

# DAMAGES

## **Introduction**

The identification, measurement and proof of damages is one of the most interesting aspects of accountants' malpractice litigation. It is also an area where the lawyer's creativity and imagination can be important and effective. Of course, in a case of any size or complexity, the parties should engage litigation support professionals – typically an accountant – to be certain that damages issues are not overlooked and can be established to a reasonable degree of certainty at the time of trial. All too often, litigation counsel defers the analysis of damages issues and the retention of economic consultants until after significant discovery opportunities have already been passed over.

The area of damages is intensely case specific, but some generalities are noteworthy.

## **Legal Measure of Damages**

The case law addressing the measure of damages applicable in various types of accountants' malpractice lawsuits is consistent with the general precepts found throughout tort and contract law.

## **Negligence and Contract Claims**

The plaintiff in an accountant's case is entitled to recover all foreseeable damages resulting, as a direct consequence, from the asserted breach of the accountant.<sup>1</sup> This is consonant with the normal measure of damages in negligence and contract cases.<sup>2</sup> The primary limitation on the recoverability of damages - under any theory - is the requirement that damages must be proven with reasonable certainty.<sup>3</sup> That is, both the fact that damage has occurred<sup>4</sup> and its amount<sup>5</sup> must be established beyond mere speculation.

In a claim against an accountant, the following types of damage recoveries have been allowed:

- loss of business reputation;<sup>6</sup>
- loss of fair market value to a business;<sup>7</sup> and
- lost profits, in a proper case.<sup>8</sup>

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<sup>1</sup> *Ryan v. Kanne*, 170 N.W.2d 395 (Iowa 1969).

<sup>2</sup> Cerillo, *Proving Business Damages* (Wiley Law Publications 1990).

<sup>3</sup> *Id.*, at pp. 1-3.

<sup>4</sup> *Lewin v. Miller Wagner & Co.*, 151 Ariz. 29, 725 P.2d 736 (Ariz. App. 1986).

<sup>5</sup> *Id.*; *Olson, Clough & Strommen v. Trayne Properties*, 392 N.W.2d 2 (Minn. App. 1986); *CAE Indus., Ltd. v. KPMG Peat Marwick*, 597 N.Y.S.2d 402 (S. Ct. 1993) (damage claimed for inability to make timely business decision, due to late delivery of audited financial statement, ruled not speculative).

<sup>6</sup> *PRC v. Wilch*, 42 Colo. App. 30, 589 P.2d 510 (Colo. App. 1978); *Bonhiver v. Graf*, 311 Minn. 111, 248 N.W.2d 291 (1976).

<sup>7</sup> *Waggenheim v. Alexander Grant & Co.*, 19 Ohio App. 3d 7, 482 N.E.2d 955 (Ohio App. 1983).

Measuring damages is a straightforward proposition where a plaintiff is seeking to recover a liquidated amount of money embezzled by an employee. In such a case, the exact amounts stolen can be computed with precision from the altered checks or deposit slips used to perpetrate the defalcation. At least one state prohibits recovery of economic losses in tort cases, including professional malpractice cases arising from claims of negligence; but this limitation does not apply to claims of negligent misrepresentation. *Congregation of the Passion, Holy Cross Province v. Touche Ross & Co.*, 224 Ill. App. 3d 559, 586 N.E.2d 600 (1991).<sup>9</sup>

Occasionally, the plaintiff in such a case will seek to recover lost business opportunities or profits which the enterprise claims it lost the chance to garner because the thefts reduced its operating or working capital.<sup>10</sup> In that circumstance, defense counsel will be quick to argue that the plaintiff is only entitled to recover prejudgment interest, at best, and not a more expansive measure of damages.

In some cases, the CPA's client has been known to argue that it relied upon overstated financial statements in making business decisions about expansion, borrowing and equipment purchases - thereby becoming overextended and suffering bankruptcy in a business climate downturn. Assuming that such a plaintiff can establish reasonable reliance on the negligently overstated financial statements and can eliminate mismanagement and environmental factors as the cause of overextension, a plaintiff might be allowed to argue such a damage theory to the jury. The defendant, in turn, will be certain to attack such a claim through the elements of reliance, causation, comparative fault and failure to mitigate damages. Methods used to prove business damages include:

- comparing plaintiff's revenue before and after defendant's alleged negligence;
- identifying the loss of specific customers or sales;
- comparing plaintiff's expenses before and after the alleged negligence;
- contrasting plaintiff's debts prior and subsequent to the claimed tort; and
- comparing the profits or operations of a closely comparable business operation to that of the plaintiff's.<sup>11</sup>

Plaintiffs sometimes assert the "straw that broke the camel's back" damages claim following a defalcation. Under this theory, a plaintiff contends that a business failed due to relatively nominal or immaterial amounts of defalcation, because the fact of the theft caused them to lose credibility in the eyes of suppliers or creditors, or triggered loan defaults and led to a liquidation. An example of this type of claim is found in the extensive discussion by the court in *Herbert H. Post & Co. v. Bitterman, Inc.*, 639 N.Y.S.2d 329 (App. Div. 1996). That court did, however, express doubt about the viability of such a claim:

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<sup>8</sup> *Rassieur v. Charles*, 354 Mo. 117, 188 S.W.2d 817 (1945).

<sup>9</sup> See also *Miller v. United States Steel Corp.*, 902 F.2d 573 (7th Cir. 1990) (Opinion by Judge Posner).

<sup>10</sup> See *Halla Nursery, Inc. v. Baumann-Furrie & Co.*, 438 N.W.2d 400 (Minn. App. 1989), *rev'd on other grounds*, 454 N.W.2d 905 (Minn. 1990).

<sup>11</sup> Cerillo, *supra*. at pp. 1-6, 1-13 and 1-14.

Nevertheless, there is an issue discernible as to whether it was reasonably foreseeable and a natural result of the risk created by [the accountant's] failure to detect [the] embezzlement that, notwithstanding these other factors, the companies would be so financially weakened by the embezzlement that they could not withstand normal business vicissitudes and would be forced to liquidate.

*Id.* at 336.

A plaintiff seeking to recover lost profits should limit its claim to net profits, because this is what the law requires and because failing to do so will tend to make the plaintiff seem greedy and overreaching in the eye of the jury.<sup>12</sup>

An interesting example of this is presented by the case of *Greenstein, Logan & Co. v. Burgess Mktg., Inc.*<sup>13</sup> In that case, the audit client's comptroller failed to accrue or pay a federal excise tax. The defendant auditors were found liable for failing to discover the error, thereby leading to the overstatement of the client's financial statements. A jury award of \$3,500,000 was affirmed on appeal, even though the unpaid taxes, penalties, and interest came to only \$2,700,000, because the client established that the value of the company would have been roughly \$3.5 million by the time of the trial "but for" the financial statement error. The court accepted the client's contention that it made erroneous business decisions as a result of the misstated financial information that impaired its potential to generate income.

Special problems are encountered by plaintiffs seeking to recover lost profits for a new business. The traditional reluctance of the courts to allow new businesses to recover for lost profits, on the grounds that such profits are unduly speculative, is not applicable where the new business owner can adduce evidence of loss with some reasonable degree of reliability.<sup>14</sup> According to one leading authority, the current trend is to allow new businesses to recover lost profits where the proof is adequate.<sup>15</sup>

Another type of future loss sometimes claimed by plaintiffs is for lost future tax benefits. For example, a plaintiff whose Keogh plan has been disallowed might assert the loss of future tax-free income accumulations. These claims tend to be on the speculative order, since the tax laws are frequently changed and a taxpayer's own tax circumstances are subject to many future contingencies. A plaintiff's failure to rule out such contingencies has been held to void a claim for loss of future tax benefits as overly speculative.<sup>16</sup> A claimed enhancement of the possibility of a future audit risk has also been disallowed.<sup>17</sup>

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<sup>12</sup> *Id.* at pp. 1-19; *Professional Rodeo Cowboy's Ass'n, Inc. v. Wilch*, 42 Colo. App. 30, 589 P.2d 510 (1978). *But see Billings Clinic v. Peat Marwick Main*, 797 P.2d 899 (Mont. 1990) (\$4,775,000 verdict against CPA for both interest on loan and loss of return on funds used to pay interest).

<sup>13</sup> 744 S.W.2d 170 (Tex. App. 1987).

<sup>14</sup> *Galindo v. Hibbard*, 678 P.2d 94 (1984).

<sup>15</sup> Cerillo, *Proving Business Damages* § 173 (Wiley Law Publications 1990).

<sup>16</sup> *Rassieur, supra.*; see also *Burdett v. Miller*, 957 F.2d 1375 (7th Cir. 1992) (only present value of net anticipated tax benefits, not gross tax write-off, is recoverable on claim of lost future tax benefits).

<sup>17</sup> *Lewin v. Miller Wagner & Co.*, 151 Ariz. 29, 725 P.2d 736 (Ariz. App. 1980).

A fascinating damages claim was at issue in the “failed-audit” case of *World Radio v. Coopers & Lybrand*, 251 Neb. 261, 557 N.W.2d 1 (1996). The audit client had failed to incorporate a debt payable of about \$890,000 in financial statements (as compared to about \$34 million in sales). Its independent auditors failed to detect the error, resulting in the overstatement of the company’s financial position. When the mistake was discovered, outside auditors were unable to issue new financial statements for an entire fiscal year following the discovery of the overstatement and the resulting discovery of deficiencies in the internal controls of the company. Despite an intervening pair of highly successful years of financial performance after the issuance of proper financial statements, the company blamed its ensuing bankruptcy on the failed audit.

At trial, World Radio alleged damages in the following particulars:

- Inability to obtain or raise equity capital for expansion.
- Inability to expand its business by opening new stores and increasing credit lines.
- The making of operating decisions based on false financial information.
- Inability to conduct normal business operations.
- Lost revenues.
- Lost discounts, rebates, and advertising allowances and participation credits.
- Inventory losses.
- Decrease in employee morale.
- Attorney, accounting and polygraph fees.
- Entering into business dealings it would not otherwise have entered into.
- Granting of benefits and bonuses it would not have otherwise given.
- Decrease in the value of the company.
- Inadequate capital to operate its business as configured.

In essence, World Radio claimed that its auditor’s negligence resulted in lost profits and “drastically decreased” its value. 557 N.W.2d at 8. The company requested damages in the amount of \$18,151,945 against its auditors - *and the jury returned a verdict in favor of the company for slightly more than \$17 million!*

At trial, World Radio offered testimony that the company “made decisions all the time” based on the assumption that the negligently prepared financial statements were accurate. *Id.* at 7. It justified the lost profits claim by applying its profit margin on the two years of profitability following the discovery of the audit deficiencies to its actual revenue and expense figures for the years of the deficient audits, in effect “grossing them up” to reflect the same gross margins as

were enjoyed in the subsequent, profitable interval. In doing so, the company's expert assumed that direct operating expenses and other costs would be the same percentage of gross sales. In addition, the plaintiff sought damages for lost value measured by the difference between the value the company would have had as a publicly traded company if it had reported the profits in the amount allegedly lost due to the audit failure, and the company's balance sheet equity for the first fiscal year after the discovery of the debacle.

On appeal, the Nebraska Supreme Court rejected the auditor's arguments that the failure of the audit client to report the account payable allowed the company to obtain credit and finance its expansion to an extent it would not otherwise have been able to do if the payable had been properly reported and that other multiple and intervening causes led to the demise of the company. The court concluded that the evidence was sufficient to allow the jury to conclude that World Radio reasonably relied on the overstated financial statements to make business decisions it might not otherwise have made, thereby causing financial damage in the form of lost profits and lost value. In addition, the court noted that the failure to discover internal control deficiencies delayed the preparation of corrected financial statements, thereby preventing World Radio from obtaining credit and resulting in its inability to purchase additional inventory and new product lines, hindering the company's ability to expand into new retail locations. In sum, the court determined that the evidence was sufficient for a jury to conclude that the auditor's negligence was the cause of the company's lost profits and loss of value.

The court did, however, rule that the manner in which World Radio attempted to prove the amount of its damages was speculative and conjectural as a matter of law. The court rejected the lost profits claim on the grounds that the plaintiff's expert mechanically extended the gross profit margin from the company's profitable years to its unprofitable years. It ruled that this was legally insufficient because the expert did not take into account in any respect the many differences in the way the company conducted business between its profitable and unprofitable periods. These differences included the following:

- The company operated more stores in different markets, between the time periods.
- The company had more selling space in its profitable than in its unprofitable years.
- The product mix sold during the company's profitable years differed "significantly" from the product mix promoted during its years of losses.
- In its profitable years, the company had new management, with "different vision and management style."
- In its profitable years, the company's management was instrumental in negotiating a variety of revenue-producing contracts.

In short, the Nebraska Supreme Court concluded that the plaintiff's expert was "almost literally, comparing apples to oranges." The failure of the plaintiff's damages expert to conduct "studies as to how the relevant changes between the time periods would affect his computations" rendered his lost profits calculation speculative and conjectural as a matter of law. The loss of value claim failed for the same reason, because it was predicated entirely upon the presumption

that the company would have enjoyed a greater value based on the higher profits assumed by the expert.

Under the Nebraska Supreme Court's decision, World Radio's recovery was limited to the amounts it paid to its auditor in professional fees and the amount of remedial accounting fees paid to the successor auditor.

Finally, most courts have rejected the "deepening insolvency" theory of damages, instead holding that this was at most only a cause of action against officers and directors for operating a corporation that was insolvent. When it has been allowed, this damages claim posited that losses were caused by the "deepening insolvency" of a corporation when its directors and officers had been lulled to sleep by overly favorable financial statements by, for example, borrowing additional capital that could not be afforded or failing to take action to correct a failed business plan. *Allard v. Arthur Andersen & Co.*, 924 F. Supp. 488 (S.D.N.Y. 1996).

But this theory quickly met with resistance. *Askanase v. Fatjo*, 130 F. 3d 657 (5th Cir. 1997) (no recovery where CPA merely "furnished the condition that made the [insolvency] possible" and insolvency actually caused by other economic factors; *Riley v. Ameritech Corporation, Inc.*, 147 F. Supp 2d (E.D. Mich 2001); see also *In re: Monahan Ford Corporation of Flushing* (340 B.R.1 (E.D. N.Y. 2006). For excellent discussions of this theory of damages, please refer to: *In re Vartec Telecom, Inc.* 335 B.R. 631 (N.D. Tex. 2005) and *In re Citex Corporation, Inc.* E.D. Pa. 2005); *Trenwick America Litigation Trust v. Ernst & Young, LLP*, 906 A. 2d 168 (Del. Ch. 2006); *Fehribach v. Ernst & Young LLP*, 493 F.3d 905 (7<sup>th</sup> Cir. 2007)(Posner, J.) In the end, even the court that first used the phrase has rejected it as a damages measure. *Seitz v. Detweiler, Hershey and Assoc., P.C.*, 448 F.3d 672 (3<sup>rd</sup> Cir. 2006).

A contrary position was taken in *Grant Thornton, LLP v. FDIC*, 2007WL4981339 (S.D.W.Va. 2007), however. In that case, it was held that a "cash out the door" method of computing damages was allowable as an alternative to "deepening insolvency," but continued in the alternative to hold that the latter theory remains viable.

### ***Daubert* Issues**

Increasingly, the application of the evidentiary standards for validating expert testimony established in *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1995), and *Kuhmo Tire Co., Ltd. v. Carmichael*, 119 S. Ct. 1167 (1999), are being extended to cases involving commercial damages. See, e.g., *Target Market Publishing Inc. v. ADVO, Inc.*, 136 F.3d 1139 (7th Cir. 1998); *Real Estate Value Co. v. U.S. Air, Inc.*, 979 F. Supp. 731 (N.D. Ill. 1997), and *Whitman's Candies, Inc. v. Pet, Inc.*, 974 S.W.2d 519 (Mo. App. 1998); see also, *World Radio v. Coopers & Lybrand*, *supra*.

In securities fraud claims, several courts now require the use of an "event study" or its equivalent to establish fraud-related stock price damages. *In re Oracle Sec. Litig.*, 829 F. Supp. 1176 (N.D. Cal. 1993), and *In re Executive Telecard, Ltd. Sec. Litig.*, 979 F. Supp. 1021 (S.D.N.Y. 1997).

## Misrepresentation

As noted in Chapter 4 above, the states are split on the appropriate measure of damages in an action for fraud. Some states allow a plaintiff to recover the benefit of the bargain, while others limit the plaintiff's recovery to out-of-pocket losses.<sup>18</sup>

The *Restatement (Second) of Torts* § 552B adopts the out-of-pocket rule for claims arising under *Restatement (Second) of Torts* § 552. As explained in the American Law Institute's official comments to § 551, this position is consistent with the general rule that there is no liability for "merely negligent conduct that interferes or frustrates a contract interest or an expectancy of pecuniary advantage." While several jurisdictions following § 552 have adopted this limitation on damages recoverable against an accountant by a nonclient who asserts negligent misrepresentation, at least one court has declined to do so.<sup>19</sup> This rule has also been adopted in states following the "reasonable foreseeability rule."<sup>20</sup> There is authority, however, for the proposition that the 'cost of funds' of a lender is a pecuniary loss recoverable under the out-of-pocket rule by a relying third party.<sup>21</sup> Section 552B states:

(1) The damages recoverable for a negligent misrepresentation are those necessary to compensate the plaintiff for the pecuniary loss to him of which the misrepresentation is a legal cause, including

(a) the difference between the value of what he has received in the transaction and its purchase price or other value given for it; and

(b) pecuniary loss suffered otherwise as a consequence of the plaintiff's reliance upon the misrepresentation.

(2) the damages recoverable for a negligent misrepresentation do not include the benefit of the plaintiff's contract with the defendant.

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<sup>18</sup> Cerillo, *supra*. at pp. 1-21. In *Minndis Acquisition Corp. v. BDO Seidman, LLP*, 559 S.E.2d 111 (Ga. App. 2002), the court applied the benefit of the bargain rule in a negligent misrepresentation case, on the grounds that fraud provides the closest analogue for measuring such damages. See also *BDO Seidman v. Mindis Acquisition Corp.*, 578 S.E.2d 400 (Ga. 2003).

<sup>19</sup> *Stockler v. Rose*, 174 Mich. App. 14, 436 N.W.2d 70 (1989); *Battenfeld of America v. Baird, Kurtz & Dobson*, 60 F. Supp. 2d 1189 (D. Kan. 1999) (*Kumho* analysis applies to damages expert and casting doubt on use of "liquidation" measure under § 552B); *contra*, *Minndis Acquisition Corp. v. BDO Seidman, LLP*, 559 S.E.2d 111 (Ga. App. 2002).

<sup>20</sup> *Rosenblum v. Adler*, 93 N.J. 324, 461 A.2d 138 (1983); *Costa v. Neimon*, 123 Wis. 2d 410, 366 N.W.2d 896 (Wis. App. 1985).

<sup>21</sup> *United Telecommunications, Inc. v. American Television & Communications Corp.*, 536 F.2d 1310 (10th Cir. 1976); *Carl Beasley Ford, Inc. v. Burroughs Corp.*, 361 F. Supp. 325 (E.D. Pa. 1973), *aff'd*, 493 F.2d 1400 (3d Cir. 1974); *New Amsterdam Casualty Co. v. Mitchell*, 325 F.2d 474 (5th Cir. 1963); *Metropolitan Transfer Station, Inc. v. Design Structures, Inc.*, 328 N.W.2d 532 (Iowa App. 1982).

Some interesting questions arise in measuring and assessing damages in claims by third parties, like banks, against accountants for an allegedly failed audit. In such cases, the third party invariably attempts to recover the full amount of the loan to the audited client, claiming that the entire loan was premised upon the accuracy of the financial statements taken as a whole. Since the third party typically is able to prove concrete and specific errors in the financial statements in only a relatively small number of balance sheet accounts (*e.g.*, inventory, sales, or receivables), counsel for the defendant accountant will argue that the third party's recovery should be limited to the amount of error in the balance sheet.

As noted above (*see* § 4.8, "Intentional Misrepresentation"), there is no privity or privity substitute requirement to maintain a claim against an accountant for fraudulent misrepresentation. However, a plaintiff who sues for fraudulent misrepresentation is not entitled to recover "benefit of the bargain" damages. *Edward J. Corp. v. Coopers & Lybrand*, 928 F. Supp. 557 (W.D. Pa. 1996). Instead, the out-of-privity plaintiff pursuing a deceit claim is limited to the out-of-pocket measure of damages.

This is consistent with § 549 of the *Restatement (Second) of Torts*, which states as follows:

(1) The recipient of a fraudulent misrepresentation is entitled to recover as damages in an action of deceit against the maker the pecuniary loss to him of which the misrepresentation is a legal cause, including (a) the difference between the value of what he has received in the transaction and its purchase price or other value given for it; and (b) pecuniary loss suffered otherwise as a consequence of the recipient's reliance upon the misrepresentation. (2) The recipient of a fraudulent misrepresentation in a business transaction is also entitled to recover additional damages sufficient to give him the benefit of his contract with the maker, if these damages are proved with reasonable certainty.

*See also Restatement (Second) of Torts* § 549 cmt. g.

The rationale for this rule is that where the perpetrator of the fraudulent misrepresentation is not a party to the underlying transaction, the perpetrator does not warrant any benefit to the victim and accrues no direct advantage from the victim. *Edward J. Corp. v. Coopers & Lybrand*, 928 F. Supp. at 565.

In a misrepresentation case, the plaintiff may be required to show both that the transaction at issue was caused by the misrepresentation and that the misrepresentation was itself a cause of the loss suffered. Borrowing the concept of "loss causation" from federal securities law decisions, the court in *Standard Chartered PLC v. Price Waterhouse*, 190 Ariz. 6, 945 P.2d 317 (Ariz. App. Div. 1 1996), ruled that a plaintiff claiming that audited financial statements misrepresented the financial position of a company was required to show that the "omissions in the financial statement adversely affected the objective value of [the] investment . . . causing the loss for which they seek to recover." *Id.* In reaching this conclusion, the court relied on *Restatement (Second) of Torts* § 548A, which provides:

A fraudulent misrepresentation is a legal cause of a pecuniary loss resulting from action or inaction and reliance upon it if, but only if, the loss might reasonably be expected to result from the reliance.

Comment B to the *Restatement* further explains:

[O]ne who misrepresents the financial condition of a corporation in order to sell its stock will become liable to a purchaser who relies upon the misinformation for the loss that he sustains when the facts as to the finances of the corporation become generally known and as a result the value of the shares is depreciated on the market, because that is the obviously foreseeable result of the facts misrepresented. On the other hand, there is no liability when the value of the stock goes down after the sale, not in any way because of the misrepresented financial condition, but as a result of some subsequent event that has no connection with or relation to its financial condition.

### **Taxes, Penalties and Interest**

It is now well settled in many states that a plaintiff may recover taxes, penalties, and interest from a CPA under the appropriate circumstances.

A plaintiff normally will not be entitled to recover taxes from the CPA where the payment of the taxes was unavoidable, as for example where the taxes were paid in the normal course and the basis of the claim against the accountant was for untimely filing.<sup>22</sup> However, where the taxpayer has paid taxes in excess of those required by law, the taxpayer may recover from the negligent accountant.<sup>23</sup> In a claim for tax benefits lost on an “oversold” investment, the plaintiff was required to use expert testimony to show that other investments were available at the time and would have yielded the desired tax results. *Eckert Cold Storage, Inc. v. Behl*, 943 F. Supp. 1235 (E.D. Cal. 1996). The recoverability of interest on the liquidated amount of the tax overpayment is discussed below.

Is a plaintiff entitled to recover interest assessed by the IRS in a case where the plaintiff underpaid taxes due to an accountant’s mistake? Logic would suggest that any interest recoverable should be offset by the amount of interest which could have been earned prior to the time of payment of the tax.<sup>24</sup> To the contrary, plaintiffs argue that they are entitled to recover the

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<sup>22</sup> *Thomas v. Cleary*, 768 P.2d 1090 (Alaska 1989); *Worman v. Carver*, 87 P. 3d 1246 (Wy. 2004).

<sup>23</sup> *Bancroft v. Indemnity Ins. Co.*, 203 F. Supp. 491 (W.D. La. 1962), *aff’d*, 309 F.2d 959 (5th Cir. 1963); *Linck v. Barokas & Martin*, 667 F.2d 160 (9th Cir. 1983); *Eckert Cold Storage, Inc. v. Behl*, 943 F. Supp. 1230 (E.D. Cal. 1996) (negligent tax planning advice). *But see Lewin v. Miller Wagner & Co., Ltd.*, 151 Ariz. 29, 725 P.2d 736 (1986) (claim against accountant for overpaid taxes was disallowed as speculative, because plaintiff failed to show that IRS agent’s determination would be upheld at higher administrative level or against legal challenge).

<sup>24</sup> *Orsini v. Braten*, 713 P.2d 791 (Alaska 1986). *See also Lien v. McGladrey & Pullen*, 509 N.W. 2d 421 (S.D. 1993) (reversible error to exclude evidence on benefits received by taxpayer to offset extra taxes allegedly incurred due to mistake by CPA); *Wirtz v. Switzer*, 586 So. 2d 775 (Miss. 1991). *But see Wynn v. Estate of Holmes*, 815 P.2d 1231 (Okla. Ct. App. 1991) (accountant not entitled to offset for interest income that could have been earned on amount saved by underpayment of taxes, when plaintiff did not actually invest the savings); and *O’Bryan v.*

difference between a “safe interest rate” and the relatively much higher interest rate assessed by the IRS - and some argue that they should be entitled to recover the full amount of interest charged by the IRS after they failed to save the unpaid taxes because they did not know that the taxes would ultimately have to be paid (and spent the money available to pay for it). It has been held, however, that interest assessed for the underpayment of tax is not recoverable since to do so would give the plaintiff a windfall, because the decision by the plaintiff on whether to invest or how to invest the same taxes breaks the chain of legal causation and because the damages from a poor use of the underpaid taxes is too speculative. *Leendertsen v. Price Waterhouse*, 916 P.2d 449 (Wash. 1996); *McCulloch v. Price Waterhouse LLP*, 971 P.2d 414 (Or. App. 1998); *Alpert v. Shea Gould Climenko & Casey*, 160 A.D. 2d 67, 559 N.Y.S. 2d 312 (N.Y. App. Div. 1990); *Orsini v. Bratten*, 713 P. 2d 791 (Alaska 1986); *Eckert Cold Storage, Inc. v. Behl*, 943 F. Supp. 1235 (E.D. Cal. 1996)(“interest paid to the I.R.S. represents a payment for the plaintiff’s use of the money . . .”)

Some courts have allowed plaintiffs full recovery for all interest charges - and have even allowed a plaintiff to recover penalties assessed by the taxing authority.<sup>25</sup> One court has regarded the defendant’s effort to claim an offset on the IRS’ interest charge for the taxpayer’s use of the money as barred by the “collateral source” rule. *Carroll v. LeBoeuf, Lamb, Greene & MacRae*, 392 F. Supp. 2d 621 (S.D.N.Y. 2005).

In the author’s opinion, any plaintiff who is in *pari delicto* with the accountant, in the sense that the client knew or should have known of the facts giving rise to the assessment of a penalty, should be precluded from recovering the penalty payment from the tax return preparer on grounds of public policy. This follows from the general proposition that public policy will not allow the perpetrator of willful misconduct to recover indemnity or contribution from a third party - even a willfully culpable third party.

In *Dover v. Baker, Brown, Sharman & Parker*, 859 S.W.2d 441 (Tex. Ct. App. 1993), a criminal conviction for tax fraud was ruled to bar a claim for negligence against the plaintiff’s tax return preparer. However, in *Consolidated Management Services, Inc. v. Halligan*, 186 Ga. App. 621, 368 S.E.2d 148, *aff’d*, 258 Ga. 471, 369 S.E.2d 745 (1988), a claim for negligent preparation of tax returns was allowed to proceed even though the plaintiff had been convicted of criminal tax fraud in connection with the same returns.

In the interesting case of *Hall v. Gill*, 108 Ohio App. 3d 196, 670 N.E.2d 503 (1995), a taxpayer sued a tax advisor for improper advice on whether the taxpayer qualified for “roll over treatment” on capital gain from the sale of the taxpayer’s principal residence. The taxpayer claimed as damages the tax, penalty and interest assessed by the IRS on an internal ruling by the IRS. The appeals court held that lacking an “official ruling” by either the IRS or Tax Court, the question of whether the taxpayer actually suffered damages as a result of the erroneous advice was speculative. Since damages were “too speculative to support recovery” without an official ruling, the plaintiff was properly denied recovery. In reaching this conclusion, the court noted that the particular tax principle involved in the dispute turned on the “particular facts and

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*Ashland*, 717 N.W.2d 632 (S.D. 2006) (interest may be recoverable, depending upon facts and circumstances of each case.)

<sup>25</sup> *Slaughter v. Roddie*, 249 So. 2d 584 (La. App. 1971); *L.B. Lab., Inc. v. Mitchell*, 39 Va. 2d 56, 244 P.2d 385 (1952); *see Jobe v. Int’l Ins. Co.*, 933 F. Supp. 844 (D. Az. 1995); *Dail v. Adamson*, 212 Ill. App. 3d 66, 570 N.E.2d 1167 (1991); *Ronson v. Talesnick*, 33 F. Supp. 2d 347 (D. N. J. 1999).

circumstances” of each taxpayer’s position - thereby rendering it impossible to determine how the IRS or Tax Court would have ruled if they had been forced to make a decision.

### **Professional Fees**

The general rule in American jurisprudence is that a party cannot recover the attorneys’ fees incurred in litigating a dispute, even if the party ultimately prevails. Some of the statutory exceptions to this rule are noted above under “Causes of Action.”

A corollary to this rule is that a plaintiff in a malpractice action may be able to recover professional fees incurred *outside* of the malpractice lawsuit, if they were required to attempt to rectify, mitigate or correct the accountant’s error. An example of this is found in situations where a new accountant is hired to handle an audit by the IRS, triggered by the initial accountant’s negligence. Such remedial fees may be recoverable even if the contest with the IRS is unsuccessful.<sup>26</sup> One court even allowed a client to collect attorneys’ fees incurred in a separate lawsuit which was brought as a result of the CPA’s negligence.<sup>27</sup>

The jurisdictions are split on whether a plaintiff can recover the fee paid to the accountant for negligently rendered services (or whether the accountant is entitled to a deduction from any damage award for the amount of unpaid fees). Some courts allow the plaintiff to recover for previously paid professional fees if the accountant’s negligence made the accountant’s services wholly worthless.<sup>28</sup> Other courts allow the accountant to claim the offset for an unpaid fee.<sup>29</sup> It has also been held that a client is entitled to recover fees incurred to correct improperly audited financial statements and related accounting issues. *World Radio v. Coopers & Lybrand*, 251 Neb. 261, 557 N.W.2d 1 (1996).

### **Prohibition of Double Recovery**

The case law is clear in its prohibition of double recovery.<sup>30</sup> This general rule is fully applicable to claims against accountants.<sup>31</sup> One of the most common ways in which plaintiffs seek double recovery is to assert damages measured both by lost future profits and going concern value.<sup>32</sup> This is because each of these concepts is merely a way of expressing the ability of an enterprise to produce profits in the future.

The law also prohibits double recovery from joint tortfeasors.<sup>33</sup> One exception to this proposition is that a defendant in a tort action is not entitled to a credit or offset for amounts received by the plaintiff from a “collateral source.” A “collateral source” is not, by definition, a joint tortfeasor.<sup>34</sup> A collateral source might include, for example, an insurance payment to cover

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<sup>26</sup> *Whitlock v. PKW Supply Co.*, 154 Ga. App. 573, 269 S.E.2d 36 (1980); *Linck*, *supra*.

<sup>27</sup> *Professional Rodeo Cowboy’s Ass’n, Inc. v. Wilch*, *supra*; *Wirtz v. Switzer*, 586 So. 2d 775 (Miss. 1991) (extra attorneys’ fees incurred in probate of estate, due to accountant’s error, are recoverable damages).

<sup>28</sup> *Ryan v. Kanne*, 170 N.W.2d 395 (Iowa 1969); *Strauss v. Fost*, 517 A.2d 143 (N.J. App. 1986); *World Radio v. Coopers & Lybrand*, 251 Neb. 261, 557 N.W.2d 1 (1996).

<sup>29</sup> *Sitton v. Clements*, 385 F.2d 869 (6th Cir. 1967).

<sup>30</sup> *Cerillo*, *supra*. at § 181.

<sup>31</sup> *Franklin Supply Co. v. Tolman*, 454 F.2d 1059 (9th Cir. 1972).

<sup>32</sup> *Cerillo*, *supra*. at pp. 1-24.

<sup>33</sup> *Franklin Supply Co.*, *supra*.

<sup>34</sup> *Id.*

the amount stolen by an employee in a defalcation case. In *W.B. Easton Constr. Co. v. Citizens & Southern Nat'l Bank of South Carolina*, 463 S.E.2d 317 (S.C. 1995), accountants sued by a bank that allegedly relied on negligently prepared financial statements were not entitled to credit against a judgment, for the amounts obtained by the bank from personal guarantors, under the collateral source rule.

### **Punitive Damages**

The ability of a plaintiff to recover punitive damages varies widely among the states. Generally speaking, punitive damages cannot be awarded against an accountant without a finding that the accountant acted willfully or with malice in reckless indifference to the rights of others.<sup>35</sup> Conversely, mere negligence in misrepresenting the financial condition of a client is not a grounds for imposing punitive damages.<sup>36</sup>

Where punitive damages are imposed, they are measured by a number of factors, including the egregiousness of the accountant's misconduct, the accountant's financial resources, and the need to set an example for others and to deter similar, future misconduct.

### **Prejudgment Interest**

Historically, the common law has not allowed a plaintiff to recover interest on the amount of damages awarded in the lawsuit until entry of judgment. An exception is made under this rule to allow a prevailing plaintiff to recover prejudgment interest where the damages were for a liquidated amount or could be calculated, as an arithmetic function, from objective facts (such as accounting records).

Even so, prejudgment interest has been denied in suits against accountants, both in jurisdictions following the common law<sup>37</sup> and in those where a state statute allows prejudgment interest to be taxed.<sup>38</sup> Prejudgment interest in an accounting malpractice case has been held to accrue from the date when an undetected diversion of funds occurs, rather than when the plaintiff makes a demand for payment of the defalcation to the accountant. *Gemstar Ltd. v. Ernst & Young*, 185 Ariz. 493, 917 P.2d 222, 238 (1996).

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<sup>35</sup> *Voight v. Abish*, 663 F. Supp. 321 (S.D.N.Y. 1987); *Gerry Clark Equip. Inc. v. Hibbits*, 612 N.E.2d 858 (Ill. App. Ct. 1993).

<sup>36</sup> *Franklin Supply Co.*, *supra*.

<sup>37</sup> *Bonhiver*, *supra*; *Wirtz v. Switzer*, 586 So. 2d 775 (Miss. 1991). See also *Congregation of the Passion, Holy Cross Province v. Touche Ross & Co.*, 224 Ill. App. 3d 559, 586 N.E.2d 600 (1991).

<sup>38</sup> *Imark Indus., Inc. v. Arthur Young & Co.*, 148 Wis. 2d 605, 436 N.W.2d 311 (1989). But see *Wynn v. Estate of Holmes*, 815 P.2d 1231 (Okla. Ct. App. 1991).