The Accountant/Attorney Liability Reporter

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December 2014

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Claim for Failure to Notify of Potential Fraud Allowed to Proceed

By Lindsey Smith, Esq.

IN A MICHIGAN CASE DECIDED THIS YEAR, the Court of Appeals of Michigan considered whether a client may sue its accountant and accounting firm for breach of contract, malpractice, and breach of fiduciary duty based upon failure to identify and prevent embezzlement by the client's controller. Although the Court split its decision, affirming dismissal of the malpractice and fiduciary duty claims, while allowing the client to maintain and amend its breach of contract claim, the decision offers a good analysis of all three claims and provides guidance for accountants to understand their exposure to civil liability arising out of the performance of their professional services.

In *Banker & Brisebois Co. v. Maddox et al.,* the plaintiff-client sued its accountant and accounting firm seeking to recover damages for breach of contract, breach of fiduciary duty, and malpractice. Banker & Brisebois Co. ("B&B") sued the defendants for failing to notify it that its controller had embezzled approximately $401,000 over the course of two years. B&B had worked with the individual accountant for several years, even as he changed accounting firms, and, in 2003, four years prior to the embezzlement, B&B specifically notified the accountant and firm of the controller's suspicious activity and requested that the defendants monitor the controller's actions and report any indication of bad acts or fraud. After the controller committed suicide, B&B discovered the embezzlement and sued the defendants. On summary judgment, the trial court dismissed B&B's claims finding no genuine issue of material fact and ruling in favor of the defendants on all three claims as a matter of law.

The Court of Appeals of Michigan affirmed the trial court's decision on B&B's claims for breach of fiduciary duty and malpractice, but reversed on the claim of breach of contract. First, regarding B&B's breach of fiduciary duty claim, the Court affirmed dismissal of this claim because Michigan law does not recognize, in general, a fiduciary relationship between an accountant and a client. The Court noted that a fiduciary relationship between an accountant and a client did not exist at common law. The Court discussed cases from other jurisdictions in which a fiduciary relationship was found to exist because the accountant performed services beyond simply preparing tax returns. The Court noted that Defendants were not socially acquainted with B&B, the Defendants did not assume control or responsibility over any part of B&B's business, and B&B did not place any heightened trust in the Defendants. Indeed, finding that the Defendants and B&B maintained a normal accountant-client relationship, the Court held that B&B could not recover against the Defendants for breach of fiduciary duty.

Second, regarding B&B's claim for malpractice, the Court dismissed this claim because it found that any negligence on the part of the Defendants did not proximately cause the damage sustained by B&B because the allegedly negligent behavior, failure to monitor the controller, could not have led to the discovery of the embezzlement because the Defendants did not have access to information necessary to discover the scheme. Further, the Court rejected the trial court's view that B&B could not maintain both a tort and contract cause of action for the same damages because while B&B's negligence claim arose from its failure to adequately protect and advise B&B, the contract claim alleged a failure to perform specific, agreed-upon actions. The Court focused on the fact that B&B did not grant the Defendants any increased access to its business records. Although B&B argued that the Defendants knew of the controller's bad acts when it discovered accounting errors in B&B's information, the Court noted that the Defendants and controller worked together to resolve such errors. And when the controller forged checks in the amount of $401,000, the Court found that the Defendants would have no way to discovery the forgeries without access to the copies of the checks and bank statements, which they did not have. While the Court found that the Defendants owed a duty to B&B and that their conduct may have been

negligent, the Court dismissed B&B's claim because these facts did not establish the requisite causal connection between the Defendants' bad acts and B&B's damages.

Finally, regarding B&B's claim for breach of contract, the Court found that B&B could maintain this claim because the Defendants had contractually agreed to monitor the controller and to notify B&B of material errors or evidence of fraud. Although the Defendants argued that no contract existed because they did not agree in writing to perform the acts that B&B alleged as the basis for its breach of contract claim, the Court found that the Defendants had previously done more for B&B than simply preparing tax returns and that the individual accountant's verbal promise to "keep an eye" on the controller became a part of that contractual relationship. And while the Court dismissed B&B's claim for breach of contract based on "material errors" because the Defendants previously worked with the controller to resolve any errors in B&B's information, the Court found a genuine issue of material fact as to whether the Defendants breached the contract by failing to notify B&B of the controller's refusal to provide additional documentation when confronted with the errors. Because the accountant agreed to monitor the controller, his failure to notify B&B of errors in the financial information supplied by the controller could constitute a breach of the contract between B&B and the accounting firm.

This decision should be a reminder that written engagement letters should be obtained for all services accountants provide. Here, the accountants went beyond the tax preparation services it agreed to provide in correspondence. In this case, there was evidence that the accountant's invoices described services including reviewing equipment leases, discussing software options and advising on employee bonuses. There was also evidence that the accountant agreed to "keep an eye" on the controller who embezzled the money. Although the court stated that in itself did not necessarily mean the accountant agreed to provide fraud protection, the Court allowed the case to proceed.

Choice of Law and State Securities Law Prevent Dismissal of Auditor

By Adam C. Benevides, Esq.

AN INVESTOR'S CLAIMS OF SECURITIES FRAUD AND NEGLIGENT misrepresentation against the fund's auditor, as well as the fund and its parent companies, survived a motion to dismiss based on the governing state law and the broad scope of that law to protect investors.

FutureSelect Portfolio Management, Inc. ("FutureSelect") is an investment management firm located out of Washington State. Between the years of 1997 and 2008 it invested nearly $200 million dollars in a product called the Rye Funds, through the Rye Fund's general partner, a New York-based firm, Tremont Group Holdings, Inc. ("Tremont"). As it turns out, the Rye Funds were a feeder fund for the infamous Bernie Madoff Ponzi scheme. When the scandal finally unraveled, FutureSelect discovered that their entire investment had been squandered. Consequently, FutureSelect brought a civil action in Washington state court against Tremont, its parent companies, and its auditors alleging violations of the Washington state securities act (WSSA), negligence, and negligent misrepresentation.

The case, *FutureSelect Portfolio Management, Inc. et al. v. Tremont Group Holdings, Inc. et al.*, 331 P.3d 29; 180 Wash. 2d. 954 (2014), was dismissed on the pleadings at the trial court level on both statutory and jurisdictional grounds but was subsequently reversed by the Washington Court of Appeals. Specifically at issue was whether Washington law or New York law applied to the transactions. If New York law were operative, FutureSelect's claims were barred as New York does not recognize a private right of action. Ultimately, the Washington Supreme Court agreed with the appellate court and determined Washington law was proper. In doing so, the high court revived FutureSelect's claims under the WSSA, which included counts against accounting firm Ernst & Young, LLP ("Ernst & Young"), among others, who conducted audits on behalf of Tremont and the Rye Fund. *Id.* at 966-71

Ernst & Young further argued that even if Washington law applied, it was not subject to suit under the WSSA because it was not a "seller" in any transactions and FutureSelect's complaint only made reference to its audits and audit reports without reference to any sales of securities. The court disagreed, relying on the WSSA's definition of "seller" which includes any party whose acts were a "substantial contributing factor" to the sale. *Id.* at 971.The Court noted that the "definition was meant to be expansive" and where the issue on appeal arises out of a motion to dismiss, the complaint need only state sufficient allegations suggesting the plaintiff will establish something more than the mere provision of professional services. *Id.* Here, the Court concluded that FutureSelect's allegations that (a) FutureSelect would not have invested in the Rye Funds if they were not audited by Ernst & Young; (b) Ernst & Yound knew its audits would be used by Tremont to solicit investors and knew that its audits would be relied upon by current investors in deciding to increase their investment in the Rye Funds; and (c) Ernst & Young reached out to FutureSelect to verify its investment in the Rye Funds and addressed its audit directly to the partners of the Rye Funds, which included FutureSelect, were sufficient to state a claim against Ernst & Young under the WSSA. *Id.* at 972.

The decision raises a few cautionary flags for accounting firms that perform audits for companies engaged in interstate and/or international securities transactions. In addition to the auditor's professional obligations with respect to due diligence and reporting fraud, the accountant is strongly advised to proactively investigate prospective clients and their related companies to gauge any warning signs of corruption and to ascertain any latent purpose behind their engagement. Further, to address the possibility of any potential exposure, it is wise to ensure that professional liability and umbrella insurance policies cover the scope of the work to be performed and are current. Lastly, it is important to partner with an experienced attorney who can confidentially advise the accountant should concerns arise.

Fiduciary Duty and Tolling of Limitations Period Considered in Connecticut

By Courtney A. Longo, Esq.

THE SUPREME COURT OF CONNECTICUT RECENTLY CONSIDERED whether a tax return preparer, including an accountant, ordinarily owes a fiduciary duty to its clients. The Court in *Lacurci v. Sax et al,* 313 Conn. 786 (2014) was presented with two issues: 1) whether a certified public accountant performing tax return preparation services owed a client a fiduciary duty; and 2) if a fiduciary duty did exist between an accountant and a client, whether this was a basis for tolling the three year statute of limitations period governing claims due to fraudulent concealment.

The accountant's client filed suit against the accountant and accounting firm for professional malpractice and negligence concerning the preparation of client's income tax returns. The Superior Court, Judicial District of Fairfield, entered summary judgment for the defendants on limitations grounds and the client appealed. The appellate court affirmed and review was granted. The Supreme Court concluded, that based on the specific circumstances of this case, the defendants did not owe a fiduciary duty to the client.

From 1989 to 2006, CPA Sax, on behalf of the accounting firm, prepared federal and state income tax returns for Lacurci. Sax also filed these tax returns on behalf of Lacurci. The returns reported Lacurci's real estate investment income as capital gains using schedule D from 1989 to 2003. From 2004 to 2006, the defendants filed Lacurci's tax returns reporting his real estate investment income as ordinary income using schedule C. In January, 2007, the plaintiff hired a financial planner to prepare his tax returns. The financial planner believed the defendants erred in reporting the plaintiff's real estate investment income using schedule C, rather than schedule D, and brought the change to the plaintiff's attention because he thought it had caused a tax overpayment. It was at this point, in late January 2007, that the plaintiff first discovered that the defendants had changed the way his real estate investment was reported.

On November 10, 2009, Lacurci filed suit claiming that as a result of the defendants' professional malpractice and negligence, he sustained damages arising from audit expenses and missed investment opportunities while the IRS possessed his overpayment funds. Lacurci claimed that these damages were caused by the defendants' arbitrary change to the way in which he reported his real estate investment income, as well as their failure to discuss the ramifications of this change with him. Defendants claimed that Lacurci's claims were time barred by the applicable state of limitations because his suit was commenced more than three (3) years after the completion and filing of his tax returns. Thus, the court was also presented with the issue of whether the fraudulent concealment statute tolled the statute of limitations.

To toll a statute of limitations by way of fraudulent concealment, a plaintiff must show: (1) actual awareness, rather than imputed knowledge, of the facts necessary to establish the cause of action; (2) intentional concealment of these facts; (3) concealment of the facts for the purpose of obtaining delay on the part of filing a complaint on a cause of action.

A fiduciary relationship is characterized by a unique degree of trust and confidence between the parties, one of whom has superior knowledge, skill or expertise and is under a duty to represent the interests of the other. See *Hi-Ho Tower, Inc., v. Com-Tronies, Inc.,* 255 Conn. 20, 38, 761 A.2d 1268 (2000). Some actors are per se fiduciaries by the nature of the duties they perform. These include agents, partners, lawyers, directors, trustees, executors, receivers, bailees and guardians. Beyond these *per se* categories, however, a flexible approach determines the existence of a fiduciary duty which allows the law to adapt to evolving situations wherein recognizing a fiduciary duty might be appropriate.

Whether ad hoc fiduciary duties exist in business relationships has turned on the presence of a special vulnerability, that is trust and confidence, superior knowledge, skill or expertise, and an expectation that one party is under a duty to represent the interest of another. See *Falls Church Group Ltd., v. Tyler Cooper & Alconr, LLP,* 912 A.2d 1019. These elements are typically necessary but are not always dispositive of a fiduciary duty in business settings. Of the most importance is whether there is a "great opportunity for abuse of the confidence reposed in the hired party." *Id.,* at 108. The Court explains that this "unique" element that inheres a fiduciary duty to one party is an elevated risk that the other party could be taken advantage of, and usually unilaterally. The Court further explains that the imposition of a fiduciary duty counterbalances opportunities for self-dealing that may arise from one party's easy access to, or heightened influence regarding, another party's moneys, property, or other valuable resources.

Other courts outside of Connecticut have concluded that a fiduciary relationship does not exist when a client relationship is limited to the preparation of tax returns. These courts reason that the relationship between a tax return preparer and a client is fiduciary in nature when a heightened risk of abuse of trust or confidence exists, such as when the tax return preparer or accountant acts as an investment advisor or manages the clients funds. See *Burdett v. Miller,* 957 F.2d 1375, 1381-82 (7th Cir. 1992) (accountant who held himself out as an expert in investments and provided advice on tax shelter investments owed client fiduciary duty). Other examples of where courts have found a fiduciary duty include: 1) where an accountant who, inter alia, filed tax returns for his elderly mother undisputedly owed her fiduciary duty by virtue of agreeing to manage her financial affairs and investments. (See *Hass v. Hass,* 137 Conn.App. 424, 434-352) and 2) where there were detailed allegations that defendants provided investment and tax advice. (See *Khan v. Deutsche Bank AG,* 978 N.E.2nd 1020, 1041 (Ill. 2012)).

As a result, on the facts of this case, the Supreme Court explained that as a matter of law, the defendants did not owe Lacurci a fiduciary duty. Although the plaintiff averred that the defendants possessed knowledge, skill and expertise that was clearly superior to the plaintiffs own in tax matters, the court concluded that this aptitude differential, without a corresponding risk of abuse, did not transform their professional relationship in any special way to warrant the imposition of a fiduciary relationship. This is in line with the aforementioned case *Hi–Ho Tower* where the court concluded superior skill and knowledge alone does not create a fiduciary duty among the parties involved in a business transaction. Additionally, the Supreme Court concluded that the duration of the plaintiff and defendant's relationship – seventeen years – did not turn it into a fiduciary nature.

Finally, the Court discussed the fact that client engagement letters do not create a genuine issue of material fact that would support the plaintiff's claim that a fiduciary relationship existed. In the end, the fact the plaintiff failed to present any evidence about the extent or nature of any tax advice that was actually rendered was fatal to his fiduciary claim.

Professional negligence implicates a duty of care, while breach of a fiduciary duty implicates a duty of loyalty and honesty. Accountants take notice: should you provide additional services to clients above and beyond preparing tax returns such as substantive advice concerning a client's investments so as to create a risk of abuse and reliance, you may be on the hook as a fiduciary down the road.

Alabama Court Dismisses a Fraud-by-Hindsight Action for Failure to Plead with Particularity

By Lauren P. Marini, Esq.

EARLIER THIS YEAR, THE UNITED STATES DISTRICT COURT in Alabama granted the dismissal of an amended consolidated class action complaint ("Complaint") for failing to state a claim under Section 10(b) of the Securities Exchange Act of 1934 ("Act")[1], because the plaintiffs failed to adequately plead the essential elements of a fraud claim. In the case of *In re Colonial Bancgroup, Inc. Securities Litigation*, 9 F. Supp. 3d 1258 (2014), pursuant to Section 10(b) of the Act, plaintiffs filed a securities class action against the defendant accountant, PricewaterhouseCoopers, arising from audit reports issued in connection with the yearly consolidated financial statements of Colonial. The accountant defendant sought dismissal of the plaintiff investors' complaint, on the grounds that the plaintiffs failed to adequately plead the necessary elements of a fraud (i.e. material misrepresentation or omission; scienter[2]; and a causal connection.)

Plaintiffs filed a complaint against the defendant alleging fraud in the issuance of audit reports. In order to survive a motion to dismiss in a fraud claim, the plaintiff must state the following with particularity: (1) precisely what statements or omissions were made, (2) the time and place of each statement and the person making the statement, (3) the content of the statement and how it was misleading, and (4) what the defendant gained from committing the fraud. In its Complaint, plaintiffs claim that the defendant made false and misleading statements in the audit reports it issued in connection with Colonial's 2007 and 2008 year end consolidated financial statements.

Defendant filed a motion to dismiss the Complaint based on the fact that Plaintiffs failed to allege with particularity material misrepresentations, scienter and causation.

As it relates to material misrepresentations, the defendant argued that the alleged misstatements related to financial reports or events that occurred after the audit reports were compiled. The Court pointed out that financial reports are a statement of professional opinion; and not a statement of fact. Furthermore, the only way an opinion is actionable is if the defendant did not actually have that opinion at the time it was relayed to plaintiffs, or that the defendant knew that there was no reasonable basis for such an opinion.

The Court noted that allegations that the defendants should have anticipated future events or made certain disclosures sooner than they did, were not sufficient to prove this element of a securities fraud claim. In essence, hindsight allegations (where a plaintiff alleges that the fact that something turned out badly must mean the defendant knew earlier that it would turn out badly), are not suggestive of fraud. Thus, the plaintiffs failed to specifically allege that the defendant knew or recklessly disregarded the falsity of its own statements at the time the statements were made. The fact that the statements later turned out to be false is irrelevant. Therefore, the Court held that the plaintiffs failed to specifically identify how the Defendants knew or were reckless in not knowing that Colonial's accounting practices were inaccurate.

In order to survive a motion to dismiss a Section 10(b) fraud claim, the plaintiff must also demonstrate that no reasonable auditor, with access to the information contained within Colonial's documents, would have made the decision to issue a clean audit report. In an attempt to prove scienter, plaintiffs allege that the defendant was "bound to know," "bound to review," or "knew or was reckless in not knowing" information contained in certain regulatory materials. Again, the plaintiff must plead with particularity and not merely refer to securities requirements or standards that were violated. Additionally, plaintiffs' allegations that an auditor had access to information that would have revealed "red flags" is not sufficient to establish scienter, because the "red flags" must actually be known to the auditor. Therefore, the plaintiffs failed to establish the necessary element of scienter.

A third element that plaintiff failed to establish was a causal connection between the material misrepresentation or omission and the actual loss. In fact, the Complaint identified that the plaintiffs sold their stock prior to the disclosure revealing the "truth" about the defendant's alleged misrepresentations. Therefore, because the plaintiffs were unable to establish that they were damaged as a result of defendants' actions or inactions, they were unable to prove another necessary element of fraud – causation.

Overall, the Court held that the failure to prove one of the essential elements of a Section 10(b) fraud claim would result in dismissal. In this case, three essential elements were not adequately pled. Specifically, the plaintiffs failed to allege material misstatements of fact, scienter and loss causation as required for securities fraud claims. Therefore, the plaintiffs' fraud claim was dismissed.

Accountants should be aware that a party filing a fraud claim against an accountant must do so with specificity. These heightened pleading requirements are designed to notify the defendant of the precise misconduct for which it is charged, and to be a safeguard against frivolous litigation.

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1 The Securities Exchange Act of 1934 makes it unlawful to: (a) employ any device, scheme, or artifice to defraud; (b) make any untrue statement of a material fact or to omit to state a material fact necessary…; and (c) engage in any act, practice or course of business that operates as a fraud or deceit in connection with the purchase or sale of security.

2 The offending party has knowledge of the "wrongness" of an act or event prior to committing it.

Appellate Court of Illinois Affirms Form 4549's Sufficiency as Notice of Injury Triggering Statute of Limitations

By Amanda E. Mathieu, Esq.

THIS SUMMER, AN ILLINOIS APPELLATE COURT AFFIRMED THE DISMISSAL of an amended complaint alleging breach of contract and negligence claims, ruling that the two year statute of limitations period, in an accountant malpractice action, begins to run when the plaintiff knew or should have known of his injuries. In this case, the signing of a Form 4549 by a plaintiff indicated receipt of such notice.

In *Villanueva v. Sweiss,* 2014 IL App. (1st) 133444-U (July 24, 2014), the accountant defendants sought dismissal of the plaintiffs' amended complaint, on the grounds that plaintiffs' complaint was time-barred. The defendants contended that the complaint was brought more than two years after the plaintiffs knew or should have known of their injuries stemming from errors in their personal and business tax returns, pursuant to signing the Form 4549 and thus agreeing to proposed tax changes.

The plaintiffs had filed a complaint against the defendants on June 21, 2012, alleging negligence in the preparation of tax returns. According to the complaint, in late 2007 or early 2008, the plaintiffs hired the defendant accountants to prepare their 2007 returns. Following the defendants' 2008 submission to the IRS, the plaintiffs were issued an assessment on June 28, 2008, in which the IRS reported errors in the plaintiffs' taxes. The plaintiffs' complaint further alleged that on March 22, 2010 the IRS issued a regular agreed report (Form 4549), showing that the plaintiffs' 2007 and 2008 tax payments were deficient and that interest had been calculated on the deficiencies.

Defendant accountant John Bethancourt filed a motion to dismiss the complaint with prejudice based on the fact that the plaintiffs knew or should have known of the alleged accounting errors no later than June 28, 2008 and therefore their June 21, 2012 complaint was untimely, pursuant to 2-619(a)(5) of the Illinois Code of Civil Procedure, which states that a defendant may file a motion for dismissal if "the action was not commenced within the time limited by law." Moreover, the defendant emphasized that even if the claims against him accrued on March 22, 2010, the date the IRS issued the Form 4549, the claims were time-barred.

Prior to a court ruling on the motion to dismiss, the plaintiffs filed an amended complaint in which they deleted the reference to the June 28, 2008 IRS assessment and instead provided that "[o]n or about June 28, 2010 an assessment was issued by the IRS showing errors in [plaintiffs'] personal and business tax returns for 2007." Defendant Bethancourt filed a motion to dismiss and/or strike the amended complaint, arguing again that the claims were time-barred. In addition, defendants, Raed Swiss and Sweiss & Associates, Ltd., filed a motion to dismiss asserting that "[i]n order for the Plaintiffs to have received an 'agreed report' from the IRS on March 22, 2010, they must have had knowledge of their allegedly erroneously prepared tax returns at a time prior to March 22, 2010."

In responding to both motions to dismiss, the plaintiffs asserted that Illinois law dictates that the statute of limitations period is not triggered until a deficiency is assessed, by means of registration of agreement with the IRS or the issuance of a notice of deficiency. Further, the plaintiffs contended that their claims were timely because their consent to the Form 4549 by signature and return for filing to the IRS on June 28, 2010, triggered the statute of limitations, as a registered settlement agreement and an opportunity for the IRS to assess additional tax deficiencies.

The circuit court granted defendants' motions to dismiss the plaintiffs' claims as time-barred, having found the statute of limitations began to run on March 22, 2010. On appeal, the court concluded that the dismissal was proper for two reasons. The first was that the plaintiffs failed to

plead allegations or provide evidence to demonstrate the timeliness of their claims. More specifically, based on the facts alleged in the amended complaint, namely that the Form 4549 "showed errors", "it appears that the [plaintiffs] knew or reasonably should have known of the alleged 'act or omission' by each of the defendants—i.e., their failure to properly prepare the 2007 tax returns—and the resulting injury to the [plaintiffs] by no later than the date of the Form 4549: March 22, 2010." *Id.* at *5. The plaintiffs argue on appeal that the assertion in their complaint that Form 4549 "showed errors" was not an admission that their injury occurred on that date or that they were on notice of their injury at that time because *shows* could mean many things, not the least of which being that Form 4549 *showed* the tax examiner's findings. Nevertheless, the appellate court agreed with the defendants, concluding that the plaintiffs had had two opportunities to plead their claims with full knowledge that the timeliness of same was being called into question and therefore, this issue did not come down to semantics.

Second, regardless of the insufficiency of the plaintiffs' claim on its face, the claims were untimely upon application of the principles established in *Federated Industries Inc. v. Reisin,* 401 Ill.App.3d 23 (2010). In *Federated,* the appellate court considered the issue of "when taxpayers, whose tax returns have been challenged by the IRS, know or have reason to know that they have a cause of action against their accountants." *Id.* at 28. The *Federated* court established a bright line rule to assist in the preservation of the accountant-client relationship, holding that "the statute of limitations in an accountant malpractice action involving increased tax liability begins to run when the taxpayer receives the statutory notice of deficiency pursuant to the Internal Revenue Code section 6212, or at the time when the taxpayer agrees with the IRS' proposed deficiency assessments." *Id.* at 36. While the amount of the plaintiffs' tax liability in *Federated* was not immediately ascertainable as of the date the plaintiffs registered their consent to the proposed tax adjustments, the statute of limitations was nevertheless triggered.

Accordingly, in this case, despite plaintiffs' contention that the Form 4549 was not a statutory notice of deficiency, the court held that the critical issue under *Federated* is when the plaintiffs knew or should have known of their injury and that the defendants were the cause of it. Irrespective of the question of Form 4549's sufficiency as a "statutory notice of deficiency," the plaintiffs signed the Form 4549 triggering the statute of limitations under *Federated* because, upon signing, the plaintiffs agreed with the IRS' proposed deficiency assessments.

Accountants may take some comfort from such decisions, which determine when former clients may bring an action. With regard to such defenses, it is important to keep in mind that while Illinois has a two year statute of limitations period in the matters discussed, the statute of limitations period differs among states. In most cases, it is when the plaintiff knew or should have known of the claim against an accountant that the statute of limitations begins to run.

In Pari Delicto: A Viable Defense in Limited Circumstances

By Jonathan A. Barnes, Esq.

RECENTLY, A PAIR OF DECISIONS OUT OF THE U.S. DISTRICT COURT, Southern District of New York, helped paint a clearer picture of when the doctrine of *in pari delicto* is applicable. The doctrine mandates that courts will not intercede to resolve a dispute between two wrongdoers.

The Plaintiffs in *In re Adelphia Communs. Corp. Secs. & Derivative Litig.*, 2013 WL 6838899 (S.D.N.Y. 2013) brought claims of breach of contract, breach of professional duty, negligent misrepresentation, tortious interference, breach of fiduciary duty, contribution , and indemnity against the former auditor and accountant for the now defunct cable company Adelphia and the entities managed by Adelphia. The Defendant Auditor/Accountant asserted, among other things, the doctrine of *in pari delicto* in an attempt to dismiss the claims. The Court applied the doctrine against one Plaintiff, John Rigas, but not others.

In reaching its decision, the Court stated that *in pari delicto* "applies if (1) a Plaintiff or Plaintiffs engaged in illegal conduct; and (2) that Plaintiff's or those Plaintiffs' claims are 'grounded upon [his or her] illegal conduct'" *Id.* at 7 (citing *Feld & Sons, Inc. v. Pechner, Dorfman, Wolfee, Rounick & Cabot,* 458 A.2d 545, 552 (Pa.Super.Ct.1983)). Given these principles, the Plaintiff John Rigas's claims were found to be barred because he was "convicted of conspiracy to commit securities fraud, conspiracy to make and cause to be made false statements in filings with the SEC, conspiracy to commit bank fraud, securities fraud and bank fraud" and "Rigas's claims were grounded upon the conduct for which he was convicted." *Id.*

The Court, however, declined to apply the doctrine against the other Plaintiffs. The Defendant Auditor/Accountant argued that the remaining "Plaintiffs' claims should be barred pursuant to the doctrine of imputation, which recognizes that principals are generally responsible for the acts of [its] agents committed within the scope of their authority." *Id.* at 8. The Court disagreed with the Defendant's argument because *in pari delicto* via imputation turns in part on whether the defendant dealt with the principal in good faith and whether the agent acted in his own interest to the detriment of the corporation. *Id.* Where a defendant does not deal with a principal in good faith or acts in his own interest to a corporation's detriment, imputation is negated. *Id.* In this case, "the Defendant Auditor/Accountant did act in bad faith towards Adelphia's Managed Entities and the Rigases by placing its self-interests above the best interests of its clients." *Id.* Therefore, there was no basis to apply *in pari delctio* to any of the remaining Plaintiffs.

Similar to *Adelphia,* in *MF Global Holdings Ltd. v. PricewaterhouseCoopers LLP,* 2014 WL 3402602 (S.D.N.Y. 2014), a bankruptcy plan administrator for debtor MF Global Holdings Ltd., a securities firm, filed suit against the firm's outside auditor and accountant alleging professional malpractice and negligence leading to a loss of approximately one billion dollars. The Defendant, PricewaterhouseCoopers LLP, asserted that the doctrine of *in pari delicto* was applicable and that the Plaintiff Plan Administrator's claims should be dismissed. Here, the Court declined to apply the doctrine because MF Global did not engage in any unlawful conduct, but rather "based its accounting practices on the advice it solicited from PricewaterhouseCoopers." *Id.* at 3. It is worth noting, however, that the Court stated that "[i]f discovery reveals a basis for allegations [that MF Global intentionally provided inaccurate financial statements to Pricewaterhouse Coopers], that the Court can revisit whether *in pari delicto* applies on a motion for summary judgment." *Id.* at 4.

It goes without saying that auditors and accountants should always act in good faith and refrain from engaging in unlawful conduct. Unfortunately, proper conduct will not always prevent auditors and accountants from being sued by the principals that hired them. In the event that auditors and accountants find themselves accused of professional negligence, they should take caution in relying upon *in pari delicto* to shield them from liability. As these decisions indicate, there may not be evidence of a Plaintiff's wrongdoing. Further, unlawful conduct by an auditor and accountant generally will not be imputed to the Plaintiff to trigger the doctrine. Instead, auditors and accountants should consider ending relationships with people and entities that they suspect may be engaging in unlawful conduct.

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The Accountant/Attorney Liability Reporter

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