

## CAUSES OF ACTION

### **Introduction**

There are a large number of diverse theories of liability which may be asserted against an accountant for malpractice. These include common-law and statutory theories.

The proper selection of an appropriate theory of liability to pursue against an accountant can be critical to the ultimate outcome of any litigation with an accountant. There are important distinctions between the various liability theories in terms of liability elements, technical defenses, measure of damages, application of comparative fault, and recoverability of attorneys' fees, to name but a few.

These differences should be explored thoroughly before legal process is issued against an accountant. Practitioners are also cautioned to thoroughly research the law of the state which will govern the litigation, since the individual states may vary considerably in their rulings on particular legal issues. An overview and summary of possible legal theories is presented below.

### **Negligence**

Professional negligence is the liability theory most often referred to as an "accounting malpractice" claim. The elements of a professional negligence action against an accountant are similar to those present in any other type of negligence lawsuit. They are:

- Duty – the accountant must have owed the plaintiff a duty to use reasonable care in delivering accounting services.
- Breach of Duty – the plaintiff must show that the accountant failed to use that degree of skill and learning normally possessed and used by public accountants in good standing in a similar practice and under like circumstances.
- Damage – the plaintiff must show that he or she suffered damage as a direct result of the accountant's breach of duty. In the words of one court, "no hurt, no tort."
- Causation – a causal nexus between the asserted breach and damages, such as a business driven into bankruptcy because it went into debt in reliance on overstated financial statements. *In re Gouiran Holdings, Inc.*, 165 B.R. 104 (E.D.N.Y. 1994).

In cases where the plaintiff was the direct client of the accountant being sued for negligence, the plaintiff will have no difficulty establishing that the accountant owed a duty to the plaintiff. This is true in most of the litigation brought against accountants. In cases where the plaintiff was not the direct client of the accountant, and hence lacks privity of contract with the accountant, the plaintiff's claim may be barred by the lack of privity.

To establish that the defendant accountant has deviated from a standard of care, the plaintiff must establish both the existence and nature of the asserted professional standard and its

breach.<sup>1</sup> In most cases, the plaintiff will establish both the standard of care and its breach through the testimony of an expert witness specially retained for litigation.<sup>2</sup> In a small minority of cases, the plaintiff might be able to prove these elements through the testimony of the defendant accountant. According to one court, the accountant must be shown to have made a “significant deviation” from the applicable standard of professional care. *Abrams & Wofsy v. Renaissance Inv. Corp.*, 820 F. Supp. 1519 (N.D. Ga. 1993). That is, expert testimony establishing merely a difference in opinion between experts on the use of acceptable, alternative methods is insufficient to establish negligence. At least one court has determined that a CPA firm’s internal procedures manual can supply the standard of care. *Grant Thornton, LLP v. FDIC*, 2007WL4981339 (S.D.W.Va. 2007).

There is no basis for a common law action for “gross negligence,” though fault rising to that level may provide a basis for inferring *scienter* in a fraud action. *HAS Residential Mortgage Services v. Casuccio*, 350 F. Supp. 2d 352 (E.D. N. Y. 2003).

The shoal on which many plaintiffs’ cases run aground is the element of damage causation.<sup>3</sup> The necessary predicate in this element is the existence of some damage, since without any damages there is no basis for a tort action.<sup>4</sup> To establish loss causation, the plaintiff will need to show that he or she would have acted differently but for the negligent advice or information supplied by the accountant. Here are a few examples of such claims:

- the owner of a small business who claims that she would not have purchased new equipment if the accountant had not prepared financial statements which overstated assets;
- the business manager who would have fired an accounting clerk if the auditor had discovered his defalcation on an earlier audit;
- the banker who would not have renewed an operating credit line if bad debts had not been understated on a financial statement; and
- the taxpayer who would not have overpaid taxes if the accountant had pointed out an additional deduction.

Even though the plaintiff bears the burden of pleading and proving a causal connection between the breach of duty and the asserted damage, accountants defending such claims typically focus so much attention on this element that it will be treated in more detail below, as a defense.

As in most other civil actions, a plaintiff pursuing an accounting negligence case has the burden of proving the essential elements of the claim by the greater weight or fair preponderance

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<sup>1</sup> Compliance with specific standards established by the American Institute of Certified Public Accountants may not be the only standard for measuring professional negligence. *Kemin Indus. v. KPMG Peat Marwick LLP*, 578 N.W.2d 212 (Iowa 1998).

<sup>2</sup> The use of experts is required to establish departures from GAAS and GAAP. *Danis v. USN Communications*, 121 F. Supp. 2d 1183 (N.D. Ill. 2000).

<sup>3</sup> *Bastian v. Petren Resources Corp.*, 892 F.2d 680 (7th Cir. 1990).

<sup>4</sup> *Huls v. Clifton, Gunderson & Co.*, 535 N.E.2d 72 (Ill. 1989); *Cenco, Inc. v. Seidman & Seidman*, 686 F.2d 449, 453 (7th Cir. 1982); *Kemin Indus. v. KPMG Peat Marwick LLP*, 578 N.W.2d 212 (Iowa 1998).

of the evidence. One court, however, requires a plaintiff to prove justifiable reliance on a financial statement by clear, cogent and convincing evidence. *ESCA Corp. v. KPMG Peat Marwick*, 959 P.2d 651 (Wash. 1998).

A plaintiff suing an accountant for professional negligence is entitled to recover all damage proximately resulting from the duty breached by the accountant. This may include:

- in an employee defalcation case, the amount stolen after the first negligently rendered audit;
- profits lost by a business, due to an employee's theft of working capital, following an auditor's negligent failure to detect the defalcation;
- taxes overpaid due to a negligently prepared tax return; and
- professional fees incurred in defending against an IRS examination, following negligent preparation of a tax return.

This list is far from exhaustive and the parties to a case of any size or complexity generally hire damages experts.

### **Breach of Contract**

There are a number of distinctions between an action against an accountant based in contract and an action based in tort law. Among the distinctions, in some states, is the existence of a longer statute of limitations for contract actions. Accordingly, the question of whether a plaintiff can or should proceed against an accountant on a contract theory can be dispositive.

The rule in a majority of states is that a plaintiff cannot sue a professional for breach of contract on the professional's failure to render services with due professional care.<sup>5</sup> The policy rationale for this rule is that professionals deal in inexact sciences and are called upon to exercise professional judgment to best serve the client. Since professionals cannot predict or guarantee a particular result with any degree of certainty, they are generally held immune from contract liability for mere failure to comply with professional standards of due care.

Consistent with this precept, it has been held that an accountant is not liable in contract for failure to follow GAAP or GAAS – even though the accountant's engagement agreement contained an express undertaking to follow GAAP and GAAS.<sup>6</sup> However, where an accountant

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<sup>5</sup> *City of Moundsview v. Walljarvi*, 263 N.W.2d 420 (Minn. 1978); *In re Investors Funding Corp.*, 523 F. Supp. 533 (S.D.N.Y. 1980); *Sato v. Van Denburgh*, 599 P.2d 181, 123 Ariz. 225 (1979); *Federal Deposit Ins. Corp. v. Schoenberger*, 781 F. Supp. 1155 (E.D. La. 1992); *In re Schlotzsky's, Inc. v. Grant Thornton, LLP*, 351 Bkpty Rptr. 430 (Bkpty. W.D. Tex. 2006)

<sup>6</sup> *In re Investors Funding Corp.*, *supra*; *Sanitary Linen Serv. Co. v. Alexander Proudfoot Co.*, 435 F.2d 292 (5th Cir. 1970); *Blue Bell, Inc. v. Peat, Marwick, Mitchell & Co.*, 715 S.W.2d 408 (Tex. App. 1986); *Federal Deposit Ins. Corp. v. Schoenberger*, 781 F. Supp. 1155 (E.D. La. 1992); *Clarck v. Milam*, 847 F. Supp. 409 (S.D. W.Va. 1994); *Contra Godchaux v. Conveying Techniques, Inc.*, 846 F.2d 306 (5th Cir. 1988); *Lumbermens Casualty Company v. Grant Thornton*, 92 S.W.2d 259 (Mo. 2003).

warrants a specific result or outcome in an engagement agreement, an action may lie *ex contractu*.<sup>7</sup>

In other jurisdictions, plaintiffs have been allowed to recover on a breach of contract theory against an accountant for failure to exercise due care in rendering professional services.<sup>8</sup> To establish a breach of contract claim, a plaintiff will need to plead and prove the following essential elements:

- Existence of Contract – this is established where an accountant has provided professional services pursuant to a mutual agreement, either written or verbal;
- Breach of Contract – this may be shown by demonstrating that the accountant failed to produce a specific result (*i.e.*, detect all employee fraud) or, in some jurisdictions, for failing to meet an appropriate standard of professional care; and
- Damage – this requires a showing that some harm resulted directly and proximately from the breach of contract.

### **Effect of Disclaimers**

Accountants are increasingly interested in using liability disclaimers in client engagement agreements. Such a disclaimer might include a shortened statute of limitations, indemnity by the client for disclosure to third parties who later claim reliance and resulting damage, or limits on the damages recoverable by the client (including a prohibition on lost profits or, in some cases, any claim greater than the fees paid by the client). Some possible language for a disclaimer could be this:

#### **Disclaimer of Liability**

The Client agrees that the CPA's liability for damages under tort, contract or statute shall not exceed the total amount paid for services under the engagement letter. This is the client's exclusive remedy.

The Client further agrees that the CPA will not be liable for any lost profits, or for any claim or demand against the Client by any other party.

No action may be brought by either party more than one year after the cause of action has accrued, except that an action for nonpayment may be brought within one year of the date of last payment.

In no event will the CPA be liable for consequential damages.

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<sup>7</sup> *City of East Grand Forks v. Steele*, 121 Minn. 296, 141 N.W. 181 (1913).

<sup>8</sup> *L.B. Lab., Inc. v. Mitchell*, 39 Cal. 2d 56, 244 P.2d 385 (1952); *In re F.W. Koenecke & Sons, Inc.*, 605 F.2d 310 (7th Cir. 1979); *Deloitte, Haskins & Sells v. Green*, 198 Ga. App. 849, 403 S.E.2d 818 (1991).

The enforceability of these disclaimers is unclear and varies by jurisdiction.<sup>9</sup> Whatever the merits and legal enforceability of a liability disclaimer in general, an accountant should give particular attention to the possibility that a disclaimer or indemnity agreement might impair his or her independence in the context of a financial reporting engagement, thereby disqualifying the accountant from performing the engagement.<sup>10</sup> See also the effect of “disclaimers” in an accountant’s compilation report, discussed in *Defenses*, “*Causation and Reasonable Reliance*.”

### **Third-Party Beneficiary**

One possible advantage of proceeding against an accountant in contract is that a nonclient plaintiff may seek to avoid the privity defense by asserting third-party beneficiary status. That is, in a state that allows a client to sue an accountant for breach of contract, it may be possible for a nonclient to claim that it was an intended third-party beneficiary of the contract and thereby avoid the accountant’s privity defense.

For example, a bank might argue that it was the intended beneficiary of an audited financial statement where the accountant’s client was motivated to produce the statement exclusively by a loan covenant requiring an audited financial statement, but that allegation was rejected in *Bank of America v. Musselman*, 240 F. Supp. 2d 547 (E.D. Va. 2003).

The legal doctrines which allow a third party to sue under a contract as an intended beneficiary are intricate and differ from one state to another. Section 302 of the *Restatement (Second) of Contracts* provides that only intended beneficiaries of a contractual agreement are entitled to sue under the contract and distinguishes intended from incidental beneficiaries as follows:

#### Intended and Incidental Beneficiaries.

(1) Unless otherwise agreed between the promisor and promisee, a beneficiary of a promise is an intended beneficiary if recognition of a right to performance in the beneficiary is appropriate to effectuate the intention of the parties and either:

(a) the performance of the promise will satisfy an obligation of the promisee to pay money to the beneficiary; or

(b) the circumstances indicate that the promisee intends to give the beneficiary the benefit of the promised performance.

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<sup>9</sup> *Clements Auto Co. v. Service Bureau Corp.*, 444 F.2d 169 (8th Cir. 1971); *Farris Eng’g Corp. v. Service Bureau Corp.*, 406 F.2d 519 (3d Cir. 1969); *IBM v. Catamore Enter., Inc.*, 548 F.2d 1065 (1st Cir. 1976). A contractual damages cap of \$50,000 was upheld, albeit for an engineer, in *William Graham, Inc. v. Cave City*, 289 Ark. 105, 709 S.W.2d 94 (1986); *Kitchens of the Oceans, Inc. v. McGladrey & Pullen LLP*, 832 So. 2d 270 (Fla. App. 2002).

<sup>10</sup> S.E.C., *Codification of Financial Reporting Policies* § 602.02.i; 3 *Federal Securities Laws* ¶ 38,335 (CCH).

(2) An incidental beneficiary is a beneficiary who is not an intended beneficiary.<sup>11</sup>

Where this rule is followed, a nonclient is likely to have a difficult time establishing that it is an “intended beneficiary” of an engagement by an accountant to perform professional services, even where the jurisdiction recognizes that an accountant can be sued for breach of contract.

The beneficiary of a decedent and her personal representative is an intended third-party beneficiary of the relationship between the decedent and her tax accountant. *Kinney v. Shinholser*, 663 So. 2d 643 (Fla. Dist. Ct. App. 1995); *see also Linck v. Barokas & Martin*, 667 P.2d 171 (Alaska 1983). The court reasoned that the “ultimate beneficiary” of the tax accountant’s work was “clearly a known intended beneficiary of the accountant’s services” regarding both the preparation of the decedent’s will and the tax return for his estate.

### **Contract Compared to Negligence**

A litigant considering an action against an accountant in contract should also be aware of these other possible advantages or disadvantages between proceeding on a contract theory versus a tort theory:

- Statute of Limitations – where the length of the statute of limitations varies between contract and tort, the contract statute typically will be longer;
- Expert Testimony – expert witness testimony might not be required to prove breach of contracts;<sup>12</sup>
- Damages – the contract measure of damages might be more restrictive than the measure of tort damages;<sup>13</sup> and
- Comparative Fault or Negligence – in some jurisdictions, a plaintiff’s comparative fault or negligence is not a bar to recovery in an action for breach of contract.<sup>14</sup>

### **Misrepresentation**

Since a significant part of the practice of public accounting consists of the provision of information, it is little wonder that claims for misrepresentation are frequently lodged against accountants. In fact, it is virtually impossible to contrive a scenario where an accountant sued for negligently certifying audited financial statements could not also be sued for at least negligently misrepresenting information pertinent to the statements.

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<sup>11</sup> *Restatement (Second) of Contracts* § 302 (1979); *Cretex Cos., Inc. v. Construction Leaders, Inc.*, 342 N.W.2d 135 (Minn. 1984); *Marker v. Greenberg*, 313 N.W.2d 4 (Minn. 1981); *see also Bily v. Arthur Young & Co.*, 3 Cal. 4<sup>th</sup> 370 n.16, 834 P.2d 745, 11 Cal. Rptr. 2d 51 (1992); *Ward v. Ernst & Young*, 435 S.E. 2d 628 (Va. 1993); *Blu-J, Inc. v. Kemper C.P.A. Group*, 916 F.2d 637 (11<sup>th</sup> Cir. 1990); *Forcier v. Cardello*, 173 B.R. 973 (D.R.I. 1994) (Rhode Island Law); *Bank of America v. Musselman*, 240 F. Supp. 2d 547 (E.D. Va. 2003) (2003 WL 136196).

<sup>12</sup> *L.B. Lab., Inc. v. Mitchell*, *supra*.

<sup>13</sup> *Hadley v. Baxendale*, 9 Ex. 341, 156 Eng. Rep. 145 (1854).

<sup>14</sup> *Lesmeister v. Dilly*, 330 N.W.2d 95 (Minn. 1983).

There are two varieties of misrepresentation in most states: intentional (also known as the tort of fraud or deceit) and negligent.

### **Intentional Misrepresentation**

The elements of a claim for intentional misrepresentation are:

- a representation;
- the representation must be false;
- the representation must deal with past or present fact;
- the fact must be material;
- the fact must be susceptible of knowledge;
- the person making the representation must intend to have the other person act or rely upon the representation, often referred to as “scienter”;
- the victim of the fraud must be induced to act or rely;
- the victim’s actions must actually have been in reliance upon the representation;
- the victim must suffer damage; and
- the misrepresentation must be the proximate cause of the injury.<sup>15</sup>

The courts are split on whether a plaintiff has the burden of proving fraud by “clear and convincing” evidence or by no more than the typical “greater weight” standard.<sup>16</sup>

The linchpin of a claim for intentional misrepresentation is typically the scienter element. Since it is exceedingly difficult to affirmatively establish that a defendant purposefully intended to deceive, it is possible to infer deceitful intent from extrinsic facts and circumstances. In an accountant’s case, gross negligence or recklessness in the preparation of financial statements, for example, can be a basis upon which to infer fraudulent intent. In the classic formulation of Justice Cardozo:

A representation certified as true to the knowledge of the accountants when knowledge there is none, a reckless misstatement, or an opinion based on grounds so flimsy as to lead to the conclusion that there was no genuine belief in its truth, are all sufficient upon which to base liability. A refusal to see the obvious, failure to investigate the doubtful, if sufficiently gross, may furnish evidence leading to an inference of fraud so as to impose liability for losses suffered by those who rely on the

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<sup>15</sup> *Western Contracting Corp. v. Dow Chem. Co.*, 664 F.2d 1097 (8th Cir. 1981).

<sup>16</sup> 37 Am. Jr. 2d, *Fraud and Deceit*, § 468.

balance sheet. In other words, heedlessness and reckless disregard of consequence may take the place of deliberate intention.<sup>17</sup>

An auditor's *scienter*, or intent to defraud, can be inferred from the accountant's failure to adequately check out the audit client, when that failure reflects such indifference to the truth as to have been reckless. *Frymire-Brinati v. KPMG Peat Marwick*, 2 F.2d 183 (7th Cir. 1993).

Ordinarily, a negligent failure to adhere to generally accepted accounting principles or generally accepted auditing standards does not justify an inference of *scienter*. *Fine v. American Solar King Corp.*, 919 F.2d 290 (5th Cir. 1990); *In re Sahlin & Assoc., Inc. Sec. Litig.*, 773 F. Supp. 342 (S.D. Fla. 1991); *In re Jiffy Lube Sec. Litig.*, 772 F. Supp. 258 (D. Md. 1991). However, a reckless departure from GAAP or GAAS can provide a basis for establishing that an accountant intended to deceive the user of a financial statement. *Bradford-White Corp. v. Ernst & Whinney*, 872 F.2d 1153 (3d Cir. 1988), *cert. denied*, 493 U.S. 993 (1989); *BFG Credit Union v. CU Lease, Inc.*, 2006 WL 544493 (Ohio App. 9 Dist).

According to one notable authority:

*Scienter* requires more than a misapplication of accounting principles. The plaintiff must prove that the accounting practices were so deficient that the audit amounted to no audit at all, or an egregious refusal to see the obvious, or to investigate the doubtful, or that the accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts.

*Miller v. Pezzani*, 5 F.3d 1407, 1426 (9th Cir. 1994).

One important advantage offered to a plaintiff by the tort of fraud is that a defendant cannot assert a defense of comparative fault or contributory negligence since the defendant's intentional tort is not comparable to any negligence by the plaintiff.<sup>18</sup>

The states are split on the measure of damages allowed in an action for fraud, between these standards:

- *benefit-of-the-bargain* – allows plaintiff to recover the difference between the value of the property at the time of a transaction and the value it would have had if the transactions had been true; and
- *out-of-pocket rule* – this approach permits recovery of only what the plaintiff has lost, measured as the difference between the value of what the plaintiff has parted with and the value of what the plaintiff has received in the transaction.<sup>19</sup>

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<sup>17</sup> *State St. Trust Co. v. Ernst*, 278 N.Y. 104, 15 N.E.2d 416 (1938).

<sup>18</sup> Schwartz, *Comparative Negligence* § 5.2 (The Allen Smith Co. 1986).

<sup>19</sup> Cerillo, *Proving Business Damages* § 1020, *et seq.* (Wiley Law Publications 1990).

These damages rules are occasionally varied to fit the unique facts and circumstances of particular cases.<sup>20</sup>

### **Negligent Misrepresentation**

An accountant may be held liable for negligently supplying false information to others, in the scope and course of his or her professional endeavors, even if the accountant does so in good faith. The elements of a claim for negligent misrepresentation are these:

- the accountant supplied false information;
- it was supplied in the course of his or her business, profession, or employment;
- it was supplied for the guidance of others in their business transactions;
- others justifiably relied upon the false information;
- this reliance caused pecuniary loss to the party relying on the false information; and
- the accountant failed to exercise reasonable care or competence in obtaining or communicating the information.<sup>21</sup>

One court has offered this cogent explanation of the tort of negligent misrepresentation and the lack of a scienter requirement:

A misrepresentation is made negligently when the misrepresentator has not discovered or communicated certain information that the ordinary person in his or her position would have discovered or communicated. Proof of the subjective state of the misrepresentator's mind, whether by direct evidence or by inference, is not needed to prove negligence. Negligence is proved by measuring one's conduct against an objective standard of reasonable care of competence.<sup>22</sup>

Since this tort is grounded in negligence and not in intentional misconduct, it is permissible to compare the fault of a plaintiff with that of a defendant who has been sued for negligent misrepresentation.<sup>23</sup>

On the other hand, the scope of liability for an accountant sued in negligent misrepresentation may be narrower than in a deceit claim. This is because there is no privity defense available in an intentional misrepresentation case, whereas most jurisdictions adhere to the privity defense in a negligent misrepresentation case, as set forth in greater detail below.<sup>24</sup>

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<sup>20</sup> 37 Am. Jur. 2d, *Fraud and Deceit* § 342.

<sup>21</sup> *Restatement (Second) of Torts* § 552 (1977).

<sup>22</sup> *Florenzano v. Olson*, 387 N.W.2d 168, 174 (Minn. 1986).

<sup>23</sup> Schwartz, *Comparative Fault* (Allen Smith Co. 2d ed. 1986).

<sup>24</sup> Compare *Restatement (Second) of Torts*, §§ 550 and 551 with 552.

A lawyer advising a client on the measure of damages in a negligent misrepresentation case should research the controlling law on the measure of damages in the jurisdiction governing the lawsuit to determine whether the tort of negligent misrepresentation has a less expansive damages standard than the tort of intentional misrepresentation. *The Restatement (Second) of Torts* does not allow a plaintiff suing in negligent misrepresentation to recover the benefit of plaintiff's contract with the defendant.<sup>25</sup> This restriction on the measure of damages can have important consequences in a state following the *Restatement*, as for example where a bank seeks to recover profits lost on a loan to an insolvent debtor in addition to the amount of the loan advanced.<sup>26</sup>

### **Breach of Fiduciary Duty**

Who is a fiduciary? A fiduciary is one who owes the duty to treat a principal "with the utmost candor, rectitude, care, loyalty, and good faith – in fact to treat the principal as well as the agent would treat himself." *Burdett v. Miller*, 957 F.2d 1375, 1381 (7th Cir. 1992). This same authority posits that the courts will impose the duties of a fiduciary as follows:

The common law imposes that duty when the disparity between the parties in knowledge or power relevant to the performance of an undertaking is so vast that it is a reasonable inference that had the parties in advance negotiated expressly over the issue they would have agreed that the agent owed the principal the high duty that we have described, because otherwise the principal would be placing himself at the agent's mercy. An example is the relation between a guardian and his minor ward, or a lawyer and his client. The ward, the client, is in no position to supervise or control the actions of his principal on his behalf; he must take those actions on trust; the fiduciary principle is designed to prevent that trust from being misplaced.

*Id.*

As the law has developed, two types or categories of fiduciaries have been established:

- *Formal or Categorical Fiduciary Duties* – Certain legal relationships create fiduciary duties per se, such as those between lawyer and client, guardian and ward, partners, trustee and beneficiary. This kind of fiduciary relationship can also be established contractually, such as when a client gives an accountant a power of attorney.
- *De Facto Fiduciary Duties* – Fiduciary duties are also imposed on an *ad hoc* basis, depending upon the facts and circumstances of a particular relationship. The dynamics of a relationship that can lead to court-imposed fiduciary duties include factors such as the relative expertise and bargaining power of the parties,

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<sup>25</sup> *Restatement (Second) of Torts* § 552B (1977).

<sup>26</sup> *Id.* at Comment b.

the nature of their communications, and the extent to which the weaker party has reposed trust and confidence in the stronger.

See “Common Law Disclosure Duties in Business Transactions,” 5 *Business Torts Reporter* 402 (1993).

Ordinarily, fiduciary duties do not inhere in the accountant-client relationship. See, e.g., *R.W. Holdco, Inc. v. Johnson*, 601 S.E. 2d 177 (Ga. App. 2004); *Harrold v. Dowd*, 149 N.C. App. 777, 561 S.E.2d 914 (2002); *Burdett v. Miller, Id.*; *Midland Nat’l Bank v. Perranoski*, 299 N.W.2d 404 (Minn. 1980); *Golden West Refining v. PricewaterhouseCoopers*, 392 F. Supp. 2d 407 (D. Conn. 2005); *Strategic Capital Resources, Inc. v. Citrin Cooperman & Company, LLP*, 213 Fed. App. 842 (11<sup>th</sup> Cir. 2007) (unpublished). This is particularly true where the CPA is engaged to audit financial statements, because the independence required to render an audit is “fundamentally inconsistent” fiduciary status. *In re Cendant Corp. Sec. Lit.*, 139 F. Supp. 2d 585, 609 (D.N.J. 2001) (citing Arnold, *Breach of Fiduciary Duty*, 506 PLI/Lit. 341); *Golden West Refining v. PricewaterhouseCoopers*, 392 F. Supp. 2d 407 (D. Conn. 2005).

Nonetheless, an accountant’s superior expertise is one element to be considered in gauging whether a fiduciary relationship existed between an accountant and client, among these factors:

- Accountant’s expertise.
- Client’s lack of sophistication, both in general and on the specific type or subject matter of advice given.<sup>27</sup>
- Length of relationship between the parties.<sup>28</sup>
- Education and experience of client.
- Personal friendship between accountant and client.
- Expectation by accountant that client would not seek advice from another party.
- Dominance in fact by accountant.
- Special vulnerability or inferiority of client.
- Steps taken by accountant to cultivate client’s trust.
- Whether accountant disclosed information harmful to client (thereby tacitly acknowledging that accountant knew client was relying solely on accountant for voluntary disclosure).

See *Burdett v. Miller, supra.*; *Business Torts Reporter, supra.*; *Midland Nat’l Bank v. Perranoski, supra.*; *Schuster v. Anderson*, 378 F. Supp. 2d 1070 (N.D. Ia. 2005).

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<sup>27</sup> *Midland Nat’l Bank of Minneapolis v. Perranoski*, 299 N.W.2d 404 (Minn. 1980).

<sup>28</sup> *Dominguez v. Brackay Enter., Inc.*, 756 S.W.2d 788 (Tex. App. 1988).

To establish the existence of a fiduciary relationship, outside of a formal category, the plaintiff must present “clear and convincing” evidence that such a relationship existed. *Burdett v. Miller, Id.* at 1382. This requires more than mere proof of a client’s “subjective trust” in the CPA, especially when they have dealt at arm’s length. *Blue Bell, Inc. v. Peat, Marwick, Mitchell & Co.*, 715 So. 2d 408 (Tex. Ct. App. 1986).<sup>29</sup>

Accountants have been held to be fiduciaries in these situations:

- When the CPA advised client to invest in a tax shelter partnership that was losing money, and in which the CPA was an undisclosed partner. *Burdett v. Miller, supra.*
- When the CPA and client were “good social friends.” *Dominguez v. Brackey Enter., Inc.*, 756 S.W.2d 788 (Tex. Ct. App. 1988).
- When the CPA performing an audit has a “special relationship” with the client, one that goes beyond “mere provision of independent audits but also provided advice upon which it knew [the client] would rely in making important decisions.” *In re Cendant Corp. Sec. Lit.*, 139 F. Supp. 2d 585, 609 (D.N.J. 2001).

Conversely, an accountant was found not to have had a fiduciary relationship with a client, in view of the limited, arm’s-length nature of the accountant-client relationship and the sophistication and experience of the client, in *Midland Nat’l Bank v. Perranoski, supra.* Typically, no fiduciary relationship will be found where the accountant only provides basic accounting functions, such as preparing tax returns and giving advice on processing tax returns. *Peterson v. H&R Block Tax Services*, 971 F. Supp. 1204 (N.D. Ill. 1997).

An accountant who performs an audit will not ordinarily become the fiduciary for a client. *Standard Chartered PLC v. Price Waterhouse*, 190 Ariz. 6, 945 P.2d 317 (Ariz. App. Div. 1 1966). The reason is that the duty of an auditor is to act “independently, objectively, and impartially” and not as a person who holds property or things of value for another, or who acts in a representative capacity for another in dealing with property of the other. *Franklin Supply Co. v. Tolman*, 454 F.2d 1059, 1065 (9th Cir. 1971).

Consistent with the general rule, a CPA does not become a fiduciary simply by entering into an engagement to serve as an “advisor” or consultant to a client, without a showing that the accountant somehow thereby gained superiority or influence over the client. *VTECH Holdings, Ltd. v. PricewaterhouseCoopers*, 348 F. Supp. 2d 255 (S.D.N.Y. 2004).

As a practical matter, the question of whether an accountant was a fiduciary to the client is often superfluous. The accountant’s duties of disclosure to a client normally require full and voluntary communications about all matters pertinent to the engagement, whether the accountant is a fiduciary or not. Along the same lines, an accountant most likely will have a duty to disclose whether he or she has a conflict of interest in advising a client about a matter, again regardless of

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<sup>29</sup> *Gillespie v. Seymour*, 14 Kan. App. 2d 563, 796 P.2d 1060 (1990).

the existence of a fiduciary relationship. Indeed, in *Bookland of Maine v. Baker, Newman & Noyes, LLC*, 207 F. Supp. 2d 38 (D. Me. 2002), it was held that there is “no need to create a [fiduciary] duty in the absence of a breach of any duty unique to a fiduciary.” The court noted that where there has been no abuse of a client’s trust or confidence, such as through self-enrichment at the client’s expense, but rather only a claim for “financial damages growing out of the professional relationship,” there is no basis for maintaining a claim for breach of fiduciary duty.

Depending upon the case, the presence of a fiduciary relationship might impact on a litigation in these ways:

- Tolling of statute of limitations.
- Application of comparative fault principles.
- Enhancement of a disclosure duty to a person who, strictly speaking, was not a client by virtue of a formal engagement or contract.

The question of whether a fiduciary duty existed is generally a question of fact. *Gemstar Ltd. v. Ernst & Young*, 185 Ariz. 493, 917 P.2d 222 (1996). In *Gemstar*, it was also held that the question of whether an accountant was a fiduciary is properly the subject of testimony by an expert. 917 P.2d at 234.

It is interesting to note the disclosure duty contemplated in § 551(2)(e) of the *Restatement (Second) of Torts*:

One party to a business transaction is under a duty to exercise reasonable care to disclose to the other before the transaction is consummated,

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(e) facts basic to the transaction, if he knows that the other is about to enter into it under a mistake as to them, and that the other, because of the relationship between them, the customs of the trade or other objective circumstances, would reasonably expect a disclosure of those facts.

In *Allen Realty Corp. v. Holbert*, 227 Va. 441, 318 S.E.2d 592, 595-96 (1984), the court held that a breach of fiduciary duty occurred when an accountant, hired to assist in the liquidation of real estate, failed to disclose several purchase offers to the client.

In *McCormick v. Brevig*, 980 P.2d 603 (Mont. 1999), a sister and brother jointly inherited an interest in a family-owned ranch, but had a falling out. An action was brought to dissolve their partnership, together with other claims. The brother sued a CPA claiming, in part, that a lifetime irrevocable trust executed by his father made him the sole owner of the ranch. Although the necessary deed to transfer the ranch into the trust was never executed and the trust was legally ineffective from inception, the Montana Supreme Court nonetheless ruled that the CPA

might have had a fiduciary duty to either disclose the unfunded trust to the brother, despite the father's direction not to tell the brother, or else to have withdrawn under an alleged conflict between the father's and brother's interests.

When a fiduciary relationship does not arise as a matter of law, the person asserting that the relationship existed has the burden of proving it. *Shofstall v. Allied Van Lines*, 455 F. Supp. 351, 360 (N.D. Ill. 1978). "Subjective trust alone is not enough to transform arm's length dealing into a fiduciary relationship." *Thomson v. Norton*, 604 S.W.2d 473, 476 (Tex. Ct. App. 1980). However, where one party has grown accustomed to relying on the judgment of another, a fiduciary relationship exists. See *Dominguez v. Brackey Enter.*, 756 S.W.2d 788, 791 (Tex. Ct. App. 1988).

As the courts expand disclosure duties in commercial settings, the tort of silence is growing. See "Common Law Disclosure Duties in Business Transactions," 5 *Business Torts Reporter* 402 (1993). Although accountants cannot be held liable for silence absent a duty to disclose, the risk that a court will impose a fiduciary duty entails heightened risks for accountants.

In some fiduciary duty cases, the accountant may have the burden of proving that his or her actions were appropriate. For example, when an accountant-fiduciary enters into a transaction with a client, the accountant must show that he or she disclosed all material facts. See *Restatement (Second) of Agency* § 390 ("Acting as Adverse Party With Principal's Consent") (1957) and § 392 ("Acting for an Adverse Party With the Principal's Consent") (1957).

When an accountant is deemed a fiduciary, he or she has a duty to disclose all relevant facts pertaining to matters within the scope of the fiduciary relationship.<sup>30</sup> See *Restatement (Second) of Agency* § 381 ("Duty to Give Information") (1958). The accountant has the duty to disclose all facts which the agent should understand would affect the judgment of the party, including self-dealing, or any facts that have a bearing on the desirability of the transaction. *Id.*

### **Defamation**

Though rare, accountants have been sued for defamation for statements contained in financial reports. In view of the involvement of accountants in detecting, disclosing, and describing illegal conduct, it is surprising that defamation claims are not more common.

The elements of a defamation suit vary among the states, but have been fairly summarized by the *Restatement (Second) of Torts* § 558 (1977):

- A false and defamatory statement concerning another.
- An unprivileged publication to a third party.
- Fault amounting at least to negligence on the part of the publisher.

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<sup>30</sup> 3 Am. Jur. 2d, *Agency* §§ 210, 211.

- Either actionability of the statement irrespective of special harm or the existence of special harm caused by the publication.

Defenses used by accountants in defamation claims frequently include these:

- The statement was not defamatory (*i.e.*, describing that a former employee has sued the company and that the company is defending on the grounds that the employee was “terminated for cause”).
- The auditor did not publish the statement, because it was contained in financial reports prepared by the company. *See Abella v. Barringer Resources, Inc.*, 260 N.J. Super. 92, 615 A.2d 288 (1992).
- The accountant has a privilege to publish the statement, provided the accountant neither knew it was false or recklessly disregarded whether it was true or false. *See Restatement (Second) of Torts § 592A and Abella v. Barringer Resources, Inc., Id.*

Auditors are entitled to the qualified privilege defense on the grounds that the public or private interest underlying the publication of financial statements, reports on illegal activities, and the like outweighs the interests of individuals asserting the defamation claims. *See Williams v. Hobbs*, 81 S.D. 79, 131 N.W.2d 85 (1964); *Ross v. Gallant, Farrow & Co., P.C.*, 27 Ariz. App. 89, 551 P.2d 79 (1976).

### **State Consumer Fraud Acts**

A number of states have adopted consumer antifraud acts, sometimes called “little FTC laws.” Too numerous to mention here with any precision, these statutes may broadly regulate fraudulent, misleading, and deceptive misrepresentations in connection with the sale of virtually anything – including securities.<sup>31</sup>

At least one court has ruled that a consumer fraud statute applies to an accountant who provides information used to sell securities, though with the caveat that some scienter or bad faith must be present for liability to attach.<sup>32</sup>

Elsewhere, it has been held that the run-of-the-mill state consumer protection act does not apply to claims of negligence against an accountant for rendering professional services.<sup>33</sup>

### **Violation of Code of Professional Conduct**

Violations of a CPA’s professional ethics or code of conduct are sometimes alleged as the basis for a finding of liability. *McCormick v. Brevig*, 980 P.2d 603 (Mont. 1999). According to other courts, however, the violation of a rule of professional conduct does not rise to a level

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<sup>31</sup> *See, e.g.*, Minn. Stat. § 325F.68, *et seq.* (1986).

<sup>32</sup> *Jenson v. Touche Ross & Co.*, 335 N.W.2d 720 (Minn. 1983).

<sup>33</sup> *Robertson v. White*, 633 F. Supp. 954 (W.D. Ark. 1986); *Haberman v. Washington Pub. Power Supply Sys.*, 744 P.2d 1032 (Wash. 1987); *Rousseau v. Eshleman*, 519 A.2d 243 (N.H. 1986). *Contra In re Rare Coin Galleries of Am., Inc.*, 862 F.2d 896 (1<sup>st</sup> Cir. 1988); *Gilmore v. Berg*, 761 F. Supp. 358 (D.N.J. 1991); *Lyne v. Arthur Andersen & Co.*, 772 F. Supp. 1065 (N.D.J. 1991).

required to sustain either malpractice or breach of fiduciary claims where the conduct does not negatively impact the professional services actually rendered. *Block v. Razorfish, Inc.*, 121 F. Supp. 2d 401 (S.D.N.Y. 2000).

### **Aiding and Abetting Liability**

Increasingly, plaintiffs allege that the CPA is secondarily liable for the intentional torts of their clients on a theory of aiding and abetting the primary tortfeasor's misconduct. This is sometimes done to avoid the privity doctrine (discussed in "Defenses").

The essential elements of an aiding and abetting claim are:

1. For harm resulting to a third person from the tortious conduct of another, one is subject to liability if he
  - (a) Does a tortious act in concert with the other or pursuant to a common design with him, or
  - (b) Knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself, or
  - (c) Gives substantial assistance to the other in accomplishing a tortious result and his own conduct, separately considered, constitutes a breach of duty to the third person.

*Restatement (Second) of Torts* § 876.

Since aiding and abetting liability is "based on proof of a scienter - the defendants must know that the conduct they are aiding and abetting is a tort." *Witzman v. Lehrman & Flom*, 601 N.W.2d 179 (Minn. 1999). The *Restatement*, however, does not take a position on whether liability can be imposed under Section 876 for merely negligent conduct; the *Witzman* court held that aiding and abetting liability requires proof of "scienter," thereby presumably rendering aiding and abetting liability an intentional tort. According to one court, the CPA must know of the primary tort at least contemporaneously with its occurrence, since knowledge acquired after that time is insufficient to meet the knowledge requirement. *Aetna Casualty & Surety Co. v. Leahey Const. Co.*, 219 F. 3d 519 (6th Cir. 2000).

If aiding and abetting liability is a tort of intent, then it is at least arguable that the comparative fault defense does not apply. (See "Defenses").

Since the upshot of prevailing on the aiding and abetting claim is to make the defendant accountants jointly and severally liable for the damages caused by the primary tortfeasor, such a claim does carry the potential to add considerable complexity to an already multi-faceted liability and damages picture. See *e.g. Aetna Casualty & Surety Co. v. Leahey Const. Co.*, 219 F.3d 519

(6th Cir. 2000). The litigation of such a count will also entail considerable extra time, cost and effort, as we will be required to conduct discovery on all of the tortious misconduct of third parties with whom the CPA is alleged to have conspired.