RISK MANAGEMENT FOR TAX ACCOUNTANTS: WHEN YOUR CLIENTS AREN'T YOUR FRIENDS ANYMORE

George J. ("Jay") Coleman
SALMON, LEWIS & WELDON, P.L.C
2850 E. Camelback Road, Suite 200
Phoenix, AZ 85016
Direct Line: 602.977.7305
Email: gjc@slwplc.com

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INTRODUCTION

The accounting profession first became a lucrative target for plaintiffs' lawyers after the savings and loan industry collapsed in the mid 1980s. By the early 1990s the profession was lamenting that it was under siege, and little has changed. After Enron and other financial frauds rang in the new century, and the recent "subprime mortgage crisis" tanked the economy, plaintiffs' lawyers have been further emboldened. For the foreseeable future accountants will continue to be seen as deep pockets whenever financial transactions go sour.

It is no fun to be sued for malpractice, much less for breaching fiduciary duties or, even worse, fraud. Even a defensible lawsuit in which you ultimately prevail will cost attorneys' fees below your insurance deductible, and will intrude upon you and your colleagues' time, attention and emotions.

Moreover, what about the damage to you and your firm's hard-earned reputation? The buzz around town will be that you got sued. The favorable resolution three years later will be yesterday's news and may be confidential in any event.

Your goal, then, is not to get sued in the first place. This outline discusses common ways tax accountants can get into trouble, offers tips that you can incorporate into your practice today that will help you avoid malpractice claims and, in the unfortunate event that you are sued, increase your chances of a successful defense. It concludes by describing how unpleasant and intrusive the claims/litigation process can be.

I. THE TAX ACCOUNTANT'S EXPOSURE IN A CHANGING WORLD

While the largest malpractice exposure historically has been from audit (for the larger firms) and tax (for the smaller firms) work, the move to offer consulting services has spawned new areas of concern. As discussed below, if your firm offers a variety of services, this can have an impact on your exposure as a tax practitioner.

A. The Return Preparer May Not Be A CPA

1. Disclosure is necessary if non-accountants are doing this work for you.

    a. Engagement letter should state qualifications of person doing the work.

    b. Otherwise the client may be led to believe the preparer is a CPA, which can form the basis for a fraud claim or can expand scope of the firm's duties.

B. Multiple Standards of Care Can Apply

1. If your firm has internal quality control procedures designed for attest engagements (workpaper maintenance, manuals, report generation, second partner review) either follow them, design new ones for tax engagements, or state in your engagement letter that they don't apply -- otherwise, plaintiff will argue you didn't comply with your firm's own standards.

2. While a return preparer usually is not a fiduciary, if your firm has had a long-standing attest or tax relationship with the client you may be held to the higher fiduciary standard of care

    a. "Utmost loyalty," must always act in best interest of your client

    b. Even Donald Trump can be a financial neophyte in this circumstance

    c. Fiduciary usually has burden of proving that the transaction was fair.

C. Imputed Knowledge

1. Remember that information learned by your firm in an attest or consulting engagement (e.g., that client is losing a large account) may be relevant to your tax engagement and vice versa.

2. The knowledge of the consultant or attest staff can be imputed to you so make sure you communicate with others in your firm who are doing work for the same client.

D. Continuing Relationship Doctrine

1. A one-time consulting engagement, unless properly terminated, can be deemed to continue if the firm is still doing annual audit or tax work, with a duty to disclose subsequently acquired information.

2. Ongoing attest or tax work can also extend accrual date of statute of limitations on the consulting engagement.

E. Exposure Under the Securities Laws

1. Accountants who prepare financial information or projections for securities offerings are more likely to be deemed to have "knowledge" of misrepresentations and omissions if they have an extensive (audit, tax, etc.) relationship with the issuer.

F. Exposure to Third Parties

1. In many states, accountants are liable not just to their clients, but also to those to whom the accountant intends to supply information or those to whom the accountant knows the client intends to supply information.

2. Thus, non-client lenders, investors, acquirers, Insurance Commissioners etc. can sue accountants.

   a. For example, if one of your tax clients is seeking a mortgage, the prospective lender may ask you to provide a letter confirming or verifying the client's financial information. (You may even feel some pressure to do this from either your client or your client's mortgage broker.) While from all you've been able to see preparing tax returns the client is successful and on sound financial footing, the simple fact of the matter is that you have never verified the tax return information provided by your client. If you provide the letter to the lender, aren't you attesting to the financial information when you never did any attest work? Not only would that be an ethical violation but it also opens you up to a lawsuit.

   b. One way out of such a situation is to explain that you've not done any attest work for the client but would be happy to do so. After you outline how much an attest engagement would cost, the client and/or lender may decide they don't need a letter from you after all. Or you could simply offer to send a letter acknowledging that you have prepared tax returns and that you will provide them to the lender upon receiving your client's written consent to disclose them.

3. Don't make it easier for these potential plaintiffs. Disclaim responsibility to non-clients in your engagement letter. If a prospective lender calls to

say he'll fund the deal based on your tax opinion, don't say that's fine. Investors finance a deal for any number of reasons; it's only in hindsight that all they relied on was you. Don't let them escape the responsibility of doing their own due diligence.

G. The Current Environment

1. Availability of errors and omissions insurance.

2. Reluctance to offer auditing services.

3. Effect on reputation of the profession.

4. Plaintiffs do not want to settle.

5. CPAs will continue to be seen as deep pockets.

II. COMMON TAX MALPRACTICE CLAIMS

A. Tax Work Results In The Greatest Number Of Claims

1. Tax advice and return preparation work results in the greatest number of claims against accountants, though their monetary value is not as significant as audit claims. This isn't surprising. Not only is tax work a mainstay of most accountant's practices, but the accountant's work product in that area -- the tax return -- is subject to a hindsight examination by a government agency (and sometimes by your fellow accountants offering a free review for any missed items so they can get paid to amend the returns!).

2. CNA data re 1995-1999 malpractice claims against accountants: consulting 11%, audit 16% (but large dollar exposure), and tax 59%.

3. This likely is not because accountants are making more return errors, but perhaps because tax software makes it easy for the IRS and plaintiffs' lawyers to second-guess and taxpayers, like other citizens, are more willing to sue.

B. Malpractice Results Most Frequently From Simple Lapses

The problems giving rise to tax claims range from missed deadlines and elections to poor advice to, most of the time, return errors. Malpractice occurs more from simple inattentiveness, lapses in judgment, and poor client communications that could have been prevented than from errors due to the complexities of the tax code. Some points to keep in mind:

1. If the services for which you were engaged are unclear (either because you never reached a clear understanding with the client or because you failed

to document the understanding in an engagement letter), the client can argue in hindsight that he hired you to do all sorts of things that you never thought you were hired to do. The client may also be able to argue that you were guaranteeing the results of the transaction on which your services were engaged.

2. Many problems can be prevented by simple quality control procedures, such as an adequate tickler system within your office.

3. Be careful when giving spur of the moment tax advice. If your client calls you during the rush of tax season with a "quick question," take a moment to decide to evaluate if the question is easy enough, and the client sophisticated enough, that you will be able to answer the question competently without taking the time to research the issue. If you do proceed with giving such "quick advice," dictate a memo for your file summarizing the advice you gave. If your client is relatively unsophisticated and/or if the question is complex -- or if there are large dollar amounts involved -- it makes sense to confirm the advice with a short letter or e-mail to the client summarizing the information you were given, the advice you gave, reminding that it was a general discussion, and inviting the client to discuss the matter in more detail with you when time permits.

4. Be careful when preparing last-minute extensions based upon what a client has told you but not confirmed in writing. It's easy during the rush of tax season to forget unusual items that should be included when calculating the extension payment. Take care to document your discussions with your client and confirm in writing that the extension is based upon and only as good as the information provided by the client.

5. Be careful when you find yourself in the position of not being able to prepare a return because your client has either not given you his underlying information at all or has given it to you in an incomprehensible fashion. Unless you carefully document in letters to your client what it is you need before you can prepare the returns, and advise him to at least file an extension, you could become involved in a spitting match in court where the client says he did give you the information that you needed and you say he didn't. Even where the client has justifiable reasons for not being able to give you the information (such as it being destroyed in a fire), remember to advise him to make estimated tax payments or file "worst case scenario" returns (especially if your client has his income information but not information concerning possible deductions). Also remember to advise your client that he may be able to obtain missing information from third parties, including obtaining transcripts of information reported by others to the IRS.

6. Be sure the tax software you and your staff use is up to date.

C. Some Of The Specific Areas That Have Spawned Malpractice Claims

1. Failure to make the Q-TIP election or not doing it properly on trust returns.

2. Failure to make S Corporation and other elections. Often the client assumes the CPA is doing it who assumes the attorney is doing it who assumes the client is doing it. Fix responsibility with the client as to who will make the election. Note also that in some states making the federal election will not carry over to make the state election.

3. Net operating loss issues have resulted in claims because it is an area of IRS focus and can involve significant sums.

4. Failure to detect fraud. While you are not acting as an auditor, when preparing a client's tax returns you will have access to the client's financial information. As such, a court may find that you had a duty to identify fraud that would be readily evident from the information you did see. Thus, when preparing returns, keep an eye out for the indicia of fraud and, if you see something, bring it to your client's attention. For example, if the controller is embezzling, and during the course of your return preparation you had access to the cash books, you could be held responsible for not questioning suspicious entries.

5. One study of reported legal decisions found that tax shelter investing and the estate and gift tax area (because it is technical and the unhappy heirs didn't have a personal relationship with the accountant -- the deceased did -- and are willing to sue) spawned the largest number of claims.

6. Failing to be sensitive to and comply with IRS regulations governing the standards of probability that must exist before a position can be taken on a tax return without being subject to penalties. This may be the standard for whether or not malpractice has been committed.

7. The process of giving tax advice and preparing tax returns has become highly regulated by the IRS. Be aware of the return preparer penalty rules in IRC Section 6694, the reportable transaction rules and penalties, and Circular 230.

8. Failing to advise clients that they can avoid the risk of penalties with respect to an aggressive return position by making a proper disclosure to the IRS. While such a disclosure will obviously invite an audit, the CPA should tell the taxpayer that that alternative exists. Otherwise, if the taxpayer is slapped with a penalty, it may sue the CPA for not informing it that it could have avoided the penalty risk, despite the fact that the client probably would not have elected to make the disclosure anyway.

9. If your client is audited and required to pay additional tax, interest and/or penalties, and then sues you, be sensitive to the question of how much you as the CPA should really be liable for.

   a. Back tax is not recoverable as damages as it was owed to the government in any event.

   b. Interest may not be recoverable either. Some courts have found that interest is not recoverable because the taxpayer had the free use of the money during the time in question. Other courts, however, have found interest to be recoverable. Still other courts increasingly have been letting the jury decide whether interest is recoverable, focusing on whether the taxpayer in fact benefited from the free use of the money. Even if interest is recoverable, the proper measure of damages should be the difference between the interest your client could have earned on the money when he did not timely pay the government minus the interest the government charged for the late payment of tax.

   c. Penalties and interest on penalties are recoverable.

III. RISK MANAGEMENT TIPS

A. Don't Promise The Moon In Your Promotional Materials

1. These often promise the moon, and the stars too, or at least an army of resources in all fields. Plaintiffs' lawyers use these, as well as the accountant's written proposals and oral sales presentations, to expand the accountants' duties and as the basis for fraud claims saying the accountant misrepresented his qualifications and/or didn't deliver what was promised. Rarely do professionals understate their qualifications when drumming up new business, and sophisticated clients will become naïve and gullible plaintiffs in litigation. Take care to make accurate and realistic statements when marketing.

2. It's worth taking a look at your Webpage, newsletters, firm brochures and other literature to make sure that you're following the ethical rules (e.g., not creating false expectations or implying that you can unduly influence an agency) and that you're not using words that an unhappy client can later twist to say that you "promised" a result but didn't deliver (e.g., words like "guarantee," "ensure," "safeguard," and "monitor"). It's okay to pitch your services and suggest that you're better than the next guy, but you want to do it in a way that doesn't set you up for a claim.

3. Once the client is on board, manage its expectations and keep them realistic. If the chances of the IRS approving of your client's position are slim, say so up front.

B. <u>Screen New Clients And Don't Be Afraid To Turn Them Down</u>

1. This is the best risk management technique.

   a. Many accountants who are sued will admit they never should have accepted the client in the first place. When announcing his firm's $400 million settlement with the government, Ernst & Young's Chairman stated: "We regret in hindsight we had some of these people as clients." (Washington Post, November 24, 1992, at A.1)

   b. That is the first question to be asked: "Do we want this person or company as a client?" Thinking that question through is the best claim prevention for all accountants, be they valuing a sole proprietorship or preparing an individual tax return.

   c. The simple fact is that judges, juries, and the business community associate you with your client, especially after a disaster. Look at Enron. Here in Arizona, did any accountant who worked for Charles Keating have a chance to convince the jury to measure him or her by the standards of the accounting profession after the plaintiff's attorney, in his opening statement, showed videotapes of Lincoln executives and others asserting the Fifth Amendment?

   d. Avoid the temptation to take on risky clients. No matter how much you might need the work, resist the pressure to get new clients regardless of the cost -- there often is one. Trust your instincts.

2. Rigorous client screening procedures are your best defense. Clients who are heavily into tax shelters will likely do anything to avoid tax; when the IRS comes after them and they don't have the money to pay the government, they may decide to sue their accountant. Clients who have poor recordkeeping procedures are an assessment waiting to happen and will not be able to substantiate their return positions when that assessment comes.

   a. Set up a client screening committee or, at the least, have another partner look at the matter and apply the "smell test" so the decision to take on the client is independent and not driven by one accountant's desire to be a rainmaker. (Not only will this help prevent claims, but it will reduce your firm's collection problems.)

   b. Talk to the prospective client's former return preparer, look at the returns for prior years, and also look at the client's supporting documentation.

   c. Other questions to ask/items to check.

- Why is this prospective client coming to you? (Are you the best CPA available or an easy mark because you just started a practice and need the business?)

- How was the prospective client referred to you?

- Why is the prospective client's old CPA firm willing to lose him? (Talk to the old CPAs.)

- Find out if the prospective client changes CPA firms frequently.

- Find out from the prior accountant if the prospective client pays his bills on time. (The client who is last to pay is usually the first to sue.)

- Review the prior accountant's management letter.

- Assess the reputation, integrity and competence of the owners and top management of the prospective client.

- Review the prospective client's financial information (i.e., year-end and interim financial statements and tax returns for the past three years) to determine the client's level of integrity and sophistication.

- Review the prospective client's recordkeeping and internal controls. (E.g., clients with poor internal controls are more likely to suffer from employee defalcations.)

- Check the prospective client's references (e.g., banks, lawyers, vendors, and its own clients).

- Check the client out on the Internet.

d. Consider your own expertise and qualifications. Is the engagement in your firm's area of expertise and is the timing for the engagement realistic? If you don't have the resources to handle a large client don't take one on. If you or your firm haven't done this type of work before, maybe you should refer the client elsewhere.

3. Conduct a similar analysis periodically on existing clients to decide if your firm should continue working with them.

4. Trust your instincts, and don't be afraid to say no.

C. <u>Always Use And Update Engagement letters</u>

1. This letter is one of your best protections against a malpractice claim. For example, clients often view CPAs as guarantors that employees will not embezzle money. The client feels that my CPA is "watching out for me" and that therefore he need not maintain proper internal controls. Unless your engagement letter limits the scope of your responsibility, you will, at the least, have to incur the attorney fees to prove that you are not responsible for something.

2. While accountants frequently use engagement letters on attest engagements (probably because of the differences between compilations, reviews and audits), the AICPA has noted that they are used only 30% of the time on tax engagements (but 85% of the time on attest). This shouldn't be.

3. Prepare separate engagement letters for each matter you take on for the same client. Update those letters yearly and whenever the nature of your engagement changes. For example, if you are doing compilation and tax return work, and the client asks you to interview a candidate for a controller position concerning his technical accounting skills, set that forth in a new engagement letter -- otherwise you may be considered to have vouched for the new controller's integrity when he later embezzles money.

4. The engagement letter is your best defense if problems should later arise with your client or the taxing authorities. Specific things to include in tax engagement letters include:

    a. If you are relying on and not verifying the accuracy or completeness of the client's records and representations when preparing returns, say so, and point out that the validity of your advice depends upon the accuracy of the factual information your client provides.

    b. Spell out the client's responsibilities in providing you with the proper information to prepare accurate returns and meet the necessary filing deadlines. Point out that the client's failure to maintain proper books and records may preclude you from complying with the necessary filing deadlines, and that it is the client's responsibility to maintain the documents necessary to support the deductions taken. Otherwise the client may argue that you were supposed to not only prepare the returns but also compile the underlying information.

    c. If all you are doing for the client is return preparation, say that too, and update the letter whenever the nature of your engagement changes.

d. Define precisely which tax returns you will prepare: if you do not make it clear that you are preparing only income tax returns, your client -- remember Zoe Baird? -- may assume you are also taking care of withholding for the client's domestic help.

e. Make clear that a tax engagement is not effective in detecting fraud and that you will not be undertaking any procedures designed to detect fraud.

f. Include a deadline by which the client must provide you with the information you need to prepare timely returns.

5. Other things to include:

a. State specifically what you will and will not do. If you don't adequately describe the attest work, you may be held to the audit and not review standard. Avoid technical terms like "audit" and "review" unless you really mean them. Avoid broad descriptions like "general business advice."

b. State your reliance on the client for any particular facts.

c. State any known adverse conditions.

d. State all appropriate disclaimers. If you are not verifying the accuracy or the completeness of the client's records, say so. If you are not assuming the responsibility to detect employee defalcations, say so.

e. Consider limiting your liability to fees paid, requiring indemnification, or providing for arbitration rather than litigation.

f. Include a provision permitting you to stop work until a past due account is brought current, or disengage if you aren't paid after a set amount of time. Such a clause will let you stop work on a tax return if you aren't paid.

6. Do not rely upon a conversation to limit the scope of your engagement; memorialize it in a letter.

7. Have the client sign and return a copy of the engagement letter agreeing to its terms. In a very real sense it is your contract with your client. If your client doesn't sign the letter the court could conclude that the client did not agree to the terms of the engagement. If you go forward with the work without a signature you are opening yourself up to an argument that you undertook the engagement under terms different from those contained in the unsigned engagement letter. Get the letter signed, and set up a tickler system to make sure that is done.

D. Document Client Communications And Advice

1. The best evidence in court is a document, not your hazy recollection of what transpired in a conversation five years ago.

2. Document your advice, assumptions, and recommendations to the client with appropriate notes to the file and/or letters and e-mails to the client.

3. Remember that, in litigation, those notes and letters can be read to a jury and opposing counsel will rigorously scrutinize them. If you record concerns in your notes, make sure you do something about those concerns or they may come back to haunt you.

4. Always date your internal notes. Avoid fragmentary notes that can later be misconstrued and taken out of context. Turn those notes into complete memoranda if they involve important issues.

5. Always send a confirming letter if the client is going to act upon your advice so that there is no question later regarding what the advice was and the assumptions it was based upon.

6. When a client calls you or asks you to attend a meeting, the client often wants you to approve of some action he wants to take. A written memo summarizing the discussion is the best way to make sure that you and the client are operating on the same wavelength. Some things to think about including in such a memo/letter are:

   a. What services you agree to perform and what services you will not be performing (such that the client may want to engage some other professional for those).

   b. If other professionals such as lawyers or appraisers were at the meeting, set forth your understanding of who is going to be responsible for advising the client with respect to what.

   c. If you made some off-hand comments or discussed things in a cursory manner, tell the client that he needs to contact you so you can do further work before he can rely on what you said.

7. Make sure you have all the facts before you give sensitive tax advice. Tell the client in writing that you need more time and/or more facts before you can be in a position to give advice. Do not let the client rush you.

8. Maintain a solid tickler system.

E. Adopt A Document Retention Policy And Stick To It

1. After Enron, this is a no-brainer. Judges, juries and the public do not react well to document destruction.

2. How long you retain documents isn't as important as consistently applying whatever policy you adopt. (You're probably better off with no policy at all than to have one but not follow it.) It's a matter of judgment but use the applicable statutes of limitation as a guide:

   a. 7 years after a return is filed for tax work in the event of an IRS audit.

   b. Remember that in many states the malpractice statute doesn't start to run until after the client should have "discovered" the problem and suffered damage, which can be long after your work is completed. For tax malpractice, that means the clock (in many states it's two or three years for malpractice) doesn't start running until after the IRS completes its audit and issues a notice of deficiency.

   c. IRS has 3 and 6 year statutes of limitation but no statute of limitation for fraud.

   d. Under the continuing relationship doctrine, the statute won't start running until you cease representing the client. So if you represent the client before the IRS, the clock won't start.

   e. 10 years for all types of engagements is a safe rule.

   f. Perhaps indefinitely if you took on a risky client.

   g. The recent Sarbanes-Oxley legislation has specific retention rules if you audit public companies.

3. If in doubt, keep the document. A document is your best defense, and only a document can refresh your recollection and show conclusively what your staff did. All workpapers and client communications should be kept. You can discard interim notes if the work is memorialized in a final document.

4. Remember to address e-mails in your policy; often they should be retained.

5. Once you adopt a policy, stick to it. If you delegate closing files to support personnel, make sure they know and follow the policy.

6. Even if the time is up, don't destroy documents if you have reason to believe a claim may be filed or a subpoena issued.

7. Consider informing your client before you destroy any documents.

F. Keep Your Clients Happy And Treat Them With Respect

1. The best way to minimize the chances that you will be sued is to keep your clients happy. Even if the result that the client receives is less than desirable (an IRS audit), a client whose telephone calls have been promptly returned, whose questions have been patiently answered, and who was informed of the pros and the cons of particular strategies all along the way is much less likely to sue.

2. Clients recognize that their accountants are people too, and if they feel their accountant tried and treated them with courtesy and respect, they may decide that business is business and decide not to file a claim after all.

3. On the other hand, clients who feel that they have been ignored or not treated properly may decide to sue even if their grounds are frivolous. Very often you can predict which types of clients these will be at the very outset.

4. One of the most frequent client complaints about professionals (and one of the biggest causes of claims, be they grievances to the State Board or lawsuits), is that "he didn't return my calls." A client who feels ignored is an unhappy client. Keep your client informed. Return his phone calls.

5. A lot of this is common courtesy and common sense. Treat your client the way you'd want your lawyer or stockbroker to treat you. And accept no less from your staff.

G. Disengage With Grace

1. It's okay to fire your client. But do so with respect.

   a. Don't antagonize or insult your client

   b. Be sure to internally document why you're disengaging for a legitimate reason (i.e., the work is done, conflict of interest, unpaid fees, or unethical/illegal client behavior).

2. Send a disengagement letter cleanly ending the engagement as of a date certain.

3. Don't leave your client in the lurch. Suggest the name of possible successor accountants, promptly return the client's original files, and let the client know in writing of any impending deadlines.

a. Be sure you give the client sufficient notice of your withdrawal so he can find another accountant to prepare his returns in a timely fashion.

b. If you have waited too long, it may not be wise to disengage. Consider at least obtaining an extension of the return deadlines (maybe even doing it for free) before resigning.

c. If you do disengage, make sure your disengagement letter advises the client of all pertinent return and compliance dates.

4. Continuing Relationship Doctrine

a. A one-time consulting or other engagement, unless properly terminated, can be deemed to continue if the firm is still doing annual audit or tax work, with a duty to disclose subsequently acquired information.

b. Ongoing audit or tax work can also extend accrual date of statute of limitations on the consulting engagement.

c. So be sure to send a letter disengaging from the particular work you are no longer doing.

5. Disengaging usually doesn't mean you never want to work for the client again -- it's just that this particular matter has concluded. It's fine to say you're available and happy to perform new engagements to be agreed upon in the future.

H. <u>Bill And Collect Frequently</u>

1. Your billing arrangement should be stated clearly in the engagement letter. It is usually best to take a retainer -- that way you won't be afraid of being stiffed when you really do need to disengage.

2. Bill frequently. The larger the outstanding bill, the more the client will begin wondering what you have really done for him.

3. Use your bills to remind the client what you've done for him. It's a lot harder for the client to stiff you if your bill reads "work on obtaining favorable IRS determination" than if it reads "research IRS regulations."

4. If unforeseen problems arise and you reserved the right to modify your fee, let your client know in writing as soon as possible if you are increasing your fee. Don't set him up for a rude surprise.

5. Monitor your collections. The client that is last to pay is first to sue. If your client isn't making timely payments, there may be a problem that you

can fix. Maybe you need to fire the client. Don't get deeper in the hole. If you stay on top of your billings and collections the receivable won't get so big that you'll be tempted to sue and risk a counterclaim for malpractice.

I. Don't Sue To Collect Unpaid Fees

1. Beware the malpractice counterclaim. If the fees are big enough, and if the client has money, it will hire an attorney who will consider whether you did an adequate job.

    a. While I do not have statistics for accountants, when lawyers sue for unpaid fees malpractice counterclaims are brought in as many as 40% of such cases.

    b. The irony is that the former client probably would never have known it had a malpractice claim if it had not had to seek counsel to defend your suit for fees.

    c. Since your lawsuit is for fees, the client will be able to discover all of your time and billing records, which all too often not only hurts your suit for fees but helps to support the malpractice counterclaim.

2. Perform a detailed analysis of the malpractice counterclaim potential before suing for fees.

    a. Have another accountant in your firm who is familiar with the substantive area, and who did not work on this particular client, perform this analysis.

    b. If the claim for fees is large enough, hire an accountant from another firm who can be objective.

    c. Consider involving a lawyer and/or your insurance carrier in this process.

3. Analyze the economics of suing for fees. For example, assume that you are suing for $100,000 in unpaid fees:

    a. Taxes will consume approximately a third of any recovery, which will leave about $65,000.

    b. The other side may or may not have to pay your fees if you are successful. If you have to pay, your lawyer will either get one-third of what you recover or an hourly fee of probably around $15,000 -- this leaves $50,000.

c. You likely will have to hire an expert witness to testify concerning the reasonableness of your fee, which will run several thousand dollars.

d. Your internal staff and professionals will expend time in the collection effort that could be used more productively in billing other clients.

e. Thus, even if there is no malpractice counterclaim, and even if you recover the entire amount of your unpaid fees, you very likely will get less than one-half back.

J. Don't Do Business With Your Clients

1. Avoid investing in your client's deals -- or accepting commissions on them. Even if there is no ethical prohibition, such practices significantly increase your exposure. Not only does it impair an auditor's independence, but if the deal goes sour the other investors may view you as their guarantor.

2. If your firm has had a long relationship with the client (e.g., prepared his returns and advised on other matters for several years), you may be considered a fiduciary with the burden of proving in court that the deal was fair to your client.

3. True, your clients may make more money and work less hours than you. Avoid the temptation to make up for it by being in the deal. It doesn't look good.

K. Don't Wear Two Hats

1. Providing investment advice is dangerous. While you may think you are just a facilitator who introduced a client to an investment entity, your client (and a juror) likely perceives you as having checked out the investment thoroughly before "recommending" it. The prudent course is to do a new engagement letter limiting your responsibility in this regard.

a. If you are going to give investment advice, provide your client with several alternatives and let the client make the final choice.

b. Don't accept commissions; get paid by the hour or a flat fee.

2. When you discuss the tax ramifications of a proposed investment with your client, make clear -- and document -- that you are offering tax advice on the assumption that the client will make the investment, not advising on whether it's a good investment for the client in the first place. Otherwise that client may conclude that you have "vouched" for the investment.

3. Watch out for conflicts of interest. You shouldn't do work for both the trustee and the beneficiary unless both consent in writing. You're an accountant and insured as such. If you also act as a securities dealer, lawyer or insurance agent you're increasing your risk and jeopardizing your insurance coverage.

4. Be careful about agreeing to serve as an officer or director of your client. It means you and your firm won't be independent for attest work or tax advice, and also can significantly increase your exposure (for things like fraud) as jurors will assume you know everything about the client.

5. Be careful representing clients before the IRS or other taxing authorities.

    a. Think twice before agreeing to represent your client before the IRS if you prepared the returns in question. Not only is there no attorney-client privilege, but your "mea culpa" attempts to exonerate your client may come back to haunt you when the client sues. You will also be extending the time your client has to decide whether or not to sue you. While the question of when the statute of limitations begins to run for tax malpractice varies from jurisdiction to jurisdiction (the majority view is that the statute begins to run when the IRS issues a notice of deficiency), the running of the statute can be tolled if you continue to represent the client in dealing with the IRS. If you are concerned that you may be the subject of a claim it is probably best that you cease representing the client.

    b. If you are going to represent a taxpayer before the IRS, you will need an IRC Form 2848 power of attorney. Be careful that the power of attorney you receive is not too broad. The standard form grants you all sorts of powers such that, if the IRS sent a notice to the wrong address for your client but also sent you a copy, your client will be on notice and on the hook. Why, for example, do you want to have the power to extend the statute of limitations for your client?

    c. Since the attorney-client privilege is stronger than the accountant-client privilege (which does not apply in federal proceedings) and the federal tax law accountant-client privilege in Section 7525, you should get your client to a lawyer when dealing with the IRS in sensitive situations.

L. <u>Get Help When Responding To Subpoenas</u>

Accountants frequently receive subpoenas for their workpapers and other client documents when the accountants are not a party to the litigation. This happens frequently in divorce cases (where one spouse wants to find out about the other spouse's financial affairs) and in securities and other fraud litigation (where the plaintiff wants to find out what the auditors were told). Sometimes plaintiff wants to simply argue that the defendant lied to its auditors along with everybody else; other times plaintiff is looking for a deep pocket. Alert your carrier and lawyer, because the goal is to keep you and your firm out of the litigation.

1. Remember that your state may have an accountant-client privilege that must be taken into account.

    a. These statutes generally provide that client records or client information you receive by reason of your employment is confidential and you can't provide it to others without your client's consent. So you should inform your client in writing of the subpoena to give him an opportunity to appear in court and assert, at his own expense, the "privilege" created by this statute. It's the client's privilege and not yours, and you shouldn't waive it without the client's permission.

    b. Some statutes also say, on the other hand, that workpapers are your property. So if you get a subpoena you may be able to produce only what your client gave or got from you (since that's all that bears on what your client knew) and not your workpapers. Why give some lawyer a free peek at your workpapers if you don't have to?

        - Some courts have found that the subpoena power cannot be used to obtain workpapers for purposes of determining if there are grounds for proceeding against the accountant.

        - You may be able to produce only what is relevant to the underlying litigation: if investor is suing company for securities fraud, and the accountant is not a party to the litigation, then only those portions of the workpapers showing what the company knew or did not know (e.g., representation and management letters, notes of client meetings, client schedules, etc.) are relevant; the accountant's internal workpapers are not.

2. Courts tend to frown upon the discovery of tax returns, permitting a client to provide only the requested financial information without producing the actual return, and requiring production of the return only if it is truly relevant and necessary. So you shouldn't produce your client's tax returns without giving him a chance to contest the subpoena at his own expense.

3. The federal accountant-client privilege for tax advice in I.R.C. § 7525 might apply in federal court. It permits "authorized practitioners" to refuse to disclose client communications that form the basis for their

federal tax advice in noncriminal tax matters before the IRS or in federal court where the IRS is a party.

4. Bottom line is that your present or former client may be unhappy if you produce documents concerning his financial situation without first consulting him. Be safe by giving the client a chance to object to the Court before you comply with the subpoena.

M. Understand What Privileges Can And Can't Protect You And Your Client

1. The accountant-client privilege is limited. It often does not apply to criminal proceedings and is narrowly construed in other contexts. Federal courts generally will not honor it. Do not count on it for help when dealing with the IRS or other taxing authorities.

2. The Federal tax law accountant-client privilege in Section 7525 isn't available in criminal tax proceedings before the IRS, or in non-criminal proceedings where the IRS isn't a party. It applies to tax advice but not to communications made for return preparation.

3. Since the attorney-client privilege is much stronger than the accountant-client privileges, you should consider getting your client to a lawyer when dealing with regulatory or litigation matters.

N. Implement Quality Control Procedures

1. Like your dentist says, an ounce of prevention is worth a pound of cure. Suggested procedures for accounting firms include:

   a. Watch out for the "lone wolf" in your firm, who is dealing improperly with clients or suing for fees without the knowledge of firm management.

   b. Some type of peer review system is an invaluable aid in loss-prevention.

   c. Controls to consider include prior approval of investments with clients and other "entrepreneurial" activities, central docketing of mail, mandatory review procedures of staff work, second partner review of returns, and tracking CPE compliance.

   d. If you practice with others, get a second opinion on the tax advice you give. Your mandatory review procedures should provide not only for a second partner to review all advice, but also for sanctions for those who do not comply with those procedures.

   e. The tax laws and regulations frequently change. Take steps to be sure you and your staff stay current.

f. To avoid clerical errors and items falling through the cracks, track the status of the returns and deadlines the office is working on with appropriate checklists, diaries or other controls.

g. The simple fact that you have adequate procedures in place can help reduce your exposure if you are sued.

2. Staff education is also important

a. Supervise your employees carefully. You are responsible for the mistakes of your junior accountants and other staff. Train them, supervise them, and periodically review their performance.

b. Possible ways of updating staff concerning loss-prevention techniques include routing seminar and other materials throughout the office, encouraging attendance at loss-prevention seminars, and sponsoring in-house presentations by insurance carriers or lawyers. Remember, if you demonstrate that loss-prevention is an important priority, your staff will respond accordingly.

O. <u>Be Careful Who You Practice With</u>

1. Very often a predecessor firm's legal troubles will become your own.

2. Perform a very careful analysis of any other accountants that you decide to practice with, including speaking with their lawyers and insurance carriers.

IV. <u>WHAT TO DO (AND TO EXPECT) IF YOU ARE THE SUBJECT OF A CLAIM</u>

Unhappy clients are no fun. Being served with a lawsuit or getting a letter from the State Board or AICPA can ruin your day. But you can't ignore the situation, and need to be careful that your next steps don't make matters worse.

A. <u>Act As Soon As You Think There Might Be A Claim</u>

Take the following steps as soon as you suspect there might be a problem. Don't wait until you are actually served with a lawsuit. What you do next can affect your ability to mount a strong defense. <u>Don't try to "fix" the problem yourself!</u>

1. Do not attempt to contact the client that is suing you or that is about to sue you to talk him out of it. He may have already gone to a lawyer. You won't change his mind and anything you say to him can and will be used against you in litigation.

2. Do <u>not</u> prepare a mea culpa written memorandum or letter to your client justifying your work. It will be discoverable by the opposition in litigation.

3. Think twice about getting a second opinion from your partner. Communications with co-workers are discoverable too.

4. Instead, speak with the management representative of your firm, contact your insurance carrier, and get an attorney involved sooner rather than later so you can invoke the protection of the attorney-client privilege.

5. Do not destroy any documents. If you kept them properly, they will refresh your memory and help convince the jury that you did do some work and, hopefully, that it was competent. Otherwise you'll have to convince them with only your own testimony.

6. Pencils down! Don't "supplement" or "update" your workpapers with what you now remember was done. Workpapers are supposed to be contemporaneous documents; that's why they're a powerful defense tool. Don't alter them in any way.

7. Notify your insurance carrier as soon as you think there may be a claim and do it in the precise manner stated in the policy. If you wait too long coverage might be denied. If you simply call your local agent, and don't follow the formal notification procedures, coverage might be denied. Will your premiums go up? Maybe, but you'll likely have to disclose the claim when you apply for next year's insurance.

8. Do not ignore the matter. It will not go away, and the sooner an attorney is involved the better off you will be.

B. Retaining A Lawyer

1. Contact your insurance carrier and/or a lawyer as soon as you discover any illegal or unethical conduct on the part of your client, or as soon as you have reason to believe that a client might sue you.

2. The sooner you get a lawyer, the sooner the attorney-client privilege will attach to protect your communications and your work-product. Otherwise, what you say and what you do will be discoverable.

    a. As noted above, the accountant-client privilege and the federal tax law accountant-client privilege in Section 7525 are limited. Neither applies to criminal proceedings and they are narrowly construed in other contexts. Do not count on them for help when dealing with the IRS, DOL or other state and federal agencies.

    b. The same is true for your clients, who will be better served if any DOL or IRS inquiries are handled by an attorney rather than an accountant.

3. Your attorney can help you prepare a proper disengagement letter if you have not already disengaged.

C. Special Considerations For State Board / AICPA Investigations

1. Just because you got a letter advising of a complaint does not necessarily mean you have a big problem. Both the State Board and the AICPA are required to follow up on every complaint filed with them, be it by an unhappy client or anybody else, even if the complaint seems frivolous on its face. What you need to do is put together a compelling letter in response that respectfully answers any questions posed in the regulator's letter, explains your position, and explains why you believe you did not cause any harm to your client.

2. Your insurance carrier and/or lawyer can help you craft such a responsive letter. You should let your carrier know about the letter, as such a letter from a regulator could be deemed notice of a claim under your policy especially if, as is often the case, they are based on a client complaint. Don't risk having coverage denied if there is a later lawsuit by this same client because you failed to tell the insurance carrier about the regulator's inquiry. More importantly, many insurance policies provide for some coverage for legal fees in helping you respond to the letter.

3. Even if you plan on signing the response letter yourself, consider getting your lawyer's objective input (especially if your insurance carrier will pay his or her fees). Often the lawyer can "ghost write" the letter for you, or at least offer helpful suggestions on the letter that you initially draft. Whether or not the letter is signed by you or your lawyer is something that will depend upon the circumstances of each case. Frequently the accountant signs the initial response out of a concern that the regulators may think the accountant thinks there is a serious problem if she saw a need to hire a lawyer; on the other hand, if the charge is serious enough or a lawsuit has been filed, it would come as no surprise that counsel was retained.

4. Do not ignore the deadlines in the letter. You will just make the hole deeper if you miss the deadlines and make the regulators think that you are blowing them off. Indeed, the Rules of some State Boards provide that failure to respond timely to inquiries from the Board is itself a violation of the Rules, and accountants have gotten in worse trouble for ignoring those deadlines than for the underlying grievance.

5. If you have questions about the regulator's letter, or if for understandable reasons you will have difficulty meeting their deadlines and would like an extension, pick up the phone and call the regulator and talk to them about it. They are people too, but remember that whatever you say would be fair game in any subsequent investigation.

6. Remember that regulators often are bureaucrats who hate to be disrespected. Some of them may not have liked private practice and that's why they are now a regulator, and may well be resentful of a practitioner who ignores them and is seen as being disrespectful. For better or worse, the best position to take with regulators is to cooperate fully. This does not mean that you cannot objectively defend yourself but leave your emotion out of it. The regulator is just doing his or her job.

7. Remember the statutory accountant-client privilege that prohibits you from sharing your client's confidential information with a third party without that client's consent. Even if it is that client who has complained to the regulator, you should first seek clarification from the regulator as to whether it has obtained the client's permission for you to share confidential client information when responding to the complaint. (It's better for the regulator to act as intermediary than for you to contact the client yourself.) While an argument can be made that the client has waived the protections of the privilege by filing the complaint against you, your taking this step will demonstrate to the regulator that you are indeed careful about the rules that govern your profession.

8. The good news is that nowadays both the AICPA and many State Boards will send a letter if they have decided to close their investigation of you. Sometimes, however, your response is not sufficient to convince the regulator to close the file, and the matter can then proceed to a full blown investigation (with an investigator retained by the regulator examining your workpapers and interviewing you) all the way to an administrative hearing. If things get past the initial letter stage, you need to consult with a lawyer.

D. <u>Remember That Litigation Is More Of A Pain Than Risk Management</u>

1. While the risk management steps discussed above can be a pain, being involved in litigation really hurts. You (and your colleagues and staff) will have to take time away from your clients to:

   a. Work with your lawyers, doing things like carefully retrieving all of your hard copy and electronic files for production to the other side, and contacting your present and former staff who may need to serve as witnesses.

   b. You may also be ordered to retrieve and produce additional information to the other side, such as your internal manuals, training materials, personnel files and performance evaluations, peer review materials, expense reports and promotional budgets, time and billing files, marketing material, and workpapers for other engagements performed for similar clients -- not to mention your firm's net worth for punitive damages purposes.

c. You will have to prepare for and testify at a deposition and again at a trial or arbitration.

2. The people who will decide your case most likely will know very little about accounting, but will expect a well-paid professional to know everything important about his or her client, including whether a transaction will succeed or whether fraud is afoot.

3. In light of the above, risk management doesn't seem so bad after all.

TABLE OF CONTENTS