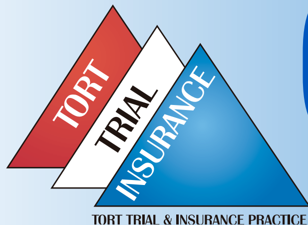

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PROFESSIONALS', OFFICERS' AND DIRECTORS' LIABILITY COMMITTEE

A SURVEY OF LIABILITY "HOT SPOTS" FOR CPAS

By Kevin M. Murphy[38]

The current economic recession creates potential liability concerns for accountants. The "subprime mortgage crisis" morphed into the "credit crunch," leading to what has now been widely acknowledged as the most significant recession in decades. While some economic indicators have improved during mid-2009, there are further storm clouds gathering on the horizon according to many economists. For example, a second wave of mortgage and related credit problems due to significant stresses in the commercial real estate market is predicted by some analysts. Others have predicted another wave of problems in the residential mortgage market in 2010-2012, when a multitude of hybrid and "option ARM" mortgages refinanced earlier this decade, reset after five to seven years, resulting in much higher interest rates or balloon note payments. Businesses have struggled throughout the economy, failing in numbers not seen for decades. Corporate bankruptcy filings were up 63 percent in the 12 month period ending June 30, 2009 compared with the period ending June 30, 2008.[39] All of this has been punctuated by the well publicized collapse of "Ponzi schemes" which were exposed as the economic tide ran out.

Given the current economic conditions described above, and the integral role played by certified public accountants in businesses throughout the economy, it is not difficult to conclude that accountants are likely to face some substantial liability exposures that are driven by the economy. This author has conducted an informal survey of certain insurers of accountants, to gather their observations regarding claims against accountants during this recession. This article develops the comments from that survey regarding likely liability "hot spots" for CPAs as the economic conditions further shake out.

What Have the Insurers and Brokers Observed?

Those surveyed for this article include several insurers of small, medium and regional accounting firms, as well as a broker of small to regional sized firms, and a broker of larger, regional and national firms. While there were some minor variations in the comments, certain general observations appeared relatively uniform. First, there seems to have been a noticeable increase in claims by companies against their accountants for alleged failure to detect embezzlement by employees. Second, business failures have spawned a small uptick in the frequency of claims related to business failures, and a more noticeable uptick in the severity of such claims. Business failures generate claims by lenders, investors, shareholders and bankruptcy trustees, among others. While recent case law has slowed the growth of the "deepening insolvency" theory, it continues to arise regularly as a claim in business bankruptcy and receivership settings. The surveyed insurers also are keeping an eye on claims arising out of "Ponzi schemes" to gauge the extent of those claims, and they are observing with some concern the potential for claims arising out of CPA services to retirement plans. Also of some note is what appears to be an increased scrutiny of accountants by financial regulators, such as the SEC and PCAOB. The following is an overview of some of these liability "hot spots."

Fraud Detection Claims

With increasing frequency, controllers, bookkeepers and other persons with access to a company's assets may be tempted to siphon off some of those assets, especially as the economy puts pressure on the finances of such individuals. Claims against accountants occur most frequently where the CPA has audited such businesses, but some insurers have noticed more frequent claims where the accountants have only reviewed or compiled the financial statements. Effective October 2002, the AICPA issued Statement on Auditing Standards 99, which called for auditors to plan, inquire and then assess fraud risks. Even though standard audit engagement letters state that an audit cannot be relied upon to uncover fraud, nevertheless the more particularized auditing standards in recent years, combined with the increased frequency of embezzlement, make this a definite liability "hot spot." As noted above, insurers have seen a growing frequency and severity of claims against CPAs for alleged failure to detect fraud.

"Going Concern" Opinions and "Deepening Insolvency"

Auditing standards require an auditor to make and document an assessment of whether the auditor has substantial doubt regarding the company's ability to continue as a "going concern" for a reasonable period of time, not exceeding one year.[40] To the surprise of some,

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39 *See* www.usgovinfo.about.com (8/19/09 report).

40 *See* Auditing Standard § 341.

standards for accounting and review services (SSARS) may also require an accountant performing a review or a compilation to assess the client's ability to continue as a going concern under certain limited circumstances.[41]

In early 2009, the CEO of Grant Thornton predicted that the number of going concern opinions could hit an "all time high" this year, and that "we will see an unprecedented number of going concern footnote disclosures and clarifications from the auditors."[42] But, as often noted, the difficulty with going concern opinions is that they can become something of a "self fulfilling prophecy." In other words, if an accounting firm determines to add a going concern footnote to a company's financial statement, this can result in the company encountering problems with lenders, creditors, etc. Auditors are caught in the middle when doing this kind of an analysis. If they fail to include a going concern footnote, and then the company deteriorates and fails within the year, claims can follow.

In recent years, bankruptcy trustees, receivers and others have increasingly asserted "deepening insolvency" claims against auditors, asserting that an auditor's failure to issue a going concern warning, or an auditor's alleged approval of financial statements with overstated income or assets, has caused delay in the liquidation of a doomed entity, thereby causing the entity to accumulate additional losses, debt, etc., which adversely affects creditors, investors and others. Courts have grappled with this relatively new theory in recent years. Some courts have recognized it as a viable cause of action, while others have rejected it or described it as a potential theory of damages. Several of the more recent cases have questioned, rejected or limited the theory.[43] For a thorough treatment of going concern opinion liability issues, see "*Malpractice in this Era of Economic Uncertainty*," by Matthew J. Iverson, *For the Defense*, May 2009, pages 26-31. Clearly, as businesses fail, bankruptcy trustees, receivers, and investors will look back to question how the failure occurred. If they deem the financial statements of the company to have been overly optimistic, litigation is likely, with particular focus on the issue of a going concern analysis by the auditor in many of these cases.

Bankruptcy Trustee Claims

The Federal Judicial Center has reported a rise in "mega Chapter 11" filings and Chapter 7 corporate bankruptcies. In recent decades, numerous battles have been waged by trustees asserting claims against not only directors and officers, but also accountants, lawyers and other professionals for their services to the bankrupt entity, both pre-petition and post-petition. In one interesting case, the Seventh Circuit (Judge Posner) noted *sua sponte* that the trustee's malpractice claim against the auditor of the bankrupt "dot.com" entity appeared potentially frivolous, and suggested the filing of a sanctions motion.[44] The court said that judges must be "vigilant in policing the litigation judgment exercised by trustees in bankruptcy."[45] Many cases have established that a trustee "stands in the shoes of" the debtor company, although certain exceptions may apply.[46] Therefore, accountants have often deflected claims by bankruptcy trustees using the *in pari delicto* defense. Nevertheless, with the tremendous jump in corporate bankruptcies, insurers polled for this article identified concerns about an anticipated rise in both the frequency and severity of claims by bankruptcy trustees.

Deals Gone Bad

Venture capital and private equity firm acquisitions of companies reached new heights in the middle of this decade. In these transactions, it is common for contract provisions to establish the purchase price or investment levels based upon past or projected financial performance of the company. Given the sharp drop in the economy, deals that closed in the months or year before the economic downturn will now look much less favorable to the investors. If the investors can demonstrate that the acquired entity's auditor had knowledge that the audited financial statement would be used by the investors to determine acquisition terms, a substantial hurdle in many of these cases, then a claim may well follow. The privity issue is often paramount in these types of cases. Additionally, accountants who have provided due diligence services to investors may face claims from their client for allegedly not anticipating the negative performance that many companies are now experiencing, but such claims for "failure to read the tea leaves" can be hard to prove.

Lender Claims

Lenders often request the financial statements of their borrowers. In recent years, many lenders were

41 *See* Accounting Standard § 100.69.

42 *See* D&O Diary at www.dandodiary.com/2009/03/articles (March 6, 2009).

43 *See Trenwick America Litigation Trust v. Ernst & Young*, 906 A.2d 168, 204 (Del. Ch. 2006); *Fehribach v. Ernst & Young LLP*, 493 F.3d 905, 908-09 (7th Cir. 2007).

44 *Maxwell v. KPMG, LLP*, 520 F.3d 713 (9th Cir. 2008).

45 *Id*.

46 *See, e.g., CBI Holdings Co. v. Ernst & Young,* 2008 WL 2405702 (2d Cir. 2008).

satisfied with reviewed financial statements and did not demand audited financial statements as frequently as in the past. Lenders will sometimes assert claims against the borrower's accountant, but when those financial statements have been reviewed and not audited, the lender claim will be less likely to prevail. Lenders also encounter difficulties proving the privity, "near-privity" or foreseeability that is required under applicable state law for a suit against the borrower's accountant.[47] But despite these legal hurdles, there arguably exists a kind of "perfect storm" for the proliferation of lender claims against accountants. With the combination of the "credit crunch" impacting lenders' financial stability, and the distressed financial condition of many borrowers who will default on commercial loans, it can be anticipated that lenders will more frequently explore potential claims against the borrowers' accountants.

Surety Claims

As a natural consequence of the credit crunch, the construction industry has dramatically slowed. Many contractors, large and small, have either collapsed or experienced substantial difficulties performing existing contracts or paying subcontractors. Sureties issue payment or performance bonds on construction projects, and when a contractor fails to perform or to pay its vendors and subcontractors, the surety may receive a demand to perform or pay. Sureties have, in this situation, brought claims against accountants for the contractors who have issued audited or reviewed financial statements.[48] Again, the privity issue becomes a significant hurdle for the plaintiff. But, as described by Richard Bale in the Fall 2008 edition of this newsletter, in "New Developments in Accountant Liability to Third Parties," recent decisions suggest that the privity limitation may be a less significant obstacle to claims against accountants. Rick Bale's article addresses two recent cases from New York which arguably somewhat dilute (at least in some specific circumstances) the degree of "linking conduct" or "foreseeability" required between an accountant and the third party who alleges reliance on the financial statements.[49]

Ponzi Schemes

The investment scam perpetrated by New York financier Bernard Madoff is the poster child for Ponzi schemes that have been exposed by the rapid downturn in financial markets. But it is not the only one. There have been literally dozens of substantial Ponzi schemes uncovered over the last two years. Some of the largest include an "electronics" scheme allegedly run by Thomas Petters and a phony investment scheme allegedly operated by Allan Stanford in Texas. The question is whether there are likely to be widespread claims against accountants arising from these schemes. Certainly, the few accounting firms that prepared financial statements for the scheme entities will likely face claims. Interestingly, Madoff used a three-person accounting firm with only one active member to audit his broker-dealer business. Claims have been filed against that firm. But the more substantial question is whether accountants for so-called "feeder funds", and those who invested in the Ponzi schemes, will face liability. Insurance representatives surveyed for this article commented that accountant liability appears more likely for those who provided investment advisory services to their clients as opposed to those who audited feeder funds or investors in the Ponzi schemes. Those who audited the feeder funds or investors arguably did not have to conduct any significant testing of the viability of the ultimate investment. Nevertheless, according to several media reports, dozens of lawsuits have been filed against accounting firms for investors and feeder funds in the highly publicized Ponzi schemes. Those cases have yet to work their way through to any resolution.

Retirement Plan Liability

When the investment value of retirement funds decreases dramatically, there arises the potential for an increase in claims against plan sponsors and plan administrators. However, accountants usually only perform the role of either an auditor of the plan, or a third party service provider to the plan administrator. These roles are typically not considered "fiduciary services" under ERISA or Department of Labor regulations. However, fiduciary status is a question of fact, determined by what the party actually did and not by formal titles or document descriptions.[50] Therefore, if an accountant strays into a role that includes discretion over plan funds, claims may well follows. This becomes a larger concern in the wake of *LaRue v. DeWolff, Boborg & Associates*, 200 U.S. 321 (2008), in which the Supreme Court held that a plan administrator could be sued by an individual plan participant for mismanagement. Prior to that, most federal circuits

47 *See*, *e.g*., *Bank of America v. Musselman*, 240 F. Supp.2d 547 (E.D.Va. 2003).

48 *See*, *e.g*., *Travelers v. Reznick Group P.C*., 2008 WL T12581 (11th Cir. 2008).

49 *See Dinerstein v. Auchin, Block & Auchin LLP*, 41 A.D.3d 167 (N.Y. App. 2007); *Chaikovska v. Ernst & Young, LLP*, 21 A.D.3d 1324 (N.Y. App. 2005).

50 *See Lockheed Corporation v. Spink*, 517 U.S. 882 (1996).

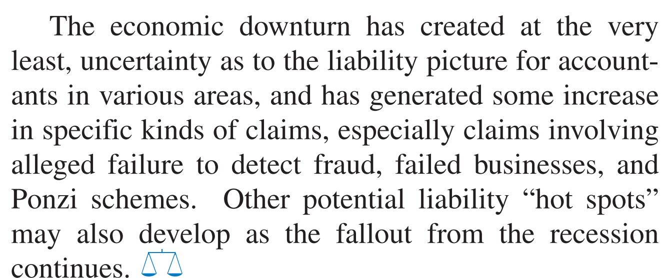
had barred individual participant claims and allowed only claims by the plan itself.

Securities Fraud Liability

Since the Supreme Court held that Section 10(b) does not give rise to a private cause of action for aiding and abetting a securities fraud in *Central Bank of Denver, N.A. v. Interstate Bank of Denver*, N.A., 511 U.S. 164 (1994), there have been several key decisions, which have generally reduced the potential for securities liability claims against accountants. In *Stoneridge Investment Partners LLC v. Scientific-Atlanta Inc.*, 552 U.S. 148 (2008), the court found that there was no private right of action under Section 10(b) for so-called "scheme liability" against third parties who allegedly assisted those who committed securities fraud. Perhaps more significantly, the Supreme Court found in 2007 that a plaintiff who brings a Section 10(b) securities fraud claim must allege facts that establish a "strong inference" that the defendant acted with the required *scienter* (intent to deceive, manipulate or defraud), and if the pleading does not establish this, it should be dismissed.[51] Most recently, the pleading requirement from *Tellabs* was applied to dismiss a securities fraud claim against an auditor where the court held that the "stronger, more plausible inference is that the accountants were, like the plaintiffs, victims of the fraud rather than its enablers."[52] There, the auditors issued opinions on financial statements for several years that had admitted overstatements of earnings, yet the court found the pleading insufficient. Therefore, the case law developments in recent years have made securities fraud claims against accountants substantially more difficult to allege and prove, which may serve to hold down the frequency and success rates of such claims despite increased corporate failures.

Conclusion

The economic downturn has created at the very least, uncertainty as to the liability picture for accountants in various areas, and has generated some increase in specific kinds of claims, especially claims involving alleged failure to detect fraud, failed businesses, and Ponzi schemes. Other potential liability "hot spots" may also develop as the fallout from the recession continues.



[51] *Tellabs v. Makor Issues and Rights Ltd.*, 551 U.S. 308 (2007).

[52] *Public Employees Retirement Association of Colorado v. Deloitte & Touche*, LLP, 551 F.3d 305 (4th Cir. 2009).

DIVERSITY SPOTLIGHT: STACEY J. MOBLEY

Breakthroughs in workplace diversity require a sincere commitment from corporate directors and officers to allocate the resources in furtherance of that goal. Persistence and dedication within the corporate hierarchy is also necessary to establish and maintain an environment receptive to racial, ethnic and cultural differences. Some are slow to change, others simply resist it. Long-term success in diversity initiatives will not be measured by the number of minority candidates hired, but by the retention rate and productivity of those individuals. Demonstrated ability and leadership among minority personnel are two of the best ways to advance the cause of diversity.

The PODL Diversity subcommittee is honored to feature Stacey J. Mobley for this SPOTLIGHT ON DIVERSITY. His more than thirty-five years as a corporate executive have served as a model for the talent that exists irrespective of race. However, his personal commitment to creating more corporate level opportunities for minorities highlights the ongoing need for proactive measures to make workplace diversity a reality.

Mr. Mobley earned his undergraduate degree from the Howard University School of Pharmacy in 1968, and his J.D. from the Howard University School of Law in 1971. He was the first African-American attorney hired by E. I. du Pont de Nemours and Company ("DuPont"); a $30.5 billion research and product development company operating in more than 70 countries around the world. While at DuPont, Mr. Mobley was named a senior vice-president in 1992 and he served as general counsel and chief administrative officer from 1999 to 2008. He further served as a member of the company's six-member office of the chief executive. Mr. Mobley retired from DuPont in June, 2008 and he is now in private practice.

Recently, Mr. Mobley took time to share with the PODL Diversity subcommittee some of his personal experiences and thoughts related to workplace