

Accountant Legal Issues Newsletter

A Newsletter from the Accountant Legal Issues Group

Winter 2010

Briefly Stated

PPEC's recent engagements include representing a firm with a high deductible in negotiating a resolution to a malpractice claim well under the deductible; advising an accounting firm as to its options in responding to a lender's request for confirmation of the value of a business which has been a long-term client of the firm and for which the lender was providing buy-out funding; advising a CPA firm as to the risks involved in forming a joint venture with a management company, under the terms of which the firm would undertake the responsibilities of performing a tax engagement for each company managed by the management company; and advising a CPA firm as to its responsibilities upon learning, in confidence, that management twice deliberately diverted receipts to a separate bank account and overstated its accounts receivable, in order to meet its cash needs and mask a violation of interest coverage loan agreement provisions.

PPEC's accountant liability team includes attorneys **Gary H. Barnes**, **Gary F. Karnedy**, and **Jon R. Eggleston**. For a description of the services we provide to accounting firms, please visit our website at www.ppeclaw.com.

ACCOUNTING FIRM ESCAPES POTENTIAL LIABILITY TO NON-CLIENT THROUGH STATE STATUTORY PRIVACY REQUIREMENTS



By: *Gary H. Barnes and Gary F. Karnedy*

Does your firm limit a non-client's right to rely on your audit, review or compilation work in its written engagement letter? If not, it should. Read on.

A non-client recently sued a New York accounting firm, in the U.S. District Court for the District of New Jersey, claiming that the Accounting Firm furthered a fraudulent leasing scheme by preparing financial statements and audits that did not reflect the true financial condition of its guarantor, Allserve Systems Corporation ("Guarantor").

The Accounting Firm audited Guarantor's financial statements and issued an Independent Auditor's Report on June 23, 2004. After reports surfaced that Guarantor was involved in securities fraud, the Accounting Firm investigated and found discrepancies in the audited financial statements. The Accounting Firm retracted its Auditor's Report and demanded that Guarantor return all copies of the report. However, the Accounting Firm was unable to recover all copies of the reports or learn the identity of all recipients. On October 12, 2004, the Accounting Firm issued

a revised Independent Auditor's Report stating that the original report should no longer be relied upon and disclaimed any ability to issue an opinion as to Guarantor's finances.

Unaware that the Accounting Firm had retracted the original June 2004 Independent Auditor's Report, Overland Leasing Group, LLC ("Overland") paid \$1,024,826 to Fortan Group International, Inc. for the assignment of a master lease agreement with Guarantor. Overland's investment decision was based, in part, upon the apparent financial strength of Guarantor as reflected in the Accounting Firm's original Independent Auditor's Report. Eight months later, Guarantor went belly up and left Overland with a substantial unpaid balance under the lease agreement.

Overland sued the Accounting Firm for malpractice and misrepresentation, claiming that the Accounting Firm had negligently or intentionally misrepresented the true financial condition of Guarantor, which in reality was on the verge of bankruptcy.

The Court disagreed. Although it was argued that the Accounting Firm should have known of Overland's potential future reliance on its work product (*i.e.*, that Overland's reliance was foreseeable), the Court ruled that under New Jersey statutory law an accountant could not be liable to a non-client unless the accountant had, among other things, directly expressed to the non-client (in words or by conduct) his understanding of the non-client's intended reliance upon the accountant's work product. The Court found that there was no evidence that the Accounting Firm had ever directly expressed such an understanding to Overland.

The Accounting Firm in this case dodged a bullet. Guarantor distributed the Accounting Firm's reports to multiple parties without any disclosure to the Accounting Firm about who the recipients of the reports were.

When the discrepancies in the audited financial statements were discovered, the Accounting Firm was left to retrace Guarantor's distribution of the Accounting Firm's report. Ultimately, the Accounting Firm benefitted from New Jersey's statutory restriction concerning an accountant's liability to non-clients, avoiding the application of the "foreseeability" standard followed in many other states across the country. Under a different state's law, the Accounting Firm may not have had the same favorable outcome. This case demonstrates the importance of dealing with the potential use of an accountant's work product by both known users (a topic covered in our last newsletter) and unknown users.

Preventing accounting firm liability from unknown third parties reliance upon an accountant's work starts with the engagement letter. A client engagement letter should not only identify those persons authorized to use the accountant's work product, but it should expressly prohibit the client's distribution of the accountant's work product to any third party not identified without the accountant's express written consent. It should also impose an affirmative contractual obligation on the client to disclose in writing any unauthorized third party to whom an accountant's work is distributed (whether intentionally or mistakenly). This helps to ensure that the accountant is made aware of unanticipated third party use at a time when the accountant can still prevent, qualify or disclaim the non-client's right to rely on the accountant's work.

Another approach that some accounting firms have adopted is a "shrink wrap" clause, bound together with the auditors report and the client's audited financial statements. Akin to licensing agreements that take effect when a purchaser breaks the shrink wrap on a package in which software is contained, an accountant's "shrink wrap" agreement with third parties might read:

Attention Users of This Audit Report. This Audit Report is prepared for the exclusive use and reliance by our client, [client name], and such other third parties whose use was known to us at the time we planned our audit procedures, under the terms and conditions of our Engagement Letter. Others who rely upon our audit report shall be deemed to have agreed to certain terms, conditions, caveats, and limitations set forth in our Engagement Letter with respect to users unknown to us at the time of our engagement. Such users may obtain a copy of these terms, conditions, caveats and limitations by request to [name and address of accounting firm].

To be added to the distribution list, send an e-mail to gbarnes@ppeclaw.com and be sure to include the recipient's name, address, phone, fax, and e-mail address. Please keep us apprised of any changes, particularly changes to your e-mail address.

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This publication is intended to provide current information, but should not be relied upon as providing definitive legal advice. No attorney-client relationship is created by this newsletter. You should consult with an attorney concerning the application of any issues discussed in this newsletter to your facts and circumstances.

Of course, the Engagement Letter should be appropriately drafted to set forth both your understandings concerning known third party users and concerning unknown users. Contact us for more information if you would like to protect yourself from suit by unknown third party users.

Reminders

What interests you? Let us know and we will keep an eye out for developments in your areas of interest.

Feel free to forward this newsletter to persons who may be interested in receiving it. We are pleased to add your friends and colleagues to our distribution list. We are always looking to expand the list of recipients. If you have a friend or colleague who may be interested, please send them our way. Malpractice insurers and accountant peer-reviewers usually find this e-newsletter to be particularly helpful.