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5 Tips For Defending An Accounting Malpractice Claim

By **Nathan Novak** *(May 14, 2018, 6:13 PM EDT)*

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To a professional accountant or tax adviser whose career is built on providing clients sound advice, the prospect of a client suffering a loss due to their faulty opinion ranks as the worst possible fear. If an accountant's or tax planner's client is assessed tax liability beyond the amount the professional advised the client would pay, the professional may be liable for those damages. But accountants and tax advisers often fail to realize that such liability is not automatic. Before jumping to the conclusion of liability — and reaching for the checkbook — the embattled professional should consider the following five factors that may affect the outcome of the client's case against it.

1. Perfection is Neither Required nor Expected

Professionals tend to measure themselves against the unattainable high water mark of perfection. Fortunately, the law is not so unforgiving.

Malpractice is synonymous with professional negligence. As in all negligence cases, the fundamental question is therefore whether the defendant acted with reasonable care under the circumstances. In the case of an accountant, negligence is the failure to act with the level of skill and care that a reasonably careful accountant would have used in similar circumstances.[1] An accountant holding himself out as a specialist in a certain area — such as tax advice — is required to act with the skill and care of specialists in the field.[2]

"Reasonable" is not synonymous with "perfect." A professional's clients are "not justified in expecting infallibility ... They purchase service, not insurance."[3] If a professional acted reasonably under the circumstances, he or she did not commit malpractice.

2. A Review of the Client's File May Be Revealing

One cannot assess what was reasonable under the circumstances without an understanding of the circumstances themselves. As memories fade and witnesses can be mistaken, the source which often best illuminates those circumstances is the client's file. That file likely contains — and should contain — documents defining the scope of the engagement, the client's instructions to the professional, the exact advice and disclaimers the accountant provided, and other correspondence that may evidence the nature of the engagement and the client's goals.

Any investigation into the client file — and the results of the interviews of witnesses who worked on the engagement — should be conducted with the involvement of knowledgeable legal counsel to ensure the attorney-client privilege and attorney work-product doctrines protect statements made and documents created as part of the investigation.

3. The Scope of the Engagement Informs the Standard of Care

While an action for professional negligence is not the same as one for breach of contract, the engagement letter can often serve as an accountant's salvation, just as a contract may limit a contracting party's obligations. For instance, in Italia Imports, Inc. v. Weisberg Lesk, the engagement letter provided that the accounting firm would perform "an annual compilation of ... financial records based on information supplied by ... plaintiff's management without verification by the accounting firm" and "expressly disclaimed any duty to discover wrongdoing and defalcations."[4] That engagement letter — and the accountants' adherence to its terms — resulted in the dismissal of a malpractice complaint brought against them by a company who fell victim to its bookkeeper's embezzlement.[5]

4. The Plaintiff Must Prove the Accountant's Negligence Caused the Damages Claimed

A plaintiff who proves that the accountant failed to live up to the standard of care is only halfway to a judgment. Professional negligence is actionable only if it caused the plaintiff damages.

The Substantial Factor Test

To prove negligence, the plaintiff must prove that the defendant's breach of the standard of care was a substantial factor in causing its harm.[6] If the same harm would have occurred regardless of the accountant's failing, there is no causation.[7]

A simple example illustrates the point. Client A is considering accepting an offer of employment from a governmental entity at a salary of $100,000 per year. Tax Planner B advises A that she will pay no tax on her income from this prospective employer on the mistaken belief that income earned from a governmental employer is tax-exempt. Client A accepts the job offer but ends up having to pay $30,000 in income tax. She sues B for the sum.

Tax Planner B has certainly not acquitted himself very well in his field, but did his advice cause Client A's tax liability? It depends on if A could have obtained a "better deal."[8] If Client A could have gotten a "better deal" than the transaction she entered — accepting the job offer for $100,000 in the year, with net income of $70,000 — but for B's faulty advice, then she can recover against B. She may prove, for instance, that she had another job offer at the same time that paid $140,000 per year, $98,000 net, but she accepted the governments employer's offer because she thought she would make more after-tax income due to its supposed "tax-free" status. If she cannot prove that she could have obtained a "better deal" — or that she would have been better off never having entered the deal at all, which would not apply in this example but which may exist in other types of transactional malpractice cases — then Client A cannot prove causation.[9]

Other Factors Impacting Causation

There are other issues that can affect the causation analysis as well. For instance, if the accountant's advice was ignored rather than followed, or if the injury alleged was not reasonably foreseeable to the defendant at the time that advice was rendered, plaintiff cannot establish causation.[10]

5. The Plaintiff May Recover as Damages Only the Additional Tax Paid

Finally, even assuming the elements of professional negligence are established, the plaintiff may collect only the additional tax paid as a result of the faulty advice. For example, assume that a taxpayer had $1,000,000 taxed at the ordinary income rate of 39.6 percent instead of the 20 percent capital gains rate as a result of a tax planner's negligence. Plaintiff was never going to pay less than $200,000 in taxes (20 percent), so the defendant is liable only for the amounts in excess of that $200,000 — in this case, $196,000 — in damages.

The takeaway is that establishing liability as a result of faulty tax advice is rarely a simple matter. A professional negligence defendant has many possible defenses available, and should explore each of those listed above in assessing a claim made against him or her.

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[1] See, e.g., Budd v. Nixen, 6 Cal. 3d 195, 200 (1971).

[2] Wright v. Williams, 47 Cal. App. 3d 802, 810 (1975).

[3] Gagne v. Bertran, 43 Cal. 2d 481, 489 (1954); see also Craig v. Anyon, 212 A.D. 55, 62 (N.Y. App. Div. 1925) ("auditors did not guarantee the correctness of ... accounts… [t]hey agreed to use such skill in the performance of their agreement as reasonably prudent, skillful accountants would use under the circumstances").

[4] 220 A.D.2d 226 (N.Y. App. Div. 1995).

[5] See also Ellis v. Grant Thornton LLP, 530 F.3d 280 (4th Cir. 2008) (when audit report "plainly states" that it is "not intended for use by third parties," third parties could not rely on it for purposes of bringing malpractice action); Cumis Ins. Society, Inc. v. Tooke, 293 A.D.2d 794, 798 (N.Y. App. Div. 2002) (contractual agreement of accountant and client may "absolv[e] the accountant of liability for not performing" certain tasks, with certain limitations).

[6] See Restatement (Second) of Torts § 432; cf. Johnson Bank v. George Korbakes & Co., LLP, 472 F.3d 439, 442 (7th Cir. 2006) ("audit report might flunk Accounting 101," but "violating accounting conventions" alone is not enough to create tort liability).

[7] See Restatement (Second) of Torts § 432 cmt. a.

[8] See Viner v. Sweet, 30 Cal. 4th 1232, 1238 (2003).

[9] See id. (on the "'no deal' scenario"); see also Jalali v. Root III, 109 Cal. App. 4th 1768, 1777 (2003).

[10] See, e.g., Begier v. Price Waterhouse, 135 B.R. 222, 227 (E.D. Pa. 1991); Swearngin v. Sears Roebuck & Co., 376 F.2d 637, 642 (10th Cir. 1967).