Accountant's Liability Newsletter, Number 31, First Quarter 1993

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

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Accountants' Liability Newsletter

Number 31 First Quarter 1993

ACCOUNTANTS LIABILITY IN THE 1990'S

By Dan L. Goldwasser
Vedder, Price, Kaufman,
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New York

RECENT COURT DECISIONS

Although the number and severity of claims against certified public accountants increased significantly in the mid - 1980's, there have been no revolutionary changes in the law. In fact, given the percentage of attorneys serving in the House (40%) and Senate (60%), tort reforms of any magnitude are remote. Most of the legal decisions dealing with accountants in recent years have generally involved minor interpretations to well recognized legal doctrines. For that reason, practitioners should be sure to be familiar with the principles handed down in relevant cases.

Decisions Regarding the Privity Doctrine

In 1931, in Ultramares Corp. v. Touche, Chief Judge Cardozo, writing for the New York Court of Appeals, ruled that an accountant may only be held liable on a negligence claim to those persons with whom the accountant was in contractual privity; all other persons aggrieved by the accountant's malfeasance are required to assert their claims on a fraud theory. This ruling was premised on the notion that accountants should not be held liable for an indeterminate amount to an indeterminate number of persons by reasons of a mere "slip or blunder."

This ruling (commonly referred to as the "privity" doctrine) soon became the standard for dealing with malpractice claims against accountants in virtually all states. It was not until the late 1950s that courts in other jurisdictions began to question whether accountants should have a special rule protecting them against the results of their negligence. Over the course of the next 45 years, a handful of courts began to hold accountants liable for negligence where the claimant, although not in privity with the defendant accountant, was known by the accountant to be relying upon his financial report. These cases led to the adoption of Section 552 of the Restatement (Second) of Torts in 1977, which proclaimed that persons whose reliance upon an accountant's report was specifically foreseen by the accountant could assert a claim against the accountant on a negligence theory. Over the ensuing decade, the courts of several states in dealing with this question began to adopt the "Restatement approach," finding it more in tune with general notions of liability that every person should be civilly responsible for any damage which they caused through their own negligence.

In 1983, the Supreme Court of New Jersey in H. Rosenblum, Inc. v. Adler, went one step further and held that an accountant could be held liable to all persons whose reliance upon his report was "reasonably foreseeable." This decision drew

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heavily upon a law review article written by Judge Weiner and upon the court's (possibly mistaken) belief that accountants could easily obtain insurance covering such claims so as to create a system for compensating persons who relied upon erroneous financial data. The New Jersey Court's decision was followed shortly thereafter by rulings in Wisconsin, California and Mississippi, all of which embraced the foreseeability standard enunciated in H. Rosenblum, Inc. v. Adler.

Although several commentators quickly predicted that the foreseeability standard was the wave of the future, most courts which have been faced with this issue since H. Rosenblum, Inc. v. Adler have refused to follow that decision. For example, in New York, the Court of Appeals in Credit Alliance Corp. v. Arthur Andersen & Co. expressly rejected the foreseeability standard and adopted a "near privity rule" setting down three criteria for determining whether a plaintiff is able to bring a claim against an accountant on a negligence standard:

1. The plaintiff did in fact rely upon the accountant's report;
2. The accountant knew that the plaintiff intended to rely upon his report, and
3. The accountant, through some actions on his own part, evidenced his understanding of the plaintiff's intended reliance.

Under the Credit Alliance standard, there is still the issue of what constitutes evidence of the accountant's knowledge of the plaintiff's intended reliance. While some federal courts have been willing to find virtually any actions on the part of the accountant to satisfy the third requirement of the Credit Alliance test, the New York Court of Appeals itself has ruled that the actions must be substantial and clearly evidence the accountant's understanding of the plaintiff's intended reliance. In this connection the Court of Appeals in William Iselin & Co. v. Mann Judd Landau, held that mere telephone calls between the accountant and the plaintiff which did not expressly deal with the plaintiff's intended reliance upon the accountant's report, were not sufficient to satisfy the third requirement under Credit Alliance.

The AICPA has been trying to promote the passage of legislation in the various states adopting the Credit Alliance formula. Although bills have been submitted to the legislatures of numerous states, as of this writing, only four states have adopted privity legislation: Illinois, Arkansas, Kansas and Utah. Under these statutes, an accountant can only be held liable on a negligence standard to those persons whom he acknowledges in writing are known to be relying upon his report. These statutes require an affirmative statement by the accountant, and a failure to so inform the client and/or the intended users leaves the accountant vulnerable to a negligence suit by all foreseeable users. To date, there has been only one case involving a privity statute and there is no indication from that decision as to any limitations of the statute.

The Credit Alliance and Restatement rules require that the accountant actually know of the plaintiff's intended reliance upon his report. This criterion raises the further question as to when the accountant must possess that knowledge. This issue has been dealt with by at least two courts, both of which ruled that the accountant must have that knowledge prior to the issuance of his report.

Since the Credit Alliance decision in 1986, virtually every court that has been asked to decide the scope of persons who can bring a negligence claim against an accountant have opted for either the Credit Alliance or Restatement rules. Although the privity and Restatement doctrines are well established with respect to the accounting profession, there have been a few cases in which they were applied to lawyers and other professionals. To be sure, there is a tendency on the part of the courts to treat all professionals alike, notwithstanding the fact that the entire privity doctrine was established by the New York Court of Appeals as a special rule for accountants.

At the time Chief Judge Cardozo rendered his decision in the Ultramares case, he had already gone on to reject the privity doctrine with respect to product liability litigation. In rendering his decision, he was concerned about the open-ended nature of the liability faced by accountants because of the generally widespread reliance upon accountants' reports. Although the Ultramares decision was rendered two years prior to the adoption of the Securities Act of 1933 (requiring accountants' reports to be included in prospectuses for all new issues of securities), it was already clear that accountants' reports were commonly relied upon by persons other than the accountant's client. Today, reliance upon accountants' reports is even more widespread than it was in 1931, and certainly more widespread than reliance upon the opinions and reports of other professionals. Notwithstanding this very essential difference, most courts have applied the privity of Restatement doctrines to claims against other professionals without giving any apparent thought to the relatively unique position of the accounting profession. Instead, they have been more concerned about applying a uniform rule for all professionals.

Reliance and Causation Issues

One of the principal defenses relied upon by accountants in professional liability claims is that the plaintiff did not actually rely on the accountant's report. This defense was used successfully for many years in class action litigation until the "fraud-on-the-market" theory gained acceptance. Under the fraud-on-the-market theory, even if the plaintiff does not actually see a copy of the accountant's report, he is nevertheless presumed to have relied upon that report if he relied upon the integrity of the market price which was affected by that report. Although the fraud-on-the-market theory has dubious logical foundations, it has nevertheless been embraced by the U.S. Supreme Court in Basic, Inc. v. Levinson, and by virtually all of the U.S. Courts of Appeal.

The fraud-on-the-market doctrine merely creates a presumption which is rebuttable by the defendant's proving any of the following:

1. The alleged misrepresentation did not lead to a distortion of the market price;
2. The plaintiff traded or would have traded despite his knowing that the alleged misstatement was false;
3. There was no efficient market in the subject securities; or
4. The market in the subject securities was artificially affected in the other direction by other false statements or rumors . . .

More recently, the plaintiffs' bar has sought to apply the fraud-on-the-market theory to claims based upon common law fraud and ordinary negligence where the plaintiff cannot satisfy his burden of proof that he in fact read and relied upon the accountant's report. These efforts have met with mixed success. For example, in Mirkin v. Wasserman, a California appellate court held that actual reliance was required in a negligence action against an accountant, rejecting plaintiff's attempt to invoke the fraud-on-the-market doctrine. On the other hand, a federal district court in California has held that the fraud-on-the-market doctrine can be used to satisfy the reliance requirement of state law claims for fraud and negligent misrepresentation.

This issue generally arises in those jurisdictions in which accountants can be held liable on a negligence standard to all foreseeable users of their reports. In New Jersey, where the foreseeability standard was first adopted, the courts have rejected the fraud-on-the-market doctrine. This may be because the New Jersey Supreme Court in Rosenblum v. Adler expressly stated that the foreseeability rule would not open accountants to unlimited liability since plaintiffs would still have to prove actual reliance. In California, another foreseeability jurisdiction, however, the federal courts have opted for fraud-on-the-market, while the lone state court decision has rejected it for common law negligence claims.

In virtually all claims, including not only those brought under the federal securities laws but also for common law negligence, a plaintiff is required to prove that he reasonably relied upon the accountant's report. As a result, some accounting firms, faced with liability claims based upon reports in a review engagement have asserted as a defense that no reasonable person would rely upon a review report in that the accountant does not express an opinion on the financial statements of his client. Indeed, in a review report the accountant expressly disclaims offering any such opinion. Although the Supreme Court of at least two states have rejected this theory, a recent appellate court in the State of California (of all places) did accept this argument in Union Bank v. Ernst & Whinney. Unfortunately, the California Supreme Court, in reviewing this decision, "decertified" it which means that it may not be relied upon as a precedent for deciding future cases. The lesson of this decision seems to be relatively clear; namely, although the courts will seriously consider whether under the circumstances the plaintiff could have reasonably relied upon a review report, they will not adopt a hard and fast rule which holds that reliance upon a review report is *per se* unreasonable.

EDITOR'S NOTE:

Recent favorable trends, perhaps best exhibited by the California Supreme Court, have limited the accountant's liability to third party claimants and struck down the so-called "unlimited liability exposure" of accountants.

Mr. Goldwasser is a Senior member of Veddor, Price, Kaufman, Kammholz & Day, a New York City Law Firm, which represents the New York State Society of CPAs and approximately 110 CPA firms. Mr. Goldwasser is actively involved in the development of Defensive Loss Prevention Techniques/Practices for CPAs. This article is the last of a series of articles that Mr. Goldwasser has contributed to this newsletter, portions of which may have previously appeared in other periodicals or presentations by the author.

What's a CPA to do about PRIVITY?

By Julia Winn

"Accounting is an art, not a science," says Larry Wojcik, CPA and partner with the law firm of Keck, Mahin & Cate. What makes accounting an art, according to Wojcik, is that it requires a great deal of professional judgment to estimate such future events as possible losses on uncollectible receivables or excess and obsolete inventories. No auditor can do enough testing to say with 100 percent certainty a client's set of financial information is accurate. "The best we can do is apply tests," Wojcik says. "On the basis of that testing and our professional experience we can opine that the financial information is, in all material respects, fairly stated."

When something subsequently does go wrong, those who suffer often attempt to seek redress through the courts. Unfortunately today's society is litigation-happy. When a company goes under, no matter what the cause, everyone (and their siblings) jumps on the band-wagon. Accountants are increasingly being hit with lawsuits from third parties with whom they had no contact or relationship in connection with their audit engagement.

Illinois lawmakers listened when CPAs expressed fears that the cost of an honest mistake on an audit would become so expensive it would make accounting too dangerous a profession to practice. In response to those fears, the legislature passed the Privity Law in August 1986. In doing so Illinois became the first state to legally limit accountants' liability in negligence to unintended third party users through legislation. Many other states have similar protection through well developed case law.

The first part of Public Act 84-1251 amended the Illinois Public Accounting Act to say "no person, partnership or corporation" licensed to practice public accountancy shall be held liable for civil damages to persons "not in privity of contract" unless the public accountant committed intentional fraud or misrepresented the facts.

In order to meet the privity requirements, accountants must know at the time they do the audit who the principle users of the audited statements are and how they intend to use the information.

"It's almost a fundamental fairness," explains Wojcik. "If I know the ABC Bank or someone else is going to rely on my financial statements for a specific purpose, I have the opportunity to adjust my conduct accordingly. For instance, if I know a company is going to buy my client's business and the purchase price will be determined on the basis of every dollar that is in equity on the audited balance sheet, my materiality threshold might change."

A second part to the Privity Law permits the accountant to further clarify who are considered in the privity with the accountant. Written notification can be given to the client (as well as any identified third parties) specifically listing those who are intended users of the audited statements.

"Under the statute, it would appear these are the only people who can sue you for negligence under the circumstances," Wojcik says.

"The up side in following such an approach is that you have clearly expressed the intention to limit liability," says Robert Mednick, former chair of the American Institute of CPAs subcommittee on accountants' legal liability.

"The down side," he continues "occurs if the client suddenly suggests you list all kinds of other people as possible users. You could end up with a list that includes people who, if you had not started the process, wouldn't have been in privity under the basic law. As a result most large firms have generally not adopted this practice to date."

In terms of broaching the subject of a limiting privity letter with the client, Wojcik says its difficult to make a hard and fast rule. Based on Wojcik's experience with his clients he says it is always a good idea to sit down with them and explain the purpose of the letter before sending something off.

"I think you should because you do not want to have any adverse consequences on your client relationship by simply sending the letter," he explains. "The client might think they are paying for one thing and you are putting a restriction on it."

"In our experience we have found the clients are very understanding because they have their own insurance problems. So they understand the concern about cutting down your potential liability."

"Also by having a frank discussion with the client, sometimes you ferret out who are going to be the users of the financial statement. This gets back to my premise that once you know who will use the information you can adjust your conduct accordingly."

Whether or not an accounting firm chooses to try to issue limiting privity letters to its clients, it could still receive requests from specific third-party lenders and others for an acknowledgment that they are intended users of the audit statements (called reliance letters).

James Adler, a partner at Checkers, Simon & Rosner, says the firm is very judicious on who they send such letters. "Every time you send out a reliance letter you are putting your neck out to a third party."

"A reliance letter should be issued by an accounting firm only when there is an understanding and mutual respect between a third party creditor and a CPA firm, and the client needs such a letter in order to enter into a credit arrangement with that third party."

"Haphazardly providing these letters on demand is like throwing $100 bills out the window on the grounds some of them may stick to the window glass."

Adler is also very careful about the wording of the letter. Each one he sends is individually tailored to the particular circumstance and individually written. "What I would want to ask that third party is what steps are they taking with respect to this credit decision? Their answer will tell me whether I should even give them a reliance letter."

"If I do, I may want to put in my letter all the other steps the third party is performing so it is clear to them and me I have established in writing that I am not the only source of credit information they are relying on, but that there are other sources of information."

"Creditors can flip a coin. If they make the loan they either can make money on it or if they don't they can sue the CPA. So they get it either way. No way are they going to get that from me under this privity law."

"They are going to have to take responsibility for their own credit decisions. And that is going to be in my letter - that they have the ultimate responsibility for making the credit decision and I am just providing them with one piece of all the information they are going to gather before making the decision."

As Wojcik says, to date no one has challenged the privity law in court. That makes it very difficult to say to CPAs if they should or should not elect the option of sending a limiting privity letter to their clients or if and how they should respond to requests for reliance letters from third party lenders and others. There is as yet no judicial precedent and everything is fair game in a court of law. As Mednick says, "It's not an easy call."

Julia Winn is the Editor of "INSIGHT" a periodical issued by the Illinois CPA Society. Ms. Winn has granted us permission to reprint several extremely informative articles in this newsletter.

Underwriters Corner

The Underwriter's Corner was developed as a service to provide AICPA Plan Insureds with answers to frequently asked questions. Should you have any questions which you would liked answered in the publication, please address your questions to:

Michael J. Chovancak, Editor
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4870 Street Road
Trevose, PA 19049

Q. We wish to inform our insurance company of the fact that we have subleased some of our office to another company which is completely independent of our firm. This other company provides general accounting services, including certified audits, to a wide range of clients. We will be sharing a common reception room and receptionist. The sub-lessee will have a separate incoming telephone line and the signs on the doors will clearly indicate that they are a separate company. Will this arrangement affect our AICPA Professional Liability Insurance Policy?

A. Please be advised that this space-sharing arrangement will not effect your AICPA Professional Liability Insurance Policy. Oftentimes, a crafty attorney will attempt to name "affiliated" firms in lawsuits for malpractice. In order to aid in the defense of such situations, we recommend that you and your suite-mate stress to your respective clients each entity's independence. By using separate letterheads, telephone lines, door and building signs you will further emphasize each firm's independence to both current and prospective clients thus, making the case for your defense more clear-cut.

Professional Liability/Litigation Crisis — Recent Developments

Recently the CEOs of the six largest accounting firms issued a joint statement of position entitled "The Liability Crisis in the United States: Impact on the Accounting Profession".

Because of the importance and the length of the publication we will print a portion of the statement in this issue and the balance in the next issue of the AICPA Newsletter for your review.

Additionally, the Board of Directors of the AICPA has likewise issued a "Resolution on Legal Liability", which endorses the aforementioned statement of position and urges necessary reform to abate the litigation crisis facing the accounting profession.

The Liability Crisis In The United States: Impact On The Accounting Profession

Introduction

The tort liability system in the United States is out of control. It is no longer a balanced system that provides reasonable compensation to victims by the responsible parties. Instead, it functions primarily as a risk transfer scheme in which marginally culpable or even innocent defendants too often must agree to coerced settlements in order to avoid the threat of even higher liability, pay judgments totally out of proportion to their degree of fault, and incur substantial legal expenses to defend against unwarranted lawsuits.

The flaws in the liability system are taking a severe toll on the accounting profession. If these flaws are not corrected and the tort system continues on its present inequitable course, the consequences could prove fatal to accounting firms of all sizes. But a liability system seriously lacking in logic, fairness and balance is not just the accounting profession's crisis. It is a business crisis and a national crisis.

This position statement describes these matters in more detail, as well as needed reforms that the American Institute of CPAs (AICPA) and the six largest accounting firms are advocating. In seeking these reforms, the firms are not attempting to avoid liability where they are culpable. Rather, the firms seek equitable treatment that will permit them and the public accounting profession to continue to make an important contribution to the U.S. economy.

An Epidemic of Litigation

The present liability system has produced an epidemic of litigation that is spreading throughout the accounting profession and the business community. It is threatening the independent audit function and the financial reporting system, the strength of U. S. capital markets, and the competitiveness of the U. S. economy.

The principal causes of the accounting profession's liability problems are unwarranted litigation and coerced settlements. The present system makes it both easy and financially rewarding to file claims regardless of the merits of the case. As former SEC Commissioner Philip Lochner recently pointed out in *The Wall Street Journal*, plaintiffs may simply be seeking to recoup losses from a poor investment decision by going after the most convenient "deep pocket" - the auditor. In too many cases, moreover, claims are filed with the sole intent of taking advantage of the system to force defendants to settle.

The doctrine of joint and several liability makes each defendant fully liable for all assessed damages in a case, regardless of the degree of fault. In practical terms this means that, even with no evidence of culpability, a company's independent auditors are almost certain to be named in any action filed against that company alleging financial fraud, for no reason other than the auditors' perceived "deep pockets" or because they are the only potential defendant that is still solvent. A particularly egregious example of the abuses encouraged by joint and several liability is the common practice of plaintiffs' attorneys settling with the prime wrongdoers, who don't have a defense or money, at a fraction of what these parties should pay. The attorneys then pursue the case against the "deep pocket" professionals, who as a result of joint and several liability are exposed for 100 percent of the damages even if found to be only one percent at fault.

Other elements in the system also act as incentives for unwarranted litigation leading to forced settlements. For example, American judicial rules make no effective provision for recovery of legal costs by prevailing defendants, even if the plaintiff's case is meritless. In addition, judicial restrictions on the types of cases in which punitive damages may be awarded have been significantly relaxed in recent years, making solvent professional and business defendants a prime target. The prospect of having to pay all damages as a consequence of joint and several liability, the high costs of defense, and possible punitive damages are persuasive factors in coercing settlements.

Abusive and unwarranted litigation is a problem not just for the accounting profession, but for business and the economy generally. A small group of attorneys is reaping millions of dollars by bringing federal securities fraud claims (under SEC Rule 10B-5) against public companies whose only crime has been a fluctuation in their stock price. These attorneys use the threat of enormous legal costs, a lengthy and disruptive discovery process, protracted litigation, and damage to reputation to force large settlements.

The CEO of a high tech company that has been the target of 13 specious Rule 10b-5 suits calls these actions "legalized extortion" and their effects go far beyond the "payoffs" demanded. These meritless suits siphon off funds needed for research and development, capital investment, growth and expansion. They divert management's time, talent and energy from the principal mission of running the business. They send liability insurance premiums skyrocketing. Ultimately, the direct and indirect costs of these suits are borne by shareholders, along with employees, customers, and all of a company's stakeholders.

Joint and several liability encourages the inclusion of "deep pocket" defendants such as independent accountants, lawyers, directors and underwriters in these suits in order to increase the prospect and size of settlements. Prohibitive legal costs, the unpredictable outcome of a jury trial, and the risk of being liable for the full damages compel even blameless defendants to race each other to the settlement table. And they do this despite the realization that, to the uninformed public, "agreeing" to settle is seen as an admission of wrongdoing.

A survey by the six largest accounting firms of the cases against them involving 10b-5 claims which were concluded in fiscal year 1991 showed that: (i) the average claim subjecting the accounting firm to joint and several liability was for $85 million; (ii) the average settlement by the firm was $2.7 million, suggesting there might have been little or no merit to the original claim against the accountant; yet, (iii) the average legal cost per claim was $3.5 million. It is not surprising that an accounting firm would agree to settle a case for less than what it had already spent in legal fees and, therefore, avoid the risk of liability of over twenty times the settlement by a jury that may be hostile to a business with "deep pockets". However, controlling risk by settling where you did nothing wrong becomes a very expensive strategy for "winning" the liability game.

The above represents the first part of a two-part statement of position issued by Arthur Anderson & Company, Coopers & Lybrand, Deloitte & Touche, Ernst & Young, KPMG Peat Marwick, and Price Waterhouse.

AICPA Board Of Directors'

Resolution On Legal Liability

WHEREAS: The AICPA, on behalf of the entire accounting profession, has been seeking judicial and legislative reforms responsive to the liability crisis affecting the United States; and

WHEREAS: Unwarranted litigation affects new business ventures in their efforts to raise capital and also impacts local, national and global businesses; and

WHEREAS: The cost of litigation ultimately is passed on to the general public; and

WHEREAS: The accounting profession as a whole faces thousands of lawsuits claiming many billions of dollars in damages, far exceeding its proportionate share of responsibility; and

WHEREAS: In 1991, the six largest firms spent $477 million on legal matters — 9% of their domestic auditing and accounting revenues and an 18% increase over 1990 litigation costs; and

WHEREAS: Litigation claims against other firms rose by two-thirds between 1987 and 1991 and 40% are "going bare" in light of the cost of liability insurance; and

WHEREAS: A growing number of firms are avoiding "high-risk" audit clients and even whole industries and some small firms are dropping public clients or abandoning their auditing practices altogether; therefore

BE IT RESOLVED: That the board of directors of the American Institute of CPAs endorses the position paper issued by the six largest accounting firms, *The Liability Crisis in the United States: Impact on the Accounting Profession*. The board believes the paper fairly reflects the nature of the litigation crisis in this country and appropriately emphasizes that in seeking litigation reform the profession is not attempting to avoid responsibility where accountants have breached their duty; and

BE IT FURTHER RESOLVED: That the AICPA believes reform of the federal securities laws is essential to curb unwarranted litigation and would be an important first step toward instituting broader liability reforms; and

BE IT FURTHER RESOLVED: That the AICPA also commends the work being done at the state level to reform state liability laws through legislative and judicial initiatives and to remove harmful regulatory and professional restrictions. The profession's ability to meet public expectations would be greatly enhanced by exploring all possible alternatives for reducing the threat unwarranted liability poses to the entire profession.

We'll be there. . .

Do you have questions about your accountants professional liability insurance? If so, members of the underwriting unit of the AICPA Plan are tentatively scheduled to be at the following AICPA and/or State CPA Society meetings to answer your questions. Please come over to our booth and visit!!

SHOW	LOCATION	DATES
AICPA PCPS Conference	Loews Coronado Bay, San Diego, CA	May 2 - 5, 1993
New York Accounting Show	New York City Hilton Hotel, New York, NY	May 2 - 5, 1993
California Computer Show	LAX Hilton Hotel, Los Angeles, CA	June 8 - 10, 1993
FICPA (Florida) Southeast Accounting Show	Omni International Hotel, Orlando, Florida	June 10 - 11, 1993
AICPA Micro Computer Conference and Exhibition	Sheraton Boston, Boston, MA	June 13 - 16, 1993
Michigan Society of CPA s Management Information Show	Hyatt Regency, Dearborn, MI	June 28 - 30, 1993

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