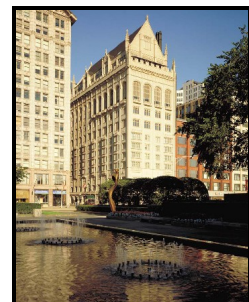


PROFESSIONAL LIABILITY DEFENSE FEDERATION'S
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PROFESSIONAL LIABILITY
DEFENSE QUARTERLY

FALL 2010

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LIABILITY

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DEFINING AND LIMITING ACCOUNTANTS' LIABILITY TO THIRD PARTIES

BY: JULIE JEFFORDS MOOSE AND AUDRA M. BYRD

For decades, courts and legislatures have struggled to define the proper scope of an accountant's duty to third parties with whom the accountant has not contracted. The debate has generally centered on identifying those persons to whom an accountant may be held liable when his work is negligently performed. Third parties, other than an accountant's immediate client, have tested countless theories of liability with varying success.

The common law claims of third parties generally include negligence (the traditional malpractice claim), negligent misrepresentation, breach of contract, breach of fiduciary duty, and aiding and abetting breach of fiduciary duty. In addition, third parties have utilized numerous state and federal statutory provisions as

grounds for imposing liability, including federal securities laws and state blue sky laws, which regulate the sale and distribution of securities. Other statutory provisions used by third parties include the federal Racketeer Influenced and Corrupt Organizations Act (RICO), the Employee Retirement Income Security Act of 1974 (ERISA), and state and federal consumer protection statutes, among others.

In the context of an accountant's liability to third parties, three questions plague both accountants and their attorneys:

- (1) When does an accountant have a duty to third parties?
- (2) Who are the third parties



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INSURANCE PRODUCER E&O:
COMMON COUNTS
FAILURE TO PROCURE
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INSURANCE PRODUCER E&O LIABILITY TO INSURED'S
BY: THOMAS D. JENSEN

Professional liability claims pending against insurance agents and brokers share elements common to malpractice claims generally. Claims may be brought by insureds, by insurers, by licensing authorities, and by third parties. We review here current developments

in this litigation involving established insured clients as well as initial applicants.

"Insurance agents are professionals in a field few lay persons know well." *Atwater Creamery Co. v. Western National Mutual Insurance Co.*, 366 N.W.2d 271, 279

(Minn. 1985). The general rule is that an insurance agent owes a duty to her or his principal to procure insurance policies with reasonable diligence and good faith. The duty owed is to provide the level of skill in procuring insurance reasonably expected of one in that profession. *Taylor*

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DEFINING AND LIMITING ACCOUNTANTS' LIABILITY, CONT'D

to whom a duty is owed?

(3) How can accountants limit their exposure to third parties?

Unfortunately, in many jurisdictions, none of these questions can be definitively answered. Across the country, courts have been consistently inconsistent in determining what standard of liability applies to accountants in the context of negligence claims asserted by third parties who have no contractual relationship with the accountant. As a result, in recent years, several states have enacted legislation to statutorily define the limits of an accountant's liability to non-clients. However, in the absence of clear statutory directives, accountants and their attorneys are often left to ponder exactly what duties accountants owe to third parties and to whom these duties are owed.

The Policy Issues

A number of considerations have been posited in favor of and against expanding the ambit of an accountant's duties and liability to third parties. Those in favor of imposing liability contend that an accountant, by virtue of his professional status and the fact that he may be a certified public accountant, invites reliance on his work by the business sector. Investors and creditors often require audited financial statements and rely on the accuracy and veracity of an accountant's opinion and work product. Audited statements are made for the use of third parties who have no contractual relationship with the auditor, and it is common knowledge that companies use audits for many proper business purposes. However, accountants, unlike many other professionals, have no functional way to control the distribution of their work. Accountants are not able to predict or manage what third parties may rely on their work.

Militating against expanding accountant liability to third parties is the concern that an accountant's potential liability may be grossly disproportionate to his fault. In all likelihood, the audited clients will be judgment proof or

unable to satisfy their share of the liability. It is argued that in many instances, the alleged accounting error involves a professional estimation taking into consideration numerous, complex factors that are not generally subject to black-letter standards or grounded in verifiable fact. In this respect, it is said that an accountant's primary role is that of a skilled decision-maker, exercising his experience and judgment in preparing financial reports.

An accountant is not the insurer of the accuracy of the financial statements and must rely upon representations of management. An independent auditor is expected to detect illegal and improper acts that would be uncovered in the exercise of normal professional skill and care; however, this does not mean the auditor will always be able to discover material fraud. Yet the audit, particularly when it uncovers fraud or some other illegal act, serves a beneficial public purpose. It is only in a secondary sense that an accountant acts as a watchdog for reliant third parties.

Proponents of expanded liability assert that accountants are capable of obtaining insurance and are in a better position to spread the risk of loss. On the other hand, critics note the rising costs of insurance and assert that in many circumstances, coverage cannot be obtained at any cost. In addition, some argue the benefits of imposing liability, including increased accuracy and more efficient loss spreading, do not outweigh the probability of increased expenses in terms of the client's indemnification obligations, insurance costs for both the accountant and his client, and decreased availability of accounting services.

Finally, critics of expanded liability argue that individuals should be encouraged to protect themselves through their own prudence, diligence, and contracting powers. They contend that at least in the context of auditing cases, the parties tend to be more sophisticated and are able to effectively use contract law, as opposed to tort law, as a means of controlling and spreading the relevant risks.

What is the Test for Liability?

"... courts have been consistently inconsistent in determining what standard of liability applies to accountants ..."



INSURANCE PRODUCER E&O LIABILITY TO INSURED, CONT'D

were incurred to mitigate the effects of the agent's malpractice).

Recent cases hold that the economic loss rule does not bar insurance broker fiduciary duty breach claims (joined with a contract breach claim) because the tort claim is extracontractual in nature. *See Kanter v. Deitelbaum*, 271 Ill. App. 3d 750, 648 N.E.2d 1137 (1995) (involving failure to procure health insurance); *SMI Owen Steel Co. v. Marsh USA, Inc.*, 520 F.3d 432, 443 (5th Cir. 2008) (interpreting Nevada law).

Claim Assignments to Judgment Creditors

Most courts hold that an E&O claim against an insurance agent can be assigned to a third party, finding the agent/insured relationship distinguishable from the attorney/client relationship. *See e.g., Webb v Gittlen*, 174 P.3d 275 (Ariz. 2008) (involving an agent who placed GL coverage but failed to recommend dram shop coverage to a tavern customer); *Forgione v. Dennis Pirtle Agency, Inc.*, 701 So. 2d 557 (Fla. 1997) (involving a tortfeasor who assigned the claim to an injured plaintiff when an uninsured gap was present between the primary and umbrella coverages); *Troost v. Estate of DeBoer*, 155 Cal. App. 3d 289, 297, 202 Cal. Rptr. 47 (1984) (finding the insurance agent/customer relationship "commercial" in nature, unlike the attorney/client relationship); *Esposito v. CPM Insurance Services, Inc.*, 50 Conn. Super. 283, 922 A.2d 343, 352 (2006); *Daugherty v. Blaase*, 548 N.E.2d 130 (Ill. App.

1989) (involving a \$400,000 coverage gap between the primary and umbrella limits). But the rule is to the contrary in Arizona which has found that the relationship between agent and client is tantamount to the attorney/client relationship that cannot be assigned. *See Premium Cigars International, Ltd. v. Farmer-Butler-Leavitt Insurance Agency*, 208 Ariz. 557, 96 P.3d 555 (App. 2004) (warning of the dangers of maintenance and champerty were assignments allowed).

Conclusion

Review of recent cases shows that insurance agent or broker errors and omissions claims track malpractice claims generally in requiring proof of professional duty, breach, causation and damages in cases brought by insureds/customers. Other common counts include breach of contract, negligent misrepresentation, breach of fiduciary duty and statutory law claims. Cases involving failure to procure coverage, and failure to procure adequate coverage, predominate. A tendency of courts is to constrict the ambit of the scope of duty owed, perhaps motivated by a sense the agent/insured relationship is a bit more commercial than professional in nature, the need for insurance is well known, insureds often choose to reduce costs, and can to a significant degree read what they purchase pre-loss. This tendency may also account for occasional comparative fault offsets seen in these cases, as well as a greater judicial willingness to allow for claim assignments.

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**PLDQ's WINTER 2011 ISSUE**

We encourage member submission of articles pertinent to professional liability claims administration, defense trial advocacy, or professional liability substantive law. The manuscript deadline for the next issue is **February 1, 2011**.

"Most courts hold that an E&O claim against an insurance agent can be assigned to a third party ..."



INSURANCE PRODUCER E&O LIABILITY TO INSURED, CONT'D

Insurance Co., 2003 WY 48, 67 P.3d 616, 626 (2003). "Clients, not agents, are responsible for reading their policies and communicating their insurance needs." *Cameron Parish School Board v. State Farm Fire and Casualty Co.*, 560 F. Supp. 2d 485 (W.D. La. 2008). Thus policyholder failure to read may result in verdict offsets. *See Zaremba Equipment, Inc. v. Harco National Insurance Co.*, 280 Mich. App. 16, 761 N.W.2d 151, 162 (2008) (upholding comparative fault finding where the insured failed to read the policy).

But some courts have held that the failure of a policyholder to read the policy (and thus failure to discover the broker's negligence) cannot constitute comparative negligence. *See, e.g., Aden v. Fotch*, 169 N.J. 64, 776 A.2d 792, 794 (2001) (noting it is the broker – not the insured – who is the expert); *Weinlood v. Fisher & Associates*, 26 Kan. App. 2d 20, 975 P.2d 1226 (1999). Comparative fault offsets also are inapplicable when the policyholder prevails on a breach of contract count. *See Hursh Agency, Inc. v. Wigwam Homes, Inc.*, 664 P.2d 27, 34 (Wyo. 1983).

Expert Testimony

In some circumstances it is held that expert testimony is not required in insurance E&O cases when the issue presented is understandable by a lay jury. *See, e.g., Lovett v. Bradford*, 676 So. 2d 893, 895 (Miss. 1996) (involving allegations arising out of application non-disclosures); *Clary Insurance Agency v. Doyle*, 620 P.2d 194 (Alaska 1980) (involving agent's failure to procure insurance, and failure to inform customer of the error). It has also been held that expert opinion is not required when the claim involves alleged failure to procure insurance. *See Wheaton National Bank v. Dudek*, 59 Ill. App. 3d 970, 973, 376 N.E.2d 633 (1978). Neither is it required when the agent fails to inform the customer that coverage could not be obtained. *See DiMarino v. Wishkin*, 195 N.J. Super. 390, 479 A.2d 444 (1984).

But ordinarily expert opinion is necessary to sustain the burden of proof. *E.g., Todd v. Malafrente*, 3 Conn. App. 16, 484 A.2d 463

(1984) (involving broker advice that workers compensation coverage was not required for part time employees). This is so when it would be speculative for the fact finder to decide the issue of negligence in the absence thereof. *See Atwater Creamery Co. v. Western National Mutual Insurance Co.*, 366 N.W.2d 271, 279 (Minn. 1985) (involving a 17 year professional relationship and alleged failure to disclose a large gap in coverage). Evidence of customary practices of other insurance brokers is admissible to establish professional standards and breach thereof. *AJ Contracting Co. v. Trident Managers, Inc.*, 234 App. Div. 2d 195, 196, 651 N.Y.S.2d 498 (1996) (involving alleged failure to inform insured the policy had a retrospective rating requirement).

Damages

The typical damages measure in a failure to procure case is based upon the coverage that should have been obtained. *E.g., Appleton Chinese Food Service, Inc. v. Murken Insurance, Inc.*, 185 Wis. 2d 791, 808, 519 N.W.2d 674 (App. 1994); *Mondesir v. Delva*, 851 So. 2d 187, 189 (Fla. App. 2003) (finding the agent would have obtained a policy limit sufficient to cover the value of the insured's property); *Filak v. George*, 267 Va. 612, 594 S.E.2d 610, 614 (2004) (finding the measure is the difference between the policy bargained for and the policy received). However, it has also been held that where the insured suffers a verdict in excess of the putative policy's limit because the agent's breach of duty voided the policy, the agent may be held liable for the full amount of the verdict. *See J. Smith Lanier & Co. v. Acceptance Indemnity Insurance Co.*, 272 Ga. App. 789, 612 S.E.2d 843, 851 (2005) (involving an application that omitted a serious prior loss known to the agent).

In a case involving an agent's error facilitating an insurer's effort to reduce available limits to the policyholder, the California appeals court allowed recovery of plaintiff's attorney's fees by finding the "American" rule inapplicable. *See Saunders v. Cariss*, 224 Cal. App. 3d 905, 908-09 (1990) (finding the fees



"Clients, not agents, are responsible for reading their policies and communicating their insurance needs."



DEFINING AND LIMITING ACCOUNTANTS' LIABILITY, CONT'D

In light of the foregoing policy rationales, courts have developed three tests for determining when an accountant can be held liable to a third party for damages resulting from the accountant's negligence. In addition to the common law tests developed by the courts, legislatures in several states have enacted statutory standards governing accountant-third party liability. These approaches are briefly summarized below.

The Privity/Near-Privity Test

Traditionally, only an individual in privity with an accountant could recover damages caused by that accountant's negligence. Thus, the scope of an accountant's duty has historically been limited to those individuals or entities with whom the accountant contracted. Underlying this rule is the notion that allowing third parties who are not in contractual privity with the accountant to recover damages resulting from mere negligence would subject accountants to potentially extraordinary and boundless liability. Writing for the New York Court of Appeals, the legendary Chief Judge Cardozo lamented:

"If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences."

Ultramares Corp. v. Touche, 174 N.E. 441, 444 (N.Y. 1931).

The plaintiff creditor in *Ultramares* made a series of unsecured loans to a company that went bankrupt. The creditor sued the company's auditors, alleging reliance on their audit report and opinion that the balance sheet accurately represented the company's financial condition. The company's balance sheet showed a positive net worth of approximately \$1 million, but the company was actually insol-

vent. According to the creditor, the auditors failed to discover "off-the-books" transactions that would have revealed the dire financial condition of the company and prevented the creditor from extending loans to the company. The jury returned a verdict against the auditors on the negligence cause of action. The court of appeals reversed, holding that the auditors owed no duty to the third party creditor for mere negligence.

The traditional privity test still exists in many jurisdictions in a slightly modified version that extends recovery to third parties who have a "near privity" relationship with the accountant. Under the modern near-privity rule, accountants may be liable for their negligence to third parties who have not contracted with them when the following three requirements are established:

- (1) the accountants know their report will be used for a particular purpose or purposes;
- (2) the accountants know that the third party is expected to rely on their report in furtherance of the particular purpose or purposes; and
- (3) there has been some conduct on the part of the accountants linking the accountants to the third party, which evinces the accountants' understanding of that third party's reliance.

Credit Alliance Corp. v. Arthur Anderson & Co., 65 N.Y.2d 536, 493 N.Y.S.2d 435, 483 N.E.2d 110, 118 (N.Y. 1985); *Colonial Bank of Alabama v. Ridley & Schweigert*, 551 So. 2d 390 (Ala.1989); *Idaho Bank & Trust Co. v. First Bancorp of Idaho*, 115 Idaho 1082, 772 P.2d 720 (1989); *Thayer v. Hicks*, 243 Mont. 138, 793 P.2d 784 (1990) (adopting modified version of near-privity approach).

To impose liability on an accountant under the privity/near-privity rule, the third party must show that the accountant had actual knowledge of the particular purpose for which the financial report was to be used and that the third party was expected to rely on the report. Further, there must be some conduct by the accountant that links the accountant to the non-client and demonstrates his under-

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"... courts have developed three tests for determining when an accountant can be held liable to a third party ..."



DEFINING AND LIMITING ACCOUNTANTS' LIABILITY, CONT'D

standing of the non-client's reliance on his work. The requisite "conduct" may take the form of written communications, meetings with the third party, or other conduct indicating the accountant's acknowledgement of the third party's reliance.

Literal contractual privity between the parties is not required. Privity is based upon the relationship established between the accountant and the third party, and privity of contract or privity of relationship will suffice. It is sufficient if the primary objective or "end and aim" of the accountant in providing his services was for the benefit and use of a known third party. *Credit Alliance Corp. v. Arthur Anderson & Co.*, 65 N.Y.2d 536, 493 N.Y.S.2d 435, 483 N.E.2d 110, 119 (1985).

Restatement (Second) of Torts Test

Some courts have adopted the test set forth in the *Restatement (Second) of Torts* §552 (1977), which applies to tort liability for negligent misrepresentation. In relevant part, the *Restatement* provides:

- (1) One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.
- (2) Except as stated in Subsection (3), the liability stated in Subsection (1) is limited to loss suffered:
 - (a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it; and
 - (b) through reliance upon it in a transaction that he intends the information to influence or knows that the recipient so intends or in a substantially similar transaction.

Restatement (Second) of Torts § 552 (1977).

Under the *Restatement* view, an accountant may be held liable to third parties for negligence if the third parties are members of "specifically foreseen and limited groups of third parties for whose benefit and guidance the accounting firm supplied the information." *Boykin v. Arthur Anderson & Co.*, 639 So. 2d 504, 510 (Ala. 1994). Thus, in jurisdictions using the *Restatement* test, the privity requirement is abandoned, but the accountant's liability is limited in two ways. First, the class of potential plaintiffs is limited to third parties who the accountant intends to influence and those who he knows his client intends to influence. Second, an accountant is only liable for damages incurred in the specific transaction that he or his client intended to influence in preparing the financial report or a transaction substantially similar to the initially-contemplated transaction.

Courts adopting the *Restatement* approach assert that it allows accountants some measure of control over their potential liability without going so far as to require privity. According to these courts, "liability is fixed by the accountants' particular knowledge at the moment the audit is published, not by the foreseeable path of harm envisioned by jurists years following an unfortunate business decision." *First Nat'l Bank of Commerce v. Monco Agency, Inc.*, 911 F.2d 1053, 1059 (5th Cir. 1990).

The Foreseeability Test

A third standard for determining when an accountant may be liable to third parties not in privity of contract or relationship with the accountant is the foreseeability test. This standard provides that accountants can be liable to reasonably foreseeable users of financial reports prepared by the accountant when the report is requested and received from the accountant's client for a proper business purpose. *Touche Ross & Co. v. Commercial Union Ins. Co.*, 514 So. 2d 315 (Miss. 1987); *Citizens State Bank v. Timm, Schmidt & Co., S.C.*, 335 N.W.2d 361 (Wis. 1983). Under the foreseeability standard, a third party

PLDF AND DIVERSITY

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"Thus, in jurisdictions using the *Restatement* test, the privity requirement is abandoned."



INSURANCE PRODUCER E&O LIABILITY TO INSURED, CONT'D

818, 820, 824 (2008) (but reversing defense summary judgment on grounds the agent "continuously made representations" the policy was still in effect). This is particularly so when cancellation is due to premium non-payment. See *Guardian Life Insurance Co. v. Goduti-Moore*, 36 F. Supp. 2d 657, 665 (D.N.J. 1999); *Kutz v. State Farm Fire & Casualty Co.*, 189 P.3d 740, 745 (Okla. App. 2008).

Causation

In failure to procure cases the majority rule is that plaintiff must prove causation, i.e., that if the policy had been issued the loss would have been covered. See *SMI Owen Steel Co. v. Marsh USA, Inc.*, 520 F.3d 432, 439 (5th Cir. 2008) (noting also the minority view that causation is an affirmative defense). In some circumstances a causally negligent agent may avoid liability if an intervening or superseding cause is shown. See, e.g., *Lancos v. Silverman*, 400 N.J. Super 258, 946 A.2d 1073, 1081 (2008) (noting that the insured's multi-year failure to read the liability coverage warning would constitute an intervening cause).

Limitations Statutes

Because insurance agent malpractice claims may include breach of contract, tort, and statutory law claims, different limitations periods may apply in the same case. E.g., *Cunningham v. Insurance Company of North America*, 521 F. Supp. 2d 166 (E.D.N.Y. 2006). Courts have held that the limitations statute begins to run at the time the negligent acts occurs, upon breach of an oral contract to renew, on the date the insured learns of the insurer's defense denial, when coverage is denied, when the broker failed to obtain the coverage, when the suit against the insurer becomes final, and when the insurer wins the declaratory judgment action. See *Commonwealth Insurance Co. v. Stone Container Corp.*, 323 F.3d 507, 511-12 (7th Cir. 2003) (citing cases).

In New York a claim accrues against an insurance broker at the time the contract for services is breached. E.g., *T&N PLC v. Fred S. James & Co.*, 29 F.3d 57 (2d Cir. 1994) (noting New York's rejection of the accrual-at-injury

rule and finding a "continuous treatment"-type exception inapplicable); *Mauro v. Niemann Agency, Inc.*, 303 App. Div. 2d 468, 469, 756 N.Y.S.2d 611 (2003) (finding also the negligence limitations statute begins to run at the first issuance of coverage). It has also been held the statute commences at policy issuance in a failure to procure proper coverage case because the insured at that point simply can read the policy. *Filip v. Block*, 879 N.E.2d 1076 (Ind. 2008) (alleging inadequate limits procurement). Courts also find that the statute commences to run when the insurer denies the claim. E.g., *Oaks v. Sellers*, 953 So. 2d 1077 (Miss. 2007).

New York has found that insurance agents are not "professionals" for purposes of applying the state's shorter nonmedical malpractice limitations statute. See *Chase Scientific Research, Inc v. NIA Group*, 749 N.E.2d 161 (N.Y. 2001). Florida agrees. See *Pierce v. AALL Insurance Incorporated*, 531 So. 2d 84 (1988) (noting in particular that agents do not require college degrees and are not subject to professional discipline). As does Kentucky. See *Plaza Bottle Shop, Inc. v. Al Torstrick Insurance Agency, Inc.*, 712 S.W.2d 349 (Ky. App. 1986). But more courts apply the professional liability limitations statutes to tort-based agent and broker claims. See Harnett, *supra*, §3.11[1][c]. Examples include Alaska and Maryland. See *American Home Assurance Co v. Osbourn*, 47 Md. App. 73, 86, 422 A.2d 8 (1980); *Gudenau & Co. v. Sweeney Insurance, Inc.*, 736 P.2d 763 (Alaska 1987).

Comparative Fault

Policyholder negligence in professional liability claims against agents may result in comparative fault offsets. See, e.g., *Kitching v. Zamora*, 695 S.W.2d 553 (Tex. 1985) (involving failure to renew flood insurance); *Florenzano v. Olson*, 387 N.W.2d 168 (Minn. 1986) (approving negligent misrepresentation verdict reduction based upon plaintiffs' 37.5% fault). A policyholder is obligated to read the policy and reject or renegotiate it if it fails to conform to the coverage requested. *Cordero Mining Co. v. United States Fidelity and Guarantee*



"Because insurance agent malpractice claims may include [multiple causes of action] different limitations periods may apply ..."



INSURANCE PRODUCER E&O LIABILITY TO INSURED, CONT'D

show the two discussed the specific coverage detail in question. See *Lipscomb v. Farmers Insurance Co.*, 174 P.3d 1182, 1186 (Wash. App. 2007) (involving inadequate coverage on a home that burned).

As well, an agent has no duty to volunteer suggestions for different or additional coverage unless the agent misrepresents the nature of the coverage being offered, the insured requests a particular type of coverage, or the agent assumes a duty by either express agreement or by holding out as having expertise in the particular field of insurance sought. E.g., *Roberts v. Assurance Company of America*, 163 Cal. App. 4th 1398, 1403-04, 78 Cal. Rptr. 3d (2008) (finding no duty to suggest liability coverage in addition to course of construction coverage). Similarly, a broker has no affirmative duty to advise an insured of gaps in the insured's coverage. *President v. Jenkins*, 357 N.J. Super. 288, 814 A.2d 1173, 1185 (2003) (involving failure to procure gap coverage between prior policy termination and new policy inception).

The same lack of agent duty to assess coverage adequacy generally exists at renewal. *Moore v. Johnson County Farm Bureau*, 343 Ill. App. 3d 581, 798 N.E.2d 790, 794 (2003) (concluding the insured is in a better position to assess adequacy than the agent). Thus, it is held that an agent does not owe a continuing duty to advise, guide or direct a customer's coverage after the agent has complied with a request for coverage. E.g., *Sintros v. Hamon*, 148 N.H. 478, 480, 810 A.2d 553 (2002). Otherwise the agent would be liable "for an indefinite period of time" and "render the Statute of Limitations meaningless." *Blonsky v. Allstate Insurance Co.*, 128 Misc. 2d 981, 984 (Sup. Ct. 1985).

Absent special circumstances, after a policy has been issued, an agent has "no ongoing duty of surveillance" or obligation "to ferret out at regular intervals information which brings policyholders within the provisions of an exclusion." *Gabrielson v. Warnemunde*, 443 N.W.2d 540, 544 (Minn. 1989). "It would be unduly onerous for brokers to warn every

client who misses a monthly premium due date that the client must pay the amount by the end of the grace period or face forfeiture." *Guardian Life Insurance Co. v. Goduti-Morre*, 36 F. Supp. 2d 657, 665 (D.N.J. 1999).

While generally there is no continuing duty from one policy to the next, when an insured specifically requests the same coverage as the prior coverage the agent has a duty to review the prior policy and secure the same coverage or explain why it cannot be obtained. See *Haynes v. Edgeron*, 240 S.W.3d 189, 195-96 (Mo. App. 2007) (involving a banquet hall insured at which a patron was shot and killed; the renewal policy lacked assault and battery coverage).

Failure to procure claims fail when other evidence proves the insured was aware coverage had lapsed due to the insured's own conduct. See, e.g., *Breck Construction Co. v. Thomas, Farr & Reeves Agency, Inc.*, 852 So. 2d 1151 (La. App. 2003) (finding the insured was aware the premium was past due before it was paid). A contract to procure claim may also fail where the insured does not provide "sufficiently definite directions" to the agent to consummate a final contract. *Harris v. Albrecht*, 2004 UT 13, 86 P.3d 728 (2004). It will also fail when the insured does not prove causation, i.e., that it would have acted in a substantially different way had it known of the true scope of the policy pre-loss. *Tri-Town Marine, Inc. v. J.C. Milliken Agency, Inc.*, 2007 ME 67, 924 A.2d 1066 (2007). Limits placed by courts in failure to procure adequate coverage cases may be explained by recognizing that the insured has a duty to read and be familiar with the terms of the policy. See *Aspen Specialty Insurance v. Muniz Engineering, Inc.*, 514 F. Supp. 2d 972, 983 (S.D. Tex. 2007); accord *W.N. McMurry Construction Co. v. Community First Insurance, Inc.*, 160 P.3d 71, 77 (Wyo. 2007) (recognizing that by the "simple act" of reading the policy the insured could have avoided harm).

It has also been held that a broker has no duty to inform the insured of policy cancellation when the agency relationship has ended. *Precision Mechanical Services, Inc. v. T.J. Pfund Associates, Inc.*, 109 Conn. App. 560, 952 A.2d

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"[A] broker has no affirmative duty to advise an insured of gaps in the insured's coverage."



DEFINING AND LIMITING ACCOUNTANTS' LIABILITY, CONT'D

can hold the accountant liable for his negligence in preparing the report so long as the financial report was disseminated by the accountant's client for a legitimate business purpose.

The foreseeability standard has been widely criticized by courts and commentators. However, in those jurisdictions adhering to the rule of foreseeability, it is argued that such a rule is necessary to deter negligence that would otherwise go unchecked. Foreseeability courts also assert that no distinction should be made between providers of services and manufacturers of goods, for whom the privity requirement has long been abolished. On the other hand, critics question the deterrent effect of the rule, as well as its failure to seriously address the problem of boundless liability.

Statutory Tests

In his oft-quoted opinion in *Ultramares*, Chief Judge Cardozo refused to expand an accountant's liability to third parties with whom the accountant did not contract absent special circumstances, but he invited the legislature to do so. Since that time, several state legislatures have responded with statutory enactments governing accountant liability.

Following the court's adoption of the foreseeability doctrine in *H. Rosenblum, Inc. v. Adler*, 93 N.J. 324, 352, 461 A.2d 138 (1983), the New Jersey legislature abrogated the foreseeability doctrine by enacting *N.J. Stat. Ann.* §2A:53A-25 (West 1995), which adopts a privity rule limiting accountants' liability to third parties and provides in pertinent part:

Notwithstanding the provisions of any other law, no accountant shall be liable for damages for negligence arising out of and in the course of rendering any professional accounting service unless:

- (1) The claimant against the accountant was the accountant's client; or
- (2) The accountant:
 - (a) knew at the time of the engagement by the client, or agreed with the client after the time of the engagement, that the professional accounting service rendered to the client would

be made available to the claimant, who was specifically identified to the accountant in connection with a specified transaction made by the claimant;

(b) knew that the claimant intended to rely upon the professional accounting service in connection with that specified transaction; and

(c) directly expressed to the claimant by words or conduct, the accountant's understanding of the claimant's intended reliance on the professional accounting service.

Under Kansas law, in order to state a cause of action for negligence, a non-client plaintiff must be identified in writing to the accountant as a party who would be receiving and relying upon the accounting information. *Kan. Stat. Ann.* § 1-402. Similarly, in Utah, a plaintiff must establish that either he was identified in writing by the accountant as a person for whom the professional services were performed, or the accountant knew that the primary intent of the accountant's client was for accounting services to benefit or influence the plaintiff. *Utah Code Ann.* § 58-26a-602. Hardly uniform, these statutes provide accountants with varying degrees of protection.

Different Tests or Different Torts? Or Different Tests for a Different Tort?

In considering negligent accounting claims, courts have consistently applied one of the tests set forth above, but rarely more than one. Of course, there exist exceptions, and at least one court has explicitly recognized the applicability of two standards. See e.g., *Bily v. Arthur Young & Co., Inc.*, 834 P.2d 745 (Cal. 1992) applying the *Restatement* rule to claims of negligent misrepresentation and the privity rule to general negligence claims).

A closer review of the various tests reveals what are actually differing standards of liability for the specific tort of negligent misrepresentation. While the vast majority of negligent accounting cases involve a failed audit and, therefore, an alleged, affirmative misrepresentation, this is not always the case. Pure negligence claims (i.e. traditional malpractice claims) have been made by third parties in



"A closer review of the various tests reveals what are actually differing standards of liability for the specific tort of negligent misrepresentation."



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other contexts. *See, e.g., Firestone v. Galbreath*, 976 F.2d 279 (6th Cir. 1992) (trust beneficiaries bringing suit for allegedly negligent accounting work performed for the plaintiffs' grandmother). The question becomes whether a *Restatement* jurisdiction would apply its negligent misrepresentation standard in a true negligence (malpractice) case. The answer appears to be a resounding "yes." *See, e.g., Firestone*, 976 F.2d at 286; *see also, Demetracopoulos v. Wilson*, 640 A.2d 279 (N.H. 1994) (holding that the plaintiff suing an accounting firm for negligently performing an audit resulting in his termination failed to state a cause of action since the audit was not for his benefit and was not relied upon by the plaintiff).

As a result, at least in jurisdictions that have adopted the *Restatement* test, the traditional accounting malpractice claim asserted by a third party has been effectively replaced with the tort of negligent misrepresentation. The distinction is crucial in terms of proof and available defenses. For example, to succeed on a negligent misrepresentation claim, the plaintiff must establish an affirmative misrepresentation by the accountant and justifiable reliance on the misrepresentation. Arguably, the privity/near-privity approach requires no such showing. In this respect, the *Restatement* view, which is generally regarded as the more expansive approach to accountant liability, is significantly *more* restrictive.

Perhaps in defining an accountant's duties and liability to third parties, courts adopting the *Restatement* approach made deliberate decisions to limit third party negligence claims to those arising out of negligently performed audits. A limitation of this type would be in line with the policy considerations outlined above. The primary policy considerations advanced by those favoring expanded liability – the accountant as the public's watchdog and reliance in the business sector – have virtually no application outside of the auditing context.

Limiting Accountants' Exposure to Third Parties

With this clearer understanding of when an accountant may owe a duty of care to non-client third parties, how can an accountant limit his potential liability? Compiled from various sources and practices, the suggestions outlined below are intended to assist accountants and their attorneys in their attempts to minimize the accountant's potential liability to third parties.

As a practical matter, there is only so much an accountant can do to limit prospectively his liability to third parties. This is so because relying third parties are obviously not parties to, and therefore not bound by, the engagement letter. However, given their potential exposure, accountants are well advised to take every available opportunity to minimize liability. The engagement letter is the first line of defense, and its importance in attempting to limit accountants' liability to third parties cannot be overstated. There are several issues that should be specifically addressed in the engagement letter.

Identify the Client and Define the Scope of Engagement

The engagement letter should clearly and specifically identify the accountant's client. The "client" is the individual or entity engaging the accountant (i.e., paying the bill). Third parties intended to benefit from the accountant's work should also be specifically identified in the engagement letter. It may seem counterintuitive to identify all potential plaintiffs in writing, however, the accountant and client should be required to identify those third parties likely to rely at the outset and agree to the same in the engagement letter. By having this information at the outset of the engagement, the accountant can attempt to control and limit his liability to third parties. Further, a factfinder may determine that the failure to identify a particular third party is persuasive evidence that the accountant was not aware of the third party's existence, much less his claimed reliance on the accountant's work.

The purpose and scope of the engagement should also be described **expressly and in**



"As a practical matter, there is only so much an accountant can do to limit prospectively his liability to third parties."



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breach claims on causation grounds; franchise insureds could not prove coverage under the required McDonald's insurance plan); *Rodriguez v. Investors Insurance Co.*, 201 App. Div. 2d 355, 356, 607 N.Y.S.2d 329 (1994) (finding no evidence proved coverage could have been obtained for a grocery store before the fire); *Haggans v. State Farm Fire and Casualty Co.*, 803 So. 2d 1249 (Miss. App. 2002). Plaintiff must also show that the claim would have been covered had the policy been procured. *E.g., National Housing Building Corp. v. Acordia of Virginia Insurance Agency, Inc.*, 267 Va. 247, 591 S.E.2d 88 (2004) (finding the agent negligent but not causally so since the policy would not have covered the putative additional insured anyway).

The agent may also have a duty to notify the client promptly if the requested coverage is not obtained. *Roger v. Dufrene*, 613 So. 2d 947, 948 (La. 1993). It has also been held that an agent has the duty to inform customers of the availability of immediate coverage via a temporary binder. *Brill v. Guardian Life Insurance Co.*, 142 N.J. 520, 542-43, 666 A.2d 146 (1995) (involving failure to advise customer of the conditional receipt option in context of health deterioration prior to policy issuance).

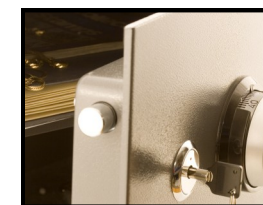
Limits on the Duty's Scope

It has been held that customer requests for "full coverage", the "best policy", or similar expressions do not create a duty for the agent to investigate the customer's entire insurance needs, unless the agent holds himself or herself out as a counselor or advisor possessing special expertise. *See Mullins v. Commonwealth Life Insurance Co.*, 839 S.W.2d 245, 249 (Ky. 1992). A broker's obligation to seek coverage includes the obligation to act with promptness and to notify the customer if the insurer declines to insure the risk so the customer is not lulled into a false feeling of security or suffer prejudicial delay in seeking coverage elsewhere. *Lake County Grading Co. v. Great Lakes Agency, Inc.*, 226 Ill. App. 3d 697, 589 N.E.2d 1128, 1132 (1992) (finding the broker had an extracontractual fiduciary duty to act before expiration of coverage).

Agents generally have no duty to assess independently the insured's needs and recommend coverage, or to advise insureds they are underinsured. *Cameron Parish School Board v. State Farm Fire and Casualty Co.*, 560 F. Supp. 2d 485 (W.D. La. 2008) (involving Louisiana law). Similarly, the broker does not have a duty to advise a client of the adequacy of a policy's coverage, *Bichelmeyer Meats v. Atlantic Insurance Co.*, 42 P.3d 1191 (Kan. App. 2001), unless a "special relationship" exists between the agent and the policyholder. *Bruner v. League General Insurance Co.*, 164 Mich. App. 28, 32, 416 N.W.2d 318 (1987) (finding a special relationship is present when the policyholder has been a long-time client, had interacted with the agent on coverage questions, and relied on the agent); *accord, Lipscomb v. Farmers Insurance Co.*, 174 P.3d 1182, 1186 (Wash. App. 2007); *Fleming v. Torrey*, 273 N.W.2d 169 (S.D. 1978) (finding no duty to provide adequacy advice when the insured did not seek the agent's advice and did specify limits desired in the absence of special circumstances).

Special circumstances may be shown where the insured pays the agent for advice, or specifically contracts to provide the advice. *See Avery v. Diedrich*, 2007 WI 80, 734 N.W.2d 159, 165 (2007). Special circumstances may also be shown where the insured in the past received assurances of adequacy from the broker, and where the broker provides such assurances with respect to the policy at issue. *Martinonis v. Utica National Insurance Group*, 65 Mass. App. 418, 421, 840 N.E.2d 994 (2006).

But it has also been held that a special relationship did not exist when the 78-year old insured placed her trust and reliance on the agent to take care of her insurance needs, when the coverage discussion arose from casual conversation, and when the court found the defendant was the agent for the insurer and not the insured. *See Lewis-Williamson v. Grange Mutual Insurance Co.*, 179 Or. App. 491, 39 P.3d 947, 950 (2002). Nor does it exist when the agent does not hold himself or herself out as an expert or receive extra compensation, where a long-standing relationship does not exist, and when evidence does not



"Agents generally have no duty to assess independently the insured's needs and recommend coverage ..."



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210 S.W.3d 253, 259 (Mo. App. 2006) (noting also causation could not be found inasmuch as the loss was caused by the volatile stock market).

Not all jurisdictions hold insurance agents to professional standards. *E.g., Busker On The Roof Limited Partnership Co. v. Warrington*, 283 A.D.2d 376, 377, 725 N.Y.S.2d 45 (2001) (adding, however, that agents and brokers may be sued for fiduciary duty breach in "extraordinary circumstances"). Indeed, New York has held that insurance agents or brokers "are not personal financial counselors and risk managers, approaching guarantor status." This is so because insureds "are in a better position to know their personal assets and abilities to protect themselves more so than general insurance agents and brokers unless the latter are informed and asked to advise and act." *Globalnet Financial.com, Inc. v. Frank Crystal & Co.*, 449 F.3d 377, 386 (2d Cir. 2006).

Aside from New York, breach of fiduciary duty claims are widely brought because "of the increasing complexity of the insurance industry and the specialized knowledge required to understand all of its intricacies." *Sobotor v Prudential Property & Casualty Insurance Co.*, 200 N.J. Super. 333, 341, 491 A.2d 737 (1984). One limitation on the scope of fiduciary duty applicability is recognized at the initial application phase where it has been held that a fiduciary relationship has not as yet formed. See *Pitts v. Jackson National Life Insurance Co.*, 352 S.C. 319, 574 S.E.2d 502 (App. 2002).

Negligent misrepresentation claims are also asserted against insurance agents and brokers. But an agent's prediction about what an insurer might pay following a loss is not actionable being a mere statement as to a future event, unless the statement is a representation of the speaker's present intention, or concerns matters within the speaker's control. *Ryann Spencer Group, Inc. v. Assurance Company of America*, 275 S.W.3d 284, 291 (Mo. App. 2008) (involving allegations the agent told the insured the carrier would pay the full market value of damaged property in the event of a covered loss).

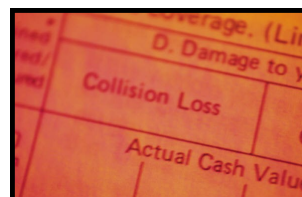
ERISA does not preempt E&O claims against insurance professionals selling plans within ERISA's scope because such claims do not "relate to" the plan. See *Coyne & Delaney Co. v. Selman*, 98 F.3d 1457, 1467 (4th Cir. 1996) (involving a health insurance agent who assured the employer/client the replacement policy would provide identical benefits at lower cost); *Perkins v. Time Insurance Co.*, 898 F.2d 470, 473-74 (5th Cir. 1990).

Failure to Procure

Many cases involve tort claims the agent or broker failed to obtain promised coverage. Prima facie proof of failure to procure insurance requires evidence that the agent: (1) agreed to procure the insurance, (2) failed to use reasonable diligence to place it, (3) failed to notify the customer the policy had not been issued, and (4) caused the customer to believe coverage was issued. *Belmont Commons, LLC v. Axis Surplus Insurance Co.*, 569 F. Supp. 2d 637 (E.D. La. 2008) (interpreting Louisiana law).

The cases are also brought on a contract basis. Here, the proposed insured must prove a request for insurance, an agreement to insure, the subject, period, amount, and rate of the insurance, and that the premium would have been paid if demanded. *Lake County Grading Co. v. Great Lakes Agency, Inc.*, 226 Ill. App. 3d 697, 589 N.E.2d 1128, 1130-31 (1992) (finding the broker liable for the difference in the cost of coverage caused by the broker's delay in reacting to the carrier's declination of coverage). Agreement to procure is not shown by evidence of a mere "vague assurance" of coverage, or evidence the broker merely agreed "to do the best he could" to find coverage. *Harnett, supra*, §3.03[2]. Obviously where the agent does not agree to procure the requested coverage, liability cannot be established. See, *e.g., Avery v. Diedrich*, 2007 WI 80, 734 N.W.2d 159, 166 (2007).

In failure to procure cases plaintiff must also show that coverage was available in the marketplace for the risk in question. *E.g., Hawk v. Roger Watts Insurance Agency*, 989 So. 2d 584 (Ala. App. 2008); *Maclaff, Inc. v. Arch Insurance Co.*, 973 So. 2d 887 (La. App. 2007) (rejecting negligent misrepresentation and fiduciary



"Agreement to procure is not shown by evidence of a mere 'vague assurance' of coverage ..."



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detail in the engagement letter. An accountant is liable only for damages incurred in the specific transaction that the accountant or his client intends to influence or one substantially similar to it. The greater detail with which the accountant can describe the transaction contemplated, the less leeway a potential third party has to make a claim based on an attenuated transaction not outlined in the engagement letter.

Disclaimers

Some engagements do not lend themselves to disclaimers, however it is worth noting that in some circumstances, statements in or accompanying an accountant's work product that qualify or explain its contents may operate to relieve the accountant of liability. An adequate disclaimer can preclude a claim of justifiable reliance on the accountant's work product, which is necessary to state a claim in negligent misrepresentation.

Similarly, the "bespeaks caution" doctrine provides that cautionary language accompanying forward-looking statements may render such statements inactionable if the statements later prove to be incorrect. The rationale is that the cautionary language negates the reasonableness of the third party's alleged reliance, as well as the materiality of such statements.

Allowing Disclosures to Third Parties

Perhaps the most damaging evidentiary material produced in accounting malpractice cases is the auditor's management letter, which is addressed to the client and contains the auditor's conclusions regarding the company's accounting policies and procedures, internal controls, and operating policies. In the management letter, the accountant may communicate perceived internal accounting weaknesses or deficiencies discovered in the course of his audit. The management letter includes recommendations for improving the client's internal reporting processes. However, the management letter does not contain information reportable on the client's financial reports,

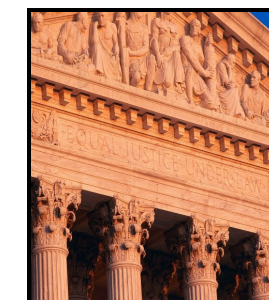
and it is generally not a part of the financial statements. Consequently, an accountant may issue a "clean" audit report accompanied by a management letter outlining the very weaknesses alleged by a subsequent third party plaintiff to have caused his damages. Thus, the management letter is a virtual playbook for potential plaintiffs.

The predicament for accountants is their inability to disclose the management letter to anyone other than the client. On one hand, if the accountant knows the identity of a relying third party and the transaction for which the third party intends to rely on his report, he can be liable to that third party. On the other hand, he has a professional and ethical obligation not to disclose the terms of the management letter to anyone other than his client.

So what is the accountant to do? One possible solution is including a provision in the engagement agreement allowing disclosure of the management letter or a similar correspondence to third parties identified in advance by the client. Alternatively, the engagement letter could permit the accountant to disclose the existence of the management letter, but not its content, to known, reliant third parties. In this way, accountants are able to remove themselves from the information exchange and avoid violating their professional obligations to the client. At the same time, pre-identified third parties are alerted and given an opportunity to obtain the management letter or similar correspondence directly from the client.

Indemnity Agreements

To counteract their expanding liability, accountants may elect to include indemnification clauses within their engagement letter. In a typical indemnification provision, the client agrees to indemnify and defend the accountant for the client's disclosure to third parties who later claim they were damaged as a result of their reliance on the accountant's work. Alternatively, the engagement agreement may provide for indemnification for designated damages, such as punitive damages, claimed by third parties. Current ethics rules governing



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accountants allow indemnification when, for example, the client's management made knowing misrepresentations to the accountant. *See, e.g., AICPA Ethics Ruling 94*. However, it should be noted that the Securities Exchange Commission has cautioned accountants that liability disclaimers and indemnification agreements may impair the accountant's perceived independence, thereby disqualifying them from performing certain reporting engagements.

Conclusion

It was once written that "public accountants

are public only in the sense that their services are offered to any one who chooses to employ them. This is far from saying that those who do not employ them are in the same position as those who do." *Ultramares*, 174 N.E. at 448. Try explaining that to a third party plaintiff who has run out of solvent defendants. In the current economic climate, accountants and their insurance carriers are likely to be the last "deep pocket" to pick, and it should be anticipated that they will end up holding the bag when companies and investments go south. To minimize potential liability, accountants and their attorneys are advised to structure carefully the accountant's engagement letter.



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Machine Works, Inc. v. Great American Surplus Lines Insurance Co., 635 So. 2d 1357, 1362 (Miss. 1994). An early case described the relationship as follows:

"One who holds himself out to the public as an insurance broker is required to have a degree of skill and knowledge requisite to the calling. When engaged by a member of the public to obtain insurance, the law holds him to the exercise of good faith and reasonable skill, care and diligence in the execution of the commission. He is expected to possess reasonable knowledge of the types of policies, their different terms, and the coverage available in the area in which his principal seeks to be protected. If he neglects to procure the insurance, or if the policy is void or materially deficient, or does not provide the coverage he undertook to supply, because of his failure to exercise the requisite skill or diligence, he becomes liable to his principal for the loss sustained thereby."

Rider v. Lynch, 42 N.J. 465, 476, 201 A.2d 561 (1964). Stated another way, where an insurance broker has experience in a particular field, that broker should possess reasonable knowledge of the general types of policies available, understand their different terms, and explore the specific coverage available in the area in which the insured seeks to be protected. Proper diligence requires the insurance broker to canvass the market and to be informed about different companies and the variations in the available terms. *Offshore Production Contractors, Inc. v. Republic Underwriters Insurance Co.*, 910 F.2d 224, 231 (5th Cir. 1990) (interpreting Louisiana fiduciary duty law).

The traditional distinction between insurance agent and broker ordinarily is triggered in actions involving efforts to bind the insurer on grounds of vicarious liability, and actual and apparent authority. Traditionally an agent is the representative of the insurer, while the broker is the representative of the insured. In reality, the distinction between the two is of-

ten blurred. 1 Bertram Harnett, *Responsibilities of Insurance Agents and Brokers*, §2.02 (2009). Regardless, the broker/agent distinction should not affect the duties owed to the customer in E&O litigation; that distinction relates to duties owed to the insurer. *Sobotor v Prudential Property & Casualty Insurance Co.*, 200 N.J. Super. 333, 337 n. 1, 491 A.2d 737 (1984). Thus, the agent's argument that no duty was owed to the insured because it acted on behalf of the insurer was rejected because the duty to procure coverage applies equally to agents and brokers. *See Shetucket Plumbing Supply Inc. v. S.C.S. Agency, Inc.*, 570 F. Supp. 2d 282 (D. Conn. 2008) (applying Connecticut law).

Common Counts

Insurance agents have been held liable to insureds and applicants for insurance on a number of theories including professional negligence and breach of contract. Common claims include failure to procure coverage, failure to procure appropriate coverage, and failure to provide sufficient limits. *See, e.g., Saunders v. Cariss*, 224 Cal. App. 3d 905, 908-09, 274 Cal. Rptr. 186 (1990) (citing cases); *Steinmetz v. Hall-Conway-Jackson, Inc.*, 49 Wash. App. 223, 741 P.2d 1054 (1987) (involving alleged failure to procure liability limits in amounts requested). Failure to renew a policy pursuant to an agreement to renew, failure to forward premiums to the insurer, and failure to notify the customer of policy cancellation also are grounds for an E&O claim. *Blonsky v. Allstate Insurance Co.*, 128 Misc. 2d 981, 983-84 (N.Y. Sup. Ct. 1985); *Adkins & Ainley, Inc. v. Busada*, 270 A.2d 135 (D.C. App. 1970) (involving policy cancellation).

The claims are presented in many jurisdictions as professional malpractice/breach of the standard of care claims. In a recent action against an agent selling variable life insurance policies tied to investment funds, a Missouri court dismissed the action emphasizing evidence the agent encouraged the insureds "to seek outside advice before investing" which met the "professional competence" standard. *See Roth v. Equitable Life Assurance Society,*

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