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Professional Liability Insurance: A Shopper's Guide

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A Shopper's Guide

By Baruch Englard

Try to picture yourself in the following rather embarrassing situation: You are lying on a hammock in your backyard on a beautiful fall day (after the exclusion period for form 1040 has expired) enjoying the sunshine and thinking about how much money you made during the recent tax season, when suddenly the phone rings. You lazily pick it up and are shocked to hear the irate voice of one of your clients demanding an explanation as to why he just received a notice from the I.R.S. for the non-filing of his tax return. Your exclamation that "I mailed it on June 14th" of course does nothing to soften his anger (nor for that matter, that of the IRS either). You put the client on hold and search the house from top to bottom. After looking in every nook and cranny (and getting your knees scraped and dirty in the process), you finally find the tax return in your baby daughter's toy chest. Apparently, one day while you were off guard, the baby snatched it off your desk and hid it!!

What do you do? You are now faced with the possiblity of a lawsuit by the client for reimbursement of his tax penalties, the loss of his account, and to top it all off, a possible damage to your reputation.

Of course the above situation is a bit far-fetched, but there are many others that are not. Every practical accountant is aware of the tremendous upsurge in the number of lawsuits that have been brought in the last ten years. There have been suits brought by taxpayers, by banks who lent money based on incorrect financial statements, and by the general investing public that bought stocks and lost money by relying on false statements. Even the most careful accountant cannot always avoid mistakes. Nobody is perfect.

To avoid this potential nightmare, it has become fashionable to buy accountants' professional liability insurance. While this is not a panacea or a substitute for using due professional care in performing accounting services, it is a vital cushion to fall back on in times of crisis. It may not save the client's account or preserve the accountant's reputation, but it can certainly rescue the latter from the financial ruin brought on by a successful lawsuit.

Since the features of this kind of policy are numerous and complicated, this article will attempt to "lead the buyer by the hand" in advising as to what all the "fine print" is really saying. It is not enough to simply compare prices and take the lowest one; different policies have different attributes and comparing them is like comparing "apples to oranges." The buyer must also be able to analyze and understand what each policy has to offer. This article will attempt to do just that and will then conclude with some advice as how to avoid a lawsuit in the first place.

Before proceeding, a word of caution is in order. Policy terms frequently change from one year to the next. Prices may change as well as other features of the policy. Accordingly, the buyer should get the most recent sample of policies before making any decision.

Types Of Policies

Claims Basis vs. Occurrence Basis

There are two types of policies available today. The most common one is the "claims-basis" type. Under this policy, the insured is covered even for acts or omissions that took place prior to the inception of the policy, provided the claim is made during the policy period. The number of years covered before the inception of the policy varies from policy to policy. Usually, the larger the "retroactive coverage" the higher the premium.

Under this policy, the insured is only covered for retroactive acts if at the time he applied for coverage, there seemed to be reason to believe that any prior acts of his would eventually result in a claim.

Should the insured decide to terminate coverage, many policies provide an option (for an extra premium) of an extended reporting period of three to six years. This means the insured will be covered for claims arising during this period for acts or omissions that took place prior to or during the policy period.

The "occurrence type" policy only provides coverage for acts or omissions that took place during the policy period.

Sponsorship by State Societies

Some policies are sponsored by their respective home state CPA societies. This is definitely a favorable feature to look for, since the society "looks over the shoulder" of the insurance company and prevents the company from taking advantage of the insureds. For example, under the terms of the agreement between the INA Insurance Company and the New York State Society, no rate increases may be initiated unless proven to be needed based on a study by the Society of the company's claims and reserves.

Areas of Coverage

S.E.C. and ERISA

Not all companies provide coverage for preparation of statements for the Securities and Exchange Commission, or ERISA work. For accountants practicing in these areas, it is extremely important to examine the policy to make sure this vital protection is included.

Defense Costs

Most companies provide coverage for legal fees incurred in defending against a suit.

Predecessor Coverage

In cases where the insured is not the original owner of the firm, it is important for him/her to get coverage for the acts of all predecessors. Not all policies provide for this.

Misrepresentation

The plan sponsored by the AICPA provides coverage for misrepresentation except if made with an actual intent to deceive or defraud.

Libel

Some policies cover libel and slander charges brought against the accountant, unless the libel or slander was done in "bad faith." This coverage, however, is only for civil libel, not criminal libel.

Innocent Partner Coverage

As mentioned previously, there are some cases of misrepresentation and libel that are not covered. This could lead to problems for a partner in a CPA firm, who, while personally innocent, is still responsible for the acts of other partners. To prevent this from happening, it is advised that "innocent partner" coverage be obtained.

Coverage for Legal Services

Many CPA's who are also attorneys perform legal services for their accounting clients. The question arises as to whether the accounting insurance policy also provides protection for these services. Many policies will, indeed, provide coverage if these services are necessary or incidental to the services provided in the insured's capacity as a CPA.

Coverage for Employees

Most policies do not provide coverage for messengers, internal bookkeepers, phone operators and all other employees of the firm who are not engaged in the doing of accounting work for the client.

Interest Costs

If the insured decides to appeal a judgment made against him/her, some policies will pay for the interest that accrues between the date of the original judgment and the date of appeal.

Policy Limits, Deductibles and Exclusions

Policy Limits

Most companies provide liability coverage of up to five million dollars (the INA policy sponsored by the New York State Society goes up to ten million). Some companies also provide limits on coverage for defense costs while others, like INA and the AICPA plan, do not. However, even INA limits defense coverage on SEC cases to the amount of the limit of the liability coverage.

It is very difficult to suggest here the limits of coverage the CPA firms in general should acquire. This depends on such factors as the size of the firm, the number of clients it services, the economic condition of these clients, and the nature of the accounting services provided. Understandably, firms doing SEC work should obtain higher limits since their potential for liability is much greater. The exact amount of the coverage is best left to discussion with the insurance agent.

Deductibles

As is the case with most other insurance policies, the higher the deductible, the lower the cost of the policy. Most policies do not provide a deductible for defense costs, only for damages.

Exclusions

Many policies exclude coverage of certain areas where it is felt the risk is too high. This coverage can sometimes be obtained for a higher premium. If the insured does not practice in these areas, then, of course, it would be advisable to avoid such excessive and expensive coverage.

> Numerous and complex features are built into liability policies. Discussion with an insurance agent will help define costs and risks.

Claim Settlement Policies

Consent of Insured

It is important that the insurance company not have the right to settle a claim without the consent of the insured. Many times a CPA firm will want to appeal a judgment in order to protect its reputation. The policy provided by the California Society of CPA's explicitly gives the CPA firm this right. However, if this results in higher costs, this policy requires the insured to pay them.

The policy should also contain a provision that the insured should not be required to contest a suit, or refuse any offer of settlement.

Acknowledgment of Claims

Under the "claims-made" type policy, a claim must be made during the policy period in order to receive coverage for that claim. To avoid any misunderstanding as to when a claim was actually made, the insurance company should be required to immediately acknowledge to the insured the reporting of a claim.

Selection of Attorney

The INA policy provides that the law firm selected to defend the claim must be on a list of approved law firms chosen by the New York State Society. This enables the insured to get the best and most experienced lawyers in this field.

Discounts

Some policies provide "good-guy" discounts — deductions in rates for firms that haven't had claims made against them over a specified number of years. Other policies provide discounts for firms with continuing professional education programs and peer reviews.

Conclusion

The selection of an appropriate professional liability insurance policy is one of the most important decisions to be made by a CPA firm. Great care should be taken in arriving at this decision. Total reliance, however, on the insurance policy while ignoring certain commonsense principles, is also to be avoided. The following are some of these principles:

A) Avoid suing for unpaid fees unless there is no other alternative. Such suits often bring on countersuits. It is usually better to arrange some kind of payment plan satisfactory to both parties.

B) Carefully follow G.A.A.S. and G.A.A.P. - many successful cases against CPA firms were based on the fact that these standards and principles were violated.

C) Obtain an engagement letter — this serves to prevent any misunderstandings on the client's part as to the nature of the service expected.

D) Avoid clients that are in trouble — many companies having financial difficulties take out their frustrations on their accountants.

E) Don't let your baby son or daughter roam around in your office unguarded.

Adherence to these principles will not guarantee freedom from lawsuits, but it certainly will go a long way toward preventing them. In case a lawsuit does arise, an accountants' professional liability insurance policy will protect and cushion the beleaguered practitioner.Ω

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