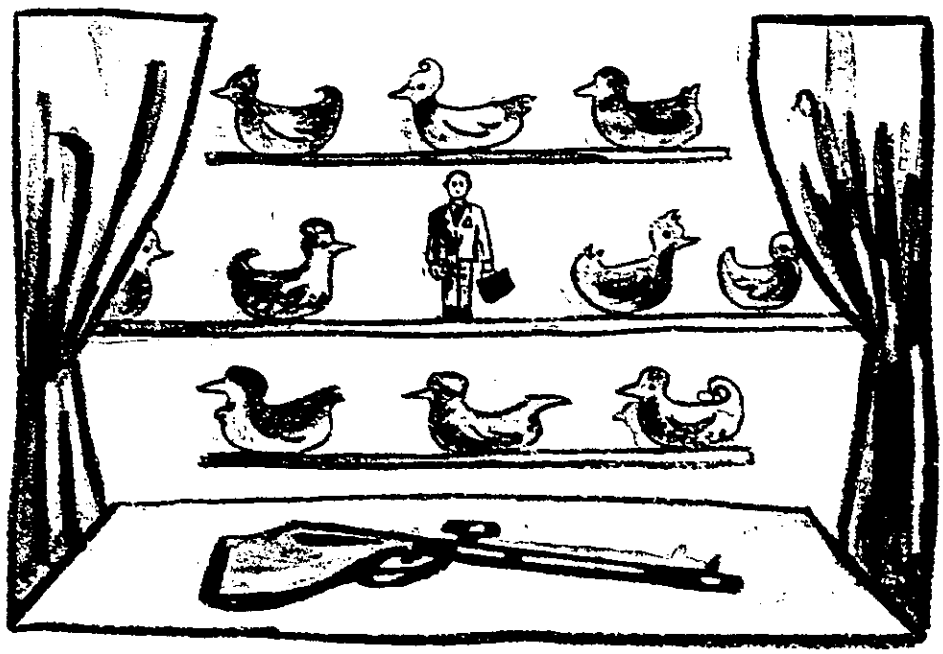
IS YOUR FIRM A CANDIDATE FOR A LAW SUIT?

Your firm can dramatically reduce the chance of being sued by a disgruntled client.

If you were told your firm is being sued for malpractice and the papers would be served tomorrow, could you guess who is the most likely client that is suing your firm? If you can't come up with a possible name maybe you believe that your firm only has clients that are very happy with your firm's work and are in excellent financial shape. Not likely. Another possibility is that you are not currently thinking in terms of a client engagement ultimately ending up in litigation. A distinct possibility. Or most likely, you are saying that it is impossible to predict who would sue and, regardless that is why you have malpractice insurance to take care of claims like that.

Insurance offers only partial protection. Large deductibles are a threat to the profitability of even the strongest firms and are often consumed in just a few months by legal costs. Also, insurance provides no coverage for the hidden costs.



LETICIA PLATE

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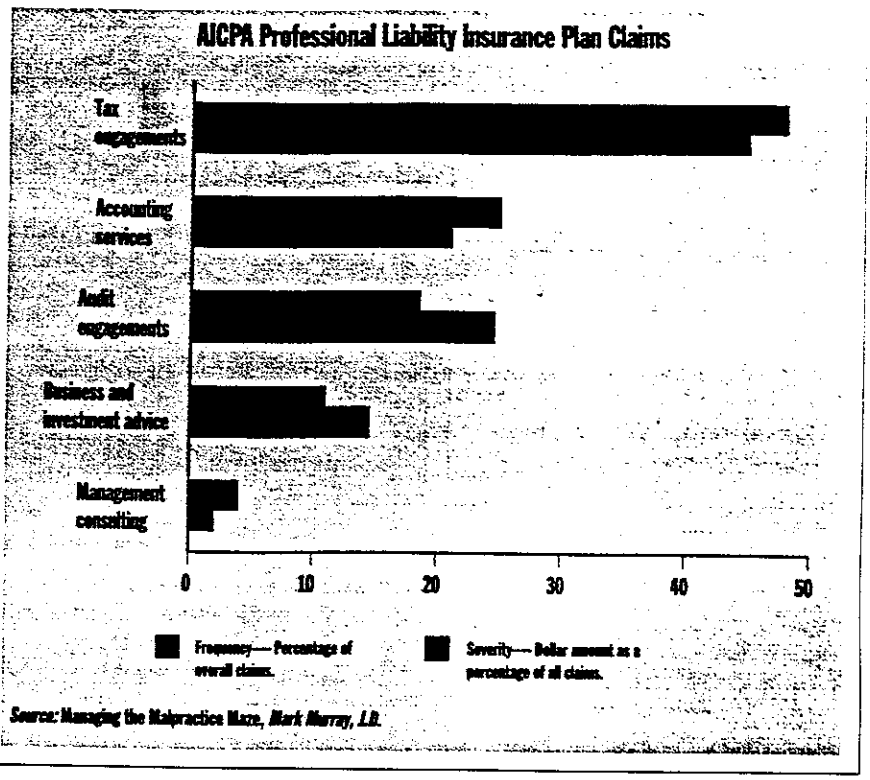
• *Time loss.* Litigants spend copious amounts of time reviewing their files, educating their attorney, experts and the other side's attorney about their files and technical standards, testifying before a judge or jury, as well as reading a blizzard of paperwork and wading through endless court appearances, conferences and meetings.
• *Distraction.* A claim always remains on the accountant's mind.
• *Emotional.* The accountant often keenly feels shame and humiliation of being sued for malfeasance, especially during the initial stages of a lawsuit.
• *Professional reputation.* Although uncommon, adverse publicity about a high-profile lawsuit or large settlement can shatter a hard-won reputation for excellence and result in a loss of business.

The increase in lawsuits against accountants is partially due to the pressures of a "no fault" society where an individual is less likely to accept responsibility for his or her own conduct, decisions and just plain bad luck. This all too often leads people to blame their troubles on others.

This factor is compounded by the advent of "consumerism." Rightly so, buyers of goods and services are more vigilant than ever about receiving fair quality at a fair price. However, the cynicism fostered by scandals in our top governmental, financial and cultural institutions all too often combines with normal skepticism to generate a litigious impulse.

The picture is completed by the lack of any significant barrier to the courtroom. "Notice pleading" allows an aggrieved party to sue on very little pretext, then use liberal discovery procedures to attempt to develop a claim through the accountant's workpapers and deposition testimony. Judges are often reluctant to dismiss cases unless there is no possible way that a reasonable person could construe evidence in favor of the plaintiff. Contingent fees allow a plaintiff to prosecute enormously expensive litigation — without spending a single penny.

CLAIMS BY TYPE OF ENGAGEMENT



Source: Managing the Malpractice Maze, *Mark Murray, J.D.*

The best way to beat this system is to avoid it.

Reduce Your Risks

The most important step that an accountant can take in attempting to avoid the chance of malpractice claims and litigation is to develop the ability to recognize warning signs and to adopt a "defensive practice" frame of mind. This entails adopting the attitude of a defensive driver: constantly staying alert and being prepared to hit the brakes or take evasive action when trouble appears.

Identify dangerous clients. The most important litigation risk factors are the personality and character of the client. Indeed, the accountant's rueful expression, "I knew that guy was trouble a long time ago," almost always follows service of legal process in a malpractice case. Aggressive and demanding, often filled with anger at the "system" or those perceived to be more powerful, this personality type has an overwhelming tendency to blame adversity on external factors. Symptoms of this personality type include chronic complainers, those with a history of numerous, mostly short-lived professional relationships, clients cynical enough to cheat on taxes or their partners and clients who are often in court or who view litigation as a "tool" to achieve business ends. Rapidly growing start-up companies, and public companies of almost any stripe, require extraordinary caution.

Some experts suggest that accountants should routinely end their relationships with 10% of their clients, on the theory that everyone has some "bad apples." But this arbitrary approach unrealistically ignores the economic pressures facing most practitioners. In extreme cases, however, a client should be "fired." But most often, a heightened sense of caution and the implementation of enhanced defensive practices will

suffice. Special caution is needed when "firing" a client—which should be done between engagements and in writing.

Reduce high-exposure engagements. Some engagements are just inherently risky. These engagements include audits for construction companies, savings and loans, grain elevators and rapidly growing, publicly owned start-up companies. Clients who are in financial trouble are also prime candidates to resort to litigation. Although the largest source of new malpractice claims continues to be tax work, such claims are typically not as large and are often more easy to resolve.

Small, closely held corporations deserve special mention because of their unique nature. All too frequently, accountants who serve this clientele find themselves embroiled in litigation, following disputes between minority and controlling shareholders.

"Rush projects," with unrealistically short deadlines, should be avoided like the plague. The fact that you didn't have enough time to adequately perform the engagement will not be a defense.

Review and compilation engagements generate a large proportion of claims. Remember that relaxed financial statement reporting responsibilities are not always understood by the client — or enforced by the courts.

Try to mediate. If you sue a client to recover a fee, you will probably be counter-sued for malpractice. The cost of defending against such a counterclaim will almost always outweigh the benefits of even a full recovery — and if the counterclaim has any merit, the results could be disastrous. In short, don't kick any sleeping dogs. Instead, dun clients shamelessly and often, and settle or mediate all fee disputes. If you settle for a discount, be sure to get a complete release of all possible claims.

Just because one should never say "never," it might be wise to beat a client to the punch by starting a suit to recover a fee, where suit by the client is inevitable, to obtain the tactical advantages available to plaintiffs.

Don't volunteer blame. When talking about a complaint with a client, or even when disclosing an adverse result to the client, we all have a natural tendency to offer an apology. This is doubtless nothing more than a continuation of the normal view that client relations are best served by always agreeing that the client is right. There is also a normal desire to express sympathy and empathy for the client's plight. In the wrong context, however, these benevolent impulses can be easily misunderstood by a client as an admission of fault — and as an invitation to serve lawsuit papers upon you.

Don't cut corners. No one likes to work for a cut rate, and hardly any compensation system ever fairly rewards those individuals who work on discounted engagements. All too often, such engagements are performed inadequately by employees eager to go onto more lucrative work. The fact that the accountant cut corners because the client didn't pay for (or couldn't afford) a proper effort is not a defense.

Always have an engagement agreement. The lack of a clearly stated, written agreement with each client, on *each* engagement, creates fertile ground for claims.

End relationships carefully. The failure to deal fairly with a client at the termination of a relationship, consider all possible ramifications of such a termination and to document the circumstances surrounding the end of a professional/client relationship can be fatal. Also, remorse over the loss of a client or an overzealous desire to help a client should not lead an accountant to turn over all workpapers to the client, absent a very strong reason. A request by a former client for unbridled access to all workpapers is often nothing more than an attempt to see if grounds exist for bringing a lawsuit.

The sensitive nature of ending a professional-client relationship may warrant seeking advice from another

partner, or even from a knowledgeable attorney. The documentation of all communications is mandatory at the withdrawal stage.

Monitor colleagues. Some of the worst claims have stemmed from work by an accountant whose personal financial, emotional or marital problems were associated with misconduct ranging up to gross negligence or intentional dishonesty. Stay in touch with your colleagues.

Eliminate conflicts of interest. Performing an engagement where the accountant's loyalty is at all divided between competing interests is filled with risk. Even the most innocent or "normal" conflict between multiple clients with divurgent interests, served simultaneously by an accountant, can provide the basis for a claim. The existence of a conflict can catapult the most innocent mistake into a claim for aggravated liability.

Protective Steps

There are a number of specific steps, *i.e.*, standard operating procedures, that accountants can routinely take to insulate themselves from the chance of being sued. These would apply to all your dealings with all the clients of your firm.

Consult with an attorney, or at least an objective and uninvolved partner, whenever you have a concern about a client or a difficult situation. When documenting your advice about complex or important matters, be sure to write clearly and in simple terms, explaining the client's options and the risks of each option. Whenever possible, follow up client communications with a letter making it clear that the client "decided," "elected" or "agreed" to the action to be taken, or to refrain from acting.

Make sure that billing statements and time entries correlate precisely with the work done on an engagement. Discard all of the preliminary and working drafts of opinion letters and workpapers and before closing your file, discard all informal "to-do" or

procedures checklists. Make certain that all formal checklists show that each task was in fact completed. Be aware of who your client is, at all times, and never take sides in a shareholders' dispute.

Write a strong management letter, particularly when describing weakness in a client's control environment. If your client has an audit committee, make sure that the management letter is sent to the audit committee. In the absence of such a committee, be sure that the outside directors are supplied with the management letter.

If You Are Sued

As soon as there is any basis on which to suspect that the client is considering a claim, *notify the insurance carrier.* There is simply no excuse for not telling the insurer about a claim or potential claim. Often, claims personnel will be able to provide advice on what to do. This will frequently involve the retention of a defense lawyer skilled in handling claims brought against accountants. Taking the proper steps and precautions before suit is commenced, or as soon as possible after suit is commenced, can be critical to the outcome of a claim.

Adopt control procedures. At the accounting firm level, procedures should be adopted for reporting and managing claims. The professional alleged to be responsible for the claim should *never* control decision-making about how to handle or resolve the claim. The objectivity of the accountant who is targeted by the lawsuit is invariably clouded. Decisions about how to handle the litigation or whether to settle are simply too important to be left in such hands.

It is important to limit the number of firm members who are involved in discussions about the claim, because any discussions within the accounting firm can be subject to discovery by the opposing party. All important discussions and decisions should be made in the presence of either personal or defense counsel, to shield them within the protection of the attorney-client privilege. Similarly, in-office memos describing the case and its background, should be addressed to legal counsel — not to the firm, its managing partner or policy committee.

The physical integrity of the firm's files, workpapers and time and billing records should be promptly and completely secured. Only those who absolutely need the file should be allowed to see or have access to it.

Maintain contact with attorney. Although the insurance company usually has the contractual right to select defense counsel, the accountant should keep in mind that the attorney represents the accountant — and not the insurance company.

Defense counsel should be required to report regularly to the accountant, in writing, advising of all activities on the file, all planned activities and the outcome of all discovery, motions and court procedures. The accountant should also insist upon receiving a written case evaluation from defense counsel.

If the amount of damages claimed from the accountant will, or might, exceed the malpractice policy limits, the accounting firm should routinely monitor the billings of defense counsel. Also, since most insurance policies now provide for the reduction of coverage limits, once the deductible has been satisfied, by the amount of fees and costs incurred by the insurer, counsel's fees should be tracked. Where large claims are presented against policies with relatively low limits, the declining balance of policy limits can pose a direct threat to the financial viability of the defendant accounting firm.

Get involved in defense. Defense counsel welcome the accountant's active involvement and participation in the defense of any claim. Timely response to telephone and written inquiries, prompt disclosure of information necessary to satisfy the reasonable discovery requests of the opposing side and diligent attendance at conferences and court appearances, go a long way toward facilitating the defense. The defendant accountant and his or her firm can be especially helpful in recommending a satisfactory defense expert and in working with the expert.

Perhaps most importantly, the defendant accountant should be prepared to take the time necessary to help defense counsel recreate all aspects of the work performed on the engagement. This will require the exhaustive review of all pertinent workpapers and technical standards, bulletins and the like. Often, this will have to be done more than once during the course of a litigation.

At the outset of a case, a thorough knowledge and understanding of all facts, including the strengths and weaknesses of the accountant's position, will allow the defense lawyer to plan the most effective defense against the malpractice claim. Later, when the accountant's deposition is taken, a thorough knowledge of the workpapers and pertinent professional standards will go a long way toward leveling the playing field between adverse counsel and the accountant. Ultimately, before the case goes to trial, this preparation will again be essential to allow the accountant to testify effectively.

Consider settlement. While no one should settle a meritless claim, accountants should dispassionately weigh the pros and cons of proceeding to trial, including: (1) the tremendous loss of time to prepare for and attend trial, (2) the risk that a trial will stir up adverse publicity, particularly if the result is negative, and (3) the inherent unpredictability of juries and judges.

In the event that settlement is deemed advisable, the accounting firm should attempt to negotiate the broadest possible release, covering all possible claims, with an acknowledgment by the opposing party that the settlement is not an admission of liability and a confidentiality agreement that would limit discussion of the claim.

Practitioners who practice defensively, with a constant vigilance against risky situations, clearly reduce the risk that they will be sued. Those who actively take preventative steps can also minimize the adverse consequences, if a suit is brought. Finally, a timely and business-like response to a malpractice claim, combined with energetic and cooperative participation in the defense of a litigation, can help the firm attain the best possible outcome and limit disruptions to its continuing operations. ■

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