

Managing Professional Liability Litigation Against Accounting Firms

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Part II of III

This is Part II 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 take into consideration 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 I covered 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 II focuses on the 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 III will discuss the latter stages of litigation from summary judgment proceedings through trial and will conclude with the mechanics of and strategies for settlement negotiation.



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Defense of a Professional Liability Lawsuit

As seen in Part I of this series, a number of pre-suit measures and decisions can significantly affect whether and how an accounting firm is positioned for defending a professional malpractice suit. Your firm's preparedness to defend a malpractice claim is put to the test, of course, only upon failure to resolve a controversy with a former client or one or more of its creditors through alternative dispute resolution efforts. At that point, in addition to complying with reporting obligations to primary and any excess insurers, a careful assessment must be made of any procedural options that are available only if invoked at the outset of a lawsuit, electronic and printed document preservation obligations, and substantive defense strategies that are implemented through pre-trial motion practice and discovery. Since most professional liability suits are settled before trial, the pre-trial stages of litigation discussed below ordinarily will drive the outcome of a lawsuit against your firm.

State Court vs. Federal Court vs. Arbitration

After being served with a professional liability complaint in a state or federal court action, where contractually agreed or otherwise legally permitted, it can sometimes be advantageous to transfer the case to a different court or to arbitration. Whether this is possible and advisable is a matter to be addressed by defense counsel for evaluation on a case-by-case basis.

Where an accounting firm and its client agreed to resolve disputes by arbitration, assuming they do not mutually or by acquiescence decide to waive their separate right to arbitrate, action to enforce that right must be taken at the very first opportunity to avoid a waiver.

Trial attorneys often feel that a federal court lawsuit is more rigorous and quickly completed, more expensive, and more reliable than in state court, due to the presence of highly qualified judges and law clerks. Such generalizations are understandable, although not universally accurate, and can be useful only when verified in a particular jurisdiction. Even if an engagement letter fixes venue exclusively in a federal court where the accounting firm or its client are located, a state court complaint can be transferred to federal court only if federal

subject matter or “diversity of citizenship” jurisdiction exists. The former requires assertion of a claim under federal law, while the latter requires that all plaintiffs as a group, and all defendants as a group, be citizens of different states with an amount in controversy of at least \$75,000.

Where federal question or diversity jurisdiction exists in a case filed in a state court, within thirty days after service of the complaint an accounting firm defendant is entitled to “remove” the case to a federal court in the geographic district where the complaint was originally filed.

Absent an exclusive venue provision in an engagement letter, regardless of whether the lawsuit was filed in state or federal court, or removed to federal court, statutory venue rules or common law principles sometimes will enable a defendant accounting firm to obtain a transfer of the case to a more appropriate jurisdiction. By statute in federal court lawsuits, or in state court cases under the doctrine of *forum non conveniens*, such a transfer can be accomplished only when most or all witnesses reside or work, and most or all documentary or other evidence is located, in a jurisdiction other than the one where the plaintiff filed the lawsuit.

Initial Assessment of Claim and Development of Defense Strategy

After absorbing the initial impact of being sued for professional malpractice, a sober look at the lawsuit must be taken with defense counsel to develop realistic goals and expectations in defending the suit and navigating it to an acceptable outcome. At the outset, it ordinarily is not possible to determine whether the claim can be defeated. The ability to defeat the claim will depend on defense counsel first gaining an understanding of applicable accounting principles, auditing standards, and/or any AICPA practice guidance viewed in the light of the standard of professional care applicable in the state jurisdiction whose law governs your firm’s relationship with its clients. It also will depend on defense counsel’s ability, assisted by professionals in charge and otherwise working on the engagement, to assemble evidence and witness testimony showing, convincingly, that those individuals in all respects exercised the applicable standard of professional care in performing the engagement.

An additional, critical component of defending and defeating the claim will be securing testimony of one or more qualified and capable expert witnesses who can explain to the trier of fact how and why the defendant professionals exercised the requisite level of care in performing the engagement. A common mistake in defending an accounting malpractice suit is waiting until pre-trial discovery is well underway before engaging an expert witness on the accounting, auditing, or other professional standard compliance issues in the case. While this generally results from a misguided effort to defer all but unavoidable defense costs, it also wastes a valuable early opportunity to assess the strength and target weak spots in the plaintiff’s liability and/or damages theory for purposes of planning focus and strategy of fact development through pre-trial discovery and independent investigation by defense counsel.

To effectively develop initial goals and expectations in a cost- and time-efficient manner as early in the case as possible, defense counsel must identify the critical legal and factual issues that will drive the outcome of the case. The key concept here is isolating the “critical” issues.

It is only by first identifying the specific professional accounting standards that were central to performing the engagement that defense counsel can pinpoint whose and what actions,

omissions, and documentation will bear on whether the professionals met those standards and whether the acts, omissions, or other conduct of the client or others were the primary cause of the accounting or financial reporting inaccuracy or error that resulted in the clients' or its creditors' financial loss. This process will enable defense counsel to develop a plan for investigating, collecting, and organizing witness testimony and documentary evidence to build a concise, coherent story explaining your firm's side of the case.

Early on in the case, your firm's professional liability insurer will want defense counsel to prepare an initial litigation budget to ballpark defense costs the insurer will incur during each stage of the case and whether the projected defense work and resulting fees appear proportionate to the complexity and scale of the case. From the perspective of a defendant accounting firm and its partners, where their professional liability indemnity coverage limit is eroded by defense costs, the initial and periodically updated litigation budget is important for the firm's leadership to understand whether and how quickly the indemnity coverage limit will be depleted or exhausted before settlement efforts are likely to occur. If a malpractice lawsuit seeks ten million dollars, the initial litigation budget is \$1.5 million, and the primary and excess policy coverage limits respectively are one and two million dollars, the remaining one million dollars coverage limit may not be enough to fund the entire settlement. In the event of an opportunity to settle for five million dollars, for example, the CPA firm partners would have to pay the \$3.5 million differential. As every dollar paid for defense costs will increase the partners' exposure, containing defense costs throughout the case will be a common objective of the insurer and its insureds alike.

In any event, and particularly where defense costs erode the indemnity coverage limit under applicable insurance, consideration should be given early on in the case to settlement efforts through mediation or otherwise. Valuation of the claim for settlement purposes can be done effectively by both sides only after thorough initial assessment of the claim, making such an assessment that much more important. Since a defendant accounting firm will have more access to material evidence early on in the case, effective early settlement efforts often require informal information and document exchange with the plaintiff preliminary to formal pre-trial discovery. Depending on counsel's view of the most effective defense strategy, if early settlement efforts fail, an early exchange of evidence and expected witness testimony often is useful toward focus and efficiency in pre-trial discovery to follow. Caution: early settlement efforts must be approved and coordinated with the accounting firm's professional liability insurer.

Stages of Litigation

Similar to most other types of lawsuits, malpractice actions typically progress in discrete stages, starting with the original complaint and continuing through trial failing settlement beforehand, and sometimes continuing on through an appeal.

Pleadings and Motions on the Pleadings

The complaint ordinarily will allege facts common to all counts, followed by multiple counts stating alternative theories of liability (e.g., negligence or breach of contract). Where the plaintiff claims its former accountants violated more than one accounting principle or standard, each such violation is likely to be asserted in a separate count. Generally, within thirty to sixty days after service of the complaint, a response must be filed with the court in the form of a motion to dismiss one or more of the counts and/or an answer admitting, denying, or asserting a lack of knowledge of the truth or falsity of each discrete allegation in each count as to which dismissal has not been sought.

The most common basis for seeking dismissal of a given count is that the complaint's allegations, even if proven, would not establish grounds for liability or recovery. Other types of motions on the pleadings are: 1) motions for a more definite statement of the claim; 2) motions to strike particular allegations; and 3) motions for judgment on the pleadings (after an answer has been filed, where it is apparent from the admissions and denials that a party is entitled to judgment as a matter of law). When answering instead of seeking dismissal, in addition to any affirmative comments included as part of any particular admission or denial, the answer also will include a variety of "affirmative defenses." Proof of allegations in a properly stated affirmative defense (e.g., expiration of the statute of limitations, contributory negligence, lack of contractual privity, or lack of reasonable reliance on the accountant's work) would, if proven, defeat the claim even if the plaintiff's material allegations were true.

Pre-Trial Discovery

As the typical professional liability lawsuit will (and should) settle before trial, the most grueling, aggravating, and expensive stage of litigation—from the perspective of the accounting firm—is pre-trial discovery. In discovery, the parties exchange evidence and witness testimony, and obtain the same from nonparties, to develop evidence for trial and determine what fact issues are contested and require determination by trial. Judges have discretion to stay discovery until denial of a motion seeking dismissal of an entire complaint and typically will enter a discovery scheduling order soon after an answer to one or more counts of the complaint has been filed. Toward determining a manageable timetable for completing discovery, the court ordinarily will require the parties' lawyers to meet, confer, and jointly submit a proposed discovery schedule. In any given professional liability case, discovery can continue for anywhere from six to sixty months, although twelve to twenty-four months is the norm.

Parties in a case engage in discovery by written requests or notices that call for production of documents, answers to written questions, and appearance of party-controlled witnesses for oral deposition. Discovery is obtained from nonparties by subpoenas requiring document production, oral testimony, or both. Discovery of electronically stored information (ESI), such as e-mail, proprietary databases, and social media accounts, is often problematic and requires close supervision by the trial court judge because of the broad scale of information and sometimes extraordinary cost of compliance involved.

Methods of cost- and time-effectively managing discovery of ESI and how courts address substantial problems and disputes between the parties that arise relative to discovery of ESI is a topic of numerous published judicial decisions and professional commentary beyond the scope of this article. A commonly addressed issue in this context is whether a party has adequately preserved its ESI by establishing and following its own internal ESI preservation and destruction policies. While failure to do so can result in serious evidentiary consequences to the offending party, more so than most, litigant accounting firms are typically vigilant in preserving their ESI and ordinarily do not encounter serious problems in this aspect of defending a malpractice claim.

Deposition of fact witnesses generally is the most critical stage of discovery. Apart from testing the credibility of the accounting firm's factual account of what happened, fact witness depositions are the proving ground for determining which relatively small subset of often thousands of documents will, at trial, shed the most light on the major issues at hand.

Typically, after deposition of fact witnesses is completed, the parties will exchange reports prepared by their respective experts whose depositions then will be taken by the opposing party to test the validity of opinions to which each expert plans to testify at trial. Sometimes before, but more often after completion of fact discovery, the parties will complete discovery by written requests for admission of specific facts, which the requesting party feels are not genuinely in dispute. To the extent such admissions are obtained, the admitted facts are submitted to the judge or jury at trial as true and need not be proven by evidence and/or witness testimony. Facts so admitted in discovery also can be a very powerful tool for defeating a professional malpractice claim without going through the ordeal, expense, and risk of trial—by means of summary judgment proceedings, which will be the lead-off topic in the final segment of this three-part series.

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