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# Accountant's Liability Newsletter, Number 35, First Quarter 1994

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

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# Accountants' Liability Newsletter

Number 35 First Quarter 1994

## Hidden Pitfalls for Accountants in Document Requests

by

Mary C. Eklund, Esq.

### UNLAWFUL DISCLOSURE OF TAX INFORMATION

Many accountants and lawyers are unfamiliar with Internal Revenue Code sections 7216 and 6713, prohibiting certain disclosures of "tax information" without the written consent of the taxpayer, by "[a]ny person who is engaged in the business of preparing, or providing services in connection with the preparation of" tax returns, or by any person who prepares a return for another "for compensation."

Failure to comply with these rules is a misdemeanor, and the penalties for violation can include both fines and imprisonment. The same disclosure may also subject the tax preparer to a civil penalty of $250 per disclosure, up to $10,000 per year. The disclosures prohibited apply only to disclosures made "knowingly or recklessly." This presumably applies to negligent disclosure as well as intentional or reckless release of information.

Even in litigation, the only clear exceptions to these rules are when disclosure is made pursuant to other provisions of the IRC or pursuant to an order of a court. But even statutory exceptions can be confusing. For example, many document requests are made by *subpoena duces tecum*. However, a subpoena is not the same as a court order because it may be issued by an attorney rather than the court in some states.

Regulations broadly define a "tax return preparer" and "tax return information." For example, a tax return preparer is just about anyone who has anything to do with a tax return. Someone who prepares tax returns, even if that is not the sole business activity, falls within this definition. A tax return preparer can even include a person who prepares a tax return outside the normal course of business or on a casual basis for a relative or friend, so long as he receives compensation.

"Tax return information" is defined to include any information that is furnished by a taxpayer in connection with the preparation of a tax return. It is important to note that such information includes "a taxpayer's name, address, or identifying number."

### DISCLOSURE WITH CONSENT

The disclosure or use of tax return information with the formal consent of the taxpayer provides that an accountant may disclose or use any tax return information consistent with the consent given. The regulation is very specific to the form of consent required, and it may be advisable for the accountant to consult with his attorney before preparing a consent form for the client. The accountant must be careful to draft a "purpose" broad enough to encompass the

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AICPA Professional Liability Insurance Plan

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information requested in the subpoena or other discovery request. As a practical matter, it is safer and easier for the accountant to tell the party seeking the information to get a court order compelling the production of such records. Even if it is too broad, such an order could protect the accountant from both criminal and civil liability.

## DISCLOSURE WITHOUT CONSENT

Disclosure or use of client tax information without client consent is allowed under some circumstances. However, IRS regulations only provide that such releases are not illegal. Many of these examples would nonetheless violate the accountant's duty of confidentiality imposed by state law, and might lead to liability to the client for damages caused by the disclosure.

Because of the length and complexity of the regulations, it is not possible to describe in this article all of the circumstances in which disclosure or use of tax information is permitted. These examples show how narrow the exceptions truly are and how carefully the accountant must proceed in trying to fit in with them.

**Disclosure to the IRS, Courts and Other Government Authorities:** Disclosure is permitted pursuant to a court order, a grand jury subpoena, or an administrative order, demand, summons or subpoena issued by any federal agency or by a state agency if it is charged "with the licensing, registration or regulation of tax return preparers." Even with such an order, the information must be "clearly identified in the document" before it is properly disclosed under this paragraph.

This can be a trap for an accountant if, as is typically the case, the discovery request is broadly worded and inherently ambiguous. For example, in federal court the court, rather than counsel, issues the subpoena. While not formally an order, such a subpoena is issued under the court's authority and it might be viewed as an order. However, the document description is generally drafted by counsel and may be too broad to fit the regulation's requirement of clearly identifying the tax return information. As a result, the accountant would still be prohibited from making the requested disclosure despite the court order.

Furthermore, the accountant should wait for the court, agency or grand jury to properly issue and serve the order or subpoena. The Georgia Court of Appeals found that an accountant could be liable to his client for damages when the accountant disclosed confidential information to the IRS pursuant to an informal request during a federal tax investigation. The court held that the disclosure violated the duty of confidentiality despite the fact that the IRS had the power to subpoena the information.

IRS regulations specifically allow disclosure "in revenue investigations or court proceedings" without the consent of the client but, again, in only two narrow circumstances. The first involves IRS investigations of the tax preparer himself, in which case he may make disclosures to his own attorney and to an IRS employee "for use in connection" with the investigation. The second involves "proceedings involving such tax return preparer before the court," or before a grand jury convened by the court, in which case he can make disclosures to his own attorney or *"to any officer of a court"* for use in connection with these proceedings.

Attorneys are typically viewed as officers of the court, but their clients are not, and it is not at all clear what the regulation means by court proceedings involving the tax preparer. Does this include any case in which an accountant is a party, or only those cases where the requested tax return information is at issue? It would seem to defeat the clear purpose of the rule to allow the former, in which case full disclosure of anyone's tax return information could be made in any case involving an accountant even where that taxpayer and his tax information were not at issue.

**Use or Disclosure for the Benefit of the Taxpayer:** If the tax preparer is a lawyer or an accountant, he may use tax information of a taxpayer whose return he has prepared in rendering other legal or accounting services for the client, or disclose it to another member of his law or accounting firm for such use. Also, in the normal course of providing those services, and if it is for the benefit of the client, he may disclose the client's tax return information to third parties such as stockholders, management, suppliers or lenders, with the express or implied consent of the taxpayer, but without the elaborate disclosure consent form otherwise required.

**Disclosure to Related Taxpayers:** The tax preparer may use one client's tax information to prepare a tax return for another client if the two clients have any of the following relationships: a) spouses; b) child and parent; c) grandchild and grandparent; d) partner and partnership; e) trust or estate and beneficiary; f) trust or estate and fiduciary; g) corporation and shareholder; h) corporations under common control under IRC 1563. This exception does not apply if the two taxpayers' tax interests are adverse or the first taxpayer expressly objects.

Although this exception seems extremely broad, remember it only makes such disclosure legal; it does not affect civil liability for breaches of an accountant's ethical obligation to keep client information confidential.

**Disclosure to Taxpayer:** Of course, the accountant can give the information requested to the taxpayer-client, who can then give it to the requesting party. No consent form is required, but a signed receipt or other record should be kept to document the procedure followed.

## INVITING CRIMINAL INVESTIGATION OR PROSECUTION

When an accountant is served with a grand jury subpoena or an IRS summons seeking client information, the accountant may unwittingly expose himself or his firm to potential criminal prosecution, either in conjunction with the prosecution of a client or separately. A typical

scenario might develop as follows:

An accountant goes out to the reception area to greet two visitors and is asked if he is the managing partner. When he answers "yes," the two gentlemen identify themselves as agents of the IRS, Criminal Investigation Division, and hand him a subpoena requiring the firm's "custodian of records" to produce the firm's records on a corporate client to a federal grand jury at the federal courthouse.

The agents explain that grand jury deliberations are secret and that they cannot disclose any details of the investigation to him. However, they do tell him that the grand jury is investigating the accounting firm's former client with respect to certain tax returns that were prepared for the client by the firm and that the firm is not a target of the investigation.

Based on these statements, the accountant assumes that his firm will not be involved except as a witness and that he is relatively safe in talking to the agents. In fact, the agents tell him he could possibly save himself a trip to the grand jury if he gives a short interview now.

During the conversation, the agents ask the accountant when his firm worked for the client and what it did on behalf of the client. He tells them. The agents also ask which accountant performed the work. The accountant gives the agents the names and telephone numbers for a retired partner and a staff accountant, neither of whom is currently with the firm. He does not subsequently contact either person himself. The accountant also agrees to produce the records and appear before the grand jury.

By handling the grand jury subpoena in this way, the accountant has exposed himself and his firm to potential criminal liability in several respects. First, the IRS agent's assurances that the firm is not a target of the investigation are unenforceable and meaningless. Just because the firm is not a target today does not protect it from becoming a target. Also, only a U.S. Attorney or Assistant U.S. Attorney can grant immunity; IRS agents cannot. IRS assurances to the contrary are similarly meaningless.

Giving a "short statement" now will not in most cases avoid a later trip to the grand jury. The "short statement" may prove to be nothing more than an introduction to the very time-consuming grand jury process. Giving a statement is particularly dangerous when no counsel is present to advise and assist the accountant. Even seemingly innocuous statements can expose the firm, its employees and the accountant to criminal liability down the road.

The accountant should also not agree to produce the records to the grand jury or to appear before the grand jury without first having consulted counsel. The assistance of counsel from the outset is especially important in grand jury matters since there is no right to have counsel present in the grand jury room itself. In other words, if the accountant is going to benefit from legal assistance, he must get the assistance ahead of time and not wait until he walks into the grand jury room.

As for the request for documents itself, the government is not going to reimburse his firm for his time and expense involved in producing the documents. Neither will the former client. In addition, the documents may contain information that could generate exposure. All of these issues can and should be negotiated with the government, but only through counsel who can shield the firm and its employees from making unnecessary but potentially expensive disclosures (both in terms of monetary cost and liability exposure).

The accountant's failure to contact former employees whose names he gave to the IRS could result in the former employees giving uncontrolled and uncounseled statements to the IRS and, eventually, the grand jury. Legal counsel for the accountant will have little if any opportunity to review those documents before the prosecutors begin to make use of them.

In short, what may seem like a simple, innocent meeting with the IRS in which the accountant tries to be efficient, helpful and cooperative is, in reality, fraught with great risk to the accountant and his firm. Care must be taken at every step of the way to avoid potential criminal exposure; that is, care must be taken to ensure that the accountant and his firm remain witnesses and never become targets of the investigation.

Such caution is well-advised because accountants, lawyers and other professionals are becoming favored targets of white-collar prosecutors. Criminal investigations involving accountants and accounting firms are increasing. And, prosecutors have been armed in recent years with racketeering and other criminal statutes that were originally aimed at hard-core criminals but which have been applied with startling ease to accountants and other white-collar defendants.

The collateral consequences to an accountant of involvement in a criminal investigation or prosecution—even if only as a witness—are severe. An accountant is not immune from suffering damage to reputation, loss of business and loss of professional licenses, let alone the threat of criminal fines and imprisonment. Also, once current or former clients become aware of the accountant's involvement (no matter how tangential) in a criminal matter, some of those clients may suddenly discover that the accountant has committed malpractice and file their own civil suits.

### FORMER CLIENT'S DEMAND FOR FULL ACCESS TO ACCOUNTANT'S WORK PAPERS AND OTHER RECORDS

Accountant's must deal with document requests not only from third parties and the government, but also from clients and former

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clients. Requests from former clients are particularly tricky to handle when the former client has not paid the accountant for services rendered.

The failure to pay may simply be the result of the client's procrastination. But too often a client fails to pay for accounting services either because the client is in financial trouble or is unhappy with the accountant's work. Unfortunately, a client who is in financial trouble may, sooner or later, look for a scapegoat. An accounting firm makes an attractive scapegoat. Therefore, there is a good chance that a client who fails to pay for accounting services will bring a malpractice claim against the accountant if the client's financial problems get out of control or if the accountant tries to collect unpaid fees.

This problem becomes especially apparent when a former client who has not paid the accountant's fees demands access to the accountant's work papers and other records. Typically, the former client asks the accountant to provide the client's new accountant with everything in the original accountant's files so that the new accountant can complete current tax or accounting work. Often, the situation arises when the former client is already in trouble with the IRS or a lender and is under a short deadline (maybe only a few days) to file new or amended tax returns or to deliver the financial statements.

The original accountant will be sorely tempted to do whatever the former client wants, particularly because the former client will almost certainly get his attorney involved if the original accountant balks at the request. The accountant can then expect to receive high-pressure phone calls from the attorney and letters filled with threats to sue the accountant for all resulting damages, including IRS or other penalties if the accountant does not drop everything else in his practice and cooperate completely and immediately.

The first thing an accountant faced with this situation should do is to consult an attorney of his own. Do not just accept everything the former client or his attorney says. More often than not, the former client's attorney is not experienced in dealing with accountants and lacks the legal knowledge and experience necessary to practice effectively or accurately in this area. The accountant who consults with an attorney who regularly deals with accountants' liability issues will be at least one step ahead of the other side.

Second, the accountant should not assume that the former client has the right to gain access to any and all documents in the original accountant's possession. States typically have statutes that deem all of an accountant's work papers and other records to be the property of the accountant, not the client. However, these statutes may also give the former client the right to copies of work papers to the extent that such working papers include records that would ordinarily constitute part of the client's records and are not otherwise available to the client. A statute like this rarely defines the terms used in the statute (like "client's record" or "otherwise available"). And there is little if any case law on point. In other words, the law appears to require an accountant to give a former client access to certain documents in certain circumstances but gives no guidance as to what specifically is required to be disclosed.

Third, before giving the former client access to any documents, the accountant may want to negotiate settlement of the fee issue first. The former client's need for documents and information can be used as leverage to get the bill paid. Obviously, the accountant will have to gauge how far he can press the fee issue without making the former client mad enough to sue, but there is no reason to simply hand over an accountant's work product to a former client who has not paid for it. If the former client is truly short on funds, he may have other assets (e.g. accounts receivable) in which the accountant can take a security interest.

Fourth, the accountant should (through his attorney) negotiate an agreement with the former client whereby any access to documents given will not be used to develop evidence for a potential malpractice suit against the accountant. For example, if the former client's new accountant is to review the original accountant's documents, the new accountant should not be allowed to testify as a witness (expert or fact witness) in any later litigation involving the former client and the original accountant. No information or documents gained by the former client or his new accountant through a review of documents ostensibly done for current tax work only should be used to develop or litigate a later suit against the original accountant.

An accountant may be faced with many requests for documents, from a wide variety of sources. But an accountant should never place his practice in jeopardy by succumbing to those demands without, first, giving careful consideration to the risks involved and, second, working hard to minimize the potential liability exposure.

*Ms. Eklund is a shareholder in a Seattle law firm specializing in the defense of professionals, including accountants.*

# The Spectre of Professional Liability ☠ Haunts Every CPA ☠

by: Julia Winn

Today when a bank fails or an acquisition goes awry the accountant is a sitting duck for plaintiffs' attorneys looking to recover lost moneys. When attorneys go down the checklist for potential defendants, accountants are right at the top. Why? They're easy targets.

"It's not that accountants have deep pockets," Ron Katch of Katch, Tyson & Company says, "it's because accountants tend to be insured." Katch, the former chairman of the AICPA Professional Liability Insurance Plan Committee, says the accountant shouldn't take the lawsuit personally. "When somebody files a claim against an accounting firm, they aren't really looking to get that accountant to dig into their pocket or bank account to pay the claim. They are looking for the insurance company to pay the claim."

Approximately 12,000 practice units are enrolled in the AICPA Professional Liability Insurance Plan. Katch says 600 to 700 claims are filed every year.

There was a time when accountants were rarely sued. According to attorney and CPA Larry Wojick of Keck, Mahin & Cate, there were very few decisions in the 1960s. Those days are over. "Now entire books are devoted to this subject," Wojick says.

Blame the situation on the competitive nature of accounting services. Many firms have become price sensitive. And sometimes when you cut corners to cut costs, controls become less stringent.

"In that sense, it makes it much harder to take additional steps because everyone is competing on price," attorney Matt Iverson of Burditt, Bowles & Radzius, Chtd. says. "You are reluctant to extend your procedures because you might have to pay for it."

There is a great deal of credence to that statement. Katch says when he first got involved with the AICPA Plan in 1985, approximately 50 percent of the claims were frivolous, 25 percent were what he termed borderline frivolous, and only 25 percent were solid claims.

"Today in more than half the claims the accountant did something wrong," Katch says. "So we are not taking the care we should be taking in terms of the quality of our work and the advice we are giving out."

The number of substantiated claims is not the only thing that has changed over the years. The type of claims made against accountants has also changed. Whereas it used to be in auditing services, the biggest area for number of claims today is in taxes. For 1993, more than 46 percent of all claims against the AICPA's Professional Liability Insurance Plan were for tax engagements.

Part of the problem may be because the accountant is at the mercy of the vagaries and whims of the federal government. According to Katch "even though the accounting and auditing area has changed significantly in the past 10 years, considering all the FASBs, SASes and everything else, it's nothing compared to what happens to the Internal Revenue Code. Any tax act that has occurred in the last 10 years has not been of minor consequence. When you consider every year or every other year there's a major tax act, you never get to really learn the regulations and codes because as you are learning, it changes again."

Even though constantly changing tax codes are a good excuse, the accountant will get no sympathy from the taxpayer if a filing or election is missing and the client is charged with penalties. "Regardless of whether the accountant offers to pay them or not, the taxpayer won't think twice about filing a claim," Katch says.

Another area ripe for claims against accountants is management advisory services. Right now, it is only 9 percent of all claims, but pundits say it won't stay that way for long.

"You have very sympathetic plaintiffs coming in saying the accountant promised after this automated computer system was installed it would be able to handle three times as much business," Wojick explains. "When that doesn't happen, it turns into a lawsuit.

"So you have a plaintiff who takes the stand and says, 'Look, it didn't work. I don't know how it's supposed to work, but it didn't and they promised me it would work.'

"In most cases it is left to the accountant to explain to the jury the nuances and complications of the systems. And, in the jurors' minds, the more complicated the system, the more likely the plaintiff, who is the uneducated party, was relying on the accountant as the expert."

The majority of claims never even make it to the judge and jury stage. "The statistic most bantered about is 95 percent of all civil cases are resolved short of a trial," Wojick says.

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The slowness of the judicial system is a great inducement to settlement. "The litigants are in the best position to know the strengths and weaknesses of the case," Wojick explains. "After pursuing discovery—which is nothing more than finding out the facts—for a couple of years, the parties are encouraged to resolve their differences rather than have a judge and jury, who know nothing about the facts, hear them in a very condensed period under very strict limitations."

Wojick says as a rule civil cases take between four and five years before they come to trial.

There is also an inherent risk in going to court because virtually anything can happen in the courtroom. "Human beings are jurors," Wojick says, "and human beings are witnesses. You find predictability decreases substantially when people enter into a public forum and testify."

Case in point: A plaintiff was seeking $381,000 plus punitive damages. The jury was out less than half an hour. The judge thought the

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# Self-Assessment Guide for Your Practice

The following guide is designed to help you evaluate your firm's exposure to professional liability claims. It is not designed to evaluate potential malpractice exposures; rather, it will help you identify common malpractice exposures and those areas where loss control can be an effective tool in controlling malpractice exposures.

## INITIAL INTERVIEW

***During the initial interview with prospective clients, do you ask about:***

- Nature, scope and purpose of services to be rendered?
- Starting and completion dates for the engagement?
- Potential conflicts of interest?
- Client business and performance?
- Stability and experience of client management?
- Client accounting policies and procedures?
- Possible client involvement in litigation or disputes with regulatory agencies?
- Client understanding of responsibilities in completing engagement?
- Client customers and suppliers?
- Acceptability of your fees and billing practices?
- Reasons for client leaving prior accounting firm?

## CLIENT SCREENING

***Prior to accepting an engagement, do you:***

- Verify client information by contacting creditors, suppliers and customers?
- Obtain information from client's former accountants?
- Gather financial information on the client's business and the industry in general?

## THE ENGAGEMENT

***Does your firm:***

- Obtain a signed engagement letter before work begins on any engagement?
- Provide the client a written fee agreement?
- Require the client to sign a management representation for compilation, review or audit engagements?
- Document all work performed and explain all decisions made?
- Ensure all engagements are performed in accordance with AICPA standards?

***Firm management:***

- Dual calendar diary system to remind the staff of all time-sensitive matters?
- System to screen clients and prospective clients for conflicts of interest?
- Quality control system to assure technical accuracy?
- Mandatory educational and training requirements for all staff?

***Client Relations:***

- Return all client phone calls or other inquiries within 24 hours?
- Confirm all oral client communications with a written follow-up?
- Provide the client detailed accounting of all time and charges for an engagement?

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accountant had won. The accountant thought he had won. The plaintiff's attorney thought the accountant had won.

When the verdict came in, after only a 30 minute debate, the jury awarded the plaintiff $400,000—which was more than he asked for—and $1 million in punitive damages.

The punitive aspect was based upon the accountant yelling at the plaintiff in the plaintiff's office in front of the secretary. The accountant found something he thought was fraudulent and brought it to the attention of management in probably what was not the calmest of terms. The jury said that was punitive damage exposure.

The case was overturned on appeal.

In addition to risk, going to court is expensive. It's an automatic six figures just for defending yourself.

In one recent case, legal fees before the trial were $227,000. Including the final pre-trial costs, the trial costs of several hundred dollars a day per diem for a three week trial plus expenses, legal fees totaled $325,000—and the accountant won.

But that is not really the expensive part because, depending on your policy, insurance could cover the legal fees minus the deductible. The expensive part lies in the intangibles of being sued.

"If Katch, Tyson & Company gets sued in Northfield, Illinois, do you think it would ever appear in the Chicago *Tribune* or Chicago *Sun-Times*?" Katch asks. "Hell no. It's not news. But in Cedar Rapids, Iowa a claim could make the headlines."

"For example," Wojick says, "an accountant gets sued for $3 million. That makes the paper. If the claim is settled for $15,000 it is doubtful, even if the accountant wanted the publicity, any paper is going to cover a $15,000 settlement. But it's important to the accountant. Obviously $15,000 reflects on the veracity of the complaint in the first place.

"Even in cases that have gone to trial I have never seen 'Accountant Wins Case' on the front page.

"It's hard to put a dollar value on what potential client is not going to call you because of adverse publicity. But it is a price that has to be factored in."

Another intangible cost is lost billable time because partners are consumed with preparations for defending themselves.

Wojick says his most recent case involved an accountant, a partner, who got to his office at 7:30 a.m. He was at Wojick's office by 8:30 a.m. to prepare for the day's trial and was in court at 10:00 a.m. He then went back to his office at night and worked until 9:00 p.m. at the earliest. And that, Wojick says, included weekends.

"A tremendous amount of human resources are required," Wojick explains. "Why is that? Because the case is usually fairly complicated. The stack of working papers themselves extend several feet deep. The accountant has to be prepared for cross examination. We have experts we have to prepare to depose and cross examine at trial. It is so much of a drain that it is almost impossible to focus on any other work or any other relationship."

One accountant had a claim filed against him that appeared frivolous. It was ultimately judged frivolous and thrown out of court. But the accountant had to pay his $5,000 deductible and his professional liability insurance paid over $75,000 in legal fees and expenses. His staff had to be interviewed by both defense and plaintiff's attorneys and files had to be photocopied. There were travel expenses from his four offices and overnight stays so he could appear for interrogatories.

There is one other cost of being sued. That is the emotional toll it takes both personally and professionally.

"I have been involved in some cases where the claim is in excess of the insurance available, where the claim is generating adverse publicity for the firm," Wojick says. "It is disruptive to the practice of public accounting. You have to explain to clients why you are being sued.

"But more important, I find, it is very disruptive within the firm. It strains relationships between partners and staff. Sometimes there is finger pointing that goes on between people as to who was responsible.

"All the accountants I have represented pride themselves on being professionals. It is a very depressing fact to learn there may be problems with one's work.

"There are probably very few experiences in life that can be as distasteful and unpleasant as being subjected to a deposition or to appear on the stand over a series of days about one's audit work and having that audit work placed under a microscope and placed out of context with all the work that was performed.

"Going to a trial is probably as close as you can come to going into battle."

*Ms. Winn is the editor of "Insight", published by the Illinois CPA Society, from which this article is adapted with permission.*

## Loss Prevention Seminars

To help AICPA members further reduce the cost of their premiums, CNA sponsors a series of Loss Prevention Seminars. CNA plans at least 60 such seminars for 1994. These seminars are designed especially for small to medium sized accounting firms. For larger firms, individualized seminars may be arranged on a case by case basis. Accounting professionals who attend the seminar can earn a credit towards their premium, and can earn up to four hours of CPE credit, depending upon state insurance department approval. The feasibility of expanding the course for additional CPE credit is being explored.

The premium discount can be as high as 7.5% a year. The discount is based on the percentage of accounting professionals in a firm that attend the seminars. For example, if three accountants in a firm of six professionals attend the seminar, the premium discount is half of the 7.5% available, or 3.75%. An individual accountant's attendance is applicable for three consecutive years towards the firm's premium credit.

The seminars increase an accountant's awareness of potential liabilities, reduce the chances of a claim, and aid an accountant in handling potential claims situations. Each seminar topic assists accountants in recognizing behaviors or conditions that may decrease the risk of a malpractice lawsuit, through a comprehensive workbook and video vignettes.

Detailed information, including dates and locations of these seminars will be mailed to AICPA Plan Insureds 8 weeks prior to the seminar in their area.


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