

Before You Sue The Accountants

Daniel J. Hurson

**Even if it looks like a strong case,
be careful—there are some surprising defenses.**

IN THE WAKE OF the corporate accounting scandals that have dominated the business news for the last few years, as well as recurring announcements of large settlements in class action suits against major accounting firms, the prospect of a malpractice case against an accounting firm would at first glance seem attractive. Juries are presumably more predisposed to

view accountants with renewed skepticism, when hardly a news cycle passes without some reference to accounting fraud, investigations, and the occasional large-scale debacles like the demise of Arthur Andersen, not to mention the high-profile criminal prosecutions that have recently gone to trial.

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Indeed, among the players in these sagas, the accountants sometimes offer the best litigation target. The companies themselves have often tanked; the errant executives dismissed, awash in legal problems, and without insurance coverage; but the accountants (Andersen notwithstanding) live on and prosper. They are generally deep-pocketed and amply insured, and the surviving "big four" firms are vast international organizations with billions in revenues. Even the middle-tier accounting firms are substantial in their own right, and are recently acquiring more and bigger clients as the big four shed smaller clients. In fact, the big four are dropping clients at three times the rate they did in 2002, either because they present liability concerns or because the new accounting requirements imposed by the Sarbanes-Oxley Act have sharply increased audit fees charged by the big four and priced them beyond the budgets of many smaller-cap public companies. *Sorry, the Auditor Said, But We Want a Divorce*, New York Times, Feb. 6, 2005.

Your prospective client may be a bankruptcy trustee, or the board members of the audit client who has been required to restate past financial reports that were previously given clean audit opinions, or the injured company itself. (Many high-profile suits have been brought by investor classes under the federal securities laws, a subject beyond the scope of this article. The pre-

sumption here is that you will be representing an individual creditor, trustee, or company. For a good primer on all liability theories, see Richard P. Swanson, *Accountant's Liability*, ALI-ABA Course of Study Materials, May 2004.) Often, a third party such as a lender, supplier, or investor in an audit client who has relied on that firm's clean report on the audited financial statements to its detriment, will ask the logical question: "Can I sue the auditors?" It seems appropriate to sue for malpractice the very accountants who opined that all was right with the debtor's books. Any lawyer who has tried negligence cases, particularly professional malpractice, might think this another trip down familiar paths.

Not exactly. Accountant malpractice litigation is a minefield of arcane judicial doctrines layered over pleading and discovery traps that can bury the best plaintiffs' counsel. The accounting industry has, for decades, successfully worked the legislative chambers and litigated in the courts to dig itself a moat of judicial and statutory protection more daunting than that enjoyed by any other profession. Even if the plaintiff breaches the fortress, he will encounter the bewildering Alice-In-Wonderland worlds of generally accepted accounting principles ("GAAP") and generally accepted auditing standards ("GAAS"), whose spider webs of rules, interpretations, and literal "layers" make the federal tax code look simple. Accounting industry defense lawyers know this territory as if they learned it in grade school.

This article represents an effort to lay out some of the initial factors counsel should consider before taking on an accounting malpractice case. Reviewing the case law, it is clear that many cases that appear to be "good on the merits" have been dismissed or lost on summary judgment for failure to meet these often confusing and conflicting legal and factual hurdles.

CONSIDER THE CLIENT'S RELATIONSHIP TO THE ACCOUNTANTS • Initially, it is critical to understand the exact relationship between your client and the accountants, from which will flow the legal ground rules for the case. Many accountant malpractice suits involve litigation by unhappy clients against their auditors, often for bad tax advice, errors in GAAP accounting that require restatements of financial reports, or for failing to catch fraud such as embezzlement. We consider these below.

Foreseeable Plaintiffs

However, unlike the typical malpractice case against the doctor or lawyer, many of the largest-dollar accountant malpractice cases involve aggrieved third parties, such as investors in, lenders to, or sellers of goods or services to companies, audited by the accountant, that have subsequently failed financially. If traditional standards of negligence law applied, reasonably foreseeable victims, even those not in privity with the defendant accountant but who placed reasonable reliance on its professional opinions, should recover. But in almost all states, that is not the law of accountant malpractice. In fact, over the last 60 years or so, individual states have diverged markedly with regard to the liability of accountants to third parties. Some states require privity, others "near-privity," but only handful apply the liberal standards of foreseeability familiar to products liability cases. A few states, New Jersey for example, have protected accountants by overruling liberal opinions by statute.

Restatement Section 552

Most states, with some important exceptions, follow the *Restatement (Second) of Torts*, section 552, which defines the tort of negligent misrepresentation, generally used in such actions, as follows:

If traditional standards of negligence law applied, reasonably foreseeable victims, even those not in privity with the defendant accountant but who placed reasonable reliance on its professional opinions, should recover. But in almost all states, that is not the law of accountant malpractice.

"One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.

[T]he liability stated in Subsection (1) is limited to loss suffered (a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it; and (b) through reliance upon it in a transaction that he intends the information to influence or knows that the recipient so intends or in a substantially similar transaction."

As noted by Professor Feinman of Rutgers Law School in a recent comprehensive analysis of auditor liability: "Courts that have adopted the *Restatement* rule regard it as prescribing an intermediate standard for liability between privity or near privity and foreseeability. As the

North Carolina Supreme Court stated in its much-cited opinion in *Raritan I* (*Raritan River Steel Co. v. Cherry, Bekaert & Holland*, 367 S.E.2d 609, 617 (N.C. 1988)):

“[Section 552] recognizes that liability should extend not only to those with whom the accountant is in privity or near privity, but also to those persons, or classes of persons, whom he knows and intends will rely on his opinion, or whom he knows his client intends will so rely. On the other hand, as the commentary makes clear, it prevents extension of liability in situations where the accountant ‘merely knows of the ever-present possibility of repetition to anyone, and the possibility of action in reliance upon [the audited financial statements], on the part of anyone to whom it may be repeated.’ *Restatement (Second) of Torts*, Sec. 552, Comment h. As such it balances, more so than the other standards, the need to hold accountants to a standard that accounts for their contemporary role in the financial world with the need to protect them from liability that unreasonably exceeds the bounds of their real undertaking.”

Feinman, *Liability of Accountants For Negligent Auditing: Doctrine, Policy, And Ideology*, 31 Fla. St. U.L. Rev. 17, 42 (Fall 2003).

States That Follow The *Restatement*

According to Prof. Fineman’s survey, as of Fall 2003, the following states follow the *Restatement* (or what amount to a similar analysis):

- Alabama;
- Alaska;
- Arizona;
- Colorado;
- Florida;
- Georgia;
- Hawaii;
- Iowa
- Kentucky;
- Massachusetts;
- Minnesota;
- Missouri (similar test);
- New Hampshire;
- North Carolina;
- North Dakota;
- Ohio;
- Pennsylvania (but not always);
- Rhode Island;
- South Carolina;
- Texas;
- Tennessee;
- Washington; and
- West Virginia.

Nebraska is “unclear.” *Id.* n.165. Wisconsin and Mississippi courts have adopted a more liberal standard, applying general negligence principles of foreseeability. *Id.* at 40-41. California follows the *Restatement* but severely limits liability, narrowly interpreting the accountant’s knowledge requirement by holding that the auditor must have “undertaken to inform and guide a third party with respect to an identified transaction or type of transaction.” *Bily v. Arthur Young & Co.*, 834 P.2d 745, 767-69 (1992). This interpretation has the effect of “practically equating the knowledge requirement of section 552 with the intended beneficiary requirement of contract law.” *Id.* at 30. (Another article that sets forth the law in multiple jurisdictions is Pecini, et al, *At the Interface of Law and Accounting: an Examination of a Trend Toward a Reduction in the Scope of Auditor Liability to Third Parties in the Common Law Countries*, 37 American Business Law Journal 171 (January 1, 2000).)

New York: The *Ultramares* Rule

New York has traditionally followed a restrictive test, set out initially in *Ultramares v. Touche*, 174 N.E. 441 (N.Y. 1931), historically the