Accountants' liability - a program for legislative reform

American Institute of Certified Public Accountants. Special Committee on Accountants' Legal Liability

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This statement has been prepared by the special committee on accountants' legal liability to explain the work and goals of the committee.

The American Institute of Certified Public Accountants (AICPA), representing 240,000 members across the country, has developed a program to address the crisis of expanding liability exposure which is affecting not only accountants but a range of other business, professional and public service groups.

The pervasiveness of the problem is reflected in the number of trade, professional, industry and civic organizations that have formed special task forces or joined coalitions to devise solutions to the liability crisis. The AICPA has joined forces with representatives of these various special groups.

Recent public attention has focused primarily on the insurance aspect of the liability crisis reflected in escalating premium costs and shrinking coverage. We believe, however, that the insurance crisis is only one facet of the liability crisis and is, in fact, a symptom rather than a cause.

It is our conviction that the chief cause of the liability crisis is a tort system which has become dangerously out of balance as the result of a trend of expanding liability, which began approximately 20 years ago. We recognize that legitimate grievances require adequate redress, but fairness demands equity for the defendant as well as the plaintiff. Such equity is now lacking in the system, and the balance must be restored.

In order to redress the present imbalance in the tort system, the AICPA has identified five principal areas in need of legislative reform, whether at the state or federal levels:
1 PROPORTIONATE LIABILITY

The most significant area in need of reform is the replacement of the prevailing rule of "joint and several" liability with "several" liability alone, in federal and state actions predicated on negligence. Under the "joint and several" rule, a claimant can collect all or part of his damages from any defendant found liable, irrespective of that defendant's proportionate fault. For example, an auditor-defendant that is held to be only 5 percent responsible, may be required to pay all of the damages awarded and, in seeking contribution from other tortfeasors, bears the risk that they may be judgment-proof.

Although many states have adopted comparative negligence laws that provide for liability apportionment based on the parties' relative degrees of fault, all but a few states continue to maintain the rule of "joint and several liability," and an evaluation of comparative fault is meaningless if a minor tortfeasor must bear the cost of all damages. If the "joint and several" rule is replaced with a "several" liability rule, a defendant would not be compelled to pay more than his proportionate share of the claimant's loss relative to other responsible persons.

2 SUITS BY THIRD PARTIES—THE PRIVITY RULE

The second target area for reform is the promotion of adherence to the privacy rule as a means of countering the growing tendency to extend accountant's exposure to liability for negligence to an unlimited number of unknown third parties with whom the accountant has no contractual or other relationship. The AICPA endorse the privacy rule formulated by the New York Court of Appeals, which permits third party negligence suits against accountants only where the accountant knows and understands that the financial statements are intended for use by that particular party, for a particular purpose, and the accountant shows that he understands this through some direct contact and communication with that particular party.

The AICPA strongly opposes the "foreseeability" rule adopted in New Jersey and a few other states, which allows a negligence suit to be brought by any third party whose reliance on financial statements audited or otherwise reported on by an accountant could reasonably have been foreseen by that accountant. The AICPA supports efforts to enact legislation that embodies the New York privacy rule. Through the submission of amicus curiae briefs, the AICPA also supports efforts to persuade appellate courts in states considering this issue to adhere to the privacy rule.

3 RACKETEER INFLUENCED ORGANIZATIONS ACT (RICO)

A third major area of concern is the proliferation of RICO claims against accountants and others. The AICPA supports corrective legislation to amend federal and state RICO statutes to provide that treble damage civil actions brought under those statutes may only be initiated against businesses and individuals who have been convicted of criminal violations under the act. Such legislation would confine the situations in which RICO suits can be filed to those in which public prosecutors have segregated those individuals who may fairly be charged with being involved in criminal activity from those who should not be subject to accusations of "racketeering."

If Congress enacts such an amendment, persons allegedly injured by conduct that has not led to criminal prosecution and conviction would still have available all other federal and state law remedies that apply to commercial disputes and alleged torts. The AICPA believes that the prior criminal-conviction requirement would be the most direct and precise way to return RICO to its intended use as a weapon against career criminals, and its abuse as a weapon in ordinary commercial litigation would end.

4 COSTS AND FRIVOLOUS SUITS

Another prime concern is deterrence of the increasing numbers of frivolous suits and attorneys' fees arrangements that provide incentives for the plaintiffs' bar to file lawsuits against "deep pocket" defendants, regardless of merit. The AICPA supports a variety of measures that would help to curb the abuses that have arisen under the current system, including legislative proposals to provide for the following:

(a) Adoption of the "British Rule," which imposes the costs of litigation on the losing party;
(b) Imposition of sanctions on parties or their counsel who bring baseless suits to engage in dilatory practices;
(c) Establishment of maximum or reduced levels for contingency fees;
(d) Abolition of punitive damages; and
(e) Reduction of the statute of limitations for negligence actions.

5 AIDING AND ABETTING LIABILITY

The AICPA also believes there is a need to clarify the scienter or knowledge standard by which auditors may be held secondarily liable for aiding and abetting a violation of law by those who are primarily responsible. Specifically, the AICPA supports legislative reforms to require a finding of actual knowledge by the CPA of the primary party's wrongdoing, as opposed to reckless disregard of facts which would have led to the auditor's discovery of such wrongdoing.

The need for reform in this area is dictated by the judicially adopted legal doctrines under which accountants are routinely charged with liability for violations of law by indirectly "aiding and abetting" another person in the commission of such violations. Although the CPA is the "secondary" and not the "primary" violator, he may be liable for the full extent of the loss. While an essential element of a fraud claim is scienter or knowledge of wrongdoing, many courts have held that reckless conduct of an auditor, such as ignoring an indication of some underlying fraud or impropriety in a client's business, is also sufficient to meet the scienter standard. Some courts do require actual auditor knowledge of the wrongdoing, but the uncertainty as to the scienter requirement itself breeds uncertain results, stimulates more litigation and increases the rate of settlement to avoid the risk of an uncertain outcome.