

# Importance of having insurance. (professional liability insurance)

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**Abstract-** Professional liability insurance provides protection to accountants against exposure to claims in the execution of tax preparation and write-up services. A majority of accountants, however, are hesitant to avail of liability insurance because of the high costs associated with the maintenance of such policies and the minimal one percent chance of assuming a claim. Accountants have consequently chosen to take the risk of laying themselves open to liability claims in return for cost savings from finances that would have been allocated to insurance payments. Accountants fail to realize though that in the absence of liability insurance they run the risk of incurring large expenses resulting from the costly defense of liability claims.

Many accountants performing tax preparation and write-up services have chosen not to purchase professional liability insurance because of its current high cost. While it is true that these types of services generally entail less risk than audit and other services involving verification procedures, they are not wholly free from liability exposures, a fact that many accountants are coming to appreciate. Indeed, approximately 40% of all claims filed against accountants arise out of tax preparation services.

To be sure, the cost of professional liability insurance is substantial, and the chances of incurring a claim in any given year are slightly less than 1% per professional. Therefore, a firm with three professionals would have roughly a 3% chance of incurring a claim in any given year.

These statistics have prompted many accountants to try to play the liability lottery, hoping they can escape liability and pocket the money they would otherwise pay for insurance. The risks of losing this lottery, however, can be enormous and could easily threaten the financial security of the losers, if not force them into bankruptcy.

The often overlooked problem is that without liability insurance, an accountant is unlikely to be able to afford the costs of defending against a liability claim, thereby becoming vulnerable to the plaintiffs allegations. This fact was recently dramatically exemplified in the case of an accountant who had been performing tax preparation and write-up services for a small business which was victimized by a \$400,000 embezzlement by its bookkeeper. The client sued the accountant seeking to recover that amount, alleging that the accountant should have uncovered the embezzlement in the course of reconciling the client's bank account.

On its face, the plaintiff's claim seemed reasonable and could clearly survive both a motion to dismiss and a motion for summary judgment, forcing the accountant to have his case tried before a jury. On the other hand, the accountant had several good defenses, including the fact that a significant portion of the plaintiff's claim was barred by the statute of limitations. Perhaps more important, the nature of the accountant's engagement was not one that could have reasonably been relied upon to uncover such a defalcation, and the plaintiff himself had ignored the accountant's advice not to place so much trust in the bookkeeper. Unfortunately, the accountant's lack of insurance precluded him from defending on any of these grounds. He simply did not have the funds to pay the considerable costs of defending against this claim.

Another Sad Story

Similarly, another accountant revealed to me that he had failed to timely file an amendment to his client's tax returns which would have enabled the client to receive a \$100,000 tax refund. He, too, was uninsured, preventing him from asserting the defense that the loss of the refund was in part due to the plaintiffs own negligence.

The cost of litigating accountants' liability cases can be quite high as such cases tend to be highly document intensive. They also generally require services of expert witnesses and the involvement of attorneys who are knowledgeable in accounting matters. Moreover, most cases (such as the two described above) must be litigated through trial, which can frequently cost anywhere between \$100,000 and \$300,000 in legal fees and associated costs depending upon: 1) the issues in the case 2) the amount at stake in the litigation and 3) the extent to which plaintiffs counsel presses discovery issues. Most accounting practices simply cannot sustain costs of this magnitude, even assuming that they will be victorious in the litigation. Thus, the alternatives for an uninsured firm faced with a liability claim are either to satisfy the plaintiffs demand for immediate settlement or seek the protection of the bankruptcy courts. While the threat of declaring bankruptcy, does have a mitigating effect upon the plaintiffs settlement demands, y those demands are not likely to be reduced to the point that the accountants financial sacrifice will be inconsequential.

As a result, my advice is that no accountant should opt to practice without liability insurance simply to have a few extra thousand dollars a year to use in the practice. The risk of future financial ruin simply does not justify such savings. In this regard, there are a number of insurance companies that now provide policies specifically designed for accountants practicing in small firms and whose practices are limited to write-up and tax preparation services. Such policies are generally written with both low deductible amounts and relatively low limits of liability. In any event, the amount of insurance provided by them is generally more than adequate to fund the defense and pay any claim likely to arise in this type of practice. Moreover, the annual premiums for these policies are generally quite reasonable, as low as \$400 per practitioner for \$500,000 of coverage.

Some insurers providing this form of coverage are listed in Exhibit 1.