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How to Get Sued: Ten Easy Ways for Accountants to Get into Trouble

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Rollins Burdick Hunter Company

American Institute of Certified Public Accountants (AICPA)

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How to get sued

Ten easy ways for accountants to get into trouble

Number 1 in a Series Prepared By
AICPA Professional Liability
Insurance Plan Committee

ROLLINS BURDICK HUNTER

As brokers and administrators of the AICPA Professional Liability Insurance Program, Rollins Burdick Hunter Co., has had the opportunity to analyze the various factors that lead to an accountant's getting sued.

We believe the article reprinted here is an excellent summary of those factors and we want every firm that has joined the Program to have a copy, in the hope that it will help you avoid the common mistakes that can lead to lawsuits.

The article is excerpted from a talk given by David B. Isbell at a meeting of the San Francisco Chapter of the California Society of Certified Public Accountants. He practices law in Washington, D.C. and is a member of the bars of the District of Columbia, Connecticut and the Supreme Court of the United States.

Reprinted from a talk given by David B. Isbell in 1975.

How to Get Sued

by David B. Isbell

RULE ONE.

Choose clients who are about to go under and stick with them.

It's an obvious fact that most suits against accountants follow some significant disaster to the client. Of course, you cannot, as a practical matter, limit yourself to fat-cat clients. But what you can do, and what on a number of occasions accountants realize afterwards that they should have done, is to take special precautions when your client is in trouble.

You can also do another thing, which is to disengage when your client is in trouble. Let me mention, by way of illustration, the *Continental Vending* case.[1] I'm going to refer to that case on several occasions in the course of my talk, but I will not describe the case because I assume that all of you are fully familiar with it. If you are not, you ought to be. In the *Continental Vending* case, the accountants had withdrawn their opinion before the financial statements of their clients were filed with the SEC in connection with the 10-K. Had they withdrawn their opinion a few days earlier, before *Continental Vending's* annual report to stockholders went out, almost certainly there would not have been that case.

RULE TWO.

When your client is in difficulty, let him cow you by blaming you for delay in discovery of the problems, by threatening loss of the account, by telling you "we're all in this together," by threatening suit.

All sorts of suits are threatened in these circumstances: suits for libel, suits for breach of contract, suits for some unspecified harm that will befall the client unless you stick with it. I won't illustrate this rule by reference to any specific reported case, but I will say that I know from personal experience that all of these are very common reactions of management of the client which has gotten in trouble. "It's all your fault," they say, "and you'd better not make it worse." I'm afraid that it occasionally happens that accountants not only put up with this kind of guff, but believe it. It sometimes happens that the accountant forgets, in this moment of

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[1]*United States v. Simon*, 425 F2d 796 (2d Cir. 1969).

stress, that his principal obligation as a professional is not to help the client, but to exercise his honest and independent judgment. It happens, too, that he forgets that if he goes down the line with financial statements which fail to make legally adequate disclosures, it's not just the company and its officers who are likely to be sued, but himself. It also happens that the accountant considers that the loss of the client is more serious than the possible losses that would result from a suit brought against him.

RULE THREE.

Choose clients whose principals are not honest, and take no extra precautions.

Here's a rule that is easy to illustrate. The *Continental Vending* case again pops to mind. The principal malefactor there was the principal stockholder and chief executive officer of the company. It was he who diverted funds from *Continental Vending* to an affiliated company, which diversion of funds was the basis of the various lawsuits involving *Continental Vending.* In the criminal case, he pleaded guilty to the conspiracy charge and testified against the accountant defendants.

The problem of crooked clients, and the hazards of criminal prosecution to which the auditors of such clients may be exposed, have been vividly illustrated also in two recent highly publicized cases where accountants have been convicted of criminal participation in their client's fraud: *Equity Funding,*[2] and National Student Marketing.[3]

The rule is also well illustrated by another case which I will refer to on several occasions in the course of the talk and which I will tell you a little bit about, because you probably have not had the opportunity to become as familiar with it as you have the *Continental Vending* case.

This is the case of *1136 Tenants Corporation v. Max Rothenberg & Co.,*[4] a case in the New York State courts involving a suit by a cooperative apartment corporation against accountants who did write-up work and prepared unaudited financial statements and tax return information. The suit was based upon a failure by the accountants to discover defalcations by the president of the corporation's managing agent. The trial court found for the plaintiffs, and the case was taken to the Appellate Division, the intermediate appellate court, where the American Institute of CPAs, together with

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[2]*United States v. Goldblum,* Crim. No. 13390, U.S.D.C.C.D. Calif.
[3]*United States v. Natelli,* CCH Fed. Sec. L. Rep. ¶ 95,250 (2d Cir. 1975).
[4]319 N.Y.S. 2d 1007 (App. Div. 1971).

the New York State Society of CPAs, filed an amicus curiae brief. That court also held against the accountant defendants, and appeal was taken to the New York Court of Appeals, the highest court of New York, where again a joint amicus curiae brief was submitted, but where the decision was affirmed without opinion.

The main issue in this case was the scope of the accountants' engagement: the question was whether they had been engaged to perform an audit, in which case it was conceded that they should have discovered the defalcations; or whether, as the accountants contended, they had been engaged merely to do write-up work. The trial court held against the defendants on that issue, and that was the main holding. The Appellate Division affirmed principally on that ground. The trial court also used some unfortunately loose language in its opinion which might be read to say that even if the accountants had only been engaged for write-up work, they nonetheless were under an obligation to perform sufficient auditing procedures to discover defalcations. It was that language in the lower court's opinion that principally gave rise to the Institute's concern and led to the submission of the amicus curiae brief. I'm glad to say that although we did not win in the Appellate Division, nonetheless the decision of that court did not appear to perpetuate this language of the lower court. While the appellate court's decision may have rested in part on the same misconception of what an accountant's obligations are, it does not appear to me to be as dangerous a case for precedental purposes as the lower court decision.

To return to Rule Three, after that little detour to describe the *1136 Tenants* case, the point I want to make by way of illustrating the rule concerns the president of the managing agent of the cooperative corporation. This fellow was an embezzler: his defalcations were the ones that the accountants had failed to discover and report to their client. He was the one who originally retained the accountants for the cooperative apartment corporation and he testified, believe it or not, that he had retained them to do an audit—which of course, had they performed it, would have uncovered his defalcations. That testimony, alas, was credited in substantial part by the court.

Still another case—one that, at this writing, is before the United States Supreme Court—should be mentioned under this rule: the case of *Hochfelder v. Ernst & Ernst*.[5] There the auditors were held subject to liability as aiders and abettors of a fraud committed by the president of their client, because they might be found negligent in failing to discover it in the course of their audit.

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[5]*Hochfelder v. Ernst & Ernst*, 503 F.2d 1100 (7th Cir. 1974), cert. granted, 421 U.S. 909 (1975).

What should you do if you think principals or key agents of the clients are crooked? You needn't quit, although as pointed out in connection with an earlier rule, you are not necessarily prevented from doing so. What you can, and indeed must, do, is to exercise extra care.

RULE FOUR.

When trouble develops, keep your own counsel; don't consult your colleagues; and never consult an attorney.

I can illustrate this rule again by reference to the *Continental Vending* case, where the failure of consultation had a particularly poignant twist to it. The Court of Appeals in that case, in affirming the judgment of the conviction of the lower court, pointed out that there was evidence that suggested that the defendants had, in the course of the *Continental Vending* audit, failed to consult a partner in their firm with whom there was an established procedure that he was to be consulted about problem audits. There are two points to be made about this. One is that it is possible, at least, that had they consulted this partner, they would not have found themselves in the position that they ultimately did, with financial statements that included a crucial footnote which they themselves admitted was susceptible of serious misinterpretation. And indeed, in this light, as you doubtless know, the firm involved has, since the *Continental Vending* decision, adopted a policy requiring in *every* audit where a report is to be publicly issued, that before the report is issued it be given a "cold" look by a partner wholly unassociated with the audit. A very good policy.

The other point—the additional twist about the *Continental Vending case*—is that the Court of Appeals pointed to this evidence that the defendants had not consulted with the partner with whom normally they should have consulted, as evidence from which the jury could infer a deliberate intent to defraud.

I'd like to address myself now to the other aspect of this rule: the suggestion that it is a good idea to consult attorneys when you have a problem that may have legal ramifications. I'm clear that this is all too seldom done. I'm also clear that it can be helpful, even if the attorney cannot bring great expertise to bear—and relatively few attorneys can, because relatively few attorneys have been consulted by accountants, or have had other occasions to become familiar with problems of accountancy from the point of view of the practitioner of accountancy. It can be useful, nonetheless, even if the attorney does not have that extra expertise. It can be useful to get even a layman's view, particularly shar-

pened with the perspective that attorneys presumably have, of what a friendly neighborhood judge or jury—who after all, are also laymen—might think about the transaction in question.

I have seen several times the quite extraordinary picture of a company in trouble negotiating with the accountants about some matter, the company being represented up one side of the table and down the other by counsel. Typically, there will be outside counsel and perhaps in-house counsel as well; there may be a director who also happens to be a lawyer; if it's an SEC problem, there may be special SEC counsel. Now it's the company versus the accountants. The company is saying no, we don't have to make this kind of disclosure, we don't want you to make that kind of disclosure, it will put the company in terrible trouble—bringing pressure upon the accountant, invoking legal expertise as to whether or not disclosure is required. And the accountant is sitting by himself, perhaps with a colleague, but without legal advice, making a decision about which his neck is in the noose, and which is often basically a legal decision. If it's a matter of adequacy of disclosure with respect to an SEC filing, for example, it is likely to be basically a legal decision.

In sum, I urge you to turn the rule upside down when there is possible trouble: consult a colleague who can bring an independent judgment to bear. Consult an attorney.

RULE FIVE.

Leave your engagement in oral form, and as vague as possible.

The *1136 Tenants Corporation* case is a perfect illustration of this rule. As I mentioned, the key issue in that case was the scope of the engagement: whether it was an engagement for an audit or only to prepare unaudited financial statements. There was no engagement letter—and I'm sure that is still true in the majority of instances where unaudited financials are called for. It was really quite clear, I believe, to the eyes of an accountant or of someone who has had some experience of such matters, that the financial statements which were submitted to the client by the accountant were unaudited financial statements. You might think that the actual performance by the accountant of his engagement, as represented by his submission of these financial statements, would be persuasive evidence of what the accountant had been engaged to do. There was, however, no explicit evidence in the form of a letter of engagement. The plaintiffs were able to put in their evidence about the scope of the engagement—part of that evidence as I have indicated, being testi-

mony by the embezzler himself that he had retained the accountants to perform an audit. The problem of that case could well have been avoided by an engagement letter, which might have effectively removed the issue of the scope of the engagement from the matters to be disputed in trial.

RULE SIX.

Pay no attention to Statements on Auditing Standards and Pronouncements of the APB and FASB.

Because I have been thinking about the *1136 Tenants Corporation* case, I suppose I'm particularly conscious of Statement on Auditing Procedure 38 (now SAS 1, §516) with regard to unaudited financial statements. That statement was not in effect at the time of the events concerned in the case, but I'm afraid that the practices that were reflected in that case do continue to this day despite the fact that a statement has been issued which prescribes exactly what should be done with regard to unaudited statements. I'm afraid it still occurs that there are financial statements prepared that do not carry the legend "unaudited" or do not carry a disclaimer—as was true of the financial statements in this case. In this case the only identification was a legend carried on each page of the financial statements, saying "subject to comments in accompanying letter," and the letter did not contain a disclaimer as such, but only, "no independent verifications were undertaken thereon."

The use of that slightly odd phrase just quoted gave rise to another area of dispute. The plaintiff produced an expert witness who testified that "independent verification" has a special meaning in auditing, referring to those audit steps that involve confirmation outside the client; so that the phrase "no independent verifications were undertaken" would carry the negative implication that other kinds of verification were undertaken. The use of this variant language, with the peculiar interpretation to which it was susceptible, was of some importance in the case because the audit steps that would have been necessary to detect the defalcations were steps involving work only on the client's records and did not require any confirmation with outside parties.

RULE SEVEN.

Make representations freely.

In illustration of this rule, I would like to refer to another case involving unaudited financial statements, a case

called *Ryan v. Kanne*[6] which was decided in 1969 by the Supreme Court of Iowa. Here again, the accountants had prepared unaudited financial statements. In this case they were adequately marked as unaudited and they carried a disclaimer, and there was no question but that they were unaudited financials. However, the accountants in an accompanying letter stated, "We have confirmed payables-trade." The accountants also orally made representations that the payables-trade were correct within $5,000. Now, in fact, the accountants had not adequately confirmed the payables, which were understated by $49,000; and the accountants wound up paying a good part of the understatement. This occurred not because the court did not recognize that they were unaudited statements but because the accountants had made an affirmative representation that they had confirmed the payables-trade, and the payables-trade were a crucial item. (The court did make a $5,000 allowance for the margin of error that the accountants had mentioned in their oral representation.)

RULE EIGHT.

Use technical terms in a loose and carefree fashion.

This is really a sub-rule of the one just stated. It is suggested, however, in a particularly impressive manner by the *1136 Tenants Corporation* case. In this case, surely the critical evidence with regard to the scope of the engagement, from the viewpoint of the court that tried the case, was use of a term on some schedules which were attached to these unaudited financial statements. The schedules included one for accrued expenses payable; and that schedule listed the amount of the accountants' fees that were accrued and unpaid. It identified those accounting fees by the word "audit." I'll bet there's more than one person in this room whose firm still uses the word "audit" simply as a convenient way of describing accounting services, regardless of whether they really involve an audit or are merely write-up work or preparation of unaudited financials. Well, I assert to you that any judge or jury would be likely to be enormously impressed by the fact that an accountant who was claiming that he had only done write-up work and not an audit, had nonetheless represented that his client owed him for "audit" services. The amount of the item in this case was $600 in one year, which was the full year's fee and in the other year was only $150.

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[6] 170 N.W. 2d 395 (Iowa 1969).

RULE NINE.

Be casual about the way you perform your professional work generally.

This, of course should be Rule One, for an accountant is legally obliged to perform his work with due professional care and competence. He is not subject to liability unless he fails to do so. As you know, there is a legal distinction of great importance between care on the one hand, and honesty on the other—want of care being negligence and want of honesty being fraud. This distinction is significant because it governs the circle of those who can sue the accountant for a breach of his obligation. The accountant is, as a general matter, liable for negligence only to the client, except in connection with offerings of securities registered under the Securities Act of 1933, where he is liable for negligence to all purchasers. He's also liable to third parties, such as creditors and stock purchasers, who fall within the primary benefit rule: that is, those whose use of the information which he furnishes is, to quote a phrase of Cardozo's, "the very end and aim of the transaction." To those persons the accountant has liability for negligence. To other third parties, who include the vast majority of those who may use the financial statements with which he is associated or on which he has issued his opinion, his liability is only for fraud.

What I've just said describes the law as it was yesterday and not necessarily as it may be tomorrow, but for the moment I believe that what Judge Cardozo in the *Ultramares*[7] case called the "citadel of privity," is still holding out—though it is still, as it was then, under attack.

In any event, all of this is really irrelevant in practical terms for you as practitioners because there is no point in trying to make a distinction between honesty and care in order to limit your liability. You must be honest in any event, and you cannot very well exercise care with regard to part of an engagement and not with regard to another part of the engagement. You simply have to be careful about everything and at all times. Let me just add a footnote here, which is that you've got an obligation of due care not only with regard to audit work but also with regard to the preparation of unaudited financial statements. What you have to do to discharge your duty of care is, of course, markedly different as between unaudited financials and audited ones, but the legal standard to which what you *do* do is held, at least as a verbal matter, is the same.

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[7]*Ultramares Corp. v. Touche*, 225 N.Y. 170, 174 N.E. 441 (1931).

RULE TEN.

Always sue for unpaid fees.

This is a very fine way of getting into trouble. I have mentioned the case in Iowa, *Ryan v. Kanne.* That case arose because the accountants had unpaid fees of $3,434.67, and brought suit to recover their fees. They were in fact awarded their fees, but they also got to pay a counterclaim for $23,000.

I'm not saying that you should never, under any circumstances, sue; I'm only saying that it is a hazardous course. A much better course, I suggest, is periodic payment as the work progresses. Keep your client paid up.

Now those are my ten rules on how to get sued. There is however, another practical suggestion that ought to be tossed in here. It has to do with saving money. Let's call it **Rule Eleven.** It is: *Don't bother with liability insurance;* or if you do, keep it to a minimum. You may save several hundred dollars a year in this fashion. Of course, you may also, like the defendants in the *1136 Tenants Corporation* case, get socked with a judgment for $236,000 on an engagement where your fee was $600 a year. (Incidentally, the accountants in that case also recovered their unpaid fees of $1,000.) Or if a suit is brought on a 1933 Act offering where you had certified the financials, you may get sued for the entire amount of the offering.

None of this, of course, will happen to you—unless you forget about one of the other ten rules.

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