Woman C.P.A.

Volume 41 | Issue 4 Article 6

10-1979

Professional Liability Insurance: Basic Principles Which Accountants Should Know and Understand

Ronald M. Mano

Follow this and additional works at: https://egrove.olemiss.edu/wcpa

Part of the Accounting Commons, and the Women's Studies Commons

Recommended Citation

Mano, Ronald M. (1979) "Professional Liability Insurance: Basic Principles Which Accountants Should Know and Understand," *Woman C.P.A.*: Vol. 41 : Iss. 4 , Article 6.
Available at: https://egrove.olemiss.edu/wcpa/vol41/iss4/6

This Article is brought to you for free and open access by the Archival Digital Accounting Collection at eGrove. It has been accepted for inclusion in Woman C.P.A. by an authorized editor of eGrove. For more information, please contact egrove@olemiss.edu.

Professional Liability Insurance

Basic Principles Which Accountants Should Know and Understand

By Ronald M. Mano

Professional liability insurance includes two general types of insurance. Those two types are (1) malpractice insurance and (2) errors and omissions insurance. The distinction between the two types is that malpractice insurance deals with professional practice which involves any contact with the human body, whereas errors and omissions insurance covers all other professional practice. Therefore, malpractice insurance is mainly for physicians, surgeons, and dentists. This article discusses and analyzes professional liability insurance in the errors and omissions area.

Because of the many different types of professionals, the emphasis of this article is on accountants and attorneys only. Some mention is made of other professionals, but no extensive analysis is presented of the professional liability insurance available for these other professions. However, most of the features of the accountants' or attorneys' errors and omissions policy also are true for other professionals.

The Needs and Uses of Errors and Omissions Insurance

All professionals could be faced with the need for professional liability insurance. This includes accountants, attorneys, architects, corporate officers and directors, consultants, engineers, insurance agents, and anyone else maintaining the position of a professional.

Errors and omissions insurance is designed to protect against claims arising out of the performance of professional services. Specific areas covered are:

1. Act — affirmative negligence
2. Error — failure to perform properly
3. Omission — failure to perform at all when expected to do so.[1]

The professional needs protection from several possible exposures which can be caused by personal mistakes. An attorney may forget to file a suit within the time limit and prevent the client from taking action for an alleged tort. The client may sue the attorney for the amount he presumed to be recoverable in the suit. Collapses of structures have resulted in suits against engineers and architects on grounds that mistakes in design or carelessness in the supervision of the construction caused the collapse. An accountant may make a mistake in the preparation of a financial statement for a client and may contribute to a loss not only to the client but to others who may have relied on the erroneous statement and lost money by investing in or loaning money to the client. An insurance agent is vulnerable if accused of not placing insurance or placing it erroneously, particularly if a loss occurs that is not covered by insurance, but on which the client thought adequate active coverage was in force.[2]

The relative exposure against which a professional must protect be protected is illustrated by a 1971 case involving a New York CPA. The New York Supreme Court awarded $237,278.83 to a client of a CPA firm that had hired the firm to do a small accounting job for which it was charged $600. The CPA firm was not hired to perform an audit and, indeed, was not compensated at audit rates. However, in the process of simply posting accounts and preparing financial reports, the auditors became aware that there were possible missing invoices. The CPA firm had not performed any audit tests and stated so in their transmittal letter, which said in part:

> *The following statements were prepared from the books and records of the corporation. No independent verifications were undertaken thereon . . .*[3]

The Court found the above statement of no consequence. In language disquieting to the entire accounting profession, the Court said:

> *Even if the defendant were hired to perform only "write-up" services, it is clear, beyond dispute, that it did become aware that material invoices purportedly paid by Riher (the client's accountant) were missing, and, accordingly, had a duty to at least inform plaintiff of this. But even this it failed to do. Defendant was not free to consider these and other suspicious circumstances as being of no significance and prepare his financial report as if same did not exist.*[4]

Even insurance companies which sell liability insurance sometimes find themselves as defendants in errors and omissions suits. A ten-year-old California case illustrates this point.

Mrs. Crisci, an elderly lady, owned and rented an apartment building. A tenant, Mrs. DiMare, was injured when an outside stairway collapsed. Mrs. Crisci had a $10,000 general liability policy issued by Security Insurance Company. Mrs. DiMare sued alleging negligence in inspection and maintenance of the stairway and sought $400,000 compensation for physical and mental injuries. Settlement negotiation reached the state where the DiMare side agreed to accept $9,000 in full settlement, Security rejected the offer and requested a jury trial. The jury returned a verdict for DiMare of $100,000 and Security refused to pay the excess over $10,000. Partial satisfaction of the claim caused Mrs. Crisci to lose her property and changed a once comfortable individual into an indigent and resulted in declining physical health

and in hysteria, and suicide attempts.

Suit was brought against Security charging that Security had breached its duty to consider the interest of Mrs. Crisci. The California Supreme Court awarded the full amount of the DiMare award ($100,000), $180,000 in punitive damages, and $60,000 in compensatory damages for emotional distress to Mrs. Crisci.[5]

In a more recent case involving a major CPA firm, a California State Court jury awarded $30 million in damages to more than twenty lending institutions that charged that Touche Ross & Co. was negligent and stated that they failed to use due care in the performance of their audit work on U.S. Financial.[6]

The Professional Liability Policy

There exists no standard professional liability policy. Moreover, the general provisions of the professional liability policy differs, depending upon whether the professional is an accountant, attorney, architect, corporate officer, consultant, engineer, insurance agent, or any other professional.

Legal Liability vs. Indemnification

The professional liability policy provides for "payment of all sums for which the insured becomes legally obligated to pay".[7] Therefore, it is not an indemnification policy. Indemnification means to reimburse for losses to the insured's property. The professional liability policy does not pay for losses but for legal obligations of the insured. Such policies pay for damages assessed against the insured for acts, errors, or omissions.

Activity Qualification

The accountant or attorney is covered only as he acts in his capacity as an accountant or attorney. Therefore, the CPA who leaves his accounting practice to become an insurance agent would not be insured under his accountant's professional liability policy.[8] The policy of American Home Assurance Company states that professional services means "Professional services performed by and advice given by the insured in the conduct of his practice . . ."[9]

Definition of Persons Insured

The policy provides coverage for all partners or shareholders and their staff. The staff includes all accountants or attorneys, assistants, stenographers, secretaries, typists, and report room staff. The term does not include messengers, internal bookkeepers, telephone operators, or other workers not engaged in or on accounting or legal work for the client of the insured.[10]

Claims Made vs. Occurrence

The claims made policy covers any act, error, or omission, the claim for damages of which is made during the term of the policy, regardless of when the act, error, or omission occurs. The occurrence policy, therefore, covers what is sometimes referred to as the risk "tail".[11] Although both types of policies can be obtained, the American Home Assurance policy for accountants illustrated in the Fire, Casualty, and Surety bulletin states, "This policy covers only claims arising before the expiration date and reported to the company during the effective period of the policy."[12] However, if the insured does not wish to continue the coverage but would like to extend the claim reporting period, he can do so for an additional premium for a maximum of six additional years. However, if the insurer cancels the coverage or elects not a renew, the maximum extension is one year.[13]

Additional Coverages[14]

A. Defense — The insurer generally agrees to pay all costs of defense of covered claims even if they are groundless, false, or fraudulent. These costs may or may not be part of the policy limits.

B. Interests on Judgment — Because of the time involved in the appeals process, interest costs of a judgment could be substantial. These costs are generally covered if the appeal is at the request of the insurer.

C. Investigation and Witness Costs — These costs are self-explanatory and are generally covered.

D. Insured's Expenses — All reasonable expenses incurred by the insured to defend a suit are generally covered, except lost profits or time.

Defense and Settlement

As was stated earlier, the insurer has a duty to defend the insured for any covered action, regardless of whether the suit is groundless or not. The insurer shall have the right to investigate and negotiate the claim and, with the written consent of the insured, settle or compromise the claim as they deem expedient.[15] If the insured refuses such settlement, then the insurer would be liable for damages up to the amount of the settlement offer and defense costs up to the time the offer was made.[16] The insured is given the right to refuse settlement because it is considered that the accountant or attorney's reputation is his most important asset. To settle a groundless claim might be more injurious than the added costs of defending such a claim.[17]

Bodily Injury

Bodily injury claims are excluded from the typical accountant's or attorney's errors and omissions policy. Seldom, if ever, does an accountant or an attorney perform or fail to perform an act which results in bodily injury to anyone. However, such coverage is usually included in an errors and omissions policy written for architects and engineers.[18]

Policy Limits

The policy limits are "to pay in behalf of the insured all sums which the insured shall become legally obligated to pay for damages . . ." No distinction is made between compensating and punitive damages.[19]

Standard Exclusions

In the area of standard exclusions, one significant difference exists between the accountants and attorneys policies. The attorney's policy excludes dishonest, fraudulent, criminal, or malicious acts or omissions. Accountants' policies provide coverage for fraud, dishonesty, or misrepresentation, except if made or committed by or at the direction of the insured with affirmative dishonesty or actual intent to deceive or defraud. This coverage was necessitated by the enactment of Rule 10b-5 of the Securities Exchange Commission.

The result of Rule 10b-5 has been that courts have found accountants guilty of fraud when their failure to disclose a material fact causes a loss to a third party, even though the accountant does not profit from the omission. This has created both criminal and civil actions. The courts have allowed recovery on the theory that the accountant's negligence "aided and abetted" his client's fraud.[20]

Innocent Partner

Although the accountant's professional liability policy covers fraud, it does not cover intentional fraud; i.e., affirmative dishonesty. This being the case, and since most accounting practices are partnerships, the innocent partner policy endorsement becomes vital. This endorsement provides that coverage will not be invalidated for partners who do not participate or acquiesce in intentional dishonesty, misrepresentation or fraud.[21]

Problems in Errors and Omissions Insurance

The major problem with errors and omissions insurance is the problem of ever-increasing claims and an inability to accurately underwrite those claims. For example, in the U.S. Financial case mentioned earlier, the stock price increased to $150 during the fraudulent years of 1970-71. Then, as the fraud was disclosed and the company was forced into a chapter 10 bankruptcy, the value of the stock fell to $1.50 per share. Those who had relied on the financial statements claim that their loss is $150 minus $1.50 multiplied by the number of shares owned. With no control over the price to which a stock price will increase, the underwriter cannot estimate the amount of a probable loss. Neither can the underwriter determine the maximum exposure of the insurance company other than the policy limit. Each new client obtained by an accountant compounds this problem.

The Duty to Defend

As was stated earlier, the insurer agrees to defend the insured, even if the claim is groundless or fraudulent. For many years, no mention was made as to how well the insurer must defend the insured. However, the California Supreme Court extended the insurer's duty to require a best effort defense or be liable for the full amount which will compensate the insured for his loss.[22] This decision prevents an insurer from forsaking the insured when it becomes obvious that the judgment will exceed the policy limits.

An insurer which refuses to defend an insured on grounds that the claim does not fall within the coverage does so at its own risk. By refusing the coverage, the insurer also relinquishes its right to defend the claim. Since most policy disputes are eventually resolved in favor of the insured, the insurer may end up paying a considerably larger judgment than it would had it defended the suit with its own counsel.[23]

If, on the other hand, the insurer assumes the defense, it incurs a commitment in terms of legal fees and expenses. Furthermore, unless the insurer properly protects itself, it will be held to have waived its rights or be stopped from later asserting the defense of non-coverage. The insurer can protect itself by entering into a "non-waiver" or "reservation of rights" agreement with the insured. If the insured refuses to agree to the reservation, the insurer may reserve its rights to later dispute by so advising the insured by letter and setting forth the reasons for the reservation of rights.[24]

The Future of Errors and Omissions Insurance

The errors and omissions policy is facing many of the same challenges as is medical malpractice and products liability policies. Therefore, the future is uncertain.

According to William Rodda, only a dozen or so domestic companies currently write the coverage.[25] More and more moderate size firms will be forced to go to London for coverage as judgments and premiums skyrocket, as is evidenced by the U.S. Financial, $30 million case cited previously.

Professional associations are active in arranging for policies for their members. One such policy is that arranged with Lloyd's of London by the Nebraska Society of Certified Public Accountants through Alexander & Alexander, professional insurance brokers. That policy provides professional liability to a maximum of $10 million.[26]

The need for professional liability insurance exists and will continue to exist into the future. In fact, the need will increase as judgments grow. Accountants and attorneys will simply have to pay the increased premiums to remain in practice.

Conclusion

The errors and omissions policy of professional liability insurance is an essential type of insurance to anyone assuming the position of a professional or expert in any area. It is a unique type of coverage that does not lend itself well to a standard policy form. Therefore, although certain provisions are common in errors and omissions policies, no standard policy exists in the industry. The professional must become intimately familiar with the policy selected and know the protection which it does and does not provide. ■

NOTES

[1]Richard D. Kirshberg, *Professional Liability Insurance,* (New York: Practicing Law Institutes, 1976), p. 10.

[2]William Rodda, "Avoid Erring and Omitting when Negotiating Your E & O Policy", *Business Insurance,* April 23, 1973, pp. 43-

[3]Letters of Transmittal from Max Rothenberg & Co., to 1136 Tenant's Corporation, 1964, reproduced in brief for the New York State Society of Certified Public Accountants and the American Institute of Certified Public Accountants AICPA as Amicus Curiae at 4, 1136 Tenant's Corp. V. Max Rothenberg & Co., 36 APP. Div. 2d 804, 309 NYS 2d 1007, (1971).

[4]Ibid. 1008.

[5]Kirshberg, op. cit., pp. 168-71. Crisci v. Security Insurance Co. of New Haven, Conn. 426 P. 2d 173.

[6]The Wall Street Journal (Illinois), December 1, 1977, p. 14, col. 3.

[7]Kirshberg, op. cit. p. 9.

[8]Ibid. pp. 11-12.

[9]FC&S Bulletins, Specialty lines Ah-2, American Home Assurance Policy, Item IV b, under Insuring Agreements, February 1971.

[10].Ibid., Specialty lines Ah-3, February 1971.

[11]Kirshberg, op. cit., p. 15.

[12]FC&S Bulletins, op. cit., Ah-2

[13]Ibid. p. 56.

[14]Kirshberg, op. cit., p. 18.

[15]FC&S Bulletins, "Accountants Professional Liability Policy of American Home Assurance Company," (New York), Aha-2, February, 1971.

[16]Kirshberg, op. cit., p. 24.

[17]Ibid.

[18]Rodda, op. cit., p. 45.

[19]FC&S Bulletins, op. cit., Item 1 under Insuring Agreements.

[20]See Ruder, "Aiding and Abetting", 7 Rev. SEC Reg 822 (1974)

[21]Arnold I. Levine and E. Stanley Marks, "Accountants' Liability Insurance — Perils and Pitfalls", *Journal of Accountancy,* October, 1976, p. 60.

[22]See *Comunale V. Traders and General Insurance Co.,* 50 Cal, 2d, 654. 328 p 2d 198 (1958).

[23]Kirshberg, op. cit., pp. 119-20.

[24]Ibid., pp. 120-1.

[25]Rodda, op. cit., p. 44.

[26]Statement by Rennie Walt, Alexander & Alexander, in a personal interview, Lincoln, Nebraska, December 5, 1977.

Ronald M. Mano, *CPA, Ph.D., is an Assistant Professor in the Graduate School of Business, University of Utah, at Salt Lake City. He is a member of AICPA, AAA, and the Utah Association of CPAs.*