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Accountant's Liability Newsletter, Number 22, July 1990

American Institute of Certified Public Accountants. Professional Liability Insurance Plan Committee

ACCOUNTANT'S LIABILITY NEWSLETTER

Cop

AICPA Professional Liability Insurance Plan

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Litigation Support Services: *Caveat Venditor* "Let The Seller Beware"

Dennis L. Bissett, Assistant Vice President
Crum & Forester Manager Corp. (Illinois)

In our function as claim handlers for the AICPA Plan insureds, we are afforded a unique opportunity to see and assess developing trends in accountants' legal liability claims. The actual claim information we receive is current, directly reflecting present engagements that are coming under attack from ever more resourceful plaintiffs' attorneys. In this position, we have noticed an increasing trend by accountants to enter into litigation support services (LSS). While the number of new claims involving LSS is not large, it is an expanding area, one which a practitioner should not enter without full knowledge.

In our discussions with insureds who have experienced a claim as a result of litigation support services, most practitioners are relatively new to the type of engagement, i.e. three years or less experience. While they may be experienced practitioners in other specialties, their entry into litigation support services is new. The advantages of establishing such a practice are several, and have been published in various trade journals. Courses, likewise, have been established to explain the establishment and growth of the litigation support services practice. Discussion concerning the potential legal liabilities of such engagements has not, however, been as widely publicized. As one insured stated, "I went into this area thinking all I had to do was call a few attorneys, get my name circulated, assess other people's work, and be finished. I had no idea that any legal liability could attach to me. It seems so straightforward."

No area of practice is, or will be, immune from a claim or potential claim. As your profession and practice evolve and are responsive to changes in clients and their needs, so too will legal liability concepts develop and challenge those activities. As a general rule, each area of your practice should be reviewed at least annually to ensure that engagements with potential legal liability are identified. Such should not be an afterthought.

But where are claims occuring in litigation support services? Note the following examples, taken from actual claims filed against AICPA Plan insureds.

Business Litigation

Expert accountant advice is necessary in most business litigation. Oftentimes an accountant is asked to supply and support his/her view of values. This could involve a sale of assets, stock valuation, or informa-

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tion to confirm a loan application. The accountant can later be sued by a disgruntled client who feels the accountant's work should have provided more benefit.

In a recent claim, a franchisee was sued by the franchisor for conflict of interest and failure to follow the terms of the franchise agreement. The franchisor's attorney retained the insured accountant as expert witness to provide damage calculations. The calculations were based upon formulas provided by the attorney.

The insured completed his calculations as requested. Subsequently, the franchisee made an offer to settle. Based upon the insured's calculations, this offer was rejected as insufficient. The case was ultimately tried to verdict with an award to the franchisor that was almost identical to the franchisee's earlier offer. In the trial, the judge characterized the damage calculations as exorbitant.

While in the end the franchisor received a fair award for his damages, he then sued his attorney and expert accountant. The allegation against the accountant was that he should have checked the formula provided by the attorney for reasonableness. As he did not, the franchisor thus had an inflated view of his claim and could have settled early with the franchisee, thus saving legal fees.

Divorce

Many litigation support engagements involve the valuations of marital assets for divorce proceedings. These calculations become a part of property settlements. While seemingly straightforward, i.e., both parties have personal evaluations, each has attorney representation, the parties negotiate the final agreement which is then court approved, remember, no area is immune. Several claims have been filed by disgruntled parties. The allegations are that if the insured had more accurately and aggressively completed the evaluations the complaining party could have received a larger settlement.

Insurance Company Engagements

With the complex nature of claims and litigation, there is a growing need for insurance companies to enlist the services of an accountant. A need exists for expert testimony in damage evaluation, or handling first party claims, i.e., evaluating inventory after a fire loss or theft, or a business interruption claim. These areas, too, are not without exposure.

A recent claim occured wherein an insurance company engaged the insured accountant to evaluate the amount of electrical equipment in a small retail store. The store had experienced a substantial theft. The accountant reviewed the available information provided by the insurance company and was not able to form a firm opinion due to a lack of complete documentation. The accountant requested further information through the insurance company for the store and actively sought to bring the engagement to a conclusion. However, the entire process was extended and the store owner sued his insurance company and the accountant for negligence and bad faith claims handling. The claim resulted, thus, from not the accountant's lack of activity, but his client/insurance company's lack of activity.

Amerinst Reports on 1989 Results

Amerinst Insurance Group completed its first full year of operation in 1989, posting earnings of $2.34 per share. For the year, Amerinst Insurance Company earned premiums of $8,538,461 and made an underwritng profit of $26,992, before income taxes. Overall, Amerinst Insurance Group had net Investment Income of $1,183,998 before income taxes.

At December 31, 1989 the Group's total assets were $14,301,346. Its liabilities, primarily for unpaid losses and loss adjustment expenses, were $5,824,415. Stockholders' equity was $8,476,931.

In his annual letter to stockholders, President Norman C. Batchelder expressed concern about the direction of the market for accountants' professional liability insurance, saying that "Many underwriters recently new to the accountants professional liability field have begun to write this coverage, while some have failed. The competition seems to be mainly in price, recalling a similar environment in the early and mid portion of the 1980's, before the near-collapse of the market..."

Mr. Batchelder expressed confidence, however, that Amerinst would continue to provide insurance either in its current capacity as a reinsurer of the AICPA Plan, or, if circumstances dictated, on a direct basis.

The problem was compounded in that the insurance company refused to defend the insured for the claim by the store owner.

Expert Testimony

A final major area of claims in litigation support services involves the accountant serving as expert witness in formal litigation. Oftentimes it will be a case of an expert accountant testifying against another accounting firm.

A recent case involved a claim by a disgruntled client against his predecessor accounting firm. The insured served as expert witness against the predecessor firm. A judgment was entered against the predecessor firm for negligence. However, the plaintiff then sued the insured for professional negligence alleging that if the expert accountant had done a more thorough and convincing job that he would have received a larger verdict. Similar exposure arises if the suing party receives no verdict in their favor.

As stated previously, no area of your practice is immune from claims activity. Practitioners must be ever vigilant and attentive to the identification of potential legal liability situations that can arise. While litigation support services in many ways seems to be of limited exposure to a claim, as we have just noted this is not the case.

In summary, an analysis of the claims made against AICPA Plan insureds reveals the following considerations:

- Be certain you are familiar with the subject of the engagement. No one is an expert in all areas of your dynamic profession. Should you not feel comfortable, seek assistance or refer the engagement to another party. In the long term, your client will appreciate your concern and you will be lessening your liability exposure;
- Use engagement letters. Define the scope of your activities, what you will do, where information will originate, and the limits of your work;
- Document your work. Cite sources of information and then relevance to the work. Conversations with clients and/or attorneys should always be noted;
- Use solid client selection techniques. Be certain you are proceeding on solid footing. Be wary of litigious clients. If they regularly sue others, you could find yourself, likewise, a target.

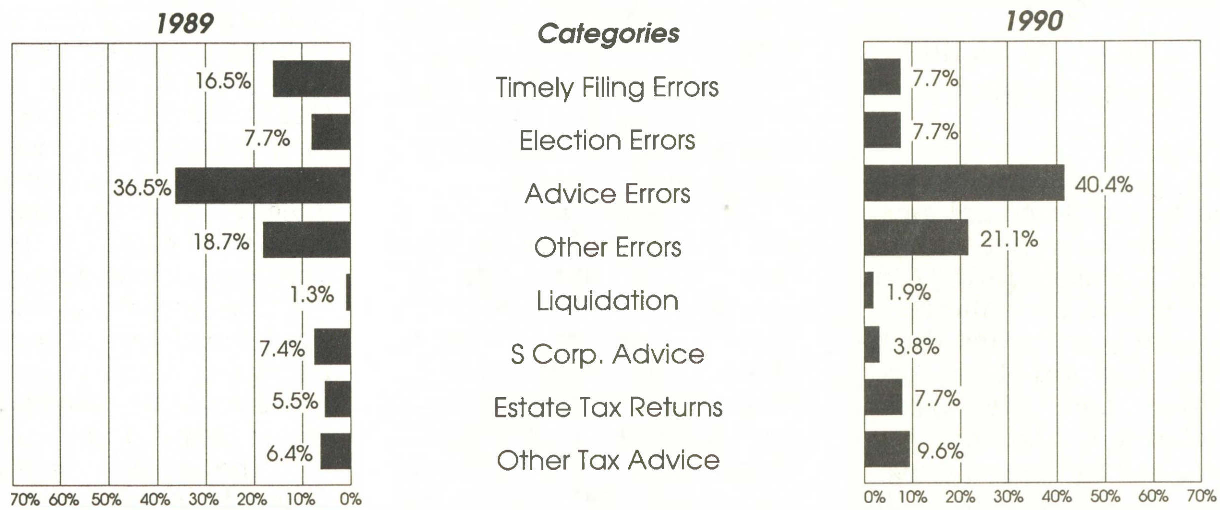
If you have any questions, or wish to discuss directly, please feel free to contact me at 1-800-879-4272.

Tax Claims Continue to Grow

The December 1989 issue of the *Accountant's Liability Newsletter* contained an article written by the RBH Underwriting Unit addressing the growing frequency and severity of losses involving tax agreements. The updated chart breaks down these claims to show specific categories of errors.

AICPA — Tax Engagement Sub-Categories

Claims Count: Comparison of 1989 vs 1990



Case Reviews

Corporate Audit: U.S. District Court, New York

Accounting firm may be liable to purchasers of company who relied on audited financial statements.

Parent corporation offered subsidiary for sale. A memorandum describing the subsidiary was distributed to potential purchasers. A buyer (plaintiff here) offered to purchase the corporation. A Stock Purchase Agreement was entered which provided that financial statements would be prepared and then audited by an accounting firm in accordance with generally accepted accounting principles. The accounting firm issued two Auditors' Opinion letters asserting that the financial statements conformed with GAAP and had been audited in accordance with GAAS.

The agreed sales price was a multiple of the earnings before interest and taxes. After closing, an audited consolidated balance sheet was delivered to the buyer. The accounting firm certified that the balance sheet fairly presented the financial position of the corporation. Later, the buyer objected to the balance sheet, and to the purchase price. An adjustment to the purchase price was then negotiated, and the seller refunded $4,885,000 to the buyer. The accounting firm then issued an unqualified opinion as to the corporation's financial statement. The financial statement indicated an earnings before interest and taxes at an amount just a little more than half of the previously projected earnings before interest and taxes. The buyer subsequently uncovered an alleged scheme designed to inflate the sales and earnings figures during the three years immediately prior to the purchase. The buyers also found reserve shortages which allegedly violated GAAP.

Liability is not restricted solely to those who actually pass title to securities.

The buyers then filed suit naming the sellers and the accounting firm as defendants. As against the accounting firm, the buyers alleged violations of §12(2) of the Securities Act, §10(b) of the Exchange Act, breach of contract, negligent misrepresentation and common law fraud. The accounting firm filed a motion to dismiss the claims.

Held: The court discussed the various claims in turn and dismissed some claims entirely, dismissed some claims with leave to replead, and allowed some claims to go forward.

The accounting firm argued that the claim for violation of §12(2) of the Securities Act of 1933 must be dismissed for failure to state a claim. The Court agreed with the accounting firm and dismissed that claim. Only a person who "offers or sells a security" is liable under §12(2) of the Act. 15 U.S.C.A. 771(2) (West Supp. 1989). However, liability is not restricted solely to those who actually pass title to securities, see Royal American Managers, Inc. v. IRC Holding Corp., 885 F.2d 1011 (2d Cir. 1989). A person who is motivated to serve his own financial interests or those of the securities owner may be liable under the Act. On the other hand, "securities professionals, such as accountants and lawyers, whose involvement is only the performance of their professional services" are not included as sellers under the act. See Pinter v. Dahl, 486 U.S. 622, 108 S.Ct. 2063, 2081 (1988). Furthermore, indirect aid does not result in liability for solicitation as an aidor and abbetor. See Wilson v. Saintine Exploration and Drilling Corp., 872 F.2d 1124 (2d Cir. 1989). Under this analysis, the accounting firm did not qualify as a seller. Therefore, the claim alleging the accounting firm violated of §12(2) of the Securities Act was dismissed.

A person who is motivated to serve his own financial interests may be liable under the Act.

The accounting firm argued the claims of securities fraud and common law fraud must be dismissed because they did not comply with the requirements of Rule 9(b) of the Federal

Rules of Civil Procedure. Rule 9(b) requires all allegations of fraud to be pleaded with particularity. The court agreed with the accounting firm that the claims of fraud did not comply with Rule 9(b). No specific instance of fraud was pleaded by the buyers. Allegations concerning general noncompliance with general accounting principles do not fulfill the requirements of Rule 9(b). Rule 9(b) requires allegations of "specific compromises" made by an accounting firm. See In Re American Int'l., Inc. Securities Litigation, 606 F.Supp. 600 (S.D.N.Y. 1985). Here, the plaintiffs' complaint only alleged failure to comply with GAAP and GAAS. Therefore the fraud claims were dismissed with leave to replead those claims within 20 days.

Next, the accounting firm argued the claims under §10(b) of the Securities and Exchange Act of 1934 (Rule 10b-5) should be dismissed. The court noted the elements of liability under Rule 10b-5 are: "(1) a misrepresentation or omission of a material fact in connection with the purchase or sale of a security, (2) an intent to defraud, (3) justifiable reliance on such misrepresentation or omission, (4) causation and (5) damages. See Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). The court found elements 1, 3, 4, and 5 were all satisfied by the pleadings. As to the first element, the court found the alleged misrepresentations as to the earnings before interest and taxes and the reserve shortfalls to be material. The purchase price was a multiple of ten times the earnings before interest and taxes. Thus, the misrepresentations allegedly caused the plaintiffs to pay more for the company than they otherwise would have paid. If the actual earnings before interest and taxes had been revealed, the purchase price based on this formula would have been $10 to $15 million less than was paid.

Finding the alleged misrepresentations to be material, the court then noted the third element of justifiable reliance was satisfied.

> The alleged overstatements of profits induced the purchase.

Justifiable reliance may be inferred from a finding of materiality. See Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972). The fourth element of causation was also satisfied by the pleadings. The alleged overstatements of profits induced the purchase, and the inflated sales figures and reserve shortfalls affected the valuation of the stock of the company. These factors constituted a triable issue as to loss causation. The fifth element of damages is satisfied by an allegation of damages in an unascertainable amount. See Seiler v. E.F. Hutton & Co., 584 F.Supp. 607 (D.N.J. 1984). Thus, this element was satisfied.

As to the second element of intent to defraud, facts alleging knowing or intentional misconduct or an intent to deceive investors satisfy the element of intent. See Ernst and Ernst v. Hochfelder, 425 U.S. 185 (1976). However, the court's analysis under Rule 9(b) of the Federal Rules of Civil Procedure had resulted in dismissal of the fraud claims with leave to replead those claims. The dismissal included the fraud claims under Rule 10b-5.

Based on this analysis, the court found all the elements necessary to establish a Rule 10b-5 claim had been adequately pleaded, except the second element. Therefore, the Rule 10b-5 claims were dismissed with leave to replead the elements of intent to defraud.

The plaintiffs also claimed damages for negligent misrepresentation under state law. The accounting firm moved to dismiss these claims, arguing the firm had no duty of disclosure to the plaintiffs. The court denied the accountants' motion to dismiss and allowed the claims to stand. Under New York Law, liability for negligent misrepresentations to third parties

> Liability to third parties requires a showing of privity or a relationship approaching privity.

requires a showing of privity or a relationship approaching privity. See Huang v. Sentinel Government Securities, 709 F.Supp. 1290 (S.D.N.Y. 1989). In addition, a relationship of trust or confidence is required. See Accusystems, Inc. v. Honeywell Information Systems, 580 F.Supp. 474 (S.D.N.Y. 1984). "[T]he relationship between the parties . . . must be such that . . . the one has the right to rely upon the other for informa-

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tion, and the other giving the information owes a duty to give it with care." See Eiseman v. State, 518 N.Y.S.2d 608 (1987).

Liability to third parties depends on three factors announced in Credit Alliance v. Arthur Andersen & Co., 65 N.Y.2d 536 (1985): 1) awareness that the representations are made for a particular purpose, 2) to be relied on to further that purpose by a known party, and 3) conduct indicating the accountants knew of that party's reliance. Considering these factors, the court noted the accounting firm negotiated the purchase price with the plaintiffs' accounting firm. Thus, the accounting firm was on notice that the financial reports were intended for plaintiffs to further the sale and were being made specifically for the plaintiffs use. Thus the Credit Alliance factors were satisfied.

> The accounting firm was on notice that the financial reports were being made for the plaintiffs use.

The result then was as follows: the plaintiffs' claims for violations of §12(2) of the Securities Act of 1933 were dismissed; the claims for Rule 10b-5 violations and common law fraud were dismissed with leave to replead; and the state law claims of negligent misrepresentation were allowed to go forward.

HB Holdings Corporation v. Scovill Inc., No. 88 Civ.7983 (SWK), U.S. Dist. Court, New York, 3/26/90.

Tax Advice: U.S. District Court, New York

Arbitration clause in partnership agreement not applicable to individuals, fraud claims resulting from investment advice.

Clients (plaintiffs here) invested in four partnerships on advice of accountants (defendants here). The accountants allegedly advised the clients that the investments wouldresult in tax benefits. The clients borrowed $70,000 to invest in one of the partnerships, and invested $36,000 in three other partnerships. The first partnership filed for bankruptcy less than two years after the clients' investment. After claiming tax benefits relating to the investments in the other three partnerships, the IRS disputed those benefits. Eventually the IRS assessed additional tax liability as to those investments, including penalties and interest.

The clients then filed suit against the accountants alleging securities fraud, common law fraud, RICO violations, negligence and breach of fiduciary duty. In addition to various procedural arguments which will not be addressed here, the accountants argued the claims should be dismissed because: the claims as to the three partnerships were subject to an arbitration agreement; the claims of fraud should be dismissed because the complaint did not plead fraud with particularity as required by Rule 9(b) of the Federal Rules of Civil Procedure; and the RICO claim was barred by the statute of limitations.

Held: The court held that the arbitration clause included in the partnership agreements did not apply to the claims against the accountants; that the allegations in the complaint did not meet the requirements of Rule 9(b); and that the RICO claim was barred by the statute of limitations. The securities fraud and common law fraud claims were dismissed with leave to replead.

As to the arbitration clause, this clause appeared in the three Partnership Agreements which were contracts between the Managing Partners and the General Partner. The clause required arbitration of any disputes arising from any matter relating to the partnership agreements. Some members of the accounting firm had signed these agreements, but they signed in their capacity as Managing Partners. They had not signed in their capacity as accountants for the clients. Therefore, the agreements and the arbitration clauses did not apply in the context

CORRECTION

The April 1990 edition of the Accountants Liability Newsletter gave an incorrect Watts line number of the AICPA used to order the "Tax Malpractice Claims and How to Prevent Them" videotape.

The correct number is 800-334-6961. The New York State number, 800-248-0445, was correct.

The price of the tape (118600), including workbook, is $69.00 with additional workbooks (118610) available for $34.50 each. Recommended CPE credit, requiring completion of the accompanying examination, is 4 hours.

of this suit by the clients against the accountants.

As to the Rule 9(b) requirement of pleading fraud with particularity, the court noted that plaintiffs must include the following information in the pleadings:

1) precisely what statements were made in what documents or oral misrepresentations or what omissions were made, 2) the time and place of each such statement and the person responsible for making (or, in the case of omissions, not making) the same, 3) the context of such statements and the manner in which they misled the plaintiffs, and 4) what defendants obtained as a consequence of the fraud.

See Beres v. Thomson McKinnon, No. 85-6674, (S.D.N.Y. 9/1/89).

The complaint alleged the following misrepresentations occurred: the accountants were familiar with the plaintiffs' tax situation, the accountants were experts in tax shelters; the accountants knew of sound investments that would provide significant tax benefits which would multiply the investment; the accountants were certain the investments were sound, the investments would provide tax write-offs that would exceed the investments thereby reducing the plaintiffs' tax liability; and that the accountants would oversee the plaintiffs' participation and calculate tax returns and benefits. The alleged misrepresentations occurring as a result of omissions included the following: that the accountants received commissions on the investments; that the accountants also performed services for the partnerships; that the accountants held interests in companies associated with the partnerships; that the partnerships were not viable tax shelters; that the accountants concealed the IRS' position from the plaintiffs and told the plaintiffs there was "nothing to worry about"; and that the accountants hired attorneys to negotiate with the IRS at the expense of plaintiffs. The court ruled that these allegations of fraudulent misrepresentations and material omissions did not include specific information as to what statements were made, or when, where or in what context they were made. Therefore, the claims were dismissed with leave to replead within 20 days.

> The IRS assessed additional tax liability as to those investments.

As to the RICO claims, the court noted the limitations period for RICO claims is four years, and the cause of action accrues on the last date the plaintiffs purchase securities. See Bankers Trust Co. v. Rhoades, 859 F.2d 1096 (2d Cir.), cert. denied, — U.S. — , 109 S.Ct. 1642 (1988). The last purchase of partnership interests in this case occurred more than four years before the suit was filed. Therefore the RICO claims were time barred and were dismissed.

Gould v. Berk & Michaels, P.C., No. 89 Civ. 5036 (SWK), U.S.D.C., New York, 4/5/90.

Ed. note: Even though the claims in this case were dismissed on a technicality, it must be remembered that the court also allowed the plaintiffs 20 days to file another complaint alleging fraud with the particularity required by Rule 9(b). Where a suit has been instituted in response to an IRS determination that taxes, penalties, and interest are due, it is most likely the suit will indeed be pursued. The IRS has assessed taxes, penalties and interest, and the taxpayer will look to the accountants to recover the loss. Needless to say, the defense of this suit has already been expensive; and most likely will become even more expensive.

Practice Management

Independence and Attest Engagements

Rule 101 of the AICPA Code of Professional Conduct requires members engaged in public practice to maintain independence when performing professional services. The executive committee of the professional ethics division of the AICPA issues interpretations and rulings which provide guidance as to the Code Rules. A new interpretation applicable to Rule 101 was recently issued by the ethics committee.

Interpretation 101-11 relates to attest engagements. An attest engagement is defined by the AICPA as follows:

An attest engagement is one in which a practitioner is engaged to issue or does issue a written communication that expresses a conclusion about the reliability of a written assertion that is the responsibility of another party.

General Standard No. 4 of the Statements on Standards for Attestation Engagements requires the member to maintain independence. Interpretation 101-11 provides that the required independence will be impaired during an attestation engagement:

1. If a relationship proscribed by interpretation 101-1 exists between the person or entity responsible for the assertion for which the attestation is being issued and an individual on the attest engagement team, or a spouse, dependent or firm of a member of the team.

2. If a nondependent close relative of an individual on the engagement team has either a position of significant influence with, or a material financial interest in, the person or entity responsible for the assertion.

3. If any of the following has either a position of significant influence with or a material financial interest in the person or entity responsible for the assertion:

a) an owner, partner, or shareholder, or

b) a spouse or dependent of an owner, partner, or shareholder of the firm who is located in an office participating in a significant portion of the attest engagement.

4. If any of the following either contributed to the development of the subject matter of the assertion or stands to gain financially directly from the success of the subject matter of the assertion:

a) the firm, or

b) an individual on the attest engagement team, or

c) either a spouse or a dependent of an individual on the attest engagement team, or

d) an owner, partner or shareholder in an office performing a significant portion of the engagement

5. If an individual on the attest engagement team knows, or could reasonably be expected to know that any owner, partner, or shareholder in other offices of the firm either:

a) contributed to, or

b) stands to gain financially directly from the success of the subject, or

c) has a position of significant influence with the person or entity responsible for the assertion.

Interpretation 101-11 does not apply to attest engagements covered by: Statements on Auditing Standards; Statements on Standards for Accounting and Review Services; or Statements on Standards for Accountant's Services on Prospective Financial Information.

The AICPA has issued five general standards, two fieldwork standards, and four reporting standards which apply to attest services. When performing an attestation engagement, an accountant will want to be familiar with those official standards.

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