Feature

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Minimizing the Legal Risks of CPA Practice, Part II

In part I of this article (see the cover story in the November/December 2012 issue of *Today's CPA*), we discussed a best practices approach and related issues to analyzing risk management for your accounting practice. In this second and concluding part, we will discuss legal liability and ancillary issues that may arise once a claim is made.

TO WHOM CAN THE CPA BE LIABLE?

First, know your client. Many professionals believe their client is the person they know and with whom they have a personal relationship. The professional overlooks that he/she may really be providing services to the entity or partnership or married couple for whom the individual is speaking. The CPA owes professional duties to the client, not the representative. Be aware of when the representative and the entity client may have a conflict of interest. The CPA should discuss the perceived conflict with the client. The CPA must protect the client's interests and should make sure the representative knows the CPA is not, in that context, the accountant for the representative.

The CPA can owe duties to persons in addition to his/her client and, therefore, may face a lawsuit from not only the client but from others. Some examples are claims made by persons that the CPA knew or should have known would likely rely on the CPA's work, such as persons likely to rely on financial statements or tax returns. This may be so even if the CPA expressly states on the work that no one other than the client can or should rely on the work. For example, if the CPA knows or should have known the client was going to show the work to others for those people to rely upon in some way in spite of the disclaimer, the disclaimer is not a magic incantation that will relieve the CPA of responsibility.

Other persons to whom a duty may be owed include persons connected to the client – spouses, partners, bankers, investors, taxing authorities, governmental agencies, creditors, and even opposing parties in a lawsuit. If the CPA knew or should have known that the complaining party (either specifically or a

member of some general group) was likely to use (and rely on) the work in deciding to take some action or refrain from some action, then there is a risk that a court will decide the CPA owed a duty to that person to perform the accounting work in the ordinary careful manner of a CPA in the same or similar circumstance. If the court decides that duty is owed to that third party, the CPA can be held liable for the damages that resulted from a breach of that duty. In addition and for example, in the case of federal tax work, there are federal statutorily imposed standards for reporting, as well as the Circular 230 ethical standards of conduct; violation of these standards can lead to sanctions, including monetary penalties and loss of right to practice.

The CPA can limit (but not eliminate) risk of third party reliance by inclusion of appropriate language in the engagement letter regarding use of the work product. Certainly, discussion by the CPA with his/her client as to who might be reading or relying upon the CPA's work is appropriate. The CPA should evaluate how the accounting work may affect that person down the chain and how the work should be done with that in mind.

FIDUCIARY DUTIES

A fiduciary relationship is one that involves a special relationship of trust or confidence with a beneficiary. A fiduciary owes special and very high duties to his/her beneficiary. Those duties include: (1) doing what is in the best interest of the beneficiary (even if it is against the fiduciary's own interest); (2) disclosing all relevant facts to the beneficiary and using the utmost good faith and scrupulous honesty; (3) not placing herself or himself in a position where there is even a temptation for a conflict; and (4) ensuring that any transaction between the fiduciary and the beneficiary is fair and equitable to the beneficiary.

A CPA's normal client relationship is not a fiduciary relationship. CPAs should be wary of undertaking fiduciary positions with clients or practicing accounting services for beneficiaries where the CPA is a fiduciary. A CPA can become a fiduciary, for example, by acting as a trustee, corporate officer or director of the client, or the client's partner. Every employee owes his/her employer certain fiduciary duties. A relationship as a close friend or family member of the client, or as a partner with another CPA, can also impose a fiduciary duty. Fiduciary duties can expose the CPA to a very long period before the statute of limitations runs on claims, and if a breach of duty is proven, the CPA is exposed to possible punitive damages. This can not only expose the CPA to financial damages, but can be the grounds for professional disciplinary actions by the governing state board of public accountancy.

In short, a CPA should only wear one hat – that of the CPA. If you feel that you must undertake other activities, act with great caution and care. These positions should not be undertaken lightly. If the CPA undertakes one of these relationships, he/she must take extra care to communicate, disclose, educate and advise, and obtain the consent of the beneficiary in all aspects of the accounting services. Needless to say, it is critically important to create, maintain and preserve excellent records of all activities.

STATUTE OF LIMITATIONS – WHEN ANY LAWSUIT AGAINST A CPA MUST BE FILED

The law requires persons who want to file lawsuits to act reasonably promptly in starting the lawsuit. The law imposes time periods on those persons by statutes of limitations – a deadline by which a lawsuit must be filed, or the claims are forever barred, no matter how meritorious.

For CPAs, the most common lawsuit is for malpractice. Malpractice is the failure to act as a CPA using ordinary care would have acted in the same or similar circumstances. A lawsuit alleging malpractice must be filed within the later of two years of the date of the alleged negligent act or the date the client (using ordinary care) should have discovered the malpractice.

If the claimant alleges intentional fraud, breach of fiduciary duty or breach of contract against the CPA (and not mere malpractice), the claimant has four years after the alleged fraudulent act or discovery of the breach or ending of the fiduciary relationship within which to file the lawsuit.

This discovery element of the statutes of limitation rules that delay the starting time for limitations can make the time period uncertain. If the client alleges he/she did not know of the bad act of the CPA, the date to start measuring the time limit is the date the client using ordinary care should have discovered the alleged bad act. In the case of tax services, for example, a long history of Texas case law holds that the discovery does not occur until Internal Revenue Service (IRS) action (which may not occur until a number of years after a return is filed). A judge or jury has to decide that question based on the particular facts involved. Predicting the result of that (or any) decision based on any particular facts is never easy. There are also other situations that may delay the required starting time to file a lawsuit, such as if the client is not an adult, is incompetent, or is in the military and overseas.

A CPA firm should set up a system so that all records are automatically and reliably kept for more than four years after the event in the records. In the case of tax services, as an example, this would be four years after the time to assess the tax has expired. An additional buffer period of at least two years (for a total of six additional years) would certainly be prudent.

The system should automatically identify clients who (i) are minors, (ii) are trusts with minor beneficiaries, (iii) are or may become incompetent in the near future (such as clients who are very elderly or in bad health), or (iv) are in the military. The system should automatically keep these records for several years after the minors come of age, the death of the incompetent client, or completion of the military service of the client.

If the CPA is an officer, director, employee, partner or agent of the client, or a partner with another CPA, or is a friend or relative of the client, the system should keep the records for the entire period of the relationship and until more than four years after that relationship ends.

SPOLIATION OF EVIDENCE

One of the pitfalls for all persons who face lawsuits is spoliation – the destruction, loss or alteration of records and other evidence of events before or during the lawsuit – when the party knew or should have known that a lawsuit was likely to result from the events.

Spoliation can occur intentionally (when the party knowingly destroys or hides the evidence), by accident (hitting the wrong key on the computer), by negligence (careless thinking or not thinking about preserving data), or by bad practices (not regularly keeping data, not backing up data, not stopping an automatic purging of files or not

continued on next page

continued from page 27

identifying and pulling data from the purge, and not training staff to recognize and save potential evidence).

The penalty for spoliation **before** the lawsuit is filed usually is that the trial court can instruct the jury to presume the lost, destroyed or altered evidence would have shown that the CPA actually committed the complained of act, or caused the damage and sometimes even the amount of the damage claimed. The penalty for spoliation **after** the lawsuit is filed may include that kind of instruction, plus a sanction of paying the cost to reconstruct the evidence if possible, or even contempt of court (fine and jail time) if the court finds the spoliation to be intentional or reckless. Because of the time periods of the statute of limitations discussed above, the starting time period necessary for preserving potential evidence may be many years before a lawsuit is filed (if it ever is).

Evidence that can be spoiled includes:

- papers,
- computer files,
- time and billing records,
- voice mail recordings,
- text messages and e-mails,
- bank records,
- travel records,
- diaries and calendars,
- phone records,
- internal notes and personal notes, and
- electronic and hard copies of any of these, back-ups of any of these, and even deleted portions of these that might still reside in some technical part of the computer system.

In addition to your required duty to preserve records for professional accounting purposes (including under tax statutes), you should set up a document retention system and procedures to recognize and identify an event that might give rise to a complaint or suit. Once your procedure identifies such an event, your procedure should protect any evidence from any purging practice. Your procedure should also automatically protect the evidence from access that might alter the evidence. For example, routinely opening a computer file to view it, or do ordinary maintenance or accounting work, will automatically alter some part of the file; protection of this information may include a requirement to make a copy within which to do all future work. Importantly, your system should thereafter not allow the original evidence to be delivered to, or accessed by, anyone (including the client) not under your supervision or control.

EFFECTS OF A LAWSUIT AGAINST A CPA

If a CPA gets sued, he/she must, as a practical matter, hire a lawyer to defend the suit. If the CPA has malpractice insurance, the insurance company generally hires the lawyer and pays the legal fees and expenses incurred after the CPA's deductible is used and up to the limit in the policy (although a policy can be negotiated so that the CPA can select his/her own counsel). Many policies have "disappearing limits" – each dollar spent on defense reduces the amount of coverage left from the policy limit if the case is lost and the CPA ends up with a judgment against him/her. So the cost of defense can be important even if the CPA is insured.

There are only two ways lawsuits are disposed of – they are settled or they are tried. There are no other ways. In fact, 95 percent of all lawsuits filed are settled before trial. Most lawsuits are settled or tried within about two years of the filing date. The idea is to settle the case sooner than later before a larger legal bill is incurred. But human nature being what it is, it is difficult to get warring parties to settle any lawsuit early in the process. That means substantial legal fees will be incurred in almost any lawsuit.

If a malpractice case goes all the way to trial, the CPA can usually expect the lawyer fees and expenses, along with the necessary accounting expert witness fees (another CPA), to run well over $250,000 over the two- to three-year period. Even if the case settles, some substantial portion of those fees will be incurred before settlement.

In a few instances, the CPA can try to get reimbursed for legal fees from the complaining party in an accounting malpractice case, but it is rarely successful under the current law. If the complaining party suing the CPA proves a breach of contract by the CPA, the court is required by statute in Texas to award the complaining party a judgment for reasonable and necessary legal fees.

Any event that might give rise to either a malpractice, breach of contract, breach of fiduciary duty, or any other professional liability claim should be immediately reported by the CPA in writing to the insurance company, as well as the CPA's own insurance agent. Also, for any claim that is made or lawsuit that is filed, an immediate report should be made to the insurance company and to the agent, and a defense requested. Cooperation with the insurance company in the defense is essential.

DAMAGES

If a court finds a CPA committed malpractice, the court can award the injured party actual damages – actual damages that naturally flowed from the wrongful act. If the court finds the CPA knew the injured party might face a special kind of damage if the accounting work was defective (such as have a loan inappropriately refused for a specific profitable business venture), the court could award the loss equal to the value attributable to that special damage.

If the court finds the CPA committed actual fraud, breached a fiduciary duty, or committed some negligent act with willful disregard of the injury that might result, the judge or jury may award punitive damages against the CPA – damages designed to punish the CPA and to discourage others (CPAs or not) from committing such acts in the future. In determining how much a punitive damage award should be to accomplish these two goals, the jury or judge may consider the wealth of the CPA. The limit on the amount of punitive damages is the subject of great debate, but generally awards of up to three times actual damages are upheld by appellate courts.

Some states like Texas have deceptive trade practices or consumer protection statutes that allow consumers of goods or services to sue for defective products or services or misrepresented goods and

services. The Texas statute allows for the recovery of actual damages always, a multiple of actual damages if a knowing or intentional violation is proved, and legal fees. But a CPA will rarely face this statute since it excludes professional services, the substance of which is providing a professional opinion. But a CPA can still face the statute if the service was not providing a professional opinion but performing some nonprofessional service, such as inaccurate bookkeeping or a clerical task like not timely filing a return or extension.

Of course, if a CPA settles or loses a malpractice or other civil lawsuit based on his/her professional practice, that fact must be reported within 30 days to the Texas State Board of Public Accountancy (TSBPA).

Many CPAs include in some of their engagement letters a provision purporting to limit damages. Note that in attest function work and federal tax services, such limitations may violate the AICPA Professional Standards or Circular 230 conflict of interest rules.

MINIMIZING RISK

As with any business, the practice of public accountancy has its own set of risks. However, by proper attention to the details of your practice and taking appropriate measures for risk management, you can minimize (but not eliminate) the risks that you will get sued and of serious loss in the event that you are sued.

These steps take effort, sometimes cost money, and frequently do not produce revenue; therefore, you may be tempted to avoid paying attention to these practice issues including steps such as the purchase of errors and omissions insurance that cost money out of pocket when there is no claim in sight. However, it seems clear that you as a CPA and a business adviser to your clients should undertake those prudent steps, steps that any businessperson should assume given the reality of business risks. ■

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