

**RISK MANAGEMENT: HOW TO LIMIT YOUR EXPOSURE
IN THE POST-ENRON WORLD**

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After Enron, accountants nationwide are legitimately wondering what the ultimate effect on their practice will be. One thing that is certain is that plaintiffs’ lawyers have been emboldened and that accountants will continue to be seen as deep pockets whenever financial transactions go sour.

It is no fun to be sued for malpractice. Even a defensible lawsuit in which you ultimately prevail will cost attorneys’ fees below your insurance deductible, will intrude upon you and your colleagues’ time, attention and emotions, and can hurt you and your firm’s hard-earned reputation. The buzz around town will be that you got sued; the favorable resolution three years later will be yesterday’s news and may be confidential in any event.

Your goal, then, is not to get sued in the first place. This article lists fourteen tips that you can incorporate into your practice today that will help you avoid malpractice claims and increase your chances of success in the unfortunate event that you are sued.

1. Don’t promise the moon in your promotional materials. An accountant's promotional materials often promise the moon, and the stars too, or at least an army of resources in all fields. Plaintiffs' lawyers use these, as well as the accountant’s written proposals and oral sales presentations, to expand the accountant’s duties and as the basis for fraud claims saying the accountant misrepresented his qualifications and/or didn’t deliver what was promised. Rarely do professionals understate their qualifications when drumming up new business, and sophisticated clients will become naïve and gullible plaintiffs in litigation. Take care to make accurate and realistic statements when marketing. Once the client is on board, manage its expectations and keep them realistic. If the chances of the IRS approving of your client’s position are slim, say so up front.

2. Rigorously screen prospective clients. Many accountants who are sued will admit they never should have accepted the client in the first place. Thinking through the question of “Do we want this person or company as a client?” is the best claim prevention for all accountants, be they auditing Fortune 500 companies or preparing projections for a small business. The simple fact is that judges, juries, and the business community associate you with your client, especially after a disaster. Look at Enron. Avoid the temptation to take on risky clients. No matter how much you might need the work, resist the pressure to get new clients

regardless of the cost -- there often is one. Set up a client screening committee or, at the least, have another partner look at the matter and apply the “smell test” so the decision to take on the client is independent and not driven by one accountant’s desire to be a rainmaker. (Not only will this help prevent claims, but it will reduce your firm’s collection problems.) Talk to any predecessor accountants. Trust your instincts, and don’t be afraid to say no. Also consider your own expertise and qualifications. Is the timing for the engagement realistic for your firm? If you or your firm haven’t done this type of work before, maybe you should refer the client elsewhere. Finally, conduct a similar analysis periodically on existing clients to decide if your firm should continue working with them.

3. Always use and update engagement letters. This letter is one of your best protections against a malpractice claim. For example, clients often view CPAs as guarantors that employees will not embezzle money. The client feels that my CPA is “watching out for me” and that therefore it need not maintain proper internal controls. Unless your engagement letter limits the scope of your responsibility, you will, at the least, have to incur the attorneys’ fees to prove that you are not responsible for something. Prepare separate engagement letters for each matter you take on for the same client, and update those letters yearly and whenever the nature of your engagement changes. State specifically what you will and will not do. If you don’t adequately describe the attest work, you may be held to the audit and not review standard. Avoid broad descriptions like “general business advice.” State your reliance on the client for any particular facts and state all appropriate disclaimers. If you’re not supposed to detect fraud, say so. Consider limiting your liability to fees paid, requiring indemnification, or providing for arbitration rather than litigation. Do not rely upon a conversation to limit the scope of your engagement; memorialize it in a letter. Have the client sign and return a copy of that letter agreeing to its terms. In a very real sense, it is a contract that can insulate you from future liability.

4. Document client communications and advice. The best evidence in court is a document, not your hazy recollection of what transpired in a conversation three years ago. Document your advice, assumptions, and recommendations to the client with appropriate notes to the file and/or letters to the client. Remember that, in litigation, those notes and letters can be read to a jury and opposing counsel will rigorously scrutinize them. If you record concerns in your notes, make sure you do something about those concerns or they may come back to haunt you. Always date your internal notes. Avoid fragmentary notes that can later be misconstrued and taken out of context. Turn those notes into complete memoranda if they involve important issues. Always send a letter if the client is going to act upon your advice so that there is no question later regarding what the advice was and the assumptions it was based upon. Remember that a client who feels ignored is an unhappy client. Keep your client informed and return his phone calls.

5. Adopt a document retention policy and stick to it. After Enron, this is a no-brainer. Judges, juries and the public do not react well to document destruction. For audits of public companies, the recent Sarbanes-Oxley Act requires that you keep “sufficient” workpapers to support the audit conclusions for seven years, and for the first five years keep “all audit or review workpapers” to avoid commission of a felony. How long you retain documents on other engagements isn’t as important as consistently applying whatever policy you adopt. It’s a matter

of judgment but use the applicable statutes of limitation as a guide. Remember that in many states the statute doesn't start to run until the client discovers its injury, which can be years after you performed the work in question. (In tax matters, some jurisdictions have found that the statute doesn't start running until after the IRS issues a notice of deficiency.) Ten years is a safe rule, and perhaps indefinitely if you took on a risky client. If in doubt, keep the document. Remember to address e-mails in your policy; often they should be retained. Once you adopt a policy, stick to it. If you delegate closing files to support personnel, make sure they know and follow the policy. Even if the time is up, don't destroy documents if you have reason to believe a claim may be filed or a subpoena issued. Consider informing your client before you destroy any documents.

6. How to handle subpoenas for your files. Be sure to protect you and your client's rights if your files are subpoenaed as part of, for example, a client's divorce proceeding. Some states have statutes that can apply. For example, some states provide that client records or client information you receive by reason of your employment is confidential, so you should inform your client of the subpoena to give him an opportunity to assert the privilege. It's the client's privilege and not yours, and he will be unhappy if you waive it without his permission. Some states provide that workpapers are your property. So if you get a subpoena you may be able to produce only what your client gave or got from you (since that's all that bears on what your client knew) and not your workpapers. Why give some malpractice lawyer a free peek at your workpapers if you don't have to?

7. Don't sue to collect unpaid fees. Beware the malpractice counterclaim. If the fees are big enough, and if the client has money, it will hire an attorney who will consider whether you did an adequate job. The irony is that the former client probably would never have known it had a malpractice claim if it had not had to seek counsel to defend your suit for fees. Perform a detailed analysis of the malpractice counterclaim potential before suing for fees, and consider obtaining objective advice from a lawyer or your insurance carrier. Also analyze the economics of suing for fees. After taking into account taxes, attorneys' fees, an expert witness to testify concerning the reasonableness of your fee, and your time and that of others in your firm that could be used more productively, even if there is no malpractice counterclaim, and even if you recover the entire amount of your unpaid fees, you very likely will get less than one-half back.

8. Your billing practices can help. Don't set your clients up for billing surprises. Your billing arrangement should be stated clearly in the engagement letter, and it's usually best to take a retainer. Bill frequently. The larger the outstanding bill, the more the client will begin wondering what you have really done for him. Use your bills to remind the client that you're doing a good job. It's harder for the client to stiff you if your bill reads "work on obtaining favorable IRS determination" than if it reads "research IRS regulations." If unforeseen problems arise and you reserved the right to modify your fee, let your client know in writing as soon as possible. Monitor your collections. The client that is last to pay is first to sue. If your client isn't making timely payments, there may be a problem that you can fix. Maybe you need to fire the client. Don't get deeper in the hole. If you stay on top of your billings and collections the receivable won't get so big that you'll be tempted to sue and risk a counterclaim for malpractice.

9. Don't do business with your clients. Avoid investing in your client's deals. True, your clients may make more money and work fewer hours than you. Avoid the temptation to make up for it by being in the deal. It doesn't look good. Even if there is no ethical prohibition, such practices significantly increase your firm's exposure. Not only does it impair an auditor's independence, but if the deal goes sour the other investors may view you as their guarantor. And if your firm has had a long relationship with the client (e.g., prepared tax returns and advised on other matters for several years) you may be considered a fiduciary with the burden of proving in court that the deal was fair to your client.

10. Be careful providing investment advice. Providing investment advice is dangerous. While you may think you are just a facilitator who introduced a client to an investment entity, your client likely perceives you as having checked out the investment thoroughly before "recommending" it. The prudent course is to send a new engagement letter limiting your responsibility in this regard. If you are going to give investment advice, provide your client with several alternatives and let the client make the final choice. Don't accept commissions; get paid by the hour or a flat fee.

11. Don't wear two hats. Watch out for conflicts of interest. You shouldn't do work for both the trustee and the beneficiary unless both consent in writing. You're trained as an accountant and insured as such. If you also act as a securities dealer, lawyer or insurance agent you're increasing your risk and jeopardizing your insurance coverage.

12. Understand what privileges can and can't protect you. The accountant-client privileges that some states have enacted are often limited in scope. They may not apply to criminal proceedings. Federal courts generally will not honor them. Do not count on them for help when dealing with the IRS, DOL or other state and federal agencies. The Federal tax law accountant-client privilege in Section 7525 isn't available in criminal tax proceedings before the IRS, or in non-criminal proceedings where the IRS isn't a party. Since the attorney-client privilege is broader, you should consider getting your client to a lawyer when dealing with regulatory or litigation matters.

13. Implement quality control procedures. Like your dentist says, an ounce of prevention is worth a pound of cure. Some type of peer review system is an invaluable aid in loss-prevention. Other controls to consider include prior approval of investments with clients and other "entrepreneurial" activities, central docketing of mail, mandatory review procedures of staff work, second partner review of audit opinions and tax returns, and tracking CPE compliance. Supervise your employees carefully. You are responsible for the mistakes of your junior accountants and other staff. Train them, supervise them, and periodically review their performance. The simple fact that you have put adequate procedures in place can help reduce your exposure if you are sued.

14. What to do if you are sued. If you are served with a malpractice lawsuit, what you do next can affect your ability to mount a strong defense. Don't try to contact the client that is suing you to talk him out of it. He's already gone to a lawyer. You won't change his mind and anything you say to him can and will be used against you. Do not prepare a mea culpa

written memorandum justifying your work. It will be discoverable by the opposition in litigation. Think twice about getting a second opinion from your partner. Communications with co-workers are discoverable too. Instead, get an attorney involved sooner rather than later so that you can invoke the protection of the attorney-client privilege. Do not destroy any documents. Don't "supplement" or "update" your workpapers with what you now remember was done. Workpapers are contemporaneous documents; that's why they're a powerful defense tool. Notify your insurance carrier immediately and do it in the precise manner stated in the policy. If you wait too long coverage might be denied. If you simply call your local agent, and don't follow the formal notification procedures, coverage might be denied. Do not ignore the matter. It will not go away, and the sooner an attorney is involved the better off you will be.

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