

# Managing Professional Liability Litigation Against Accounting Firms (Part 1)

By Mitchell Bryan and Russell I. Shapiro

*This is Part 1 of a three-part series discussing the basic components of a professional liability lawsuit brought against an accounting firm and its partners, and the factors a firm's managing partner should consider before and during this type of litigation for utilizing applicable insurance coverage, maximizing effectiveness of defense and, where possible, bringing the controversy to conclusion by settlement. Part 1 focuses on the current litigation environment for accounting firms, relevant provisions in engagement letters, responding to subpoenas, professional liability insurance, and the risk of instigating a professional liability counterclaim in a fee-collection action. Part 2 will cover differences between litigation in state and federal courts, and in private arbitration, initial assessment of a professional liability claim, development of defense strategy, and the stages of litigation from the initial pleadings through discovery. Part 3 will cover the latter stages of litigation from summary judgment proceedings through trial and will conclude with the mechanics of and strategies for settlement negotiation.*

An unfortunate reality among accounting firm managing partners (MPs) is that at some point—if not more than once—while serving as MP, a client will sue one or more of your partners and the firm itself for professional malpractice. As primary leader of your firm, at first you will experience disbelief and denial that a client has blamed your partners and firm for a financial reporting error the client itself caused, mostly or entirely due to its own incorrect accounting entries, which normal and proper review procedures were not designed or intended to detect or correct. Once past the initial grief, anger, or both, as your firm's leader, you will need to move forward by working with lawyers that you, your firm's general counsel, or its professional liability insurer have selected to defend the claim, toward navigating the matter to resolution. This article will aid the accounting firm MP in traversing, with the guidance of legal counsel, the typically rough terrain encountered in defending a professional liability lawsuit. Readers of this article will be able to sleep at night while dealing with this challenge, in part, because they and their firms were prepared for it well before the lawsuit was filed.

## Litigation environment for accounting firms

Before looking at how you and your firm readied yourselves for the humbling, potentially devastating experience of being sued for an alleged professional error, let's briefly consider what industry analysts have been seeing in the accounting malpractice arena. This subject has been addressed by at least two research teams in recent years. In 2011, professor Ross Fuerman and his team at Suffolk University conducted a pre- and post-Sarbanes-Oxley study of 1,169 lawsuits filed from 2001 through 2008. The results showed a perceptible decrease in auditor liability risk and award size. Similarly, a 2009 study by the Ives Group reported that securities class action lawsuits against the "Big Four" firms peaked in 2003, against second-tier national audit firms in 2003 through 2007, and against third-tier regional audit firms in 2003 and 2004.

The less-encouraging news is that accounting malpractice suits persist as a byproduct of fraudulent activities by businesses and individuals in the aftermath of the recession and financial crisis. There are few major bankruptcies, liquidating receiverships, or bank failures where the failed entity, its insolvency fiduciary, creditors, or investors do not take a close look at whether a viable malpractice claim can be asserted against the defunct entity's former accountants. This type of investigation is made routinely toward tapping the accountants' professional liability insurance as a source of partial repayment of creditors.

## Engagement letters

Once served or threatened with a malpractice suit, the first line of defense will be your firm's engagement letter with the client. The engagement letter should be in place long before the alleged professional error occurs. Apart from scope and reliance limitations, there are a number of key provisions your firm should include in its standard engagement letter, most of which are procedural, that may be pivotal in positioning a successful defense. One such provision is a clause requiring that any dispute relating to the engagement be resolved by binding arbitration.

Arbitration is not a complete antidote for the extraordinary expense, bad publicity, and punitive damage ex-

posure commonly associated with lawsuits filed in state and federal courts. But, arbitration does tend to lessen these types of disadvantages of formal legal action. Although comparative advantages of arbitration over conventional litigation have been questioned in recent years, on balance, arbitration is completed faster than a lawsuit, incorporates principles of equity and fairness more so than conventional litigation, and often is more conducive to achieving pre-trial settlement.

Sometimes accompanying an arbitration clause, or in the absence of such, is a preliminary requirement that the accounting firm and former client first attempt and exhaust efforts to mediate the dispute with an independent neutral intermediary as a pre-condition to initiating arbitration or litigation. In the absence of an arbitration and/or mediation requirement, an engagement agreement should include a waiver by the client to any right it may have to a jury trial in a state or federal court lawsuit. This will help contain the otherwise time-consuming and expensive procedures associated with jury trials and also will minimize potential exposure to punitive damages more readily awarded by juries than by judges in bench trials.

The engagement letter also should include a provision requiring the client to consent to resolving any dispute in the jurisdiction where the accounting firm's main offices are located. While the engagement staff, relevant records, and other witnesses may very well be situated in a jurisdiction where the client is located, being compelled to arbitrate or litigate in the accounting firm's home territory generally places the client and its lawyers at a disadvantage. A further deterrent to a lawyer-driven or otherwise baseless claim by a former client is a provision entitling the accounting firm to recover from the former client attorney fees and all other legal expenses resulting from a dispute involving the engagement when the accounting firm is the prevailing party. Often seen as distasteful or sending the wrong message to a client at the outset of an engagement unless drafted to benefit the client reciprocally if it were to prevail in a dispute, fee-shifting provisions are too often omitted from accounting firm engagement letters.

Another provision that belongs in an engagement letter is one requiring the client to reimburse its accountants for legal fees and other expense resulting from a document or testimony subpoena seeking information involving the engagement. Litigants subpoena their opponents' accountants not only so they can serve as expert guides to financial and other details involved in business disputes, but also as a means of investigating the accountants' involvement in the preparation and review of data

and in decisions underlying the dispute toward implicating the accountants. The significant cost of searching for, reviewing and assembling documents, and analyzing potential professional liability exposure can and should be borne by the client by operation of the engagement letter. While many accounting firms once hesitated to include such a provision—out of concern that the client would view it as oppressive and unfair—it is now seen in most accounting firm engagement letters.

### **Responding to subpoenas**

Apart from whether the client or accounting firm pays for compliance, for reasons noted above, care should be taken in responding to a subpoena. Often enough, a subpoena forewarns of a possible claim against the accountants by the client or its creditors or, in some instances, a criminal indictment by a grand jury. Accountants are subpoenaed not only in civil lawsuits, arbitration, and regulatory matters involving their clients, but also in grand jury investigations targeting their client for tax fraud, racketeering, or other white collar criminal prosecution.

Judges, arbitrators, and regulatory hearing officers normally limit the scope of a nonparty subpoena more so than the scope of discovery served on a party. Such protection is invoked by timely served and properly drafted objections. Applicable procedural rules typically require the serving party to obtain a ruling on a respondent's objections to over-breadth or otherwise unduly burdensome or oppressive information requests in a subpoena. Battles over such objections can be particularly vigorous with respect to email and other electronically stored data, which can be a potent source of evidence—and which also can involve a very high cost of retrieval and prior review for privileged communications.

No different from a litigant complying with written discovery requests or deposition questions, a subpoena respondent should take precautions to avoid disclosure of written or oral privileged communications. So too should precautions be taken, by written objection followed by a stipulated or court-imposed protective order, to safeguard a subpoena respondent's trade secrets, proprietary information, or other confidential data within the scope of information sought by the subpoena. To avoid confusion between documents subpoenaed from accountants and those produced by their clients, other litigants, and other nonparty witnesses, and to facilitate orderly deposition of an accounting firm's partners or staff, all produced documents should be branded with control numbers—including a prefix identifying the subpoena respondent who produced the documents.

## Professional liability insurance

An accounting firm MP should understand his or her firm's errors and omissions liability policy and its notice requirements that are a pre-condition to obtaining coverage. A professional liability policy ordinarily provides "claims made" coverage only for claims made, threatened, or apparent *and reported to the insurer* within the effective period of the policy or any agreed-upon extension of the claim reporting period after the current policy term expires. The "declarations" and "coverage forms" of such policies will state:

- primary and any excess liability coverage limits;
- amount of the deductible or self-insured retention amount the firm must pay before the insurer is obligated to start paying or reimbursing for defense costs;
- whether covered defense costs include expense of government or internal investigation;
- whether defense costs paid erode the primary coverage limit;
- whether any sub-limits, deductibles, or both apply to any special coverage (*e.g.*, for investigation costs);
- technical compliance required for notification to the insurer of an actual, threatened, or apparent potential claim (*i.e.*, circumstances the firm reasonably believes could result in a claim); and
- various exclusions that negate coverage otherwise provided under the policy.

Given that most accountant malpractice lawsuits settle before trial, perhaps the most important component of professional liability insurance is the insurer's duty to defend its insured. On certain types of claims, it is the insurer's only duty. Where coupled with a duty to indemnify for any actual liability an insured accounting firm is required to pay, an insurer's defense obligation also includes a duty to settle a claim, if possible, for a reasonable amount within the policy limits.

In performing its defense obligation, a professional liability insurer ordinarily is entitled to select defense counsel, although some policies permit the insured to do so. A conflict between the insurer and insured sometimes exists, such that the insurer must pay for independent defense counsel of the insured's own choice. Some jurisdictions recognize such a conflict and impose this obligation on the insurer when a policy exclusion may or may not apply depending on which alleged facts or which of two or more alleged theories of liability potentially could be proven at trial. When this occurs, the insurer will defend the claim under a "reservation of rights," and counsel selected by the insured accounting

firm is entitled to control defense free from direction by or any attorney-client duty to the insurer.

When allowed or entitled to select its own defense counsel, the insured must pay any differential between billing rates regularly charged or specially negotiated by its attorneys and lower rates the insurer pays lawyers it routinely hires to defend claims. To comply with the insured's obligations under the "cooperation clause" found in every insurance policy, independent defense counsel must periodically report to the insurer's own in-house "claims attorney" the progress of and significant developments in the case, risk of liability at trial, any settlement demand by the plaintiff client—and any settlement offer the accounting firm proposes to make. Generally, as a pre-condition to funding settlement, the insurer must approve as reasonable any settlement proposal made by the policyholder.

Often, particularly when the insurer is defending a claim under a reservation of rights, the insurer's internal claims attorney will participate in mediation or other settlement meetings. Judges or arbitrators sometimes require such participation. In major cases, the insurer's claims attorney will attend trial toward determining whether to pursue settlement efforts before a court, jury, or arbitrator issues its decision on the merits of the claim.

### Risk of counterclaim in a fee-collection action

Common sense and practical experience suggest that suing a client for unpaid professional fees substantially increases the risk of the delinquent client suing its accounting firm for professional malpractice. This must be carefully considered in deciding whether to sue a former client.

Before attempting to collect fees in court or arbitration, an accounting firm should closely scrutinize any practice issues that arose and negatively impacted the client and its relationship with the firm during the engagement. In conducting such an investigation, legal counsel should participate not only to facilitate objective evaluation of any potential professional liability, but also to insulate with attorney-client privilege what might later, in the context of litigation, be viewed as sensitive or damaging communications about professional work performed for the former client. Consideration also should be given to any financial or operating difficulties of the client that led to nonpayment of professional fees, or related disputes with third parties, which potentially could influence the client to defend a fee-collection suit by alleging that its former accountants committed professional negligence.



Against this backdrop, earnest and exhaustive settlement efforts are almost always advisable before suing a former client for unpaid fees. When a client has warned its former accountants that any legal action to collect fees will result in a counterclaim for professional negligence, consensual mediation by an independent neutral intermediary should be considered and, if appropriate, proposed to the former client as an alternative to formal legal action. Equally if not more important, any such warning should cause the firm's managing partner and legal counsel to check the firm's malpractice insurance policy to determine whether it requires the firm to give the insurer written notice of "circumstances the insured reasonably believes could lead to a covered claim"—regardless of whether a decision is ultimately made to sue for unpaid fees. Again, settlement of the fee claim should be a managing partner's primary goal. †

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