster.

Liability insurance may, because it indemnifies the accountant for the cost of defending a claim, enable him to pursue his defense to whatever ends are necessary to preserve his general reputation. Without the security of indemnity insurance, an accountant might have to abandon the defense before the point is reached in legal proceedings that might be required to prevent irreparable damage to his reputation. Alertness, the proper degree of caution, and high-quality audit work, together with professional indemnity insurance, are essential to guard against both the economic loss and the damage to one's reputation that might result from a claim brought against an accountant.

Under the usual policy the accountant is not indemnified for claims against him for libel or slander. The usual policy does, however, cover claims arising from dishonesty, misrepresentation, or fraud, except if made or committed by the insured with affirmative dishonesty or actual intent to deceive or defraud. Such coverage may, in some policies, be included in the base premium; in others it may be excluded from the base premium and included only by payment of an additional premium. A third party, in bringing a claim against an accountant, usually will allege fraud. Such an allegation, of course, is based on the precedent relating to gross negligence as set forth in the *Ultramares* case and subsequent cases, including the recent *C.I.T.* case. An accountant, therefore, cannot afford to have excluded from his policy coverage for claims based on allegations of this technical type of fraud.

The usual policy covers claims brought against the firm or any of its partners, by reason of an alleged breach of professional duty by the members of the accounting firm or its employees. In most policies the claims covered are those which are made during the term of the policy, even though such claims are by reason of an act or an omission of a prior period. Provisions of policies will vary as to rights of the insurer or the insured to settle or defend a suit. In some policies the cost of defending a suit is included in the stated coverage, and in other policies it is considered as additional coverage. Termination provisions may vary considerably, particularly as to the period of notice that may be required if the insurer terminates the policy. Frequently, the policy permits, by payment of an additional premium, the extension of the coverage after termination up to two years (in some cases three years) for claims alleged to have been caused by acts which occurred prior to the date of termination.

Insurance in an amount equivalent to any payments made by the insurer is, in the usual policy, reinstated and requires payment of an additional pro-rata premium. The amount of insurance that can be reinstated is usually limited to an amount such that the insurer's total liability in any one year does not exceed twice the original sum insured.

The accountant should be cautious about making any statement, oral or otherwise, that might be interpreted as an admission of responsibility in connection with any claim; otherwise, the insurer may be relieved of any responsibility under the policy.

The basic premium rate for any given accounting firm ordinarily depends upon the number of its partners and employees, other than telephone operators, porters, messengers, and the firm's own bookkeepers.

Selecting the insurer with whom the policy is to be written must be based on factors other than basic premium rates. Total premium rates will vary with the exceptions included in the policy, some of which have been mentioned in the foregoing. Apart from premium rates, in purchasing insurance the provisions of the policies should be considered carefully. As is the case in purchasing other services, the general reputation of the insurer and his demonstrated willingness to serve his clients are important considerations in selecting an insurer.

Summary

Accountancy has come a long way in the past fifty years along the road toward full professional status. Such progress is attended by new risks and changing and generally known responsibilities. Our goal individually should be to shape the day to day conduct of our professional practice in such a way as to (1) maximize the assurance that we are observing generally accepted professional standards and (2) limit our responsibilities to a level consistent with the presumed degree of competence of the members of our profession. I think it very important in striving for this end that we anticipate, and thus seek to avoid, any situation where we might be subjected to pressure to accept responsibilities incompatible with our field of professional competence. Such circumstances can arise, for example, in connection with an underwriting agreement or an indenture which might, without preliminary consideration by the accountant, place responsibilities on him that he cannot accept.

The profession as a whole should not be unduly concerned because claims are brought against its members from time to time, so long as

the number of such claims is kept within reasonable bounds. Such a condition is a mark of professional status. An individual member, however, views, as he should, any claim against him as a threat to his professional standing. Avoidance of such claims, therefore, is all-important to him. When he has reduced the risk to the level which is consistent with high-quality service to his clients, he must rely on liability insurance to protect him against any potentially disastrous invasion of his professional well-being.