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DEFENDING THE ACCOUNTING MALPRACTICE CASE: AN OVERVIEW OF GENERAL STRATEGIES AND TACTICS ON DISCOVERY, MOTION PRACTICE AND TRIAL

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This outline summarizes some of the more common issues that arise in the defense of accounting malpractice litigation. It is not intended to be a comprehensive discussion of any of those issues, but references to caselaw and more detailed sources are provided. Issues that are not unique to but nonetheless may arise in accounting malpractice cases -- such as Rule 9(b) defenses for failure to plead fraud with specificity -- are not discussed.

I. PRETRIAL INVESTIGATION

A. Reviewing the Workpapers

1. Logistics

a. It is imperative that defense counsel become familiar with and understand the workpapers.

(i) Retain a non-trial consultant early on to guide you through the thicket.

(ii) Pay attention to the interrelationships between workpapers; they do have a logical order and progression.

b. Be sure to examine the originals (pencil, color coding, tickmarks erasures, bad handwriting, spreadsheets do not copy well). For example, red and blue pencil often signify different reviewers and multiple erasures can suggest the staff person wasn't confident of his work, so you can't learn the full story without the originals.

c. Use the accounting firm's document log and document retention policy as a guidepost to ensure you see -- and produce -- everything.

(i) Different firms include different documents in what they consider to be "workpapers."

2. <u>What To Look For In Workpapers</u>

a. Limiting the scope of engagement

(i) Engagement letter, client selection and continuance materials, and qualifications in opinion letters all can define and limit the auditor's role.

b. Defending the auditor's work

(i) Audit planning memos, audit programs and engagement control sheets can show all the good things the auditor did (or didn't) do on the overall audit in planning, fieldwork and testing.

(ii) Engagement letters and workpapers can show that audits are not a guarantee; explain concept of selective testing and role of judgment.

(iii) Workpapers can show what auditor did (or didn't) do on the tender spots and why that approach was reasonable.

c. Client's comparative fault

(i) Workpapers can document what information the client gave the auditor, and thus can show how client lied to or misled the auditor.

(ii) Look for client's representations in the management representation letter, internal control questionnaires, and notes of auditor interviews with client.

(iii) Show how client did not follow auditor's advice as given in management letter and audit committee meetings.

d. Pay attention to what is not in the workpapers (a critical test may not have been performed).

B. <u>Contacting/Interviewing Client Witnesses</u>

1. Staff auditors frequently leave their firms for other positions. As time passes, not only will their memory of the audit in question diminish but also their incentive to cooperate, especially if their present employer is not accommodating. Therefore, it is important to establish contact early on with all of the audit team members.

2. If the auditor has left your client, obtain his or her agreement to be represented by you, at the expense of the firm, for purposes of the litigation to establish an attorney-client privilege. This should be done before the identity of the person is disclosed to the plaintiff under Rule 26 or its equivalent.

3. While sometimes permissible with lower-level staff, generally "I don't remember" from an audit team member is not helpful at deposition or trial. Someone needs to carry the ball and, in addition to the partner and manager, the staff members who did critical audit work will need to review the workpapers and refresh their recollection before testifying.

4. If the witness is no longer with your client and wants to be compensated for his or her time, be certain that any compensation does not exceed the person's usual hourly rate.

C. <u>Retaining Non-Trial Consultants/Expert Witnesses</u>

1. Given the technical nature of auditing in general and workpapers in particular, it pays to retain a consultant very early on in the process. That person can be invaluable in reviewing the workpapers, advising as to the pertinent standards, and offering an initial opinion on the strengths and weaknesses of the audit. You will want the benefits of this analysis before you offer up any of the audit team for deposition.

2. As in any other piece of litigation, this person should be treated as a non-trial consultant before being formally designated as an expert witness.

3. There are many sources for such assistance. Some of the larger accounting firms have in-house litigation consultants who will perform this function. Other sources include insurance carriers, national and local accounting organizations, and litigation support analysts.

4. When it comes to designating an expert, it helps to have someone who has actual auditing experience during the time of the audit in question and who, preferably, has also audited clients or at least otherwise worked in the same industry as the audit client at issue.

5. In some jurisdictions, you will learn the identity of the plaintiff's expert early on because statutes require that an expert affidavit specifying the alleged malpractice be filed with the complaint. These statutes are subject to constitutional challenges. <u>E.g.</u>, Ariz. Rev. Stat. § 12-2602.

D. <u>Investigating A Claim Against The Client</u>

1. The financial statements are the company's representations, not the auditors, and over the course of the past decade courts have become more willing to entertain independent claims by auditors against the officers and

directors of their client companies as well as the companies themselves. These claims can take the form of counterclaims when the auditor has been sued by its client or third-party claims. Generally, these claims arise out of the company making intentional or negligent misrepresentations -- in the management representation letter and elsewhere -- to the auditor. See Michael R. Young, The Liability of Corporate Officials To Their Outside Auditor For Financial Statement Fraud, 64 Fordham Law Review at 2155. See also In re The Leslie Fay Companies Securities Litigation, 918 F.Supp. 749 (S.D. N.Y. 1996).

2. Another basis for auditor claims against their clients derives from an offensive use of the Cenco imputation doctrine that is discussed further in Part III(F) below. See also Schwab, Marks & Richmond, Claims Between Auditors And Their Clients, 32 Securities & Commodities Regulation No. 13, p. 139 (July 1999).

3. If the client has not sued the accountant, careful thought should be given, before any cross-claim or third-party claim is asserted, to the potential consequences of alienating the client. Sometimes the client can be an ally in defending the accountant against claims from lenders or investors, where testimony from the client that it prepared sound financial statements and stands behind them can help. Only if the client's wrongdoing is clear should a claim be asserted.

4. If you feel the accountant may have a claim against the client, but you would like the client's cooperation in defending a third-party suit, consider a tolling agreement.

II. DISCOVERY ISSUES

A. A Dozen Common Discovery Disputes

1. Internal Audit Manuals

a. These manuals set forth the firm's interpretations of GAAS and suggest what steps auditors should take to comply. Plaintiffs want these to show the auditors didn't comply with the firm's own procedures, and to suggest the standard of care.

b. Cases denying discovery: In re Worlds of Wonder, 147 F.R.D. 214 (N.D. Cal. 1992); Tonnemacher v. Sasak, 155 F.R.D. 193 (D. Ariz. 1994). Cases granting discovery: Gohler v. Wood, 162 F.R.D. 691 (D. Utah 1995); Fields v. Oliver's Stores, Inc., 1991 WL 44845, 1990 U.S. Dist. LEXIS 2271 (S.D. N.Y. 1990).

c. Reasons not to produce:

(i) Not relevant as GAAS, not the firm's internal standards, provides the standard of care.

(a) See World of Wonder, 147 F.R.D. at 216; Tonnemacher, 155 F.R.D. at 195; In re CIS Corporation, 123 B.R. 488, 491 (S.D. N.Y. 1991).

(b) Plaintiff already has the workpapers which show how the audit was conducted (the manuals don't show that) and experts to review those workpapers and opine as to whether the audit complied with GAAS.

(c) While this argument is strong in negligence cases, in a fraud case plaintiff will argue that the degree by which the firm's guidelines were departed from is evidence of recklessness/scienter.

(ii) Against public policy as judging auditors by the standard set in their manuals would encourage accountants to set low internal standards.

(a) See Worlds of Wonder, 147 F.R.D. at 217.

(iii) Manuals contain proprietary trade secrets.

(a) See Rubin v. Doctors Officenters Corp., 1986 WL 141133 (N.D. Ill. Dec. 9, 1986); Tonnemacher, 155 F.R.D. at 195; Worlds of Wonder, 147 F.R.D. at 216, Peat, Marwick, Mitchell & Co. v. Creditor's Committee, 65 B.R. 886, 887, (N.D. N.Y. 1986).

(b) Protective order is inadequate because plaintiff's consultants/experts often are or could be the accountant's competitors and "it would be naive to think [they] will erase the audit materials from their minds at the end of the case." Worlds of Wonder, 147 F.R.D. at 217.

(iv) General requests can be overbroad and burdensome. Ask that the court narrow the request.

(a) To only the manual portions pertinent to the audit issues in dispute (e.g., related party transactions).

(b) To only the manual portions referred to in the workpapers or that the auditors actually used and relied on. E.g., In re Crazy Eddie Sec. Litig., 1998 WL 127457 (E.D. N.Y. Nov. 18, 1988).

(c) To only those manual portions that plaintiff's experts say they need in order to better understand the workpapers.

(d) To only the manuals in effect when the audit was performed.

2. Training Materials

a. Such documents include: CPE logs, training materials from in-house and outside courses the accountant attended, sometimes in-house training materials from important courses the accountant did not attend.

b. Plaintiffs want these to attack the accountant's technical training and proficiency, to show the accountant didn't do what he or she had been taught, or had been taught poorly to begin with.

c. Reasons not to produce:

(i) As with audit manuals, GAAS and not the firm's training materials provides the standard of care.

(ii) The firm's internal training materials are proprietary trade secrets.

(iii) Courts are likely to order some production in this area.

(iv) Try to narrow the scope of the production to only the accountants who worked on the audit in question, and only their training on the issues in dispute in the litigation (e.g., internal controls).

3. Personnel Files and Performance Evaluations

a. Plaintiffs want these to attack the individual accountant's qualifications, to show the individual was in over his or her head and the firm knew it, and/or that the firm intentionally or recklessly assigned young and inexperienced people in order to make the audit more profitable.

b. A case finding personnel files not to be discoverable is New York Stock Exchange v. Sloan, 22 Fed.R.Serv.2d 500 (S.D. N.Y. 1976). A case allowing discovery is In re The Hawaii Corporation, 88 F.R.D. 518 (D. Hawaii 1980).

c. Reasons not to produce:

(i) Self-critical analysis privilege. E.g., Bredice v. Doctor's Hospital, 50 F.R.D. 249 (D.D.C. 1970); In re Crazy Eddie Sec. Litig., 792 F.Supp. 197 (E.D. N.Y. 1992); Apex Oil Co. v. Di Mauro, 110 F.R.D. 490, 495 (S.D. N.Y. 1985); O'Connor v. Chrysler Corp., 86 F.R.D. 211, 217 (D. Mass. 1980).

(ii) Confidentiality. In re Del-Val Financial Corp. Sec. Lit., 158 F.R.D. 270 (S.D. N.Y. 1994); Quinn v. Nat'l Basketball Ass'n., 1992 WL 179781, 1992 U.S. Dist. LEXIS 10822 (S.D. N.Y. July 23, 1992); In re Sunrise Sec. Lit., 130 F.R.D. 560, 580 (E.D. Pa. 1989); In re One Bancorp Sec. Lit., 134 F.R.D. 4, 11 (D. Me. 1991).

(iii) Against public policy because disclosure would invade privacy rights and discourage accounting firms from candidly and frankly criticizing their employees' performance for fear that such documents would be used against them in litigation. See New York Stock Exchange Ins. v. Sloan, 22 F.R.Serv.2d 500,503 (S.D. N.Y. 1976); In re Sunrise Sec. Lit., 130 F.R.D. 560, 580 (E.D. Pa. 1989).

(iv) Weigh individual's privacy expectations versus relevancy to the lawsuit.

(a) E.g., discoverable only if staff member worked more than 40 hours on the audit. In re Alert Income Partners, MDL 915, Civil Action No. 92-2-9150 (D. Colo. 1992)

(b) Some courts require that plaintiff first show that the firm was negligent in using the particular employee on the audit. E.g., In re One Bancorp. Sec. Lit., 134 F.R.D. 4 (D. Me. 1991).

(v) Redact non-relevant information (evaluations of work done after the date work in question was performed, names of other clients . . .).

4. Peer Review Materials

a. Plaintiffs want these to attack the accountant's technical training and proficiency.

b. Reasons not to produce:

(i) Self-critical analysis privilege.

(a) <u>Bredice v. Doctor's Hospital</u>, 50 F.R.D. 249 (D. D.C. 1970); <u>In re Crazy Eddie Sec. Litig.</u>, 792 F.Supp. 197 (E.D. N.Y. 1992).

(ii) Irrelevant if end product of peer review does not state what engagements or firm offices were reviewed.

(iii) Limit production to review of the office and the accountants who actually did the work at issue.

(iv) Redact non-relevant information.

5. <u>Expense Reports and Promotional Budgets</u>

a. Plaintiffs want these to attack the auditor's independence. Expense reports can show how close an individual auditor is to his or her client (expensive dinners, Super Bowl tickets etc.); budgets can show how important that client is to the office.

b. Reasons not to produce:

(i) Relevance: is independence really at issue in the lawsuit or is request a fishing expedition?

(a) Some courts require plaintiff to first make a fact specific showing of relevance. <u>E.g.</u>, <u>In re One Bancorp Sec. Lit.</u>, 134 F.R.D. 4 (D. Me. 1991).

(ii) Might contain proprietary marketing information.

(iii) Redact out irrelevant information: <u>e.g.</u>, identity of other clients.

6. <u>Time and Billing Files</u>

a. Plaintiffs want these to learn more about the audit work (if detailed time entries were kept) and to try and show the auditors were overworked and thus prone to mistakes, or underworked such that an independence issue arises because of their motivation to keep the client. They can also be used to attack independence if, for example, they show that this client accounts for most of the partner's total billings.

b. Reasons not to produce:

(i) Generally are discoverable for accountants who worked on the engagement in question and for that engagement only.

(a) Can argue that must only produce records for this particular client and redact out references to other clients together with data for that work.

(ii) Plaintiffs may insist on obtaining time records for work done for other clients/engagements by the accountants who worked on the audit in question in order to show that the auditor was either overworked and thus unable to do a competent job on this client or that this client was his only client and he had an independence issue.

(a) Argue relevance.

(b) Offer to produce a summary of the total hours worked.

7. Marketing Materials

a. Such documents can include advertisements (the KPMG tricycle), marketing brochures, newsletters, and "beauty contest" materials. Their content can range from generic pamphlets to fact specific client proposals, and their audience could be national or local in scope. Sometimes plaintiffs can obtain helpful statements from the accounting firm's website.

b. Plaintiffs want these to show what the accountants promised about their expertise so they could get the business in the door -- and often these materials do tout the accountant's abilities and qualifications and, for better or worse, create high expectations. Plaintiffs will suggest that the promises made in these materials are enforceable because they induced the client to hire the accounting firm. These materials may also describe work the firm offers that the accountants weren't hired to do but that plaintiff now says was promised to them.

c. Reasons not to produce:

(i) Irrelevant if client did not rely on the document when entering into the engagement.

(ii) Irrelevant to negligence issues.

(iii) Industry or client specific promotional materials (or lists of to whom generic materials were sent) contain proprietary marketing strategies.

(iv) General requests are often burdensome because firms do not keep records of what is sent out.

(a) Would it include, for example, business development letters sent out by individual accountants from different offices to prospective clients in different industries?

(v) Courts may order production of some of these materials, but request should be narrowed to materials:

(a) On the precise subject of the audits at issue.

(b) Specific to the industry that the client was in.

(c) Generated by the particular accountants or office of the firm that did the work in question.

(d) Prepared at or about the time of that work.

(vi) Offer to produce samples with client references redacted.

8. Workpapers From The Firm's Audits Of Other Clients In The Same Or Similar Industry (E.g., Other Insurance Clients)

a. Plaintiffs want these to show negligence: that the firm generally follows certain audit steps when auditing this industry but didn't follow them on the audit in question.

b. Cases discussing this issue:

(i) In re One Bancorp Sec. Lit., 134 F.R.D. 4 (D. Me. 1991); WAIT Radio v. Century Broadcasting, 1989 W.L. 135005 (N.D. Ill. 1989); Eliasen v. Hamilton, No. 81C0123, slip opinion (N.D. Ill. 1986).

c. Reasons not to produce:

(i) Not relevant because GAAS provides the standard of care, not what the firm may or may not have done on other audits.

(ii) Not relevant because each audit is unique and tailored to a particular client: that a certain test was employed for one insurance client does not necessarily mean that it was appropriate for another. (SAS 22, AU §§ 311.03, 312.11, 326.20, 329.07, 339.04 all indicate that each audit is unique.) Consider an expert affidavit.

(iii) Client confidentiality comes into play. Consider having the other client appear and move for a protective order saying it will be harmed if its competitors gain access to sensitive workpapers.

(iv) Overbroad and will needlessly expand scope of depositions.

(v) Narrow request to workpapers dealing with specific issue in dispute (e.g., loss reserves).

9. Workpapers For Other Engagements Performed For The Same Client

a. Such other engagements might include prior and subsequent year audits, agreed upon procedures, S-1 registrations, tax work etc.

b. Other audit workpapers may show that the accountant employed a significant test in one year but not another.

c. Especially with large firms, the tax team may learn something and document it in the tax workpapers that would be pertinent to the audit but not communicate it to the auditors. Since most courts will impute the knowledge of one department to a different department within the same firm, this can have an impact on, for example, an auditor's subsequent event responsibilities, especially in fraud cases.

d. Reasons not to produce:

(i) Not relevant because GAAS provides the standard of care, not what was or wasn't done on a different audit.

(ii) Not relevant because only a particular year's audit work is in question.

(iii) Not relevant because each engagement is unique and based on the objectives and facts existing at the time.

(a) That a test was employed in one year but not another may be because the client had different internal controls.

(iv) Overbroad and will needlessly expand scope of depositions.

10. Other Lawsuits Against The Accounting Firm Or Engagement Partner

a. Plaintiffs want these to bolster their claims of incompetence and negligence, and also to show that the firm was painfully aware of the individual auditors' deficiencies but nonetheless assigned them to the audit in question.

b. Reasons not to produce:

(i) Not relevant because the facts and circumstances in the separate lawsuit are not comparable to the audit in question.

(ii) Not relevant because GAAS provides the standard of care.

(iii) If the other litigation is still pending, unproven allegations have no probative value.

(iv) Such requests are frequently overbroad and not limited to situations analogous to the case at bar.

(v) Such requests can be burdensome and plaintiff has access to public court filings in any event.

(vi) Highly prejudicial.

11. <u>Insurance Information</u>

a. Rule 26(a)(1)(D), Fed.R.Civ.P., as well as similar state rules, requires that a defendant disclose its insurance agreements. Prior to the enactment of this rule, whether such coverage was discoverable was a frequently litigated question.

b. Even in jurisdictions where the insurance policy must be disclosed, the rule only provides for discovery of the policy itself and not any other information such as whether claims have been made against the policy or the extent to which defense costs have reduced the available coverage. While it is within the court's discretion, frequently courts will not permit a plaintiff such additional discovery concerning insurance information. <u>E.g.</u>, <u>Wegner v. Viessman, Inc.</u>, 153 F.R.D. 154 (N.D. Iowa 1994); <u>Resolution Trust Corp. v. Thornton</u>, 41 F.3d 1539, 1547 (D. C. Cir. 1994).

12. <u>The Accounting Firm's Net Worth For Punitive Damages Purposes</u>

a. If plaintiffs have asserted a claim for punitive damages, they will ask for evidence of the firm's net worth. While each state has its own caselaw concerning whether or not the plaintiff must make a <u>prima facie</u> showing of entitlement to punitive damages before getting this discovery, there is some caselaw in the accounting area that can prove helpful in attempting to avoid this discovery.

b. Several courts have found that its strains common sense to believe that an accounting firm would risk its hard-won reputation for integrity in order to earn some minimal audit fees by permitting a client to engage in fraud.

B. Protective Orders/Redacting Workpapers/In Camera Review

1. Protective orders are often employed to cure confidentiality concerns.

   a. Sometimes the accountant can argue that a protective order is insufficient if plaintiff's consultants/experts are from competing accounting firms.

   b. Prevent plaintiff from providing the documents to third-parties or from using them in separate proceedings.

   c. Address access of client/experts/consultants.

   d. Address what happens to documents at conclusion of litigation.

2. Many courts will permit the redaction of irrelevant information.

   a. E.g., names of other clients.

3. In camera review.

   a. Can resolve discovery disputes.

   b. Can also educate court.

   c. Consider offering assistance to the court in its review of complex workpapers. Should producing party meet ex parte with court to explain significance? Should parties split cost of an independent accountant to assist court or to serve as a discovery master?

C. Third Party Subpoenas For Workpapers Where Accountant Is Not A Party To The Litigation

1. Goal is to keep the accountant out of the litigation.

   a. Sometimes plaintiff wants to simply argue that the defendant lied to its auditors along with everybody else; other times plaintiff is looking for a deep pocket.

2. Don't let prospective plaintiffs get a free look at the workpapers. Subpoena power cannot be used to obtain workpapers for purposes of determining if there are Rule 11 grounds for proceeding against the accountant.

a. See Nicholas v. Poughkeepsie Savings Bank/FSB et al., 1990 U.S. Dist. LEXIS 17143, [1991 Tr. Binder] Fed.Sec.L.Rep. (CCH) ¶ 96,066 (S.D. N.Y. 1991).

3. Produce only what is relevant to the underlying litigation: if investor is suing company for securities fraud, and the accountant is not a party to the litigation, then only those portions of the workpapers showing what the company knew or did not know (e.g., representation and management letters, notes of client meetings, client schedules, etc.) are relevant; the accountant's internal workpapers are not.

4. If client is not a party, inform it of the subpoena to permit it to appear and object to disclosure of sensitive workpapers.

a. In some states must resolve accountant-client privilege issues before complying with subpoena.

b. In some jurisdictions, statutes provide that the accountant owns its mental impressions and "work product" while the client owns the raw information provided to the accountant, such that the client must be consulted.

(i) For example, Arizona Revised Statute § 32-744 ("[a]ll statements, schedules, working papers and memoranda" prepared by an accountant in the course of performing work for a client "remain the property" of the accountant).

D. Privileges

1. United States Supreme Court has noted that "no confidential accountant-client privilege exists under federal law, and no state-created privilege has been recognized in federal cases." Couch v. United States et al., 409 U.S. 322, 335 (1973).

2. United States Supreme Court also has found that under federal law the accountant's workpapers do not enjoy a work product privilege. United States v. Arthur Young & Co. et al., 465 U.S. 805, 817 (1984) (accountant's tax accrual workpapers).

a. Rationale is that, unlike lawyers, an accountant's duty to the investing public transcends its duty to its client.

b. In-house investigations of the accounting work in question may not be privileged if counsel was not involved.

c. But in United States v. Adlman, 134 F.3d 1194 (2nd Cir. 1998), the Second Circuit suggested that work product protection could extend to documents prepared by an accountant in a business planning context.

3. Some states have statutory accountant-client privileges.

   a. Example is Arizona Revised Statute § 32-749 (accountants shall not divulge client records or information).

   b. Ascertain whether or not the privilege will apply (e.g., some state statutes will not apply in federal bankruptcy litigation).

4. The federal accountant-client privilege for tax advice in I.R.C. § 7525.

   a. "Authorized practitioners" can refuse to disclose client communications that form the basis for their federal tax advice in noncriminal tax matters before the IRS or in federal court where the IRS is a party.

   b. Does not apply in state court, before federal agencies other than IRS, or if IRS makes a criminal referral.

III. MOTION PRACTICE

Some of the more common defense motions unique to accountant's liability cases are discussed below.

A. Statute of Limitations

1. Most jurisdictions find that an accounting malpractice claim arises in tort and not as a breach of the engagement contract, such that the shorter tort statute of limitations is applied. E.g., Sato v. Van Denburgh, 123 Ariz. 225, 599 P.2d 181 (1979). See also FDIC v. Ernst & Young, 967 F.2d 166, 172 (5th Cir. 1992) (Texas law); Clark v. Milam, 847 F.Supp. 409, 420-21 (S.D. W.Va. 1994); FDIC v. Schoenberger, 781 F.Supp. 1155, 1157 (E.D. La. 1992). Some jurisdictions, however, will apply the longer contract statute of limitations.

2. A large body of caselaw has developed concerning the accrual of a cause of action for tax malpractice. Jurisdictions vary, at least one finding that the statute begins to run when the return is prepared, others when the IRS initiates an audit, while most find that the statute does not begin to run until the IRS has actually assessed a deficiency or made an assessment. See generally Application of Statute of Limitations to Actions for Breach of Duty in Performing Services of Public Accountant, 7 ALR 5th 852 (2001).

3. Some statute of limitations defenses are also based upon the imputation doctrine discussed in Part III(F) below. If someone at the client company

knew of the fraud and that individual's knowledge is imputed to the company, often the statute will have run.

4. In some instances the limitations period can be lengthened by the "continuous representation" doctrine, which tolls the statute while the accountant is still providing services to the client. The application of this doctrine varies from jurisdiction to jurisdiction.

B. Ultramares and Privity Defenses

1. Some jurisdictions, including New York, have held that those not in privity with the accountant -- i.e., third parties who allegedly relied upon the financial statements -- cannot sue unless they were in privity with the accountant. Under this traditional common law rule, a third-party lender or investor could not recover from the accountant unless he could establish that the accountant knew that he would be relying on the financial statements. See Ultramares Corp. v. Touche, 255 N.Y. 170, 174 N.E. 441 (1931).

2. Some jurisdictions have rejected the privity bar in favor of the tort standard of reasonable foreseeability. E.g., Citizens State Bank v. Timm, Schmidt & Co., 113 Wis.2d 376, 335 N.W.2d 361 (1983).

3. Other jurisdictions have adopted a middle ground approach based upon the Restatement (Second) of Torts § 552, which limits an accountant's liability to losses suffered by certain categories of intended recipients whom the accountant knows will be relying upon the audit report. See e.g., Bily v. Arthur Young & Co., 11 Cal.Rptr.2d 51, 69-70, 834 P.2d 745 (1992). In these jurisdictions, third parties cannot sue for negligence but only for negligent misrepresentation under § 552, and must establish justifiable reliance. E.g., Standard Chartered PLC v. Price Waterhouse, 190 Ariz. 6, 945 P.2d 317, 339-340 (App. 1996).

4. Still other jurisdictions have enacted statutes to deal with the issue. E.g., N.J. Stat. § 2A: 53A-25; Ill.Rev.Stat., Ch. 111, § 5535.1.

5. In any event, the trend in most jurisdictions is to restrict the accountant's liability to third parties by either adopting § 552 or enacting a statute requiring some form of privity.

C. An Independent Auditor By Definition Cannot Be A Fiduciary

1. Plaintiffs frequently assert breach of fiduciary duty claims in auditing malpractice cases. Several courts have dismissed such claims by finding that an independent auditor, who by definition must deal at arms length from his client and whose primary duty is owed to the public, cannot have a fiduciary relationship with its client. See, e.g., Standard Chartered PLC v. Price Waterhouse, 190 Ariz. 6, 945 P.2d 317 (App. 1996); Franklin

Supply Co. v. Tolman, 454 F.2d 1059, 1065 (9th Cir. 1971); Mishkin v. Peat, Marwick, Mitchell & Co., 744 F.Supp. 531, 551 (S.D. N.Y. 1990); In re Storage Technology Corp. Securities Lit., 630 F.Supp. 1072, 1076 (D. Colo. 1986); Fund of Funds, Ltd. v. Arthur Andersen & Co., 545 F.Supp. 1314, 1356 (S.D. N.Y. 1982).

D. Scope Of The Engagement

1. Plaintiffs will frequently attempt to expand the scope of the accountant's engagement beyond that which is set forth in the engagement letter. For example, plaintiffs may argue that the accountants agreed to review loan portfolios or to serve as the company's internal auditor. Motions arguing that the accountant never contracted to perform certain work can be successful. See, e.g., University National Bank v. Ernst & Whinney, 773 S.W.2d 707, 710 (Tex. App. 1989); Atlantic Richfield Oil & Gas Co. v. McGuffin, 773 S.W.2d 711 (Tex. App. 1989); Italia Imports v. Weisberg & Lesk, 220 A.D.2d 226, 631 N.Y.S.2d 363 (1st Dept. 1995).

2. Don't let plaintiffs hold an accountant responsible for misstatements in documents that the accountant did not attest to. For example, an auditor should only be liable for misstatements in the financial statements that he issued his audit report on, not for statements that management may have made in a letter to shareholders or other portions of a 10-K filing. Similarly, an accountant is not responsible for inaccuracies in financial statements that it has not audited or prepared a report on. For example, plaintiffs frequently seek to hold accountants responsible for misstatements in quarterly financial statements included in 10-Q filings when the accountants did not audit or opine on those financial statements.

E. The Audit Interference Rule And Comparative Fault

1. With the advent of comparative fault, accountants accused of negligence can frequently spread the blame around between the client and others, including non-parties to the lawsuit, and thereby decrease their exposure.

2. Plaintiffs will try to prevent this by arguing that the court should apply the "audit interference" rule, which essentially allows an accountant to assert the defense of the client's contributory negligence only if the client's negligence directly interfered with the performance of the audit. See National Surety Corp. v. Lybrand, 9 N.Y.S.2d 554 (N.Y. 1939); Lincoln Grain, Inc. v. Coopers & Lybrand, 345 N.W.2d 300 (Neb. 1984).

3. With the advent of comparative fault, the rationale for the "audit interference" rule no long applies, and most all states that have expressly considered the rule in conjunction with their comparative negligence statutes have rejected the rule and found that any negligence of a client can reduce the client's recovery. See, e.g., Scioto Memorial Hospital

Ass'n v. Price Waterhouse, 659 N.E.2d 1268, 1272 (Ohio 1996); Halla Nursery, Inc. v. Baumann-Furrie & Co., 454 N.W.2d 905, 909 (Minn. 1990); FDIC v. Deloitte & Touche, 834 F.Supp. 1129, 1145 (E.D. Ark. 1992); Devco Premium Finance Co. v. North River Insurance Co., 450 So.2d 1216 (Fla. Ct. App. 1984); Capital Mortgage Corp. v. Coopers & Lybrand, 369 N.W.2d 922, 925 (Mich. Ct. App. 1985); Standard Chartered PLC v. Price Waterhouse, 190 Ariz. 6, 41-43, 945 P.2d 317, 352-53 (App. 1996).

4. The reasons given by the above courts for rejecting the "audit interference" rule in the context of comparative fault are persuasive. The audit interference rule arose out of a need to mitigate the harsh effect of contributory negligence's 100% bar on a plaintiff's claim if the plaintiff was at all negligent. This reasoning is no longer viable in the context of comparative fault.

5. Some courts, however, have applied the "audit interference" rule in a comparative fault situation. The Oklahoma Supreme Court did so last year. Stroud v. Arthur Andersen, 2001 Ok. 76, 2001 Okla. LEXIS 86 (Sept. 18, 2001). See also Fullmer v. Wohlfeiler & Beck, 905 F.2d 1394 (10th Cir. 1990) (applying Utah law).

6. For general discussions of this issue see Auditor Liability -- The Effect Of The Client's Contributory Negligence, 65 Pa. B.A.Q. 109 (July, 1994); The Defense Of Contributory Negligence In Accountant's Malpractice Actions, 13 Seton Hall L.Rev. 292 (1983); Note: The Peculiar Treatment of Contributory Negligence In Accountants' Liability Cases, 65 N.Y.U.L. Rev. 329 (1990).

F. Imputation Defenses

1. A frequent defense, usually asserted where the auditor is accused of failing to discover and disclose a fraud perpetrated by a company's own managers, is that the corrupt managers were the agents of the company such that their knowledge of the fraud must be imputed to the company to bar its claims against the auditor. Put another way, if the company, through the imputed knowledge, "already knew" what it now claims the auditor failed to discover and disclose to it, it cannot establish the reliance and causation elements of its claim. This "imputation doctrine" was first applied in the auditing liability context by the Seventh Circuit in Cenco, Inc. v. Seidman & Seidman, 686 F.2d 449, 456 (7th Cir. 1982). See generally, Presumed Innocent? Financial Institutions, Professional Malpractice Claims And Defenses Based On Management Misconduct, 1995 Columbia Business L.Rev. 127.

2. Plaintiffs will argue that the "adverse interest" exception to the imputation rule should apply: that if the corrupt manager in fact was acting adversely

to the company (e.g., embezzling funds from the company as opposed to fraudulently inflating the financial statements which benefited the company by helping it raise capital), then the agent's knowledge should not be imputed to the company.

3. Where the accountant can show that the agent was acting both for himself and for the company, such that there was a "mixed benefit," several cases have rejected the "adverse interest" exception and applied the imputation doctrine. See, e.g., Crazy Eddie Inc. v. Peat Marwick Main & Co., 802 F.Supp. 804, 817 (E.D. N.Y. 1992); Center v. Hampton Affiliates, Inc. , 497 N.Y.S.2d 898, 899-900, 488 N.E.2d 828, 829-30 (1985); FDIC v. Ernst & Young, 967 F.2d 166, 170-171 (5th Cir. 1992); In re American Continental/Lincoln S&L Sec. Lit., 794 F.Supp. 1424, 1463 (D. Ariz. 1992).

4. Some cases have also held that a short term benefit of limited duration is sufficient for imputation, even if the company is ultimately harmed by the agent's actions in the long run. See Seidman & Seidman v. Gee, 625 So.2d 1 (Fla. Dist. Ct. App. 1993); Security America Corp. v. Schacht, 1983 U.S. Dist. LEXIS 19621 (N.D. Ill. Jan. 31, 1983).

5. Some courts have also found that even if the agent's motives were entirely self-serving, if the corporation benefited from the fraud the agent's knowledge will still be imputed to the company. E.g., In re American Continental, supra, 794 F.Supp. at 1424; In re Drexal Burnham Lambert Group, Inc., 148 Bankr. 1002, 1006 (S.D. N.Y. 1993).

6. Many trial courts, however, are reluctant to dismiss cases or grant summary judgment based upon the imputation doctrine, preferring instead the find factual issues for trial. Because of this inclination, any motion urging imputation should also discuss the merits enough to suggest that the auditor is wearing the white hat and being unfairly accused.

G. Accounting Errors Do Not Supply Scienter

1. In securities fraud actions, a plaintiff's attempt to prove scienter on the part of the accountant frequently boils down to a litany of alleged violations of GAAS and GAAP. Absent facts providing a strong inference that such accounting errors were part of a scheme to defraud, allegations of the misapplication of accounting principals are insufficient to supply scienter. Several courts have dismissed securities fraud claims against accountants on these grounds. See, e.g., In re World of Wonders Sec. Litig., 35 F.3d 1407, 1426-27 (9th Cir. 1994); Adams v. Standard Knitting Mills Inc., 623 F.2d 422 (6th Cir. 1980); In re Software Toolworks, Inc. Sec. Litig., 50 F.3d 615 (9th Cir. 1994); In re Peritus Software Sec. Litig., 52 F.Supp.2d 211, 223-24 (D. Mass. 1989); In re Credit Acceptance Corp. Sec. Litig. 50 F.Supp.2d 662, 680 (E.D. Mich. 1999).

2. The same rationale applies to common law fraud claims. Indeed, even the accountant's knowledge of some "red flags" may be insufficient to establish fraud. E.g., Chill v. General Electric Co., 101 F.3d 263, 270 (2d Cir. 1996) ("[f]raud cannot be inferred simply because [a defendant] might have been more curious or concerned about the activity [in question]").

H. Attacking The Elements Of The Plaintiff's Case

1. Reliance, while not an element of a standard negligence claim, is an element of a negligent misrepresentation claim under Restatement (Second) of Torts § 552 and of fraud based claims. In addition to the imputation doctrine discussed above, motions are frequently premised on plaintiff's failure to plead and/or create triable issues concerning justifiable reliance. E.g., Delmar Vineyard v. Timmons, 486 S.W.2d 914 (Tenn. Ct. App. 1972); Devaney v. Chester, 1989 WL 52375, 1989 U.S. Dist. LEXIS 4986 (S.D. N.Y. 1989).

2. Causation, while sometimes difficult to dispose of as a matter of law, can also be the subject of motion practice.

   a. If the plaintiff already knew what it alleges the auditor failed to discover, it cannot establish causation. Such knowledge can be established through the imputation doctrine discussed in Part III(F) above or from the company's own actions. E.g., E.F.Hutton Mortgage Corp. v. Pappas, 690 F.Supp. 1465 (D. Md. 1988); Drabkin v. Alexander Grant & Co., 905 F.2d 453 (D.C. Cir. 1990); Stratton v. Sacks, 99 B.R. 686 (D. Md. 1989), aff'd 900 F.2d 255 (4th Cir. 1990); Begier v. Price Waterhouse, 135 B.R. 222, 224 (E.D. Pa. 1991).

   b. Sometimes the loss causation facts will be so overwhelming that they are worth bringing on a motion for summary judgment. Even if that motion is denied, the judge will be better educated as to the deficiencies in the plaintiff's proof.

3. Timing is important, and it helps to make a chronology of the plaintiff's actions and compare it with the dates of the auditor's reports. For example, if the plaintiff parted with its money (e.g., made its investment or loan) before the audited financial statements were issued, it cannot demonstrate reliance. Similarly, a plaintiff cannot recover losses that were incurred before it ever saw the audit report, which is often the case with a continuing embezzlement.

I. Motions In Limine

1. Depending upon the court's rulings on substantive motions, various motions in limine on those issues may be necessary.

2. Don't forget to revisit the various discovery disputes discussed in Section II(A) above. Just because the court decided that the plaintiff could discover your client's internal audit manuals does not mean that they should be admissible at trial.

IV. JURY THEMES AT TRIAL

Given the complex and technical nature of accounting liability cases, jury consultants are often very helpful in identifying persuasive themes.

A. Avoid Technical Defenses

1. "It's not my job" per the engagement letter or that "financial statements are management's responsibility" per the management representation letter don't play well at trial.

    a. An accountant taking the position that he or she somehow is not responsible for financial statements will be seen as evading responsibility.

    b. What was the auditor hired to do anyway?

2. That the client further represented in the management representation letter that everything was fine and there was no fraud isn't a solid defense either.

    a. Plaintiff will argue that the auditor drafted and "made" the client sign the letter.

    b. The auditor couldn't rely exclusively on the letter anyway. He had to do some testing, otherwise there would be a scope limitation.

3. Technical defenses based on the auditing standards, even if they are explained succinctly and well, won't absolve the auditor of all responsibility either.

4. These arguments may be okay on motion, but generally are not persuasive with a jury.

B. Jurors Want To Know The Auditor Tried. Show this through:

1. Explain what an audit is. Jurors usually do not understand what auditors do. An audit is not a guarantee and can provide only reasonable assurance. Go over the concept of selective testing and that the auditor is not expected to test every transaction the company had -- otherwise audits would take years to complete, be far too expensive and reports would not be timely. Point out that auditors are not required to presume that management is dishonest and may believe what they are told if it appears

reasonable. Explain the role of judgment, including why auditing is an art and not a science.

a. Frequently you can get such admissions from the plaintiffs' expert.

b. See generally Cenco, Inc. v. Seidman & Seidman, 686 F.2d 449, 454 (7th Cir. 1982) (an auditor is not a "detective hired to ferret out fraud"); Bily v. Arthur Young & Co., 11 Cal.Rptr.2d 51 (1992) ("an auditor is a watchdog, not a bloodhound"). Indeed, the Bily quote is a good rejoinder to the United States Supreme Court's statement, frequently quoted by plaintiffs, that an auditor is a "public watchdog" who "assumes a public responsibility transcending any employment relationship with the client." United States v. Arthur Young & Co., 465 U.S. 805 (1984).

2. Focus the jury's attention on the entire audit, not just the tender spots plaintiff emphasizes.

a. Emphasize all the work that the audit team did.

(i) Mark as an exhibit and show how big the workpapers are and thus how much work was done.

(ii) Show planning memos.

(iii) Go through the other 32 steps on the audit program and engagement control sheet that plaintiff's counsel didn't discuss.

b. Point out examples where the auditors didn't roll over and instead stood up to the client.

c. Have reasonable explanations for why the auditors didn't do what plaintiff now says they should have done.

d. If some important work is not documented in the workpapers, have a reasonable explanation for why.

3. If necessary, explain the difference between negligence and fraud. In some respects, a fraud case is easier to defend because jurors can appreciate that auditors have no real incentive to conceal a client's fraud.

4. Emphasize that a team was involved, not just one individual.

a. So they'd all have to be fraudulent or negligent for the firm to be liable, not just one of them.

b. Point out that teams are not perfect. There can be some gaps, but that doesn't mean there was fraud.

c. It's hard to believe that an entire team was dishonest or incompetent.

d. While accounting firms can generate large fees, often the audit fees are so minimal that the engagement partner would have no incentive to conceal a client's fraud.

5. Stress the unfairness of hindsight, where red flags seem much bigger than they were at the time. Focus attention on the status of the company when the auditors were doing their work. Remind the jury that the auditors were making difficult judgment calls based on the then known facts and did not have the benefit of hindsight.

   a. The standards do not require perfection. An audit consists of numerous individual decisions, some made by lower-level personnel exercising their judgment on the basis of incomplete information. Auditors are human, and can only be expected to make reasonable judgments under the known circumstances. They cannot predict the future.

   b. See generally Stanley L. Bloch Inc. v. Klein, 45 Misc.2d 1054, 1056, 258 N.Y.S.2d 501, 504-05 (Sup. Ct. N.Y. Co. 1965) ("an accountant does not guarantee correct judgment, or even the best professional judgment, but merely reasonable competence"); Mishkin v. Peat, Marwick, Mitchell & Co., 744 F.Supp. 531 (S.D. N.Y. 1990) (an auditor "is not responsible for mere error in judgment. . . Deviation from standards does not perforce thereof spell negligence in an audit, nor are innocent blunders culpable fault").

6. Acknowledge where, in hindsight, mistakes were made.

7. Coach audit team witnesses to come across as competent professionals who know what they are doing and take responsibility for their actions.

   a. At least the engagement and concurring partners, manager and senior staff should review the workpapers and standards before testifying. They have to carry the ball, and "I don't remember" doesn't help.

   b. They should be proud of and not embarrassed by their work.

   c. The auditor should take full responsibility for the parts of the audit that he or she performed.

d. Boring can be okay -- we're talking about accountants here, and if they fit the stereotype that probably helps. The accountant witness needs to appear honest and competent, and if that means putting a juror to sleep with a technical explanation so be it.

C. <u>Attacking The Plaintiff</u>

1. After you've established that the auditors tried hard, you can start throwing stones. A "bad plaintiff" case can really help, even if the audit was problematic. Portray the auditor as a victim if you can.

2. That is especially important in comparative fault jurisdictions.

   a. In most jurisdictions with comparative fault, you can explore all of plaintiff's actions, though some jurisdictions still follow the <u>Lincoln Grain</u> "audit interference" rule discussed in Part III(E) above.

   b. If the plaintiff was a third-party investor and not the audit client, remember that you can explore the comparative fault of both the plaintiff investor and the audit client.

3. Show that plaintiff didn't rely on the audited financials.

   a. For example, that plaintiff already knew what it now says the auditors failed to discover and disclose to it. If the plaintiff's own personnel saw the bad news or themselves perpetrated the fraud, their knowledge should be imputed to the company.

   b. Timing is often critical. Was the audit report even available when plaintiff made its business decision?

4. Point out that clients have obligations too. They must provide complete, accurate and reliable financial information to the accountant, provide full access to their books, and otherwise cooperate with the accountant. Explaining how the client failed to live up to those obligations is quite effective. Not only does it cast the plaintiff in an unfavorable light, but it can explain why the auditors couldn't do their job properly.

   a. That the client withheld important information from, misled, and otherwise deceived the auditors is a compelling argument. To make it stick, you also have to suggest a motive for why the client would do something so dishonest. For example, that the CFO was skimming funds to support his extravagant lifestyle.

   b. Even if the client wasn't intentionally hiding things, you might be able to portray it as being in a financial box (sales down, creditors unhappy, pressure to show good numbers) that it desperately needed to get out of, such that it wasn't entirely cooperative or forthcoming.

5. Show that the client did not heed the warnings given by the accountant. If, for example, the accountants advised the client, in a management letter or elsewhere, to institute or improve certain controls and the client did not heed this advice, a jury can conclude that the accountants were doing their job and that the client was not paying attention to what the accountants had to say such that, even if the accountants had discovered and disclosed the problem that is at issue in the lawsuit, the client would have ignored that too. That the client ignored the accountants' advice and rejected their recommendations does not make for a sympathetic plaintiff.

6. Loss causation: other reasons why the client's business failed, <u>e.g.</u>, economy tanked, industry had setbacks, plaintiff made bad business decisions, plaintiff failed to do due diligence, or plaintiff is a real risk taker. An audit is not a guarantee that such factors will not cause a loss.

7. Sometimes a plaintiff fails to mitigate its damages by cutting its losses when it first learns of the company's financial problems.

8. Some judgment is called for in attacking a plaintiff. While a sophisticated businessman should know better and is fair game for such attacks, be careful that the jury does not sympathize with an unsophisticated retirement investor.

D. <u>Tell A Story</u>

1. As in any jury trial, the defense must have a theme and a story must be told. The technical aspects of GAAS and GAAP can put a jury to sleep (though they must be addressed in order to demonstrate the accountants' professionalism and competence). Highly paid and credentialed expert witnesses often tend to cancel each other out. What is left is that something bad happened to the plaintiff, and the jury wants to know why. You need to answer that question by showing, first, that it was not the accountants' fault (who did a professional and competent job under the circumstances) and, second, that there is another valid and reasonable explanation for what happened (the plaintiff was greedy or did not do adequate due diligence, the entire industry tanked, etc.).

2. It often comes down to what a jury believes is fair. If you have established that the accountants were honest people who tried their best, and have offered a reasonable explanation having nothing to do with the accounting for why the plaintiffs suffered their losses, a jury can conclude that it is unfair of the plaintiffs to blame the accountants for their losses.

CONCLUSION

This outline hopefully has highlighted some of the major issues to be considered by defense counsel in accounting malpractice litigation. A more comprehensive discussion of many of these issues can be found in the caselaw and other sources cited above and in the other articles found in this volume.

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