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AICPA Tort Reform Handbook: A Guide for State Societies

American Institute of Certified Public Accountants. Subcommittee on Accountants' Legal Liability

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AICPA TORT REFORM HANDBOOK

A GUIDE FOR STATE SOCIETIES

Subcommittee on Accountants' Legal Liability

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

AICPA TORT REFORM HANDBOOK

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I. INTRODUCTION

Legal liability reform has been a very high priority for the AICPA and state societies of CPAs for the past several years. It is likely to continue to be a major focus for the foreseeable future.

This handbook is intended as a basic primer on the most significant tort reform issues including; proportionate liability, privity, statutes of limitations and punitive damages.

This handbook is part of a series of materials produced by the Subcommittee on Accountants' Legal Liability, which includes two other guidebooks for state societies, Alternative Dispute Resolution Handbook, Implementing a Legal Liability GAP Analysis Study as well as the Legal Liability Update newsletter. In addition, the Subcommittee has produced media relations materials that state societies can use to promote their legal liability programs.

The AICPA Legal Liability Subcommittee hopes that this handbook will be useful to state CPA societies as they implement their GAP Analysis programs and as they continue to pursue legal liability reforms.

The AICPA Legal Liability Subcommittee is happy to assist you in any way possible as you undertake your legal liability reform program. If you have questions on legal liability issues,

please contact any of the following staff members:

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December, 1994

II. JOINT AND SEVERAL LIABILITY

Introduction

The following provisions which are derived from the AICPA/NASBA Uniform Accountancy Act (UAA) establish a general principle of proportionate liability in all actions for money damages (both common law and statutory) against accountants except fraud actions. (Fraud actions would continue to be governed by generally applicable rules.) An accountant would be liable for the portion of the plaintiff's injury caused by the accountant's conduct; the accountant would not be required to compensate the plaintiff for harm caused by others. Accountants' liability cases frequently involve situations in which an accountant issues a report on the financial statements of a company that subsequently becomes insolvent or has serious financial difficulties. Investors or creditors who allegedly relied on the report of the CPA firm sue the accountant and the company. Because the company is often either bankrupt or has no available assets, the accountant is -- in an alarming large number of cases -- the only solvent defendant left to answer the damages claim. Under a rule of joint and several liability, the accountant is required to bear the burden of the entire damage award, even if the harm was caused principally by others such as the company's management. This provision is intended to prevent that unfair result. It is not designed to eliminate the accountant's responsibility for causing another's loss but to only to avoid being unjustly punished.

Uniform Accountancy Act

The Uniform Act provision reads as follows:

SECTION 22 - UNIFORM ACCOUNTANCY ACT

PROPORTIONATE LIABILITY

(a) This Section applies to all causes of action of the type specified herein filed on or after the effective date.

(b) This Section governs any claim for money damages brought against any accountant; or any accounting firm registered, licensed, or practicing in this State; any limited liability company or limited liability partnership; or any employee or principal of such firm by any person or entity claiming to have been injured as a result of the practice of public accountancy by the defendant accountant or other person or entity.

(c) No judgment for money damages may be entered against any accountant, firm, employee, or principal described in subsection (b) (collectively referred to in this subsection as the "accountant") in an action covered by this Section except in accordance with the provisions of this subsection.

(1) If the party seeking a judgment for damages against the accountant proves that the accountant acted with the deliberate intent to deceive, manipulate or defraud for the accountant's own direct pecuniary benefit, the liability of the accountant shall be determined according to the principles that generally apply to such an action.

(2) If the accountant is not proven to have acted with the deliberate intent to deceive, manipulate or defraud for the accountant's own direct pecuniary

benefit, the amount of the accountant's liability in damages shall be determined as follows:

(A) The trier of fact shall determine the percentage of responsibility of the plaintiff, of each of the defendants, and of each of the other persons or entities alleged by the parties to have caused or contributed to the harm alleged by the plaintiff. In determining the percentages of responsibility, the trier of fact shall consider both the nature of the conduct of each person and the nature and extent of the causal relationship between that conduct and the damage claimed by the plaintiff.

(B) The trier of fact shall next determine the total amount of damage suffered by the plaintiff caused in whole or in part by the plaintiff, the defendants, and other persons alleged to have caused or contributed to the damage.

(C) The trier of fact shall then multiply the percentage of responsibility of the accountant (determined under (A)) by the total amount of damages (determined under (B)) and shall enter a judgment or verdict against the accountant in an amount no greater than the product of those two factors.

(D) In no event shall the damages awarded against or paid by an accountant exceed the amount determined under (C). The accountant shall not be jointly liable on any judgment entered against any other party to the

action.

(E) Except where a contractual relationship permits, no defendant shall have a right to recover from an accountant any portion of the percentage of damages assessed against such other defendant.

Conclusion

The Accountants' Legal Liability Subcommittee urges the adoption of the UAA provision. Local legal counsel can best advise the state society on the current state law on joint and several liability. The review by counsel may be a part of the Legal Liability GAP Analysis Study which is intended to help states move toward an ideal practice environment for CPAs with regard to legal liability issues. For more information, contact John Sharbaugh at (202) 434-9257, Virgil Webb, (202) 434-9222 or Paul Geoghan at (212) 596-6099.

III. PRIVITY

Introduction

In 1986, the AICPA Subcommittee on Accountants' Legal Liability developed a model statute providing for a privity requirement in lawsuits for negligent performance of accounting services that was ultimately incorporated into the Uniform Accountancy Act, Section 20 - Privity of Contract. The Section is based on the New York Court of Appeals decision in Credit Alliance v. Arthur Andersen & Co. It is designed to limit an accountant's liability to third-parties for negligence in connection with the performance of accounting services. The Section permits third-party negligence lawsuits only by those with whom the accountant directly contracted and other third-parties whom the accountant knew in advance would rely specifically on the financial statements or other material for a known particular purpose. It also requires that the accountant acknowledge that these third-parties will rely on the financial statements or other material through some direct contact or communication with that party.

This document is intended to serve as an explanatory guide to Section 20 and the policy considerations justifying its adoption. Before turning to the specific statutory provisions, some background on the development and current state of law is provided.

Review of the State Court Decisions

There is universal agreement among the state courts that the party who contractually engages the accountant can bring a lawsuit against the accountant for negligence in connection with that engagement. The issue on which there is disagreement, however, is the extent to which third-parties who have not contracted with the accountant should be allowed to sue the accountant for negligence when they rely to their detriment on audited financial statements.

State court decisions on this issue are generally divided into three different views. The Credit Alliance rule, embodied in Section 20, permits third-party negligence suits only in cases where the accountant knows and understands that the financial statements are intended for use by a particular party, for a particular purpose, and the accountant shows that he understands this through some sort of "linking conduct" with that particular party. At the other extreme, the "foreseeability" rule, currently in effect in New Jersey, Wisconsin and Mississippi, allows third-parties to recover their loses if the accountant could have reasonably foreseen that the third- party would rely on the financial statements audited or otherwise reported on by the accountant. A third approach is based on the Restatement of Torts, Second, Section 552, and permits recovery by third-parties who are either known or actually foreseen by the accountant, either personally or as a member of a limited class of persons, who would rely on the accountant's report on financial statements. Although this rule is somewhat more restrictive than the foreseeability rule, it does not include the requirement of conduct on the accountant's part linking him to the particular non-contracting party as called for by Credit Alliance.

The Rationale Behind the Credit Alliance Rule

The Subcommittee's decision to support the Credit Alliance rule was based on a careful policy analysis. This analysis recognized that although the auditor may be able to anticipate that certain third-parties, such as investors and creditors, might read and rely on the auditor's opinion, the auditor typically has no ability to limit their number or control or influence the magnitude of the risk they may take in reliance on the opinion. As Justice Benjamin Cardozo so aptly put it in the seminal case of Ultramares v. Touche,

> "If the 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 kindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences."

While it may arguably be socially beneficial to compensate these third-parties, this benefit is vastly out-weighed by the consequences of allowing a professional to be held liable for the negligent rendering of such an opinion to an unlimited number of unknown users of financial statements. Because the accountant is usually a secondary, not a primary participant in the circumstances giving rise to the loss and relies on information generated by the client, the

auditor is often victimized as well by the primary wrongdoer. In essence, the accountant is held liable for someone else's error or fraud from which the accountant's mistake may have stemmed. This is especially unfair when one considers the amount of compensation received by auditors for the services they perform compared to the disproportionately large risk they are asked to assume.

As the analysis shows, the foreseeability approach is clearly an inappropriate means of determining to whom an auditor should be responsible since essentially anyone can be a reasonable foreseeable third-party user. However, the analysis does not effectively explain why the Restatement standard is equally wrong. In fact, many state societies, when confronted with opposition to the UAA provision, have difficulty explaining why it is preferable to the Restatement standard.

The primary distinction between the UAA provision and the Restatement standard is the requirement for linking conduct demonstrating the accountant's awareness that the third-party intends to rely on the audited financial statements. The Restatement standard extends liability regardless of the presence of this linking conduct, as long as there is knowledge on the part of the auditor that some third- party will rely on the audited financial statements for a particular known purpose. Once this is established, all other similarly situated third-parties engaged in a similar transaction are entitled to hold the auditor responsible whether the auditor is aware of their existence or not.

Opponents of the UAA provision contend that the auditor should be held responsible to any third-party user of an audit report once it's shown that the auditor knows the report will be used by someone for a particular purpose. They insist that the identity of the third-party user is irrelevant so long as the auditor has consented to use of the opinion by someone. Since the report itself will not change, it is essentially irrelevant who it is that seeks to hold the auditor responsible. Hence, that the linking conduct requirement called for by the model statute is unnecessary.

The Subcommittee on Accountants' Legal Liability, continues to believe that the linking conduct requirement is appropriate for several reasons. First, the linking conduct requirement assures that the auditor has specific notice of who will use the financial statements and in what circumstances. While an audit conducted in accordance with GAAS is good for all purposes, this knowledge allows the auditor to warn the third-party that reliance on the financial statements may be misplaced if the transaction the third party is contemplating is inappropriate under the circumstances. It gives the auditor an opportunity to suggest additional due diligence steps which the third-party should take prior to completing the transaction in question.

Secondly and just as important, the linking conduct requirement clearly establishes that the third-party intended to rely on the opinion. As some courts and commentators have pointed out, it is far too easy for a third-party to claim reliance on audited financial statements. At the time a loan is made, a third-party can merely peruse the report before placing it in the

files for documentary purposes. Later on after a transaction or investment has failed a claim can be asserted against the auditor whether or not serious consideration was given to matters disclosed in the financial statements and the audit opinion. In essence, the model statute prevents the opinion and financial statements from becoming an insurance policy, taken out of the drawer and called upon for use only after things have gone wrong. The linking conduct requirement clearly establishes the level of the third- party's reliance on the audit opinion at the time the transaction is under consideration.

Finally, if the auditor knows who has received the audit opinion the auditor can apprise that person of facts existing at the date of the auditor's report that are discovered by the auditor subsequent to the issuance of the report. This was precisely the problem in Chevron Chemical Co. v. Deloitte & Touche, a Wisconsin case in which the Institute filed an amicus brief. In Chevron, Deloitte examined and reported on the financial statements of its client American Fuel and Supply Company. Subsequent to the issuance of the audited 1985 year end financial statements, Deloitte learned, through no fault of Deloitte, that the financial statements materially overstated the company's assets and income. The firm urged AFSCO to disclose these facts but they refused to do so. AFSCO also refused to reveal to whom the financial statements had been provided and threatened to sue Deloitte if Deloitte disclosed the information. As a result, Deloitte resigned from the engagement and advised the only entity it knew was still relying on the 1985 financial of the withdrawal of its opinion.

The plaintiff, one of AFSCO's vendors, who was unknown to Deloitte, sued alleging that the

firm's failure to notify it constituted negligent and intentional misrepresentation. Although the case is still under appeal, the trial court found for the plaintiff, allowing a $1.5 million judgment to be entered against the firm. As a result, at least in this case, Deloitte was required to notify all foreseeable third-party users of the financial statements, whether known to Deloitte or not.

More clearly than any other, the case demonstrates why the linking conduct requirement is necessary. Had Deloitte specifically known the identity of the plaintiff as called for by the model statute, it could have simply provided notification so that the loss could have been avoided. It's lack of knowledge precluded this possibility.

Applicability and Scope

Paragraph b of UAA Section 20 delineates the applicability and scope of its terms. The statute is drafted to cover the broadest possible category of suits against accountants for negligent performance of accounting services. It covers suits against an accountant licensed to practice in the state or practicing in the state and it applies to suits arising out of every form of engagement, including engagements to compile, review, audit or otherwise report on financial statements. The Section even covers engagements to "certify" financials, because, although that term has largely become obsolete, it is still used in the accountancy statutes of many states.

The one crucial limitation on the reach of the Section is that it is limited to actions predicated

on negligence as opposed to fraud. The AICPA does not regard the legal standards applicable to accountants' liability for fraud as overexpansive. The Institute believes that active and knowing wrongdoing by accountants should be judged by the established and stern standards that are currently applied, but that accountants' liability for negligence -- for unintentional mistakes and oversights -- should not be extended to impose liability on accountants for indeterminate losses incurred by a potentially unlimited class of unknown users of financial statements.

The Privity Requirement

Paragraph C of Section 20 incorporates limitations on third-party suits against accountants adopted by the New York Court of Appeals in the Credit Alliance decision. Thus, the Section limits the class of persons who may sue accountants in negligence to those in direct privity of contract with the accountant (paragraph (c)(1)), or third-parties who meet a tripartite test derived from Credit Alliance (paragraph (c)(2)). Essentially, this test ensures that the accountant will only face liability to persons or entities specifically known and identified to the accountant as parties who would rely on the financial statements, based on direct contact and communication between the accountant and the third-party.

Uniform Accountancy Act

SECTION 20 - UNIFORM ACCOUNTANCY ACT

PRIVITY OF CONTRACT

(a) This Section applies to all causes of action of the type specified herein filed on or

after the effective date.

(b) This Section governs any action based on negligence brought against any accountant or firm of accountants practicing in this State by any person or entity claiming to have been injured as a result of financial statements or other information examined, compiled, reviewed, certified, audited or otherwise reported or opined on by the defendant accountant or in the course of an engagement to provide other public accountancy services.

(c) No action covered by this Section may be brought unless:

(1) The plaintiff (1) is issuer (or successor of the issuer) of the financial statements or other information examined, compiled, reviewed, certified, audited or otherwise reported or opined on by the defendant and (2) engaged the defendant accountant to examine, compile, review, certify, audit or otherwise report or render an opinion on such financial statements or to provide other public accountancy services; or

(2) The defendant accountant or firm: (1) was aware at the time the engagement was undertaken that the financial statements or other information were to be made available for use in connection with a specified transaction by the plaintiff who was specifically identified to the defendant accountant, (2) was aware that the plaintiff intended to rely upon such financial statements or other information in connection with the specified transaction, and (3) had direct contact and communication with the plaintiff and expressed by words or conduct the defendant accountant's understanding of the reliance on such

financial statements or other information.

Conclusion

The Subcommittee on Accountants' Legal Liability believes that judicial decisions rejecting the privity rule and, thereby, increasing accountants' exposure to liability for negligence, will have a chilling effect on the practice of accountancy. One means of addressing this problem is UAA Section 20 which the Subcommittee continues to endorse as the best standard for resolving third-party liability questions. This trend can be reversed by legislative action at the state level through the lobbying efforts of the state societies. The Institute welcomes the opportunity to provide assistance and guidance in this effort. Local legal counsel can best advise the state society as to the current state law on privity. Counsel's review may be part of the Legal Liability GAP Analysis Study which is intended to help states move toward an ideal practice environment for CPAs with regard to liability issues. For more information, contact John Sharbaugh at (202) 434-9257, Virgil Webb at (202) 434-9222 or Paul Geoghan at (212) 596-6099.

IV. STATUTE OF LIMITATIONS

Introduction

The statute of limitations are provisions stating that lawsuits must be brought within a certain time frame. It has been suggested that the primary purpose of a limitations period is fairness to a defendant and that there is also a need to protect the judicial system from the burden of adjudicating stale and groundless claims. Limitation periods make it unnecessary for defendants to investigate and prepare a defense where the lawsuit is filed after the expiration of the time limit because the law presumes memories have faded and witnesses have disappeared.

The issue is important to CPAs for several reasons. Although CPAs customarily retain carefully documented workpapers, those workpapers may not tell the full story behind the decisions made by the CPA during the engagement. The workpapers may not contain communications with the client that detail the advice and information the CPA provided during the engagement. Because workpapers may not tell the full story, the CPA will need to have access to the staff person who actually provided the accounting service. If the claim is brought several years after the work has been completed, there is a substantial likelihood that the staff person will no longer be available due to staff turnover or retirement. Even if the staff person can be located, particularly if a number of years have passed, there is a very

serious doubt whether the CPA will be able to recall with any degree of accuracy why a position was taken. In addition, the memory of the client too is likely to fade and thus deprive the CPA the benefits associated with cross examination. In addition, even though workpapers may not be sufficient to refute claims, a lengthy statute of limitations may require CPAs to retain documents indefinitely at enormous cost. There is also the issue of insurance. If the limitations period is lengthy, it is possible that a CPA may be sued beyond the time period for which the CPA can obtain extended reporting insurance coverage.

Statutes of limitations vary from state to state. Even within a given state, the limitations period may differ depending on the type of lawsuit, for example, one period may be applicable to lawsuits based on contract and another may be applicable to a lawsuit based on a tort. The period may vary within a given state for different types of torts or different types of contracts. There can be ambiguity as to when the time period begins to run. The period may begin on the date of the alleged act or omission that gave rise to the lawsuit, it may begin based on the date the plaintiff discovers the alleged error or it may begin to run on the date the plaintiff suffers harm from the alleged error or omission. There may be additional uncertainty as to how the date is calculated even within each of these rules. For example, it may be held that the harm in a tax case occurs when the plaintiff receives notice that a penalty is due or it may be on the date the penalty is actually paid. These variations make it impossible to state any general rule. The issue is important to accountants because of the uncertainty over potential liability exposure under these different state limitations periods.

This issue has been a part of the AICPA Accountants' Legal Liability Subcommittee's tort reform initiative for many years. The AICPA strongly urges state societies to work for enactment of a uniform statute of limitations for lawsuits against accountants. The same limitations period should apply whether the suit is brought in negligence or breach of contract.

The AICPA/NASBA Uniform Accountancy Act includes Section 21, a statute of limitations provision. The section establishes a uniform statute of limitations applicable to negligence and breach of contracts actions of one year from the date of discovery of the claim, but in no event more than three years from the date of the completion of the accounting services that are the subject of the lawsuit or within three years from the date of the initial issuance of the accountant's report, whichever is earlier. The section is applicable to all public accounting services as they are broadly defined in the Uniform Act.

The Uniform Accountancy Act

The Uniform Act provision reads as follows:

SECTION 21 - UNIFORM ACCOUNTANCY ACT

UNIFORM STATUTE OF LIMITATIONS

(a) This Section applies to all causes of action of the type specified herein filed on or after the effective date.

(b) This Section governs any action based on negligence or breach of contract brought against any accountant, or any accounting firm practicing in this state by any person

or entity claiming to have been injured as a result of financial statements or other information examined, compiled, reviewed, certified, audited or otherwise reported or opined on by the defendant accountant as a result of an engagement to provide public accountancy services.

(c) No action covered by this Section may be brought unless the suit is commenced on or before the earlier of:

(1) one year from the date the alleged act, omission or neglect is discovered or should have been discovered by the exercise of reasonable diligence;

(2) three years after completion of the service for which the suit is brought has been performed; or

(3) three years after the date of the initial issuance of the accountant's report on the financial statements or other information.

Adoption of the above provision would promote uniformity among the states and would reduce uncertainty for accountants who provide services to clients in more than one state. In addition, it would eliminate the ability of a plaintiff to evade the statute of limitations by picking and choosing between a negligence or a contract theory as the basis for the complaint against the accountant.

The AICPA also urges the states to adopt the Uniform Act provision because it strikes a reasonable balance between the plaintiff and the accountant. If the plaintiff discovers, or should have discovered, the alleged error it is reasonable to require the plaintiff to take action with some haste to seek redress of the alleged injury. In addition, the three-year outer

limit for bringing an action is reasonable. As was stated at the beginning of this section, the statute of limitations is designed to prevent the unfairness associated with bringing a lawsuit after memories have begun to fade and evidence may no longer be available. After three years, it is possible the records may have been destroyed, certainly witnesses may no longer be able to recall all the relevant facts surrounding the engagement that gave rise to the lawsuit.

Overview of Limitations Provisions

There is no uniformity in the states with regard to limitations periods. A review of the states indicates that, for malpractice actions, the rule may run from the "one-and-three" formulation set out in the Uniform Accountancy Act to a limit based on the date of discovery, in effect an unlimited period. For contract actions the range is similarly broad, ranging from one year to as many as fifteen years.

Conclusion

Because of the wide variation in state laws, it is essential that state societies utilize local legal counsel to review the situation in each particular state. Local counsel will be able to provide advice as to how the courts are likely to interpret the statute of limitations provisions in the state. Review by legal counsel should be a part of the Legal Liability GAP Analysis Study which is intended to help states move toward an ideal practice environment for CPAs with a regard to legal liability issues. For more information, contact John Sharbaugh at (202) 434-9257, Virgil Webb at (202) 434-9222 or Paul Geoghan at (212) 596-6099.

V. FORM OF PRACTICE

Introduction

At the beginning of the 1990's, the choice of forms of practice open to accounting firms was generally limited by state laws to; sole proprietorships, general partnerships or professional corporations. Because of problems and limitations associated with those forms, CPAs have begun to examine additional forms of organization. Particularly since the membership vote that changed Rule 505 of the AICPA Rules of Professional Conduct in 1992, the form of practice issue has been a very high priority for state societies across the country.

It is important to remember that there is no one form of organization that is perfect for all CPA firms. The AICPA strongly urges elimination of arbitrary restrictions on forms of organization in state laws so that firms may choose for themselves the form, or combination of forms, that best meet their individual needs.

In the wake of a business failure, CPA firms are often one of the targets of a lawsuit. Because of the forms of organization in which CPAs must practice in many states, if a settlement is reached or if the firm is found culpable, innocent members of the firm can be held personally liable for the acts of others within the firm, even though they did not actively participate in the event or engagement giving rise to the lawsuit.

Many have argued that the current liability situation may have a deleterious effect on the profession, making it difficult for firms to recruit the best and brightest college graduates and causing existing members in firms to pursue other career options. In order for the profession to meet its responsibilities to the public and to assure that investors and creditors can continue to have confidence in the financial information developed by CPAs, it is important that the profession be able to continue to attract and retain highly qualified people.

Unless action is taken to address the liability concerns of CPAs, the cost of accounting services may rise. Accounting services may also become unavailable as firms reduce or eliminate their audit practices. Certainly, CPAs may be forced to avoid high risk clients such as new businesses or smaller businesses that pose a higher risk of failure. These higher risk clients may be the ones who most need accounting services. All of these developments would have an adverse effect on the capital markets. Clearly, none of these possible scenarios are in the public interest.

The inequitable litigious environment for CPAs has increased the accounting profession's interest in a broad range of initiatives to assist CPAs in limiting their liability exposure. Among the many activities being undertaken is the effort to increase the forms of organization available to accountants.

It should be stressed that the additional forms of practice under consideration will not shield the accounting firm in the event of a lawsuit, nor are they intended to shield the individuals

who may be responsible for a negligent act or omission. The additional forms of practice are designed to protect the personal assets of innocent firm members or shareholders who had no part in the negligence. An injured party will always be able to seek redress from those actually responsible for the harm and from the firm itself. In addition, even innocent firm members may lose their investment in the firm.

The profession's sole objective is to eliminate restrictions on the types of business entities that can be used by accounting firms so that they may operate on an interstate basis in forms that will limit the personal liability of innocent CPAs. The changes also will have added benefits by allowing firms to compete cost effectively in the market place and to position themselves for future growth. For example, the nature of firms has changed. There is increased need for specialists in order to provide quality services, to keep accounting firms from being at a competitive disadvantage with respect to other businesses in providing consulting and other non attest functions. In addition, larger multi-state firms have become common.

Currently, accountants in many states may use only three forms of organization; sole proprietorship, partnership or professional corporation. However, the options were not always so limited and they have evolved over time.

The restrictions on forms of practice were apparently placed on the CPAs by the profession itself. In the early days of the profession, accounting corporations were fairly common. As

early as 1908 there were attempts by the AICPA's predecessor organization to amend the by-laws to prohibit members from concealing their identity behind a corporate name. A ban on corporate practice was not adopted until 1938. In 1969, the AICPA rules were amended again to allow members to practice in Professional Corporations (PCs). In early 1992, the membership voted overwhelmingly to amend Rule 505 to allow members to operate in any "... form of organization permitted by state law or regulation whose characteristics conform to resolutions of Council."

Thus, because of the tremendous increase in liability exposure for CPAs, the time appears ripe for another evolutionary change in the form of practice area for CPAs. Change that will provide a more rational basis for individual liability exposure.

Rationale

The unfairness of the current tort system and the vulnerability of CPAs require the profession to seek legislative changes that will allow firms of all sizes to protect their owners from unreasonable liability. These changes in form of practice do not insulate the firm from liability, nor are they designed to shield any person who is actually negligent. Those who may have suffered a loss due to negligence on the part of a CPA firm will still be able to sue for their damages. The change is only intended to bring rationality to a system which puts the personal assets of innocent CPAs at risk.

A limit on forms of organization requires a CPA to risk not only the CPA's investment in

the firm, but also personal assets that may not have any connection with the CPA's practice. In effect, a CPA must gamble that during the course of the innocent CPA's career, no one in the firm will make an error that will require the innocent CPA to give up what has been acquired over a lifetime. Given the unfairness of the system, it is unreasonable to expect CPAs to continue to make that wager.

No one could have envisioned that CPAs would be subjected to the excessive legal liability that exists in today's climate. It has been suggested that the only legitimate reason for regulating the forms of practice is to protect the public. Today, there is a risk that the public will not be served unless the forms of organization open to CPAs are expanded. Costs may rise and the availability of accounting services may decrease unless these modest reforms are made. The existing situation may adversely affect the integrity, the utility and reliability of the audit function and the ability of the profession to perform that function.

The public policy issue has already been resolved. All states allow CPAs to use the Professional Corporation (PC) a form which is designed to limit personal liability. The new forms of practice only allow CPAs to accomplish easily what they could always have done in a cumbersome fashion by forming a partnership of PCs. There is no rational reason for treating CPA firms differently from other professions. Innocent individuals in CPA firms do not need to be exposed to the threat of unlimited liability to ensure that they perform their work completely.

Overview of Forms of Practice

There is no single form of practice that will meet the needs of all firms in all states. Because of the vast diversity in the sizes and types of CPA firms across the country, it is important to seek legislation that will allow for all options. Each firm can then choose the form, or combination of forms, that best meet its individual needs. The following is a brief discussion of the forms of organization and changes needed to allow CPA firms to make use of them:

a. Professional Corporations (PCs)

Currently, the PC is widely used across the country. However, there are some drawbacks associated with the PC. In the majority of states, the PC laws require all shareholders to be licensed in the state. This feature makes the PC unworkable for multistate firms that include CPAs licensed in other states. In addition, the liability provisions in PC laws vary from state to state. In some states, the PC shareholders may have liability akin to partners in a partnership, which exposes them to virtually unlimited personal liability.

b. General Corporations (GCs)

Only a few states currently allow CPAs to form general corporations. The chief advantage of the GC is that innocent shareholders are generally not liable for negligent acts committed by other shareholders. They are only responsible if they were personally involved in the negligent act or omission. In order to allow CPAs to use GCs, it will usually be necessary to amend the accountancy laws and regulations. It may also be necessary to amend the GC

and PC laws so that professions are permitted to form GCs.

c. Limited Liability Companies (LLCs)

The Limited Liability Company (LLC) is a recent development. It is a hybrid business entity that combines the characteristics of a corporation and a partnership. It has been suggested that due to their tax benefits and operational flexibility, LLCs are likely to become a major economic development vehicle. An LLC is generally treated like a corporation for liability purposes and permits its members to limit their personal liability exposure. In addition, if properly structured, LLCs may be treated as partnerships for federal tax purposes. The first LLC law passed in Wyoming in 1977. The LLC did not attract widespread attention until 1988 when the IRS ruled that Wyoming LLCs would be treated as partnerships for tax purposes.

The AICPA has worked with other national groups promoting LLCs. It has also provided information and assistance to state societies that have worked on the issue. From the perspective of the accounting profession, the ideal LLC law should:

1) Authorize professions to use LLCs.
2) Limit liability of members, managers, employees and agents in professional LLCs.
3) Provide for organizational flexibility for professional LLCs.
4) Include provisions that adequately allow for interstate practice by professional LLCs.

d. Registered Limited Liability Partnerships (LLPs)

Another very recent phenomenon is the Registered Limited Liability Partnership. The LLP is not a new form, it is merely a type of general partnership. State societies across the country have been active in working to pass LLP legislation. Thus far, nearly two dozen jurisdictions have passed laws creating or recognizing this type of entity and the number is expected to continue to grow rapidly.

Partners in an LLP may be insulated from personal liability for errors and omissions of other partners. In some states, partners in LLPs may have the same liability protection as members of an LLC. The LLP may also provide an advantage in terms of ease of conversion for existing CPA partnerships. In addition, if legislation allowing creation of LLPs is passed, it may be possible for CPAs to form LLPs without amending the accountancy laws and regulations. In all states foreign LLPs can register and practice accountancy even if their state has not passed an LLP law. State societies across the country have been extremely active in promoting LLP legislation.

In early 1994, the AICPA Accountants' Legal Liability Subcommittee provided state societies with sample LLP testimony and talking points. The Subcommittee also provided a model Limited Liability Partnership statute to state societies.

e. <u>Accountancy Laws</u>

Passage of an LLC law or legislation amending the GC law may not automatically provide CPAs with greater organizational flexibility. Before CPA firms may take advantage of all

the additional forms of practice, it will usually be necessary to amend the state accountancy law, the accountancy regulations and the state code of ethics. In making amendments to the accountancy law, it is beneficial to amend the law broadly so that it will not be necessary to reamend the law each time a new form of practice is developed.

The AICPA/NASBA Uniform Accountancy Act, which was published in 1992, has recently been revised to provide for additional forms of practice for accounting firms. The Uniform Act defines "firm" to mean "... a sole proprietorship, a corporation, a partnership or any other form of organization."

Strategy and Status

State societies in all regions have been extremely active in pursuing form of practice legislation. Over the past several years, virtually all state societies have been working on some aspect of this issue. Many have spearheaded coalitions formed to enact LLC and LLP legislation. Many are also working to complete other changes necessary to allow CPAs to use additional forms of practice and to modify the PC and GC laws.

In general, there has been wide support for the form of practice efforts in the states. However, there has been concern in some of the states that, if a large number of businesses shift to the LLC form, there could be a revenue loss to the states.

Currently, over forty-five states have passed LLC legislation. The accountancy laws in

nearly two dozen states have been amended to allow CPAs to use additional forms of practice. Limited Liability Partnership legislation has passed in nearly two dozen states. In addition, licensing authorities in all states have indicated that they will allow LLPs formed in other states to practice public accountancy.

The status with regard to GCs is less clear. In general, most states have not yet modified their laws. Currently, it appears that approximately a dozen states may allow CPAs to form GCs. In a few cases the existing law may be broad enough to allow CPAs to form general corporations. In other cases, states have specifically amended their laws to allow CPA GCs.

Conclusion

It is in the public interest that quality accounting and consulting services be available at a reasonable cost. In order to assure that the profession continues to be able to provide the highest possible quality of service to the public, it is essential that the states move quickly to enact legislation to deal with this issue. Removal of restrictions on forms of practice will benefit the public as well as firms of all types and sizes.

Because of the wide variations in state laws, it is essential that state societies utilize local legal counsel to review the situation in each particular state. Local counsel will be able to give advice on how the courts are likely to interpret the laws and how the proposed and existing legislation dovetails with other state statutes. The review by local counsel can be a part of the Legal Liability GAP Analysis Study which is intended to help states move toward

an ideal practice environment for CPAs with regard to legal liability issues.

For more information, contact John Sharbaugh at (202) 434-9257, Virgil Webb at (202) 434-9222 or Paul Geoghan at (212) 596-6099.

VI. PUNITIVE DAMAGES

Introduction

In 1989 the AICPA Subcommittee on Accountants' Legal Liability developed model punitive damages legislation in response to the U.S. Supreme Court decision in Pacific Mutual Life Insurance Company v. Haslip. Although the decision had established that the due process clause of the Fourteenth Amendment should limit juries' discretion in setting punitive damages amounts, it gave little or no guidance for determining how punitive damages awards should be calculated. The Subcommittee's model legislation was designed to provide that guidance. It included provisions establishing reasonable limits on the amount of punitive damages which limited punitive damages awards to twice the defendant's actual or expected gain from the wrong committed. In the case of the accountant's malpractice cases it was assumed that these would at most constitute the audit fee.

At about this same time, the American Tort Reform Association also developed a model punitive damages bill that was slightly less restrictive. Included in the ATRA model bill were provisions limiting punitive damages awards to $200,000 or an amount equal to the claimant's compensatory damage award, whichever was greater. In addition, the model bill contained requirements that claimants who sought punitive damages must establish by clear and convincing evidence that any harm done was the result of intentional or malicious misconduct involving a conscious intent to cause injury. It also required that punitive damages issues be considered only in a separate proceeding after compensatory damages

were awarded.

The rationale behind the more restrictive AICPA model related directly to the nature of accounting malpractice litigation. The Subcommittee believed that ATRA's approach which tied punitive damages to the compensatory award could result in large punitive damages awards against accountants. The ATRA model, while attempting to accommodate the profession's needs was also designed to appeal to a broader spectrum of the business community. However, since accounting malpractice actions typically include compensatory awards that are much larger than product liability or negligence cases, it was believed that a formula that tied the punitive award to the amount of the compensatory damages would not necessarily be beneficial.

Since the creation of these two model bills, the business community has made efforts to pass punitive damages legislation. Unfortunately, based on a review of the punitive damages statutes that have been passed to date, it is apparent that the recommended AICPA provisions with respect to limitations have received little support. Indeed, only Kansas has provisions that are at all similar to those recommended by the AICPA. In contrast, a number of states have passed punitive damages legislation containing provisions that require calculation of the award by application of some multiple to the compensatory damages award similar to the ATRA proposal. These latter provisions generally use multiples of up to four times the compensatory damages award. In addition, some bills limit the award to a specific dollar amount.

In addition to these legislative activities, developments in the judicial arena continue to unfold. For instance, the Supreme Court reconsidered the constitutionality of punitive damages awards in TXO Productions Corp. v. Alliance Resources Corp. a case in which the major firms submitted an amicus brief that raised due process objections to large punitive damages awards and discussed the problems inherent in punitive damages awards that are calculated by application of some multiple to the compensatory award. Unfortunately, the Court's decision did little to mitigate the punitive damages problem. The Court ruled that a punitive damages award of $10 million - 526 times larger than the $19,000 in actual damages caused by the misconduct - did not violate the company's due process rights. Because the Court acknowledged that the award was not so grossly excessive that it must be overturned, it would appear that limits on punitive awards or at least specific guidance as to how such limits should be calculated will not be forthcoming from the Supreme Court.

As a result, the business community has continued to propose punitive damages legislation. However, since the previously recommended AICPA model has not been given serious consideration, the Subcommittee decided to reconsider its approach to punitive damages limitation provisions. The Subcommittee agreed that provisions that tie the amount of the award to some multiple of the compensatory award can be risky but are probably the only avenue likely to gain any support. Nevertheless, in order to improve on the formula set forth in the ATRA model, in cases where there is more than one alleged wrongdoer the Subcommittee recommended provisions requiring that the amount of compensatory damages which will serve as a foundation for any punitive damage award be the amount a trier of fact

finds is due solely to the conduct of the individual defendant involved, and not to the total amount of compensatory damages awarded, on a joint and several basis, against all defendants. This recommended provision requires that the defendant's percentage of responsibility for the plaintiff's losses (his proportion of fault) be calculated as a percent before a punitive damages award can be entered. This percentage is then applied to the compensatory damages awarded on a joint and several basis which amount is then multiplied by one. The trier of fact can also reduce the amount of the award upon consideration of the gain realized by the defendant.

The State Societies should consider proposing these provisions whenever they are confronted with punitive damages legislation that only contains requirements limiting punitive damages to some multiplier of the compensatory award. You may also want to submit the model bill as a stand alone initiative.

AICPA Model for Computation of Liability for Punitive Damages

Analysis

The following legislation is designed to govern the computation of punitive damages. In cases where the trier of fact has decided to award punitive damages based on the application of the relevant standards, the legislation will govern the calculation of the award. The legislation requires a jury to determine the percentage of a particular defendant's responsibility for the compensatory award. The punitive damages award is then limited by this determination. A reasonable relationship is therefore established between the behavior of the particular

defendant and the amount of the punitive damages award. In cases where a defendant's responsibility for a particular plaintiff's losses is small, the defendant is protected from a punitive damages award that is disproportionate to the nature of the conduct in cases where the compensatory award is large.

Model Legislation

In any action in which punitive damages have been determined appropriate, the maximum amount of punitive damages shall be calculated by the trier of fact in the following manner:

(a) The trier of fact shall determine the percentage of fault of the claimant and all other persons and entities (whether or not a party to the case) who caused or contributed to the injury, damage or economic loss. In determining the percentages of fault, the trier of fact shall consider both the nature of the conduct of each party at fault and the extent of the causal relation between the conduct and the damages claimed.

(b) The trier of fact next shall multiply the percentage of fault of any defendant liable for punitive damages by the amount of the compensatory award.

(c) Punitive damages, if any, that are awarded against a particular defendant shall not exceed the product of the amount determined by application of subdivision (b) times one.

(d) The maximum amount of punitive damages so calculated can be reduced by the trier of fact upon consideration of the monetary benefit derived by the particular defendant.

Conclusion

Local legal counsel can best advise you as to the current state law on punitive damages. Counsel's review can be part of the Legal Liability GAP Analysis Study which is intended to help state societies move toward an ideal practice environment for CPAs with regard to liability issues. For more information, contact John Sharbaugh at (202) 434-9257, Virgil Webb at (202) 434-9222 or Paul Geoghan at (212) 596-6099.

VII. WORKING GLOSSARY

ALTERNATIVE DISPUTE RESOLUTION (ADR) - A term used to describe a variety of means that are used to resolve disputes, other than litigation. Arbitration and mediation are the most commonly used forms of ADR. ADR proceedings are private and do not usually entail the adverse publicity associated with litigation.

ARBITRATION - A dispute resolution proceeding in which a third party (other than a court) decides the outcome of a dispute or controversy after a hearing at which both sides are permitted to submit proof and argue their respective cases. Arbitrations, which can either be binding or non-binding, tend to be less formal than court proceedings and do not normally permit the parties to engage in extensive pre-hearing discovery, making them less costly than a trial.

FEE SHIFTING - A process often currently utilized in judicial proceedings or proceeding (but only available in certain court proceedings) wherein the losing party is required to pay the legal fees of the victorious party. Fee shifting tends to discourage the parties from advancing frivolous claims and defenses.

GAP PROGRAM - A project initiated by the AICPA under which each State Society is encouraged to analyze the laws of its state affecting the liability exposures of CPAs and to set legislative goals for improving the legal environment. The program is intended to help states "bridge the GAP" between the current legal liability environment and the ideal environment.

GENERAL CORPORATION FORM - The traditional general, or Subchapter "C", corporate form of business entity traditionally used by commercial enterprises.

LIMITED LIABILITY COMPANY (LLC) - An LLC is a hybrid between a corporation and a partnership. It has the personal liability protection of a corporation and the flow-through tax benefits of a partnership.

LIMITED LIABILITY PARTNERSHIP (LLP) - An LLP is a form of general partnership which provides protection to the personal assets the firm's partners for the debts and liabilities of the partnership so long as the partner was not personally involved in the wrongful actions giving rise to the liability. LLPs will normally be treated as partnerships for income tax purposes.

LITIGATION SUPPORT - Providing assistance to parties engaged in a lawsuit through such means as expert witness testimony, business or asset valuation, damage assessment, etc.

MEDIATION - A method of settling disputes in which the parties are assisted through conciliation and advice by an independent third party or parties. Mediation can also be used

in conjunction with a litigation to help focus the parties on important issues.

PRIVITY - Privity is a legal doctrine designed to identify those persons who stand in a sufficiently close relationship to a professional to be owed a duty of due care by the professional. Accordingly, only persons deemed to "in privity" with the professional are entitled to assert negligence claims. There are generally three standards of privity used by the various states: 1) the "near privity" standard under which a CPA is liable only to those by whom the CPA has been engaged as well as those with whom the CPA has a relationship approaching that of an accountant-client relationship; 2) the "Restatement" standard where a CPA owes a duty of due care to third parties the CPA knew would rely upon the CPA's work; and 3) the "foreseeability" standard under which a CPA is liable to any party the CPA could have "reasonably foreseen" would rely on the CPA's work.

PROPORTIONATE LIABILITY - A method for apportioning liability between co-defendants advocated by the AICPA. Under a proportionate liability system a defendant found liable would only be responsible for that portion of the plaintiff's damages corresponding to the percentage of responsibility of that defendant relative to the responsibility for such damages accorded by the court (or jury) to all responsible persons, including the plaintiff. Most courts currently utilize a "joint and several" standard under which any defendant (regardless of its degree of fault) may be held responsible for the entire amount of damage incurred by the plaintiff, a system that often works unfairly against CPA firms which are frequently the only financially viable defendant in a litigation.

PUNITIVE DAMAGES LIMITATIONS - Punitive damages are a form of damages awarded by a court over and above the damages awarded to compensate a plaintiff for its injuries to punish a defendant for egregious conduct, often including intentional wrongdoing or fraud. The threat of nearly unlimited punitive damages causes many defendants to settle rather than face a potentially devastating damage award.

QUALITY REVIEW PRIVILEGE - An AICPA legislative proposal which would ensure that any documents or other information generated as part of the quality review process would remain confidential and not be introduced as evidence in a legal proceeding.

STATUTE OF LIMITATIONS - Statutory provisions stating that lawsuits be brought within a certain time frame. They are intended to promote timely filing of lawsuits while records are available and memories still fresh. The AICPA recommends a limitation of one year from the earlier of (a) the date the alleged act or omission is discovered or should have been discovered in the exercise of reasonable diligence, or (b) three years after the CPA completes the services for which the suit is brought.

STATE SOCIETY - A generic term used throughout the text to identify professional associations representing CPAs.

UNIFORM ACCOUNTANCY ACT (UAA) - A model statute developed jointly by the AICPA and NASBA containing recommended statutory language and rules for a wide variety of issues affecting the accounting profession which includes legal liability reform provisions dealing with privity, proportionate liability and the statute of limitations.