

PI CLAIMS

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1. OVERVIEW

1.1 Both the frequency and severity of claims against members of professional bodies have dramatically increased since 1980. The type of professional suffering claims has broadened, and some categories (such as Accountants operating in the United States) have become virtually uninsurable. Insurers have reacted by dramatically increasing premiums and deductibles, but even in the most recent years it is unclear whether the mainstream PI classes have returned to profitability.

1.2 This workshop paper aims to provide background information on how claims are likely to arise, and comment on the trends in claims by profession. Some examples are included in this text, but more detailed cases will be incorporated in the presentation, as will a discussion of underwriting problems.

2. ACCOUNTANTS PI

2.1 How is a claim likely to arise?

- (a) An accountant may be liable for the acts or omissions of partners or employees.
- (b) Direct liability may occur for negligence in the selection, training or inadequate supervision of staff.
- (c) A duty of care is owed to the client and to third parties who use financial statements (in some cases). A breach of this duty of care may result in a claim.
- (d) The standard of care varies by location (for example the standard is much higher in the US than the UK).
- (e) The standard of care is determined by accepted professional ethics and accounting standard (subject to modification by statute or the courts).
- (f) The standard of care should not depend on the fee.
- (g) Practitioners are expected to know the law as it relates to their functions

2.2 Liability of Accountants under UK law.

- (a) The auditor of a company that goes into liquidation may be liable for a misfeasance action as well as a claim for negligence.
- (b) A court may order auditors to make good any loss to a company caused by their breach of duty.
- (c) Third parties cannot bring a misfeasance action but they can sue for negligence.

2.3 The case of *JEB Fasteners v Marks Bloom 1983* demonstrated that auditors may be negligent in certifying accounts showing an inaccurate stock value. However, they may not be liable to the purchaser of a business if the stock valuation does not affect the decision to buy.

This demonstrates the UK approach to accountants' liability, which appears to be based on a approach reflecting the concept of negligence rather than strict liability.

2.4 UK: Circumstances in which auditors suspicions ought to be aroused.

In considering a case involving an allegedly inaccurate stock valuation, Lord Alverstone (Chief Justice) summarised:

" I decline to find people guilty of negligence unless I feel satisfied without reasonable doubt that any prudent man looking at those stock sheets would have come to the conclusion that they were suspicious. "

This statement also implies strict liability is unlikely to apply to auditors in the UK.

2.5 Auditors Liability to Third Parties (UK).

Auditors have a legal liability to their clients and in the case of a negligent audit a company can sue the auditor. An action can be brought under contract or tort law.

Other auditor parties are third parties to the audit contract, but courts recognise that the function of the statutory audit is to monitor the performance of the company management on behalf of shareholders.

2.6 UK Legal Background - Liability to Third Parties.

(i) 1932 *Donoghue v Stevenson*

This case established the right of an injured party to sue for damages, but the courts didn't allow cases which involved economic loss only.

(ii) 1964 *Headley Byrne v Heller and Partners*

This case established the right of third parties suffering economic loss only to sue for damages.

(iii) 1978 *Scott Group v McFarlane* 1983 *JEB Fasteners v Mark Bloom & Co.* 1988 *Twomax v Dickson, McFarlane & Robinson* 1985 *Lloyd Cheyham v Littlejohn*

In all of the above cases, the courts accepted the rights of third parties against auditors although subsidiary issues resulted in the defendant auditors not being found liable. Consequently, no clear definition of auditors' liability emerged from these case.

2.7 *CAPARO Industries v DICKAM & Others.*
(Decided House of Lords February 1990).

(i) Background:

- May 1984: share price of Fidelity Plc fell significantly because of disappointing profits for the first quarter of 1984
- CAPARO Industries purchased 100,000 Fidelity shares at 70p per share.
- June 1984: Fidelity released annual financial statements confirming reduced profits, which were approved by their auditors (Touché Ross) without qualification.
- CAPARO increased their holding to 30% buying 50,000 shares at 73p per share. In September 1984 CAPARO launched a successful take-over, paying 125p per share.
- Soon after the acquisition, CAPARO realised that Fidelity's financial position was worse than its accounts implied, and the purchase price was too high.
- CAPARO started an action against Touché Ross, claiming the audited financial statements should have shown a £400,000 loss instead of a £1.3 million profit.

(ii) House of Lords decision:

- no duty of care was owed to CAPARO
- Auditors owed a duty of care to the company shareholders as a whole but not individually.
- The audit was not prepared for the purpose of a take-over, and no duty was owed.

(iii) Implications:

- (a) Accounts are prepared or audited to provide shareholders as a body with information to enable them to control a company.
- (b) Auditor's duty of care is owed to shareholders as a group and not individuals.
- (c) Auditors are not liable to third parties (other than shareholders as a group) unless they know that a third party intends to put the audited accounts to a particular use.

Despite the decision in the CAPARO case many users of audited accounts no doubt believe that auditors bear greater responsibilities for the accuracy of the accounts than the court cases suggest. This may well be because of various high profile actions in the United States where strict liability tends to apply (this is discussed in section 2.8 below).

2.8 Accountants PI in the US

- (i) The number of actions against auditors has increased dramatically over recent years, more so than in Europe.
- (ii) Particular problems in US because:
 - (a) Lawyers act on contingency fee basis.
 - (b) Willingness of courts to accept class actions. (e.g. a lawyer who is a shareholder could offer to act for all shareholders).
 - (c) If an accountant follows GAAP they are normally unlikely to be found negligent. However, courts sometimes find professional standards inadequate.
- (iii) Contributory Negligence:

In most states, the defence of contributory negligence has been replaced by comparative negligence. This implies that the client's own negligence cannot be regarded as a complete defence (although it may reduce damages).

(iv) Liability to Third Parties

As in the UK, US courts have been reluctant to establish the rights of third parties to sue the auditors for negligence. However, the concept of "Third Party beneficiary " allows third parties to acquire rights under contract.

(v) Trends in claims against US Accountants.

(a) Some awards (e.g. Savings and Loans Settlements) have exceeded the professional indemnity coverage limit purchased.

(b) Claims become more frequent in periods of recession or high interest rates, and there is a marked underwriting cycle.

(c) New interpretations of professional's legal duties have extended auditors' responsibilities and raised standards of care such that potential liabilities are unquantifiable.

(d) Potential losses have increased faster than the growth of companies or accounting firms.

(e) Financial costs of defending claims have risen dramatically and firms are devoting much more internal time to fighting law suits.

(f) The profession has itself set higher standards, but each publicised claim induces others to consider claiming. There is also pressure on plaintiffs, who are often public companies, to make claims on any grounds available to demonstrate they have taken all possible steps.

2.9 Accountants PI - Conclusions.

(i) Claims are not due to falling standards.

(ii) Litigation has raised the standard of care.

(iii) There appears to be a widespread assumption by shareholders/third parties that the audit report is a guarantee or warranty of the accuracy of accounts and the soundness of the company, enhanced by the knowledge that accountancy firms carry substantial PI cover.

(iv) Claims can substantially exceed the value of the company audited.

(v) Auditors' liability is effectively unlimited.

3. LAWYERS PI

3.0 UK - Background.

- (i) Barristers cannot be sued for anything in course of a trial or certain pre-trial work.
- (ii) Solicitors are in a similar position, but limited to court proceedings and preliminary decisions affecting the conduct of a case where it comes to court.
- (iii) A duty of care is owed to the client, the standard of which is that of a "reasonably competent practitioner".
- (iv) The duty of care can extend to persons other than the client.
- (v) A solicitor may be held liable for mental distress caused to a client.
- (vi) PI insurance has been required for all barristers since 1983, and solicitors in England and Wales must also be insured.

3.1 UK Claims Exposure.

- (i) Solicitors are more likely to have claims than barristers as they have less immunity.
- (ii) Typical exposures include:
 - (a) Failure to find out relevant facts before a case reaches court.
 - (b) Failure to observe time limits for steps in litigation.
 - (c) Failure to appear in court leading to an action being struck out.
 - (d) Bringing the proceedings in the wrong court.
 - (e) Suing the wrong party.

The most common cause of claims against solicitors is for failure to start actions within statute limitations

3.2 Insurance Cover.

- (i) Cover for Barristers is provided by the Bar Mutual Indemnity Fund, and for solicitors by the Solicitors Indemnity Fund.
- (ii) Cover basis is claims made for both.

3.3 Sources of Claims.

- (i) In 1991, the Solicitors Indemnity Fund sustained 44% of all claims by number (41% by amount) from conveyancing work.
- (ii) The average claim cost from commercial work in the same year was three times that of other types.

3.4 US Lawyers PI.

- (i) There has been a dramatic increase in the number of claims for "negligence".
- (ii) In the 1980s the number of actions was four times the number in the 1970s.
- (iii) The main growth area of claims has been the securities and financial institution fields. The governing law in these two areas changes continuously, and lawyers in these fields are exposed to significant potential claims.
- (iv) Causes of malpractice claims.

(a) Negligence - breach of the lawyer's duty to perform with the necessary standard of care.

(b) Breach of contract.

(c) Breach of fiduciary duty.

The standard of care referred to in (a) is developed through the courts and is different in each State. Good faith on the part of the attorney (i.e. an honest mistake) is generally not a defence to malpractice claims.

- (v) Punitive Damages.

If a lawyer's conduct is decreed to be fraudulent, malicious, or intentional he or she may be exposed to punitive damage awards.

3.5 Financial Institutions Claims against US Lawyers.

- (i) Lawyers involved with banks and savings associations have faced increased risks due to the Savings and Loans crisis. Many of the key law firms involved purchased insurance cover via large facilities placed in the London Market.
- (ii) The Financial Institutions Reform Recovery and Enforcement Act of 1989 (FIRREA) gives the federal government extended powers in bringing claims against professionals, including lawyers, who are decreed to have contributed to a financial institution's failure.

Whilst it could be agreed that accountants were first in the firing line in savings and loans cases, substantial claims have been brought against several leading US law firms.

- (iii) Example: *Sunrise Securities*.
 - (a) Claims against a Philadelphia based law firm were made in a multi - district litigation filed in the district court for the Eastern District of Pennsylvania.
 - (b) Sunrise Savings was set up in 1980 and declared insolvent in July 1985. The law firm acted as general counsel to Sunrise, providing a variety of services. Moreover, two of the firms partners were co-founders of Sunrise and directors of it and various subsidiaries.
 - (c) Claims brought by regulators included allegations that the firm negligently advised Sunrise and closed loans, as well as aiding Sunrise executives in violation of banking regulations.
 - (d) In addition, shareholders brought a class action against the law firm for securities violations.
 - (e) The law firm and its insurers agreed to a US\$ 50 million settlement.

4. OTHER PROFESSIONAL INDEMNITY

4.0 Other Professions who may require PI cover.

Although Accountants and Lawyers are two of the largest buyers of PI cover, many other professions are exposed to claims for negligent advice. The following list may not be exhaustive, but indicates the wide range of professions exposed to lawsuits:

- Actuaries
- Architects
- Dentists
- Design Consultants
- Doctors
- Engineers
- Estate Agents
- Insurance Brokers
- Lloyd's Members Agents
- Lloyd's Underwriting
- Management Consultants
- Patent Agents
- Ship brokers
- Stockbrokers
- Surveyors

The largest buyer in the US apart from auditors/attorneys is doctors, substantial volumes of Hospital Professional Liability Insurance being placed with US domestic Insurers and the London Market (medical malpractice is not included in this discussion as other papers consider this class)

Some of the other categories are discussed briefly below.

4.1 Architects / Engineers.

- (i) Architects / Engineers usually have a contractual relationship with their client, hence can be liable for breach of contract as well as professional liability under tort for breach of duty.
- (ii) The general standard of care demands that services are rendered with reasonable care and competence. Applying this in practice is complex, and expert testimony is often required unless there is an obvious failure to comply with building regulations etc.

(iii) Economic conditions.

Claims against architects/engineers are significantly influenced by the state of the economy. In a recession many professionals bid for the same job, possibly resulting in taking on an unfavourable contract to "win" a job. There may be an indemnity or limit of liability favouring the owner in such contracts.

There also tends to be an increase in the number of claims in a recession, influenced by such factors as the weak financial position of contractors.

(iv) Liabilities to Third Parties.

In the past, the liability of Architects / Engineers was limited to directly connected parties (usually just the client). However, the concept of a " foreseeable injury" to third parties (who have no contractual relationship) could extend the range of claimants to workers, subcontractors, contractors, tenants, neighbours, lenders, vehicle occupants etc.

(v) UK Claims.

In 1992, 85% of claims against architects/engineers were reserved at less than £100,000.

88% of claims by value were brought against construction professionals by their own clients.

The most common type of property resulting in a claim were houses and apartments blocks, which accounted for 38% of UK claims.

(vi) US Claims.

In contrast to accountants and lawyers, very few claims against Architects / Engineers in the US have exceeded US\$ 1 million. However, the sources of claims are less predictable than in the UK, encompassing most of the third party type claims discussed in 4.1 (iv).

The following case is a good example:

Tieder v Little (1987)

A student was pinned against a wall by an out of control car. The wall came off its foundation on impact, collapsing and killing the student.

A medical expert stated that the student would not have died as a result of being struck by the car alone, the collapsing wall being the immediate cause of death. An engineer's report confirmed that the wall was negligently designed and constructed.

The architect claimed that his alleged negligence was not the proximate cause of the accident, but the District Court of Appeals of Florida held the architect liable, stating:

"the collapse of the brick wall resulting in death of a person near such a wall is plainly a reasonably foreseeable consequence of negligently designing and constructing such a wall..... even though the exact sequence of events leading to the collapse of the wall may have been entirely unforeseeable."

4.2 Insurance Brokers.

- (i) The majority of claims arise due to declinature of claims by the insurer.
- (ii) Insolvency of the insurer is a common exclusion from most broker's policies, hence many brokers have invested considerable care in selecting insurers who are believed to be financially secure.
- (iii) However, a court case in Edinburgh brought into question whether this exclusion is enforceable:

Lothiansure v Lloyd's Underwriters

- the case involved the insolvency of "Signal Life"

- the judge considered that the insolvency exclusion should not apply.

4.3 Professional Surveyors.

- (i) Considerable confusion has arisen over the nature of surveys/reports performed by surveyors in connection with property valuations.
- (ii) The exposure to claims has risen dramatically, resulting in increased costs. This has largely been due to the recession in the UK for the following reasons:
 - (a) Property developers are suing construction professionals and surveyors as they have found difficulty in finding buyers or tenants.
 - (b) Claims against surveyors have increased due to repossessions (where properties have been found to be worth significantly less than surveyors' reports suggested).
 - (c) Cases have emerged where surveyors spent insufficient time on surveys (particularly in the late 1980s) or allowed themselves to be persuaded to overvalue properties to assist clients in raising capital.

5. CONCLUSIONS

- (i) The size and frequency of PI claims has increased in all the major categories.
- (ii) In the US, strict liability effectively applies in many situations. This has made it very difficult to provide cover at an affordable cost to certain professionals:

Big Six Accountants: Costs of Litigation (defence and payments) in the US.

1991	9% of total revenues
1992	11% of total revenues
1993	14% of total revenues (estimated).

- (iii) The situation for highly exposed professionals in the UK (such as Accountants) is worsening and some would argue it is following the trend in the US.

Examples: (settlements against Auditors)

Ferranti	£ 40 million
Insurance Corporation of Ireland	US\$ 110 million

- (iv) Other professions which previously avoided significant claims are increasingly becoming exposed (for example: Actuaries).

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