The Accountant/Attorney Liability Reporter

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Accounting Firm Liability to Creditors

By Amanda Sirk

A FEDERAL DISTRICT COURT IN TENNESSEE HELD THAT AN ACCOUNTING FIRM ("Accounting Firm") which audited a now bankrupt company (the "Company") could not escape liability from creditors (the "Creditors") on summary judgment, and the Creditors' claims would have to be decided by a jury. The Accounting Firm's arguments that (1) the statute of limitations barred the claim, (2) it owed no duty to the Creditors, and (3) its actions or omissions did not cause the Creditor's damages, all failed to persuade the Court to dismiss the Creditors' claims before trial.

The liquidating agent for the Company and certain Creditors of the Company sued the Accounting Firm, alleging professional malpractice, negligence, breach of contract, and aiding and abetting tax fraud. The Plaintiffs contended they relied to their detriment on the Accounting Firm's audits of the financial statements of the now-bankrupt Company.

The Creditors owned and operated restaurants in Tennessee and surrounding states. In 1999, they sold their franchise rights to the Company which borrowed money from banks and executed a $6.4 million promissory note to the Creditors. The Asset Purchase Agreement between the Creditors and the Company required the Company to provide audited financial statements to the Creditors each year during which any of the debt remained outstanding.

In August of 2008, it became apparent that the Company owed more than $1 million in unpaid taxes and penalties to the IRS. In early August of 2008, the Company's Chief Financial Officer disappeared without notice and the Plaintiffs discovered suspicious deposits and withdrawals in the Company's checking account, which appeared to have been part of a check-kiting scheme. On August 25, 2008, the Company filed for bankruptcy. The Plaintiffs claimed that the Accounting Firm was aware of the inconsistencies in the Company's finances and growing tax liability, yet failed to alert anyone of these problems, issued unqualified audit opinions and misrepresented the Company's financial condition.

The Accounting Firm moved for summary judgment to dismiss the Creditors' claims. It argued that the Tennessee one-year statute of limitations for accounting malpractice actions barred the Plaintiffs' lawsuit. It asserted that because the Plaintiffs were aware of their claims for over a year and did not file suit, Tennessee's one-year statute of limitations barred the Plaintiffs' claims. The Plaintiffs responded that the statute of limitations had been tolled by a tolling agreement between the Accounting Firm and the Official Committee of Unsecured Creditors in the bankruptcy (the "Committee"). The Court ruled that the tolling agreement with the Committee tolled the Plaintiffs' claims. The Court reasoned that the Committee had no separate claims of its own to be tolled and had been appointed to represent the interests of all unsecured creditors in the bankruptcy with the authority "to perform such other services as are in the interest of those represented." Alternatively, the Court found that the Plaintiffs, even if not parties to the tolling agreement, are, at a minimum, third-party beneficiaries.

The Accounting Firm asserted that it owed no duty to the Plaintiffs because its contract was with the Company and it had no knowledge that the Plaintiffs would rely on its work. The Court rejected that argument, holding that an "accountant's liability extends to the person or persons for whose benefit and guidance he intends to supply the information and anyone with whom the accountant knows the client intends to share that information."

The Accounting Firm admitted that it was aware that the Company's lenders required audited financial statements and that the Asset Purchase Agreement expressly required the Company to provide its audited financial statements to the Plaintiffs' primary contact. The Court reasoned that it is reasonable to expect that creditors of the Company and those who were loaning money to the Company would obtain and rely upon the Company's audited financial statements. The Court denied the motion for summary judgment since there were genuine issues of material fact as to whether the Accounting Firm knew or should have reasonably known that the Creditors would receive and rely upon that financial information.

Finally, the Accounting Firm claimed that the Plaintiffs could not show that it caused them any damage. The Accounting Firm asserted that the Company never had the money to pay off the Plaintiffs' promissory notes, regardless of the Accounting Firm's conduct. In rebuttal, the Plaintiffs presented expert testimony proving the sufficiency of the Company's cash flow to satisfy its debts to the Plaintiffs. The Plaintiffs claimed that the Company could have continued making payments, if it had been correctly apprised of its financial position. The Court ruled that there were sufficient factual disputes to deny summary judgment.

Accounting firms must take heed that creditor's rights may survive statute of limitations periods and be tolled by agreements with banks and unsecured creditors' committees. In addition, auditors may be liable to all who may be reasonably expected to receive and rely upon the audited financial statements. Third-party liability claims are a real risk. Finally, damages claims, when based on credibility determinations, are usually not subject to early dismissal and will most likely be decided by a jury.

Accounting Firms Successful in Dismissing Fraud and Other Claims

By Justin Jagher

IN A RECENT CASE INVOLVING ALLEGATIONS THAT THE DEFENDANT accounting firms took part in a fraudulent scheme to divert and steal funds from the plaintiff, two accounting firms were successful in persuading the Court to dismiss all of the claims. A New York Federal District Court ruled that the plaintiff failed to show that the accounting firms violated the standard of care or engaged in fraudulent behavior.

In *Technology in Partnership, Inc. v. Rudin, et al.*, 2011 WL 4575237 (S.D.N.Y.), a closely-held corporation that provided computer consulting services filed claims against a prior shareholder, two accounting firms, and various individual defendants and companies. Technology in Partnership, Inc. ("TIP") was formed in 1997 by Robert Baker ("Baker") and Edward Rudin ("Rudin"). Baker was the President of TIP and Rudin was the Vice-President. Rudin, who had an accounting background, operated the day-to-day business of TIP and oversaw TIP's financial filings. Between 1997 and 2010 Baker received and reviewed Schedule K-1 statements annually, but otherwise did not review TIP's financial documents. In May of 2010, Baker requested certain financial documentation, which he was denied. Subsequently, Baker locked Rudin out of TIP's office and reviewed financial documents and records on the firm's file server. Baker then learned that Rudin was in charge of an enterprise that was conspiring to divert and steal funds from TIP.

Between 1997 and 2010, Rudin had engaged two separate accounting firms (collectively, the "Accountants") on behalf of TIP. The Accountants took direction from Rudin and were responsible for TIP's accounting and tax filings. TIP contended that the Accountants schemed with Rudin to prepare tax returns containing fraudulent information and stated that the Accountants did not independently verify the data within the tax returns. TIP also alleged that the Accountants failed to provide him with any documentation regarding tax returns or financial documents beyond the annual Schedule K-1 statements. TIP filed a complaint against the Accountants alleging: (1) civil RICO violation; (2) civil RICO conspiracy; (3) malpractice; (4) breach of fiduciary duty; (5) fraudulent concealment; and (6) accounting.

The RICO Counts

The Court dismissed the RICO counts against the Accountants with prejudice, meaning the claims could not be re-filed. The Court found that TIP failed to demonstrate that the Accountants participated in the operation or management of the illegal enterprise that Rudin allegedly conducted. The Court further found TIP had not alleged facts to support a claim that the Accountants exerted any control over the enterprise, which is an element of the RICO count that must be alleged in the complaint. TIP's Complaint did not allege that the Accountants were officers or employees of TIP "with authority to draw on its accounts." Ultimately, TIP did not demonstrate the participation element by the Accountants that was necessary to sustain the RICO counts against the Accountants.

The Accounting Malpractice Count

A claim of accounting malpractice must show (1) a departure from the accepted standards of practice and (2) that the departure was the proximate cause of the injury. *Housing Works, Inc. v. Turner,* 179 F. Supp.2d 177, 216 (S.D.N.Y. 2001). As described above, the focus of TIP's allegations were that the Accountants failed to independently verify information in TIP's tax returns and did not provide copies of the tax returns to Baker. The Court rejected these arguments and referred to the American Institute of Certified Public Accountants ("AICPA") Professional Standards for its rationale. The Court quoted the AICPA Professional Standards which states that: "In preparing or signing a return, a member may, in good faith rely, without verification, on information furnished by the taxpayer or by third parties." Thus, reliance on Rudin, one of two shareholders at TIP and the officer responsible for financial filings, was not a deviation from accepted practice. Additionally, since Rudin was responsible for TIP's financial filings and provided Schedule K-1 statements to Baker annually, the Accountants were not under an obligation to provide tax returns to Baker. The Court also dismissed the malpractice claims with prejudice.

The Breach of Fiduciary Duty Count

A claim for breach of fiduciary duty requires: (1) a fiduciary relationship between the parties and (2) a breach of that fiduciary duty. *Kottler v. Deutsche Bank AG,* 607 F.Supp.2d 447, 465-466 (S.D.N.Y. 2009). Absent special circumstances, an accountant-client relationship does not give rise to a fiduciary duty. Here, the Complaint did not supply any factual allegations showing that the Accountants committed any fraud, and the Complaint did not allege any actions by the Accountants that were considered more than basic advice. Accordingly, there was no breach of any fiduciary duty.This count was also dismissed with prejudice.

The Fraudulent Concealment Count

A claim for fraudulent concealment must show: "(1) failure to discharge a duty to disclose, (2) an intention to defraud, or scienter, (3) reliance, and (4) damages." *TVT Records v. Island DefJam Music Group,* 412 F.3d 82, 90-91 (2d. Cir. 2005). The complaint must allege with particularity "(1) what the omissions were; (2) the person responsible for the failure to disclose; (3) the context of the omissions and the manner in which they misled the plaintiff; and (4) what the defendant obtained through the fraud." *DirecTV Latin Am., LLC v. Park 610, LLC,* 691 F.Supp.2d 405, 436 (S.D.N.Y. 2010). The Court dismissed this specific claim by TIP against the Accountants because the Complaint did not include any allegations that the Accountants were aware of any fraudulent transactions. The Accountants simply took direction from Rudin and provided professional services; they were not aware of any illegal plot Rudin was conducting, if any. The claim was dismissed with prejudice.

The Accounting Count

A party seeking an accounting must meet four requirements: "(1) relations of a mutual and confidential nature; (2) money or property entrusted to the defendant imposing upon him a burden of accounting; (3) that there is no adequate legal remedy; and (4) in some cases, a demand for an accounting and a refusal." *Pressman v. Estate of Steinvorth,* 860 F.Supp. 171, 179 (S.D.N.Y. 1994); *300 Broadway Realty Corp. v. Kommit,* 37, Misc.2d 325, 235 N.Y.S.2d, 205, 207 (N.Y.Sup. Ct. 1962). The Court agreed with the Accountants that the Complaint lacked any allegations of money or property that was entrusted to the Accountants, but allowed that, if the facts revealed the Accountants had duplicate copies of TIP's financial books and records, the Accounting Count may be reinstated. The Court dismissed this count, but allowed that it may be reinstated by TIP.

The impact of these rulings by the Court is that (1) accounting firms can rely on the information provided to them, particularly in preparing tax returns if the supplier of the information is responsible for and knowledgeable about financial filings and documents, and (2) specific facts must be alleged in a Complaint to support claims for fraud.

California Court of Appeals Interprets "Accrual" for Tort Claims Against Financial Advisors as Occurring When an Adverse IRS Determination is Made

By Peter Lenart

A RECENT CALIFORNIA COURT OF APPEALS DECISION FOR THE Fourth District, *Kelter v. Yelland*, addressed an involved statute of limitations argument concerning claims of fraud, breach of fiduciary duty and negligence arising out of tax and investment services of financial advisors and accountants. The Court's decision functionally expanded the statute of limitations for accountants counseling clients with respect to tax shelter investments. Although narrowly written, the decision also creates potential concern for attorneys involved in tax law and those who provide legal advice regarding tax shelter investments, sales of real property, and other transactions designed to defer or avoid tax liability.

In California, as in most states, causes of action must be brought within a certain number of years. These state law timeframes are also almost always governed by what is called "the discovery rule." This means that a statute of limitations begins to run when the aggrieved party either knew, or should have known, about the events which created his or her cause of action. This starting point is known as accrual. The application of the discovery rule is fact specific, and the point in time whereby a person is deemed to have known or should have known all elements essential to the cause of action is resolved by a matter's finder of fact. That is either a jury or by a judge if this particular issue is resolved by an evidentiary hearing or bench trial. California's statute of limitations for negligence is two years, subject to the discovery rule. California's statute of limitations for fraud and misrepresentation types of claims is three years, and is also subject to the discovery rule. The statute of limitations regarding legal malpractice is one year, subject to the discovery rule.

While the above may seem to be a complex analysis, it is actually largely well settled and straightforward to savvy risk managers and their counsel. It permits for the reasonably accurate calculation of a transaction's liability tail. This calculation can be important to various business decisions, including the type, coverage amounts, and premiums charged for professional liability insurance. In this case the Court determined the claim did not accrue, and the statute of limitations did not begin to run, until the date of a ruling by the IRS adverse to the legality of a tax shelter, which indicated to the claimant that he had been damaged.

In *Kelter,* Plaintiff brought suit against his insurance companies, financial advisors, attorneys and accountants regarding unanticipated taxes owed with respect to a Pension Plan determined by the IRS to be an illegal tax shelter. Following an audit, the IRS determined that the plan was illegal, and was thus not entitled to income tax benefits. The IRS notified Kelter that he owed back taxes, penalties and interest. Kelter sought recovery of these costs from Yelland, his tax accountant, who introduced him to a financial advisor who ultimately created and structured Kelter's Pension Plan. Kelter argued that Yelland misrepresented the professional qualifications of the financial advisor. Kelter also alleged that Yelland failed to disclose the fact that Yelland received a substantial referral fee from the financial advisor.

At the trial Court level, Kelter had his case dismissed following the traditional application of California's statutes of limitation, described above. The trial Court used the transaction date for the Pension Plan as the accrual date and ruled that Kelter's claim was thus barred by the statutes of limitations. California's Fourth District Court of Appeals reversed and reinstated Kelter's suit. The Judges on the Court of Appeals held that the proper accrual date was the date the IRS issued its adverse tax ruling against Kelter.

While the Court's decision in *Kelter* is unpublished, which means that it has little, if any, precedential value, it, as well as the cases on which the Court relied in reaching the decision, present accountants and tax attorneys with cause for concern. Accountants and financial professionals may be subject to potential liability when advising clients about tax shelters for a longer period of time, as the limitations period may not begin to run until after the IRS makes a final determination. In this case, neither the start of the plan nor when IRS revenue rulings put the claimant on notice that the plan could be determined illegal started the running of the limitations period.

In order to manage exposure, accountants and tax counsel should utilize carefully drafted engagement letters with their clients. These agreements should include limitation of liability provisions. We note that such provisions may not be enforced by California Courts upon a finding of gross negligence, but will be enforced in circumstances where common negligence may have occurred. Engagement letters should also contain mandatory mediation provisions. Finally, such agreements should also contain an arbitration provision which can be activated solely on the option of the professional services provider. This allows the provider to select arbitration as the exclusive means of resolution *only* if it is to his or her advantage to do so. Accountants should also have their engagement letters reviewed and updated annually by their business counsel to ensure compliance with all laws and regulations, and to take advantage of any beneficial changes in governing law.

Emerging Market Audit Risks – PCAOB Audit Practice Alert

By Cheryl Waterhouse

EMERGING MARKETS OFFER OPPORTUNITY FOR ACCOUNTING FIRMS, but with such opportunity comes risk. The recent *PCAOB Staff Audit Practice Alert No. 8, Audit Risks in Certain Emerging Markets* highlights the heightened fraud risks for auditors working with companies in such markets. The risks identified are important for accountants to be wary of in other circumstances as well.

As an example of the need for heightened awareness of risks in emerging markets, the Alert notes that, in two months this year, more than 24 Chinese companies filed forms 8-K reporting auditor resignations, accounting irregularities or both. Other examples of emerging market company risks noted were separate and different sets of financial books, discrepancies between auditor bank confirmations and actual bank records, revenue recognition without corroboration of contract or customer existence, double-counting of fixed assets, manipulation of records to conceal bribes and management alteration of confirmation requests.

The Alert stresses the importance of understanding the company and its environment. Cultural issues and inconsistent regulatory oversight and reporting requirements can increase incentives, pressures and opportunities, leading to fraud risk. Auditors must include tests of details to respond to assessed risks, including the risk of management override of controls. The authenticity of documents should be carefully assessed. Management provided documentation may not be sufficient and third party corroboration required. Information from knowledgeable individuals free from bias is essential. Procedures should be performed to evaluate evidence from all sources and auditors should not rely solely on management representations.

Indications of heightened risk of fraud may include vague or implausible responses from management, conflicting evidence or problems between the auditor and management.

To address these heightened risks, the engagement partner needs to be more involved. In addition, careful screening of the client, the prior auditor and local firms or assistants, if used, must be conducted. Understanding the local customs, culture, business practices and business activities is crucial.

The PCAOB's Alert is a helpful guide to assessing and understanding the heightened risks posed by working in emerging markets. As accountants enter the market or delve more deeply into providing services to emerging markets, they must take steps to protect themselves from risks while taking advantage of the opportunities. Necessary preliminary steps can include refining engagement letters and structuring agreements for entering into relationships with other firms, including local firms. Each of these steps requires care and deliberation.

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- The Donovan Hatem Professional Practices Group assists accountants with risk management advice, with the drafting and review of contracts and engagement letters, and with expanding their scope of professional services. The Group also represents accountants in Internal Revenue Service-related matters, including assisting them in producing documents and representing them at depositions.

- The Donovan Hatem Professional Practices Group represents attorneys in litigation involving professional liability claims in state and federal courts, at mediations, arbitrations, and other dispute resolution forums, and before the Board of Bar Overseers.

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