

DEFENSES

Introduction

This chapter deals with a number of legal issues pertinent to the defense of accountants' malpractice cases. Some of these issues are not, strictly speaking, affirmative defenses (*e.g.*, privity) and several of the "defenses" treated here revolve primarily around issues of fact (such as causation and reliance).

This is not intended to be an exhaustive or exclusive list of defense issues and perspectives, but is rather a discussion of issues of primary importance and which recur with a high degree of frequency in lawsuits brought against accountants.

Standing of Plaintiff

An issue emerging with increasing frequency is the question of whether the plaintiff actually has standing to pursue a claim against the defendant accountant. A closely related concept, the "privity defense," is discussed below.

As a general proposition, a plaintiff does not have standing to maintain an action unless the plaintiff has some individual or representative interest in the cause of action.¹ To establish standing, a plaintiff must show that he or she has a legally protected interest that the defendant has invaded, and that he or she will be benefited by the relief sought.²

In the case of an action against an accountant, the accountant's direct client has standing to maintain an action for professional negligence. Where such an action is based in contract, the client is the party to the contract with the accountant and has standing to sue. In a tort action, it is the client who has suffered harm from the alleged misconduct.³

Significant standing issues can also be found in situations where a trustee or receiver seeks to assert claims against an accountant for negligently failing to discover that management was looting the assets of the audit client. Competing public interests have led some courts to allow such representatives to pursue accountants without imputation of wrongdoing by the management of the failed company.⁴ Other courts have limited the ability of such a representative to recover against accountants charged with failing to discover management fraud.⁵

The identification of the accountant's true client is sometimes clouded by the nature of the accountant's relationship with a constellation of closely related clients. This typically occurs where the accountant's direct clients consist of a closely held corporation and its controlling shareholder. Many accountants frequently provide all of the tax, accounting, and auditing services to closely held corporations and their controlling persons. The

¹ 59 Am. Jur. 2d, *Parties* § 30.

² *Id.*

³ *Id.* at §§ 28, 29.

⁴ *Bonhiver v. Graf*, 311 Minn. 111, 248 N.W.2d 291 (1976); *Schact v. Brown*, 711 F.2d 1343 (7th Cir. 1983).

⁵ *Redington v. Touche Ross & Co.*, 592 F.2d 617 (2d Cir.), *rev'd on other grounds*, 442 U.S. 560 (1978).

comprehensive nature of these types of engagements sometimes leads to confusion, for both the accountant and clients, as to whom the accountant is serving.

Where such confusion is present, a plaintiff might attempt to assert an action on behalf of both the corporation and the controlling shareholder, even where the accountant's alleged negligence has damaged only the corporation. This has occurred, in the author's experience, on engagements arising out of negligence asserted in the preparation of financial statements and a resulting failure to detect employee defalcation, as well as when a corporation claimed to have overpaid taxes and the shareholders later brought suit in their own names for the overpayment, following their sale of all stock in the company.

The general rule is that a shareholder does not have standing to bring an action for damages suffered by a corporation.⁶ Instead, a shareholder is allowed to bring an action derivatively, on behalf of the corporation and against a defendant accountant, where the shareholder meets the requirements of Federal Rule of Civil Procedure 23.1:

- The corporation must have failed to enforce a properly assertable right against the CPA.
- The complaint must be verified by the shareholder.
- The plaintiff must allege that he or she was a shareholder at the time of the transaction in question or that the plaintiff acquired stock thereafter by operation of law.
- The plaintiff must allege that the action is not brought collusively to confer jurisdiction on a federal court.
- The complaint must allege with "particularity" efforts made by a plaintiff to obtain action from the directors of the corporation and the reasons for the failure to obtain the requested action or for not making the required effort.
- The action can only be maintained by a plaintiff who fairly and adequately represents the interests of similarly situated shareholders.

As with a class action, court approval is required for settlement of a shareholder's derivative claim.

Standing might be supplied contractually, as when a third party takes a contractual assignment of a malpractice claim from an accountant's client. Although claims for legal malpractice are generally not assignable, different considerations of public policy were held to militate in favor of allowing assignments of accounting malpractice claims in *First Community Bank & Trust v. Kelley, Hardesty, Smith & Co.*, 663 N.E.2d 218 (Ind. Ct. App. 1996). The

⁶ *Semida v. Rice*, 863 F.2d 1156 (4th Cir. 1988); *Robertson v. White*, 633 F. Supp. 954 (W.D. Ark. 1986); see also *Dickerson & Son, Inc. v. Ernst & Young LLP*, 846 A.2d 1237 (N.J. 2004) (members of cooperative lack standing to pursue coop's CPA.)

court distinguished the role of an accountant from that of an attorney in determining that an accounting malpractice claim is assignable, on the following grounds:

- Attorneys are duty bound to serve as “zealous advocates” for their clients, in an adversarial setting, whereas accountants do not advocate for clients in an adversarial system.
- The attorney-client communications privilege is broader and more closely tied to an attorney’s role as an advocate, whereas the accountant’s duty of confidentiality is merely “evidentiary” and “based solely on the intrinsic value of confidentiality to the client.”
- Attorneys would become mere “puppets on a string” if legal malpractice claims were routinely bartered, and the commercialization of such a product “would be disastrous in a legal setting where adversaries could control the outcome of underlying litigation by purchasing malpractice claims against their opponents”; on the other hand, “there is no threat” of commercialization when an accounting malpractice claim is assigned incidentally to the purchase of other assets.
- Allowing the assignability of legal malpractice claims would give the plaintiff in a lawsuit the opportunity to both sue the original defendant and, in the event that a judgment proved uncollectible, later sue the defendant’s attorney (on defendant’s assignment of the claim that the attorney’s malpractice caused the adverse judgment).

Id. at pp. 220-23. The court’s opinion did not consider the increasing role and involvement of accountants in serving as advocates for their clients in business negotiations, tax appeals, and litigation, thereby suggesting the possibility that the assignability of other types of accounting malpractice claims remains unsettled. *See also Riley v. Ameritech Corp. Inc.*, 147 F. Supp. 2d 762, 771 (E.D. Mich. 2001).

Privity

Literally scores of articles and commentaries have been written about the accountants’ privity defense. This proliferation likely reflects the inroads made in recent years, in some states, by plaintiffs challenging the scope of the privity defense.

Strictly speaking, it is not entirely accurate to refer to the absence of contractual privity between an accountant and a claimant as the “privity defense.” Instead, it is more appropriate to characterize the presence or lack of privity as an element of an affirmative claim against an accountant for negligence or negligent misrepresentation on which the plaintiff carries the burden of persuasion.

In those jurisdictions, which require a plaintiff to be in privity with a defendant accountant, or to have some “privity substitute,” the courts regard the issue as a question of law

reserved for disposition by the court.⁷ In the same vein, in those jurisdictions which have abandoned the privity requirement in accountants' cases for a rule of "reasonable foreseeability," the court is the arbiter of the zone of an accountant's liability.⁸ (See also "Causes of Action" for use of aiding and abetting liability to circumvent privity doctrine.)

Throughout this discussion, the term "nonclient" will be used to denote a business or individual who lacks privity of contract with the defendant accountant. Virtually without exception, the class of nonclients who attempt to sue accountants consists of trade creditors, lenders, and shareholders suing to recover their losses from an accountant who prepared financial statements for a corporation.

Some states have codified the accountant's privity defense. See, e.g., Utah Code Ann. § 58-26-1,2 (1990).

The courts are split along three lines in their treatment of the ability of nonclients to sue an accountant, as follows:

- traditional privity defense – privity or a privity-substitute is required;
- *Restatement* § 552; and
- reasonable foreseeability.

Effect of Accountants' Fraud

A plaintiff does not have to establish privity, in any shape or form, where an accountant has perpetrated an intentional misrepresentation and the plaintiff has suffered resulting harm. This is true in all jurisdictions, even in those that follow the traditional or *Restatement* positions.⁹

The rationale for allowing an accountant to be sued for fraud or deceit, even by a nonclient, is that a morally culpable accountant, acting with dishonesty or bad faith, is not entitled to special protection from the claims of nonclients.

Traditional Rule

Accountants have traditionally enjoyed limited immunity from the negligence-based claims of nonclients. The rule is a vestige of the privity limits once uniformly imposed on tort liability and traces its roots to the opinion in *Ultramares Corp. v Touche*.¹⁰

⁷ Privity is question of law for court. Compare *Credit Alliance Corp. v. Arthur Andersen & Co.*, 65 N.W.2d 536, 493 N.Y.S.2d 435 (1985); with *Touche Ross v. Commercial Union Ins.*, 514 So. 2d 315 (Miss. 1987).

⁸ Reasonable foreseeability is issue for the court. See generally *Citizens State Bank v. Timm, Schmidt & Co.*, 113 Wis. 2d 376, 335 N.W.2d 361 (1983).

⁹ *Spherex, Inc. v. Alexander Grant & Co.*, 122 N.H. 898, 451 A.2d 1308 (1982); *State St. Trust Co. v. Ernst*, 278 N.Y. 104, 15 N.E.2d 416 (1938); *Restatement (Second) of Torts* § 531 (1977).

¹⁰ *Ultramares Corp. v. Touche*, 255 N.Y. 170, 174 N.E. 441 (1931).

In that decision, the New York court declined to abandon the requirement of contractual privity in an accountant's case out of concern that accountants will face indeterminate liability exposure if they can be sued by a virtually unlimited class of nonclients. This is because an accountant who expresses an opinion on a financial statement has no way to know exactly to whom the statement will be shown, how nonclients will use the statement, or the length of time during which it will be used by nonclients.

It is important to note that the traditional rule does not require literal contractual privity between an accountant and a plaintiff. Instead, it will suffice if the "end and aim" of the accountant was to supply a financial statement opinion to a known third party, even indirectly. In the landmark decision of *Credit Alliance Corp. v. Arthur Andersen & Co.*,¹¹ the New York court established "flexible criteria" for determining whether privity or surrogate privity is present:

- The accountant has to have been aware that the financial reports were to be used for a particular purpose.
- The accountant has to have been aware that a known party intended to rely on the financial reports.
- There must be some conduct by the accountant linking the accountant to the nonclient that is evidence that the accountant had an understanding that the nonclient intended to rely on the CPA's work.

At least in New York, a nonclient suing an accountant must plead the existence of facts supporting each of these elements.¹² An independent accountant who provides "internal" accounting or bookkeeping services may be a de facto employee of the client, thereby establishing privity with a reliant third party. *Bank of Tokyo Trust Co. v. Friedman*, 197 A.D. 2d 354, 602 N.Y.S.2d 125 (1st Dep't 1993).

In addition to New York, the following states continue to adhere to at least some version of the traditional requirement of privity in a negligent misrepresentation case against an accountant:

- Arkansas – Ark. Code Ann. § 16-114-302 (1987);
- Delaware – *McLean v. Alexander*, 599 F.2d 1190 (3d Cir. 1979);
- Idaho – *Idaho Bank & Trust Co. v. First Bank Corp. of Idaho*, 115 Idaho 1082, 772 P.2d 720 (1989);
- Illinois – 225 Ill. Comp. Stat. Ann. 450/30.1 (2004);
- Indiana – *Toro Co. v. Krouse, Kern & Co., Inc.*, 827 F.2d 155 (7th Cir. 1987);

¹¹ *Credit Alliance Corp. v. Arthur Andersen & Co.*, 65 N.Y.2d 536, 493 N.Y.S.2d 435 (1985).

¹² *Id.*

- Kansas – Kan. Stat. Ann. § 1-402 (1995);
- Louisiana – La. Rev. Stat. Ann. § 37.91 (1999);
- Maryland – *Walpert, Smullian & Blumenthal, P.A. v. Katz*, 361, Md. 645, 762 A.2d 582 (Md. App. 2000);
- Michigan – Mich. Comp. Laws § 600.2962 (1996);
- Montana – *Thayer v. Hicks*, 243 Mont. 138, 793 P.2d 784 (1990);
- Nebraska – *Citizens Nat'l Bank of Wisner v. Kennedy & Coe*, 232 Neb. 477, 441 N.W.2d 180 (Neb. 1989); *but see St. Paul Fire & Marine Ins. v. Touche Ross*, 507 N.W.2d 275 (Neb. 1993);
- New Jersey – N.J. Stat. Ann. § 2A:53A-25 (1995);
- Utah – Utah Code Ann. § 58-26a-602 (2000);
- Virginia – *Ward v. Ernst & Young*, 246 Va. 317, 435 S.E.2d 628 (Va. 1993);
- Wyoming – Wyo. Stat. Ann. § 33-3-201.

Restatement (Second) of Torts § 552

A majority of American states now recognize the modified privity requirement imposed by § 552 of the *Restatement (Second) of Torts*. The *Restatement* modifies the traditional rule of privity by allowing nonclients to sue accountants for negligent misrepresentation, provided they belong to a “limited group” and provided that the accountant had actual knowledge that his or her professional opinion would be supplied to that group. One court explained the difference between the traditional rule and the approach of the *Restatement*, as follows:

The *Restatement* represents the moderate view, allowing only a restricted group of third parties to recover for pecuniary losses attributable to inaccurate financial statements. Significantly, the accountants retain control over their liability exposure. The restricted group includes third parties whom the accountants intend to influence and those whom the accountants know their clients intend to influence. Accordingly, liability is fixed by the accountants’ particular knowledge at the moment the audit is published, not by the foreseeable path of harm envisioned by jurist’s years following an unfortunate business decision.

However, the *Restatement* is more generous than New York’s near privity rule since section 552 does not require that the accountants manifest conduct underscoring their understanding of a particular nonclient’s reliance upon the work product. The near-privity rule, in other words, requires that the precise identity of the

informational consumer be foreseen by the auditors; however, the *Restatement* contemplates identification of a narrow group, not necessarily the specific membership within that group.

First Nat'l Bank of Commerce v. Monco Agency, Inc., 911 F.2d 1053 (5th Cir. 1990).

The question of whether an accountant intended to benefit a class of shareholders of an audit client was held to be an issue of triable fact in *Forcier v. Cardello*, 173 B.R. 973 (D.R.I. 1994) (Rhode Island law).

In adopting this modified privity requirement, the American Law Institute expressed the view that the magnitude of losses by accountants which might flow from total abandonment of the privity requirement would constrict the unrestricted flow of information “upon which the operation of the economy rests.”¹³ The ALI further justifies imposition of a limited privity requirement on the grounds that the pecuniary loss resulting from negligent preparation of financial information is different from property damage and bodily injury suffered as a consequence of other types of negligence.

Section 552 provides as follows:

(1) One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.

(2) Except as stated in Subsection (3), the liability stated in Subsection (1) is limited to loss suffered

(a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it; and

(b) through reliance upon it in a transaction that he intends the information to influence or knows that the recipient so intends or in a substantially similar transaction.

(3) The liability of one who is under a public duty to give the information extends to loss suffered by any of the class of persons for whose benefit the duty is created, in any of the transactions in which it is intended to protect them.

¹³ *Restatement (Second) of Torts* § 552, comment a.

One important question arising under § 552 is the judicial gloss, which will be used to define the extent to which a nonclient is a member of a “limited group.” Some courts have held that shareholders and other investors in a corporation do not constitute a limited class.¹⁴ According to the ALI, lenders do not comprise a limited class.¹⁵ The class of “potential purchasers” of stock in a publicly traded company is not a “limited group” within the meaning of § 552, even though an auditor knew that investors “in general” might rely on audited financial statements. *Scottish Heritable Trust, PLC v. Peat Marwick Main & Co.*, 81 F.3d 606, 614 (5th Cir. 1996). A contrary rule would, according to this court, “eviscerate the *Restatement* rule in favor of a *de facto* foreseeability approach,” by predicating an accountant’s duty to a third party on mere general knowledge about “typical investors or tenuous inferences concerning future events.” Conversely, it was held in *Reisman v. KPMG Peat Marwick LLP*, 781 N.E.2d 821 (Mass. App. 2003), that an auditor “had reason to expect” that its financial statements will be relied upon by a “limited subgroup of investors – those whose companies its [audit] client company wishes to acquire,” and can thus be held liable under § 552.

Another prerequisite to the maintenance of a negligent misrepresentation claim against an accountant by a nonclient is the need to show that the accountant was “manifestly aware” that financial information would be provided to a specifically foreseen user or limited class.¹⁶ The mere showing that an accountant was generally aware of the “ever-present possibility of repetition to anyone” does not satisfy this requirement.¹⁷ The court in *Marcus Bros. Textiles, Inc. v. Price Waterhouse, LLP*, 513 S.E.2d 320 (N.C. 1999), arguably expanded the concept of “specifically foreseen” to the realm of the “reasonably foreseeable” user or limited class.

Banks and other financial institutions seeking recovery from an accountant, following the insolvency of their borrower, often attempt to show that the accountant was aware that the bank was using audited financial statements because the business was obligated to provide audited financial statements to the lender as a part of the loan agreement. The decisions go both ways on whether the plaintiff in such a case must directly establish that the accountant had “manifest knowledge” of the use of the financial statements by the lender or whether this element can be satisfied by a showing that the accountant “should have known” of such limited use.¹⁸

Another issue under § 552 is the meaning to be given to the requirement that the accountant is liable only for the transaction, or a substantially similar transaction, that he or she intends the financial reports to influence.¹⁹ According to the ALI:

[I]ndependent public accountants who negligently make an audit of books of a corporation, which they are told is to be used only for the purpose of obtaining a particular line of banking credit, are not subject to liability to a wholesale merchant whom the corporation

¹⁴ *Briggs v. Sterner*, 529 F. Supp. 1155 (S.D. Iowa 1981); *Milliner v. Elmer Fox & Co.*, 529 P.2d 806 (Utah 1974).

¹⁵ *Restatement* § 552, comment h, illustration 5.

¹⁶ *Id.* at comment a.

¹⁷ *Id.* at comment h; *Bank of New Orleans v. Monco Agency*, 719 P. Supp. 1328 (E.D. La. 1989).

¹⁸ *Compare BancOhio Nat'l Bank v. Schiesswohl*, 33 Ohio App. 3d 329, 515 N.E.2d 997 (Ohio App. 1986), with *Blue Bell, Inc. v. Peat, Marwick, Mitchell & Co.*, 715 S.W.2d 408 (Tex. App. 1986).

¹⁹ *Restatement* § 552(2)(b).

induces to supply it with goods and credit by showing him the financial statements and the accountant's opinion. On the other hand, it is not necessary that the transaction in which the opinion is relied on shall be identical in all of its minute details with the one intended. It is enough that it is substantially the same transaction or one substantially similar. Thus, in the situation above-stated, if the corporation, finding that at the moment it does not need to obtain the credit for which the audit was procured, uses it a month later to obtain the same credit from the same bank, the accountants will remain subject to liability to the bank for the loss resulting from its extension of credit, unless the financial position of the corporation has materially changed in the interim or so much time has elapsed that the bank cannot justifiably rely upon the audit.²⁰

One court has ruled that a loan by a second lender, on terms "almost identical" to those granted by the first lender, whom the accountant knew would receive and rely upon the financial statements, did not constitute a substantially similar transaction within the meaning of the *Restatement*.²¹ The court in *North American Specialty Insurance Co.*, 258 F.3d 35, 41 (1st Cir. 2001) adopted a two part test for determining if the "substantially similar" element has been met:

1. What risks in performing the audit did the auditor reasonably perceive were being assumed when he *delivered* the report or financial statement?
2. Do the transactions "share essentially the same character"? The court must make an "objective comparison" between the transaction of which the auditor had "actual knowledge" and the transaction that in fact occurred. This leg of the test is to be conducted in light of the "ordinary practices and attitudes of the business world," citing *Restatement* § 552, comment (j).

The court then applied this test in a failed audit claim by a surety that had issued bonds on construction jobs that arose after the delivery of the auditors' report. The court rejected the bonding company's argument that the CPA knew that the annual audit was merely to "qualify" the contractor for future bonds. According to the First Circuit, ". . . the key is the accounting firm's actual knowledge of the surety's intention to rely on the financial statement for a specific purpose—deciding whether to issue a bond in a known amount for known project." *Id.* at 43.

The following states have adopted § 552:

- Alabama – *Boykin v. Arthur Andersen & Co.*, 639 So.2d 504 (Ala. 1994);
- Alaska – *Selden v. Burnett*, 754 P.2d 256 (Alaska 1988) (adopting slightly modified version of § 552 standard);

²⁰ *Id.* at comment j.

²¹ *Bank of New Orleans, supra.*

- Arizona – *Standard Chartered PLC v. Price Waterhouse*, 190 Ariz. 6, 945 P.2d 317 (Ariz. App. 1996);
- California – *Bily v. Arthur Young & Co.*, 3 Cal. 4th 370, 834 P.2d 745, 11 Cal. Rptr. 2d 51 (1992);
- Florida – *First Florida Bank, NA. v. Max Mitchell & Co.*, 558 So. 2d 9 (Fla. 1990);
- Georgia – *Badische Corp. v. Caylor*, 257 Ga. 131, 356 S.E.2d 198 (Ga. 1987);
- Iowa – *Pahre v. Auditor*, 422 N.W.2d 178 (Iowa 1988);
- Kentucky – *Ingram Indus., Inc. v. Nowicki*, 527 F. Supp. 683 (E.D. Ky. 1981);
- Louisiana – *Bank of New Orleans v. Monco Agency*, 719 P. Supp. 1328 (E.D. La. 1989);
- Maine – *Bowers v. Allied Inv. Corp.*, 822 F. Supp. 835 (D. Me. 1993);
- Massachusetts – *Nycal Corp. v. KPMG Peat Marwick, LLP*, 688 N.E.2d 1368 (Mass. 1998);
- Minnesota – *TCF Banking & Sav., P.A. v. Arthur Young & Co.*, 706 F. Supp. 1408 (D. Minn. 1988);²²
- Missouri – *Mid American Bank & Trust Co. v. Harrison*, 851 S.W.2d 563 (Mo. Ct. App. 1993) (adopting four-part standard comparable to § 552);
- New Hampshire – *Spherex Inc. v. Alexander Grant & Co.*, 451 A.2d 1308 (N.H. 1982);
- North Carolina – *Raritan River Steel Co. v. Cherry, Bekaert & Holland*, 367 S.E.2d 609 (N.C. 1988) and *Marcus Bros. Textiles, Inc. v. Price Waterhouse, LLP*, 513 S.E.2d 320 (N.C. 1999);
- Ohio – *Haddon View Inv. Co. v. Coopers & Lybrand*, 436 N.E.2d 212 (Ohio 1982) and *BancOhio Nat'l Bank v. Schiesswohl*, 33 Ohio App. 3d 329, 515 N.E.2d 997 (Ohio App. 1986);
- Pennsylvania – *Williams Controls, Inc. v. Parente, Randolph, Orlando, Carey & Assocs.*, 39 F. Supp. 2d 517 (M.D. Pa. 1999); *but see Landell v. Lybrand*, 264 Pa. 406, 107 A. 783 (1919);
- Rhode Island – *Forcier v. Cardello*, 173 B.R. 973 (D.R.I. 1994) (Rhode Island law);

²² *But see Bonhiver v. Graff*, 311 Minn. 111, 248 N.W.2d 291 (1976), and discussion in Shroyer, *Accountants and the Dynamics of Duty*, 14 Wm. Mitchell L. Rev. 77 (1988).

- Tennessee – *Bethlehem Steel Corp. v. Ernst & Whinney*, 822 S.W.2d 592 (Tenn. 1991);
- Texas – *Blue Bell, Inc. v. Peat, Marwick, Mitchell & Co.*, 715 S.W.2d 408 (Tex. App. 1986), *McCamish, Martin, Brown & Loeffler v. F.E. Appling Interests*, 991 S.E.2d 787 (Tex. 1999) and *Abrams Centre Nat’l Bank v. Farmer, Fuqua & Huff, P.C.*, 225 S.W.3d 171 (Tex. App.-El Paso 2005);
- Washington – *Haberman v. Wash. Public Power Supply Sys.*, 109 Wash. 2d 107, 744 P.2d 254 (Wash. 1987);
- West Virginia – *First Nat’l Bank of Bluefield v. Crawford*, 386 S.E.2d 310 (W. Va. App. 1989);

The question of whether an accountant owes a duty to a third party under *Restatement* § 552 presents a mixed question of law and fact. *Scottish Heritable Trust, PLC v. Peat Marwick Main & Co.*, 81 F.3d 606, 614 (5th Cir. 1996). The court, however, decides the “outer boundaries” in deciding whether the “limited group” element of the *Restatement* has been satisfied. *Id.*

Reasonable Foreseeability

A minority of jurisdictions has abolished the privity requirement and allows suits by any nonclient whose reliance upon an accountant’s opinion was reasonably foreseeable to the accountant. Proponents of the rule of reasonable foreseeability assert these policy reasons for abrogation of the privity requirement:

- The accounting profession has become financially powerful.
- Accountants are uniquely responsible for monitoring marketplace integrity.
- Expanding liability against accountants serves the purpose of deterring their negligence.
- Accountants are insured or able to pass the cost of self-insurance onto their clients, thereby efficiently allocating the risk of loss.

States following the rule of reasonable foreseeability have not adopted any firm guidelines for application of the rule. In the most extreme example of expanded accountants’ liability, *International Mortgage Co. v. Butler*, an accountant audited a mortgage company and issued an unqualified opinion on its financial statements.²³ The accountant had no knowledge that the plaintiff, who purchased mortgages in the secondary market, was going to receive the financial statements, planned to rely upon them, or even existed. The court ruled that the accountant could nonetheless be liable to the unforeseen (but *foreseeable*) plaintiff, stating:

²³ *International Mortgage Co. v. Butler*, 177 Cal. App. 3d 806, 223 Cal. Rptr. 218 (Cal. Ct. App. 1986).

An independent auditor (as opposed to an in-house accountant) is employed to analyze a client's financial status and make public the ultimate findings in accord with recognized accounting principles. Such an undertaking is imbued with considerations of public trust, for the accountant must well realize the finished product, the unqualified financial statement, will be relied upon by creditors, stockholders, investors, lenders, or anyone else involved in the financial concerns of the audited client.

The only evident limitation on an accountant's exposure to a nonclient, under this standard, is that the foreseeable user of the accountant's work product may only recover if reliance was for a proper business purpose.²⁴

The courts, which have adopted the rule of reasonable foreseeability, include:

- Mississippi – *Touche Ross & Co. v. Commercial Union Ins. Co.*, 514 So. 2d 315 (Miss. 1987); and
- Wisconsin – *Citizens State Bank v. Timm, Schmidt & Co.*, 113 Wis. 2d 376, 335 N.W.2d 361 (1983).²⁵

Causation, Foreseeability and Reasonable Reliance

The weak links of many plaintiffs' claims against accountants are the elements of causation and reliance. While these elements are technically considered to be separate and discrete components of a plaintiff's case-in-chief, they are so closely related in most accountants' cases as to be indistinguishable from one another. In many cases, these elements are but different sides of the same coin, namely, can the plaintiff establish that the accountant's advice or information was linked to the asserted loss?

The element of causation is undeniably broader, in scope and application, than is the element of reliance:

- Causation – the courts often assert that this element is satisfied if the plaintiff can show that, “but for” the accountant's negligence, the asserted loss would not have occurred. *Alliance Group Services, Inc. v. Grassi & Co.*, 406 F. Supp. 2d (D. Conn. 2005).
- Courts consider whether the specific plaintiff was reasonably justified in basing a decision on the accountant's advice or information.

A few examples to illustrate these points will be helpful:

²⁴ *H. Rosenblum, Inc. v. Adler*, 93 N.J. 324, 461 A.2d 138 (1983).

²⁵ New Jersey legislatively overruled the seminal “reasonable foreseeability” decision of *H. Rosenblum, Inc. v. Adler*, 93 N.J. 324, 461 A.2d 138 (1983), in 1995. N.J.S. 2A:53A-25.

- A sophisticated and wealthy investor claims to have based an investment decision on negligent advice by an accountant. Although the investor would not have made the investment decision without the accountant's advice ("but for" the negligent advice the investment would not have been made), the investor may not recover if his experience and sophistication obviate the reasonableness of his claimed reliance on the accountant's advice.²⁶
- For the converse point, assume that a banker reasonably relies upon audited financial statements in extending working capital to a business. Although the audit was negligent, the banker cannot recover if the failure of the borrower was due to the collapse of the borrower's market (a cause unrelated to audit negligence).²⁷ The creditor is not entitled to recover if the business becomes judgment-proof after the rendering of the negligent audit report. *Kemin Indus., Inc. v. KPMG Peat Marwick LLP*, 578 N.W.2d 212 (Iowa 1998).
- An audit client asserts that it lost the ability to obtain any financing due to the accountant's alleged error in requiring the client to lower its reported income as a condition of receiving an unqualified auditor's opinion. In *Hydroculture, Inc. v. Coopers & Lybrand*, 848 P.2d 856 (Ariz. Ct. App. 1992), the court ruled that an accountant could be liable for forcing the downward revision of earnings by threatening to withdraw from the audit engagement shortly before the client's deadline for reporting to the SEC, but in *Sunshine Mining and Refining Company v. Ernst & Young LLP*, 114 S.W.2d 48 (Tex. App. 2003), the plaintiff was required to identify *specific* investors who were dissuaded from an investment due to a delayed financial statement.

A list of all of the possible factors to be taken into account in determining what caused a plaintiff's loss is impossible to assemble because the possible causes will be as varied as the fact patterns that give rise to claims against accountants. Some general "loss causation" categories to be considered are:

- mismanagement;
- change in law or regulation;
- technological obsolescence, recession, inflation, or other adverse changes in the marketplace; and
- misconduct by another party, not related to the accountant's alleged negligence.

The timing and sequence of events can also be fatal to the ability of a plaintiff to establish the causation element. The courts have rejected a plaintiff's claims where the

²⁶ See *Vernon J. Rockler & Co. v. Glickman, Isenberg, Lurie & Co.*, 273 N.W.2d 647 (Minn. 1978).

²⁷ Cf. *Bastian v. Petren Resources Corp.*, 892 F.2d 680 (7th Cir. 1990).

accountant's advice or information was received after the occurrence of the transaction or event which plaintiff claims was undertaken in reliance on the accountant's work.²⁸

The question of whether a plaintiff has reasonably relied upon an accountant's advice or information revolves around these factors:

- plaintiff's education;
- plaintiff's business or investment experience;
- plaintiff's intelligence;
- whether verbal advice or information was contradicted by written disclosures; and
- whether plaintiff had independent knowledge of material information that contradicted the accountant's advice or information.

Accordingly, where a knowledgeable, educated, and sophisticated plaintiff claims that she was told by her accountant that she was investing in a limited partnership, but then signed documents clearly showing that she was a general partner, the claim against the accountant is not actionable.²⁹ Along the same lines, a creditor who failed to follow prudent lending policies and loosely extended credit in order to avoid a loan loss, after it learned that the borrower was in trouble, cannot recover even where the accountant failed to conduct a proper audit.³⁰ Consistent with the usual approach, a stock purchaser's claimed justification in relying on allegedly overstated financial statements was deemed "simply incredible" as a matter of law, where the claimant (1) was an "extremely sophisticated multi-national conglomerate; (2) had unfettered access to the audited company's internal financial records; and (3) suspected and was later warned by an advisor that a problem existed in the very same balance sheet account that it later claimed was improperly audited." *Scottish Heritable Trust, PLC v. Peat Marwick Main & Co.*, 81 F.3d 606, 615 (5th Cir. 1996).

Judge Posner rejected a bank's claim of reliance in his inimitable style:

The audit report might flunk Accounting 101, but if the report didn't mislead any one toward whom the auditor had a duty of care, the auditor would not have committed a tort. * * * At the root of the bank's argument for liability is that it was entitled to look no farther than the bottom-line numbers in the audit report, which together with the numbers in it gave the reader an accurate picture of [the borrower's] financial situation. *The bank cannot base a claim for damages on a refusal to read.*

²⁸ *Stockler v. Rose*, 174 Mich. App. 14, 436 N.W.2d 70 (1989); and *LHLC Corp. v. Kluett*, 842 F.2d 928 (7th Cir. 1988); *Frank Cooke, Inc. v. Hurwitz*, 406 N.E.2d 678 (Mass. App. 1980); but see *AUSA Life Insurance Co v. Ernst & Young*, 206 F. 3d 202 (2d Cir. 2000).

²⁹ *Hutton Mortgage Corp. v. Pappas*, 690 F. Supp. 1465 (Md. 1989); and *Midland Nat'l Bank of Minneapolis v. Perranoski*, 299 N.W.2d 404 (Minn. 1980).

³⁰ *Bunge Corp. v. Eide*, 372 F. Supp. 1058 (N.D. 1974).

Johnson Bank v. Geroge Korbakes & Co. LLP, 472 F.3d 439, 442-3 (7th Cir. 2006)(emphasis added.)

On the other hand, in a case of fraud, the plaintiff need only be free of deliberate or reckless risk taking, because normal prudence does not require one to assume the defendant to have been a liar or to “dig beneath apparently adequate assurances.” *Dougherty v. Zimpler*, 922 F. Supp. 110, 115 (N.D. M. 1996).

Where the plaintiff claims that it incurred losses due to poor business decisions based on overstated financial statements, it needs to prove that it would have acted differently if it had received accurate information.³¹ The plaintiff should also be prepared to establish that the alternative conduct would have made a difference to the success of its business. Often, this will require expert testimony from an economist or business expert.³² In *Board of Trustees v. Coopers & Lybrand, LLP*, 333 Ill. App. 3d 225, 775 N.E.2d 55 (2002), the trustees of a college brought suit contending that it would have made different investment decisions if only its auditors had disclosed the high-risk investment strategy pursued by the board’s treasurer. At trial, innocent trustees testified that they would not have tolerated the risky strategy and would have “cleared up” the situation. In rejecting the auditor’s argument that the board’s testimony was mere speculation and insufficient to establish causation, the court held that the strength of the proof was for determination by the jury and that the jury’s decision was adequately supported by these factors:

- Five trustees testified that they would have acted differently “but for” their ignorance of the risky investment strategy.
- The trustees produced “circumstantial evidence” that they had relied on other suggestions made by the auditors.
- The trustees established that as soon as the investment policy was discovered, immediate corrective action was taken.

The court distinguished the holding in *Drabkin, supra.*, noting that the auditor in that case had issued a “going concern” opinion and that the directors failed to take corrective action even after they learned of the facts giving rise to their claim. Oklahoma also recently joined the cases following the audit interference rule in *Stroud v. Arthur Andersen & Co.*, 37 P.3d 783 (Okla. 2001).

Sometimes, expert testimony is required to establish a causal nexus between the CPA’s error and the claimed loss. *Board of Trustees v. Towers, Perrin, Forster & Crosby, Inc.*, 191 S.W.3d 185 (Tex. App. 2005).

To establish loss causation, each plaintiff in a relying class of nonclients must show individual reliance on financial statements, rather than indirect reliance through state regulators, according to the decisions in *Forcier v. Cardello*, 173 B.R. 973 (D.R.I. 1994) (Rhode Island law); *SIPC v. BDO Seidman, LLP*, 222 F.3d 63 (2d Cir. 2000) (New York law).

³¹ *Drabkin v. Alexander Grant & Co.*, 905 F.2d 453 (D.C. Cir. 1990), *cert. denied*, 111 S. Ct. 559 (1990).

³² *Greenstein, Logan & Co. v. Burgess*, 744 S.W.2d 170 (Tex. App. 1987).

In *Edward J. DeBartolo Corp. v. Coopers & Lybrand*, 928 F. Supp. 557 (W.D. Pa. 1996), the plaintiffs contended that they purchased stock in a corporation in reliance on audited financial statements. The problem faced by the plaintiffs was that the financial statements in existence at the time of their stock acquisitions did not materially overstate the financial condition of the audited company. To overcome this hurdle, the plaintiffs argued that the audits did not comply with GAAS, thereby allowing management of the company to perpetrate a massive fraud in subsequent years, which was not detected due to the same audit deficiencies that had existed in the prior years.

After noting that proof of loss causation is not an element required to sustain a common law fraud claim, the court nonetheless found that the concept as applied in the federal securities law context is “instructive” in applying the doctrine of proximate causation. Because, according to the court, the evidence showed that the plaintiffs would have purchased their stock even assuming a GAAS audit for the years in question, and at the same price that they actually paid for their acquisitions, they would eventually have suffered the same losses anyway and were thus not damaged by the alleged, pre-stock purchase audit failures. *Id.* at 563.

The requirement that damages must have been foreseeable at the time of the tort is related. Thus, a CPA is not liable if the cause of the loss alleged could not have been foreseen at when the negligence occurred. In *Oregon Steel Mills, Inc. v. Coopers & Lybrand*, 83 P.3d 322 (Or. 2004), the auditor negligently prepared a financial statement for 1994. When the negligence was discovered in 1996, the required remedial action delayed the issuance of stock by the audit client – until after the price of the stock had declined. The court held that the stock price decline occurred due to the general decline in the price of steel company stocks and was not, as a matter of law, a foreseeable harm at the time of the mistake. Absent a causal relationship between the damages suffered and the CPA’s misconduct, the plaintiff could not recover.

This discussion also raises the possibility that the accountant can escape liability by arguing that the management of the audit client defrauded the accountant during the audit work. This is often referred to as the “CENCO defense.”³³ In *Cenco, Inc. v. Seidman & Seidman*, it was held that an accountant could not be held liable where the management of the audit client defrauded the auditor for the purpose of benefiting or “aggrandizing” the audit client. The court distinguished the situation where the fraud was perpetrated at the expense of the audit client (as well as the auditor), as would normally be the case in a claim for failure to detect employee defalcation. This defense is not applicable where:

- the acts were not committed on behalf of the corporation;
- the corporation did not benefit from management fraud; and/or

³³ *Cenco, Inc. v. Seidman & Seidman*, 686 F.2d 449 (7th Cir. 1982), *cert. denied*, 459 U.S. 880 (1980); *see also Miller v. Ernst & Young*, 938 S.W.2d 313 (Mo. App. E.B. 1997).

- the management of the audit client was merely negligent in making representations relied upon by the auditors.³⁴

The defense has been rejected, even in cases of criminal fraud, elsewhere.³⁵ More recently, one court has allowed an auditor to assert a claim of negligent misrepresentation against the management of an audit client, for intentionally or negligently supplying the auditors with false and misleading financial information on which the auditors relied in issuing an unqualified audit report. *In re Leslie Fay Co. Sec. Litig.*, 918 F. Supp. 749 (S.D.N.Y. 1996). The auditor asserted that it was damaged by management’s misrepresentation because it had been sued for securities fraud, thereby suffering damages in the form of attorneys’ fees, “harm to its business,” and loss of reputation. Under New York’s *Wagoner* rule, the misconduct of a corporate agent will be imputed to the entity when the agent and the entity are indistinguishable, such as where the agent is the sole shareholder, has unfettered control or operates without meaningful supervision. *Breeden v. Kirkpatrick & Lockhart, LLP*, 268 B.R. 704 (S.D.N.Y. 2001). The *Wagoner* rule does not apply, however, when there is an “innocent” shareholder or director, who would have been capable of acting on the disclosure of management fraud, had it been reported by the auditor. *SIPC v. BDO Seidman, LLP*, 49 F. Supp. 2d 644 (S.D.N.Y. 1999), *Sharp Int’l Corp. v. KPMG LLP*, 278 B.R. 28 (E.D.N.Y. 2002).

Since a mere compilation of a financial statement bears the disclaimer that no representation is proffered by the CPA concerning the accuracy or reliability of reported information, it stands to reason that no third party may reasonably rely upon the CPA’s involvement in making a decision based on the completeness or accuracy of those statements. This commonsense analysis was adopted by the court in *First Nat’l Bank of Newton City v. Sparkmon*, 212 Ga. App. 558, 442 S.E.2d 804 (1994); *Rino v. Mead*, 55 P.3d 13 (Wy. 2020); and *Evans v. Israeloff, Trattner & Co.*, 208 A.2d 891, 617 N.Y.S. 2d 899 (1994). See also *In re Citx Corporation, Inc.* (Bkpty E.D. Pa. 2005) and *Dakota Bank v. Eiesland*, 645 N.W.2d 177 (Minn. Ct. App. 2002) (no reasonable third-party reliance on audited, compiled financial statements, except in cases of CPA fraud). An accountant’s disclaimer that information contained in a report is unreliable was ignored – and third-party reliance claims allowed to proceed – in *Liberty Finance Co. v. BDO Seidman*, 123 N.C. App. 515, 473 S.E.2d 13 (1996), and *ML-Lee Acquisition Fund LP v. Deloitte & Touche*, 320 S.C. 143, 463 S.E.2d 618 (1996), *aff’d in part and rev’d in part on other grounds*, 489 S.E.2d 470 (1997).

But the court rejected a *per se* rule that compiled financial statements could never form the basis for reasonable reliance in a negligent misrepresentation claim in *Fejedelem v. Kasco*, 269 Mich. App. 499, 711 N.W.2d 436 (2006). Even in that case, however, the court held that plaintiff could not satisfy the reasonable reliance element of *Restatement* § 552, because his efforts to get more specific financial information underlying the compiled financial statements had been rebuffed (an “indicia” of misrepresentation, according to the court.)

³⁴ *Holland v. Arthur Andersen & Co.*, 469 N.E.2d 419 (Ill. App. 1984); *Greenstein, Logan & Co. v. Burgess Mktg., Inc.*, 744 S.W.2d 170 (Tex. 1987).

³⁵ *Bonhiver, supra*; see also *Schact v. Brown*, 711 F.2d 1343 (7th Cir. 1983).

Plaintiff's Fault

There is a division among the states on whether the doctrines of contributory negligence and comparative fault can be asserted as defenses by an accountant.

A small minority of states does not allow a defendant accountant to assert the defense of contributory negligence against a plaintiff.³⁶ One state, Nebraska, has adopted a rule prohibiting an accountant from comparing fault with a client in a case where the auditor negligently failed to detect embezzlement by an employee unless the accountant is able to show that management of the audit client contributed to the audit failure.³⁷ In Iowa, if the only officer or employee of a corporation with knowledge of fraud is the person making the false assertion to an auditor, that person's knowledge of the falsity is not imputed to the CPA's corporate client. *Kemin Industries v. KPMG Peat Marwick LLP*, 578 N.W.2d 212 (Iowa 1998). Illinois adopted the "audit interference" rule of *National Surety in Board of Trustees v. Coopers & Lybrand, LLP*, 803 N.E.2d 460 (Ill. 2003) (but an inaccurate "management representation" letter afforded a basis for finding "audit interference").

A majority of states with reported decisions do allow an accountant to assert the defense of contributory negligence or to compare fault with the client.³⁸ In *American Bank v. Touche Ross & Co.*, 74 Ohio St. 3d 482, 659 N.E.2d 1276 (1996), and *Scioto Mem'l Hosp. Assn. Inc. v. Price Waterhouse*, 74 Ohio St. 3d 474, 659 N.E. 2d 1268 (1996), a pair of cases decided simultaneously, the Ohio Supreme Court held that it was proper to compare the fault of the plaintiff with that of the defendant accountant, including the admissibility of evidence of the plaintiff's failure to buy business interruption insurance, and evidence that the management of the audit client was aware that the embezzling employee owned a \$600,000 house, drove a Maserati, was repeatedly overdrawn on a personal checking account maintained with the client, and never took the minimum required two consecutive weeks of vacation – while earning an annual salary of \$21,000.³⁹

The issue of comparative fault in a "failed audit" case arose in an interesting fashion in *Imark Industries, Inc. v. Arthur Young & Co.*⁴⁰ In that case, a creditor sued for loan losses incurred in reliance upon audited financial statements which allegedly overstated revenues and gross profits for the audited business. While finding the accountants negligent in the preparation of the financial statements, the jury also held that top management of the audit client had intentionally misrepresented information provided to the accountants during their audit and that the accountants had justifiably relied upon that fraud. The court reconciled these facially inconsistent jury findings on the grounds that the accountants could have been held

³⁶ *National Surety Corp. v. Lybrand*, 9 N.Y.S.2d 554 (1939); *Jewelcor Jewelers & Dist. v. Corr*, 542 A.2d 72 (Pa. Super. 1988).

³⁷ *Lincoln Grain, Inc. v. Coopers & Lybrand*, 216 Neb. 433, 345 N.W.2d 300 (1984).

³⁸ *Devco Premium Fin. Co. v. North River Ins. Co.*, 450 So. 2d 1216 (Fla. App. 1984); *Delmar Vineyard v. Timmons*, 486 S.W.2d 914 (Tenn. App. 1972); *Capital Mortgage Corp. v. Coopers & Lybrand*, 142 Mich. App. 531, 369 N.W.2d 922 (Mich. App. 1985); *Halla Nursery, Inc. v. Baumann-Furrie & Co.*, 454 N.W.2d 905 (Minn. 1990); *E.F. Hutton Mortgage Corp. v. Pappas*, 690 F. Supp. 1465 (D. Md. 1988).

³⁹ Counsel should be alert to the possibility that a CPA asserting a comparative fault defense will need to establish the standard of business care through use of a business expert. *Battenfeld of America v. Baird Kurtz & Dobson*, 60 F. Supp. 2d 1189 (D. Kan. 1999).

⁴⁰ *Imark Indus., Inc. v. Arthur Young & Co.*, 148 Wis. 2d 605, 436 N.W.2d 311 (1989).

liable for negligent audit work unaffected by the intentional misrepresentations, or because the jury might have found that the accountants negligently relied upon some intentional misstatements by management but not on others.

A defendant auditor was entitled to apply comparative fault for the misconduct of the audit client in a case brought by the buyer of the audit client, who allegedly relied on negligently prepared financial statements in making the acquisition. *Standard Chartered PLC v. Price Waterhouse*, 190 Ariz. 6, 945 P.2d 317 (Ariz. App. Div. 1 1996) (rejecting argument that buyer of company cannot be attributed with the fault of the company when buyer relied on independently prepared financial statements).

Accountants have begun to bring counterclaims against clients who assert failed-audit liability, on the grounds that the audit client failed to disclose high-level fraud by its top managers. See *Ameriwood Indus. Int'l Corp. v. Arthur Andersen & Co.*, 961 F. Supp. 1678 (W.D. Mich. 1997); see also "Siedman Wins Fraud Settlement Suit Against an Audit Client," *Wall Street Journal*, Nov. 11, 1992, at A6. The assertion of such a counterclaim might be more effective in a jurisdiction that limits or does not recognize comparative fault as a bar to a plaintiff's recovery.⁴¹

Statute of Limitations

There are too many variations between and among the states, statutes, and federal courts to allow the presentation of a comprehensive analysis of the statute of limitations defense. Rather, each practitioner is referred to the law of the jurisdiction providing the statute of limitations applicable to the claim. A schedule of state statutes of limitations is found at Appendix A.

The shortest statute of limitations is one year, and the longest known statute runs for six years.⁴² In addition, the jurisdictions have adopted divergent theories as to when the statute of limitations commences to run on a claim against an accountant.

In cases where the claim against the accountant is based upon underpayment of tax, most courts have held that the statute of limitations begins to run when the IRS issues its deficiency assessment:

- California – *Moonie v. Lynch*, 64 Cal. Rptr. 55 (Cal. App. 1967);
- Idaho – *Streiv v. Veigel*, 706 P.2d 63 (Idaho 1985);
- Maryland – *Feldman v. Granger*, 257 A.2d 421 (Md. App. 1969), and *Leonhart v. Atkinson*, 289 A.2d 1 (Md. App. 1972);
- Missouri – *Brower v. Davidson, Deckert, Shutter & Glassman, P.C.*, 686 S.W.2d 1 (Mo. App. 1984);

⁴¹ See also Young, "The Liability of Corporate Officials to Their Outside Auditor for Financial Statement Fraud," 64 *Fordham Law Review*, 2155 (1996).

⁴² Compare *Don Reid Ford, Inc. v. Feldman*, 421 So. 2d 184 (Fla. 1982), with *Bonhiver v. Graf*, *supra*.

- Delaware – *Isaacson, Stolper & Co. v. Artisans’ Sav. Bank*, 330 A.2d 130 (Del. 1974);
- Ohio – *Sladky v. Lomax*, 538 N.E.2d 1089 (Ohio 1988);
- Florida – *Lane v. Peat, Marwick, Mitchell & Co.*, 540 So. 2d 922 (Fla. App. 1989);
- Texas – *Atkins v. Crosland*, 417 S.W.2d 150 (Tex. 1967); and
- Oklahoma – *Wynn v. Estate of Holmes*, 815 P.2d 1231 (Okla. Ct. App. 1991).

A minority of jurisdictions has adopted the position that the statute begins to run when the negligently prepared tax return has been filed:

- Nebraska – *Klosure v. Johnson, Grant & Co.*, 229 Neb. 369, 427 N.W.2d 44 (1988);
- Georgia – *Consolidated Management Services v. Halligan*, 368 S.E.2d 148 (Ga. App. 1988); and
- Arkansas – *Fords, Inc. v. Russell Brown & Co.*, 773 S.W.2d 90 (Ark. 1989).

In one case, it was held that the meter begins to run on the statute of limitations where taxes have been overpaid at the time when the tax was actually overpaid.⁴³ On the other hand, one court has ruled that the statute of limitations does not begin to run for the negligent provision of tax advice until the accountant’s engagement for the rendering of advice has ceased.⁴⁴

In the context of negligent preparation of financial statements, it has been held that the statute of limitations commences running when the accountant’s report on the financial statements is delivered to the client.⁴⁵ The claim of a third party commences to run when the third party receives the financial statements – and not when they are delivered to the audit client.⁴⁶

There is a conceptual split among the states between the theory of accrual of damage and the discovery rule when determining the time the statute of limitations begins to run:

- Accrual of damage – in states following this theory, the statute of limitations begins to run when the plaintiff accrues any harm from the asserted negligence. This harm may be contingent and only a future possibility – yet the statute will begin to run anyway.⁴⁷

⁴³ *Leon Jones Feed v. General Business Serv.*, 333 S.E.2d 861 (Ga. App. 1985).

⁴⁴ *Boone v. C. Arthur Weaver Co., Inc.*, 235 Va. 157, 365 S.E.2d 764 (Va. 1988).

⁴⁵ *Lincoln Grain, Inc. v. Coopers & Lybrand*, 215 Neb. 289, 338 N.W.2d 594 (1983); *see also Owhee County v. Rife*, 593 P.2d 995 (Idaho 1979).

⁴⁶ *Toro Co. v. Krouse, Kern & Co., Inc.*, 644 F. Supp. 986 (N.D. Ind. 1986), *aff’d*, 827 F.2d 155 (7th Cir. 1987).

⁴⁷ *Grimm v. O’Connor*, 392 N.W.2d 40 (Minn. App. 1986).

- Discovery rule – courts following this rule hold that the statute does not begin to run until the plaintiff knew or should have known of the accountant’s negligence.⁴⁸

The implications for accountants in jurisdictions following the “discovery rule” are as obvious as they are profound. That is, since accountants deal in arcane and esoteric concepts, typically expressed in elaborate and highly refined, but relatively inaccessible verbiage, accountants are particularly vulnerable to claims by plaintiffs that they had no possible way to know about the accountant’s negligence until they actually had to “come out of pocket” with additional taxes or the like or by recognizing the insolvency or failure of their business or investment. Conversely, the more objective “accrual rule” at least affords accountants with the possibility that they can know with some degree of certainty when their exposure to claims has passed.

The statute of limitations in a state following the discovery rule may be tolled during the time the accountant continues to provide services to the client, even when the client was aware of the alleged malpractice during the continuing representation. *See Cuccolo v. Lipsky, Goodkin & Co.*, 826 F. Supp. 763 (S.D.N.Y. 1993) (applying New York law).

One court has ruled that the statute begins to run, even under a discovery rule, as soon as the plaintiff has been placed on notice of the need to investigate a potential claim, by virtue of having suffered a financial loss. *City Nat’l Bank v. Checkers, Simon & Rosner*, 32 F.3d 277 (7th Cir. 1994).

Finally, it should be noted that an accountant who fraudulently conceals his or her own negligence from a client is not entitled to have the statute of limitations begin to run until the client is aware of the misconduct.⁴⁹ Mere silence or inactivity upon discovery of an error does not rise to the level of “active concealment” required to invoke this doctrine.

⁴⁸ *Godfrey v. Bick & Monte*, 713 P.2d 655 (Or. App. 1986).

⁴⁹ *Cooke v. Hurwitz*, 406 N.E.2d 678 (Mass. App. 1980).