The prevailing wisdom has always been that CPA firms need to carry malpractice insurance. Nevertheless, many smaller firms do not actually have such coverage—roughly half of all CPA firms (as opposed to individual CPAs) do not have malpractice insurance, raising the question of whether malpractice insurance makes sense for all CPA firms.

There is no legal requirement for CPA firms to have malpractice coverage. In the early days of the AICPA’s SEC Practice Section, carrying professional liability malpractice insurance was a requirement for membership. In the late 1980s, however, when the malpractice insurance market collapsed, it became impossible for many accounting firms to obtain such insurance, prompting the SEC Practice Section to drop the requirement. (For a period of two or three years thereafter, many midsize accounting firms did not have malpractice coverage. Since the early 1990s, however, malpractice insurance has been readily available, although the price of that insurance has fluctuated significantly, with prices rising following an economic downturn when claims run high and interest rates are low. Conversely, when the economy is overheated and interest rates are high and claims are down, malpractice insur-
The reasons most often given are as follows:
- The firm has never had a claim.
- The firm limits its practice to low-risk areas.
- The firm maintains high quality control standards.
- Liability insurance tends to attract professional liability claims.
- Insurers add to the cost of defending litigation.
- Insurance creates conflicts of interest.

While many firms are persuaded by these considerations, some involve a certain degree of wishful thinking.

**Firm has never had a claim.** The fact that a firm has never had a claim is commonly cited as a reason for not purchasing insurance. While the absence of prior claims is some basis for predicting the future, it is not a very good one. From a historical perspective, small accounting firms practicing in non-industrialized states incur on average approximately one malpractice claim per professional every 120 years. Thus, a firm of 10 professional owners and employees in these states can expect to incur one claim every 12 years. On the other hand, CPA firms practicing in the industrialized states and California have a much higher claims frequency: approximately one claim per professional employee every 50 years. Thus, a firm of 10 professionals practicing in these states can usually expect a claim every five years. In addition, as the size of the firm increases, this ratio declines, because larger firms tend to take on larger matters requiring more professionals per engagement. (Correspondingly, the magnitude of malpractice claims tends to increase with the size of the firms and the matters they handle.) Thus, if a CPA firm consisting of five professionals has never had a claim in its 20-year history, the absence of a malpractice claim does not mean that it will never incur one. One might just as easily conclude that a claim is likely to be incurred within the next few years.

**Firm has a low-risk practice.** It is certainly true that some practice areas entail greater liability risks than others. For example, attest services tend to give rise to a relatively small number of malpractice claims, but these claims are often among the most serious liability claims. This is particularly true of SEC audit engagements, where almost every revision of a company’s financial statements seems to produce a liability claim, which can involve damages in the hundreds of millions of dollars. Similarly, investment advisory services generate a disproportionate number of claims, and those claims also often involve high levels of damages. As a result, many liability insurers exclude coverage for such claims from their policies. Claims arising out of tax advisory services are both common and often involve substantial damage claims.

Although roughly 40% of all professional liability claims come from tax return preparation engagements, the percentage of tax return engagements giving rise to those claims tends to be relatively small, as even small CPA firms are likely to prepare several hundred returns each year. Moreover, these claims generally entail small amounts of damages, as the plaintiff’s claim is usually limited to any unnecessary tax liability the plaintiff has incurred, and in many such cases those damages may have been incurred because the taxpayer provided the CPA firm with erroneous or incomplete data. Because the damages from this class of claims tend to be relatively small, they correspondingly entail relatively minor legal defense costs, making this category of claims generally appropriate for self-insurance. Indeed, most firms that forgo malpractice insurance coverage largely limit their practices to tax return preparation services.

This, however, does not mean that errors in the preparation of tax returns all give rise to only small claims. Failure to make appropriate tax elections can lead to very substantial claims. This is particularly true of elections on gift and estate tax returns. Even relatively small tax return preparation practices can experience ruinous professional liability claims.

**Firm has high quality control standards.** No professional will readily admit that his firm does not provide high-quality services. Even if a firm may not have the capability of performing complex audit or tax engagements, it will nevertheless contend that the quality of the services it does provide are of the highest quality. If these arguments were true, there would be no malpractice claims. In many cases, such contentions are frequently unfounded; CPAs are human, and humans from time to time make mistakes, meaning that even the best quality control systems may fail to correct such errors. Equally important, although numerous claims against CPA firms are wholly unfounded, they are nevertheless expensive to defend, and the CPA firm must be prepared to pay these defense costs.

**Insurance attracts claims.** Although it is true that liability insurance provides a strong incentive to persons damaged by professional malpractice to assert a liability claim (the “lightning rod” effect), this is not a particularly good reason for not purchasing liability insurance. Certainly, no potential plaintiff wishes to incur the con-
siderable expense of pursuing litigation if the defendant will not be able to pay any judgment or settlement that she is likely to obtain. With this in mind, among the first inquiries of any plaintiff in a professional liability litigation is the amount of malpractice coverage of the defendant accounting firm. This enables the plaintiff to determine what level of resources she wishes to expend in the litigation, and on rare occasions, a plaintiff might even discontinue her claim when it is discovered that the defendant does not have malpractice coverage.

The problem with this consideration is that the initiation of a lawsuit is usually not deterred by a lack of insurance coverage because, in the vast majority of cases, the plaintiff merely assumes that the defendant CPA firm has malpractice coverage and proceeds accordingly. By the time the plaintiff actually learns that the defendant accounting firm does not have malpractice insurance, she has already invested a significant amount in the litigation and, therefore, may decide to continue to prosecute the claim in an effort to recover those resources already expended. Moreover, knowledge that the defendant does not have liability insurance could lead a plaintiff to believe that the defendant is ill-prepared to defend the claim and, therefore, press her claim even harder.

Insurance adds cost. Another consideration in not purchasing liability insurance is the cost of that coverage. Because most insurance companies are for-profit entities, they have a strong incentive to collect more in premiums than they pay out in litigation expenses and damages. Insurance companies also incur sales and administrative costs, which generally amount to 6% and 20%, respectively, of their total premiums. This means that a substantial amount of the company’s premium receipts do not even go toward paying for the defense and resolution of claims. To some extent, these extra costs are offset by insurers’ ability to obtain lower defense costs, because all insurers (owing to the volume of their claims) are in a good position to bargain for lower billing rates from their defense counsel; in many cases, that reduction can amount to 30%. This reduction, however, only applies to the defense costs, which in small claims amounts to roughly 50% of the total cost of disposing of a claim, whereas the selling, administrative, and profit items referred to above are stated as a percentage of total premium dollars. As a result, there is a loss factor in funding the costs of liability claims through a liability insurer.

It can also be argued that involving an insurance company can further add to the cost of resolving malpractice claims, because an insured accounting firm is frequently required to retain an attorney just to deal with its insurer. Under the laws of all states, an insurance company must reserve its right to disclaim liability of a claim at the outset or forever waive its right to do so. Accordingly, insurers commonly issue a “reservation of rights” letter at the outset of each claim, spelling out all of the ways in which the claim ultimately might not be covered. Insured accounting firms often have to hire their own attorney to interpret such letters.

In addition, in order to explore whether the claim is actually covered, malpractice insurers routinely ask their insureds to answer a number of questions relevant to whether the claim might be excluded from coverage. Responding to these questions also may require the assistance of legal counsel. Finally, if there is an allegation of fraud in the complaint, the insurer may use this possibility to compel the insured accounting firm to contribute to the settlement of the claim over and above the insured’s deductible amount. When this happens, the insured will also need the assistance of legal counsel. Thus, on top of paying the cost of the insurance and the deductible amount under the policy, the insured accounting firm may have to retain its own legal counsel to assist it in dealing with its insurer.

Some accounting firms contend that insurance companies pay too much to settle malpractice claims. It must be appreciated that once the insured firm has paid its deductible amount, the insurer is responsible for paying both the defense costs as well as the amount of any settlement or judgment obtained by the plaintiff up to the limits of the policy; many insurers frequently opt to be generous in agreeing on a settlement amount in order to eliminate the costs associated with continuing the defense of the claim. Although every malpractice insurance policy contains a provision requiring the insurer to obtain the insured’s consent to any settlement of a claim against the insured, the rights conveyed to the insured by this type of provision are largely illusory, as an insured firm that does not consent to a settlement recommended by its insurer bears the risk of paying any excess—either in the form of judgment, settlement payment, or defense costs—over the recommended settlement amount that may ultimately be incurred in resolving the claim. As a result, few insured accounting firms object to a settlement recommended by their insurer. It is not at all clear, however, that this is a valid reason for not buying insurance, because an uninsured firm is faced with the same consideration when settling a claim against it, and an uninsured accounting firm is undoubtedly more risk-averse than a well-financed insurer. It can just as easily be argued that uninsured firms are likely to pay more to settle a claim than insured firms.

As for nonmonetary issues, there is a general consensus that litigation is an emotional strain on a firm’s partners, and dealing with an insurance company poses additional strains. As discussed above, there may be many instances in which the insurer’s interest and those of the firm will differ. This might also happen when the insurer advises the firm that it may not cover the claim, in certain circumstances. It may also happen in connection with the selection of the law firm that will defend the claim. The insurance company might want to pursue a settlement strategy when the firm wants its good name vindicated from the “spurious” charges that have been made against it. It could also arise out of the insurer’s balancing at paying the legal costs of pursuing a counterclaim that the firm wants to assert against the plaintiff. These conflicts with the insurer are rather common and certainly add to the aggravation of the insured firm.

Insurance creates conflicts of interest. Using an insurer also adds another form of conflict—the conflict between the firm and the lawyers appointed by the insurer to defend the claims made against the firm. Although the law is clear that a law firm appointed by the insurer to defend a liability claim owes its highest loyalty to the insured firm, law firms are also well aware that they are likely to receive far more future business from the insurer than the insured firm. Thus, an insured accounting firm can never be fully comfortable that
the advice it receives from a defense counsel appointed by its insurer is not being tempered by the interests of the insurer.

The decision to carry insurance also presents other vexing issues. Having decided to purchase insurance, a firm must also decide upon the amount of insurance it needs, the level of the deductible amount, the scope necessary to cover its practice, and the insurance carrier that will provide the firm with that coverage and the defense of any claims that may be asserted against it. (Section 1004 of PPC’s Guide to Managing an Accounting Practice contains a discussion of considerations in selecting an insurance carrier and purchasing professional liability insurance.) Furthermore, when the firm incurs a claim, the focus is solely on the resolution of the claim and not on how to deal with the insurance company.

**Advantages of Having Malpractice Coverage**

Carrying malpractice insurance does have several obvious advantages:

- It represents a known cost (not a zero cost that could suddenly skyrocket), thus allowing professionals the peace of mind to sleep better at night and not worry about being put out of business.
- It pays for defense counsel while the partners are under the emotional strain of defending the litigation.
- It can aid in attracting and retaining clients, as well as recruiting young professionals.

**Allowing peace of mind.** Although a malpractice policy will give a significant degree of peace of mind to a professional firm’s partners and employees, it does not afford complete comfort. With or without malpractice insurance, one cannot insure oneself against one’s own fraud. Insurance only covers a firm and its partners for negligence, not fraud. An insurance company can disclaim coverage on the basis that the firm was a participant in a fraud, rather than a victim of it. Interestingly, most malpractice claims against accounting firms performing attest services assert one or more fraud claims—largely to avoid the privity defense—and, therefore, create a basis for the insurer to deny coverage. (Even though insurance companies rarely actually disclaim liability, the risk of a denial of coverage is significant enough to prompt a firm to retain and bear the cost of its own counsel, in addition to the insurance company’s lawyers.)

Even if a firm carries malpractice insurance, the policy will occasionally be inadequate to cover the entire risk of a potential claim. Over 40 years ago, when claims against accountants were rare, accounting firms had little difficulty obtaining, at a relatively modest price, malpractice policies with limits of liability as high as the largest claim that they were likely to incur. That changed radically as the popularity of accounting malpractice claims grew. By the late 1980s, many accounting firms had difficulty finding any malpractice insurer that would cover their practices. Today, few, if any, accounting firms can afford insurance coverage for their largest conceivable claim; even high levels of coverage may not be readily available. As a result, many accounting firms are likely to have less insurance coverage than the amount of damages that the plaintiff has actually sustained, and far less than the plaintiff is seeking to recover. This places an insured accounting firm in a highly risk-averse situation. The good news, however, is that most plaintiffs and their attorneys understand this and are often willing to settle within the policy limits, as long as the firm has a reasonable amount of coverage, considering the size and nature of the firm’s practice. When a firm has no insurance, the plaintiff may not be as understanding, as she knows that the firm is also not likely to have the resources necessary to defend the claim.

The greatest advantage of having malpractice insurance is surely having peace of mind knowing that the firm is not likely to be put out of business by a malpractice claim. All conscientious professionals are afraid of being bankrupted by a malpractice claim and being stripped of their retirement funds, their homes, and other assets. Professionals frequently have most of their life savings tied up in their firm’s equity, not to mention the goodwill they hope to sell to partners or successors when they retire. Such assets can quickly evaporate if the firm incurs a substantial uninsured liability claim. While there are other ways to mitigate such calamities (some of which will be discussed below), liability insurance remains the best way of avoiding such events, especially in a firm with more than a handful of owners who may not all share the same priorities. For example, junior members of the firm—with few clients, little equity, and many years in which to make up their losses—may be far less risk-averse than the firm’s more senior members.

**Paying for defense counsel.** Another reason for having malpractice insurance is that it limits the firm’s obligation to pay the costs of defending a claim. Professional liability claims are highly factually intensive, which makes them very expensive to litigate. Even claims against relatively small accounting firms arising out of an attest engagement could involve defense costs of several hundred thousand dollars, and the defense costs associated with claims against the larger accounting firms frequently run into the tens of millions of dollars. Most accounting firms simply do not have funds of that magnitude available, and if they cannot afford the ante to stay in the game, they will be forced to settle the claim on the best terms that are available to them.

Although CPAs generally have a large number of clients and acquaintances within the legal profession, they may not know any attorneys who specialize in defending accounting firms, as such attorneys represent an extremely small segment of practice. Moreover, because of the highly technical nature of the professional standards governing the accounting profession, having an attorney who is familiar with those standards is a tremendous advantage. Every liability insurer has a defense panel in every juris...
diction consisting of attorneys with substantial experience in handling liability claims against accounting firms. Thus, they have little difficulty in not only locating an attorney with the requisite experience in handling such claims, but also the attorney whose experience and billing rates are best suited to handle their insured’s particular claim. While resourceful CPAs can locate a competent attorney by asking colleagues or persons at their accounting society, they may not be able to locate an attorney whose knowledge, experience, and billing rates are best suited to the defense of their individual claim.

**Attracting clients and recruiting new professionals.** Having malpractice insurance is also important in attracting certain classes of business. Underwriters have long shunned accounting firms with limited or no insurance coverage, and as a result, companies seeking to tap the public financial markets will not opt to retain auditors without liability coverage. Similarly, bonding companies may not be willing to insure contractors whose auditors do not have adequate liability coverage, and banks and other financial institutions may not wish to extend credit to companies whose auditors do not have adequate liability coverage because they must rely heavily on the financial reports that they receive from their customers. Any firm that engages in attest services may find it difficult to acquire and retain clients if it does not have liability insurance.

Another, less obvious advantage of having malpractice insurance is that it aids in recruiting professional talent. All young professionals want to associate themselves with a firm at which they can work their way up into the partnership ranks, build their equity in that firm, and be able to enjoy retirement. The lack of malpractice insurance greatly enhances the prospect that by the time the professional has reached her prime earning years, that firm may no longer exist and the professional may have to invest many more years of hard work to reach a similar position in another firm. Thus, the absence of malpractice insurance may impede a CPA firm from attracting the quantity or quality of young professionals that is necessary for the growth of its practice.

One frequently overlooked benefit of professional liability insurance is the loss prevention services provided by many liability insurers. Such services include liability hotlines, which provide insured firms with free legal and practical advice for avoiding or minimizing the impact of a potential liability claim. Many insurers will also provide legal representation in disciplinary proceedings against an insured accountant that might precede a liability claim. Some insurers provide their customers with loss prevention manuals and loss prevention seminars, which not only help protect them from incurring liability claims but also may qualify for continuing professional education credit.
Protective Measures for Uninsured Firms

There are a number of measures that should be taken by firms that opt not to purchase professional liability insurance. These include structuring the firm and the assets of its owners in such a way as to make them less vulnerable to liability claims. In addition, a firm rejecting liability coverage should take other measures designed to better position it to defend itself and its owners against liability claims.

Perhaps the first step a firm should take is to organize itself in a limited liability format, such as a business corporation (if permitted by state law) or as a limited partnership, LLC, or LLP. (It should be noted, however, that a few states require professional firms practicing as an LLC or LLP to carry a minimum amount of liability insurance.) In this way, the assets of those individuals who did not participate in an engagement that gave rise to a liability claim would not have their personal assets at risk. It would not, however, protect the assets of the firm and those professionals who either worked on that engagement or supervised the work on that engagement.

A second measure that an uninsured firm should take is to compartmentalize its assets and practice. If the firm had an investment advisory or other high-risk practice, it could put that practice into a separate entity in which few assets were maintained. If a liability claim arose out of that practice, it would not affect the financial viability of the remainder of the firm’s practice. Similarly, the firm could hold certain assets outside the entity or entities engaged in providing professional services. For example, if the firm owned the building in which its practice is conducted, it could place the ownership of that building into a separate entity and have its practice entities rent space in the building. If the firm has obligations to buy the interests of its retiring owners, it could place the monies set aside for that purpose into a pension trust for the benefit of its present and future retirees. In this way, even a significant malpractice claim might not prove fatal to the continuing existence of the firm.

Similar measures should be taken at the owner level. Firm owners should hold as much of their assets as possible in funds that are not subject to attack by creditors. A partner could place assets in a trust for the benefit of his heirs. The laws of virtually every state protect assets held in federally insured pension plans and profit-sharing plans from the claims of creditors. It is generally advantageous for owners of an uninsured firm to place as much of their personal assets in such plans as they are legally permitted to do. A few states, such as Florida and Texas, also protect a significant amount of a person’s assets (principally real estate) from creditors’ claims. In these ways, firm owners can insulate themselves from a financial disaster resulting from liability claims.

A commonly used approach is to transfer firm partners’ assets to their spouses. Partners of large firms have been doing this for many years. Such transfers must be made prior to there being any claim in order to avoid being invalidated as a “fraudulent transfer.” Such transfers should include any real estate and other nonprotected assets. Knowing that one’s residence and spare funds are protected make it possible to fight a claim where, if there was no such protection, the individual responsible might be forced to settle.

One of the most important steps an uninsured firm can take is to establish a defense fund. Rather than pay liability insurance premiums, the firm can annually contribute to its defense fund and, hopefully, over time it will develop sufficient liquid assets to help defend itself against a liability claim. Having such a fund gives the firm substantial ability to defend a claim and to bargain down the plaintiff’s settlement demands. There is, of course, a tendency to simply distribute the firm’s liquid assets on the theory that if a claim does arise, the firm’s members will contribute back to the firm the funds necessary to defend and resolve the claim. Unfortunately, this rarely works in practice, because some members may well decide to leave the firm rather than make their proportionate contributions. In addition, while a defense fund will certainly improve a firm’s defense posture, it may prove wholly inadequate if the firm has multiple claims within a relatively short period of time, and it is not uncommon for a firm to discover that it has repeatedly made the same mistake in work performed for multiple clients.

If a firm is planning not to carry insurance, it should also consider retaining an experienced liability defense counsel because once a claim is made, there is little time for a firm to look for counsel. Accountants’ litigation is a complex field. A firm’s defense counsel has to be familiar with the law in its state, and possibly other states; the standards of the accounting profession; and the rules promulgated by the SEC, the PCAOB, and state regulators. In addition, when a claim does arise, no one wants to start explaining to a lawyer not familiar with accounting the firm’s responsibility for various levels of attestation work, its responsibility for tax returns, and generally accepted auditing standards.

Taking Firm Size into Consideration

Most firms with attest practices and with more than a dozen professionals will likely want to have malpractice insurance, because it will enable them to readily market their services and maintain a quality professional staff, in addition to minimizing certain conflicts between the differing interests of the firm’s owners. Firms of this size can generally expect to incur a liability claim at least once every 10 years, so betting against the odds that the firm can dodge the liability bullet is not a particularly wise course of action. Rather than go without coverage, such firms should give serious consideration to purchasing policies with high deductible amounts that would greatly reduce the costs of malpractice coverage and utilize the savings to create a defense fund.

Smaller firms and those with a practice that is limited to low-risk engagements might well conclude that going without insurance makes economic sense. They should, however, consider buying a relatively small policy that will largely cover their defense costs, because such policies tend to be inexpensive and can provide the firm with a good bargaining position in resolving claims that might be asserted against them.

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