

ACCOUNTANTS' PROFESSIONAL LIABILITY: A CLEAR STANDARD UNDER KANSAS LAW

Richard C. Dearth, JD*

J. Russell Hardin, Ph.D., CPA &

Abstract

The standards for accountants' liability have been based upon court-made law. Each state now has a different standard. A recent Kansas court case has provided a clear standard for professional liability by applying a state statute. Kansas has held that an accounting professional is liable only to those who directly engage the firm and to those who the accounting professional knows at the time of the engagement intend to rely on the services.

INTRODUCTION

A recent Kansas Court of Appeals decision, *Sparks V. CBIZ Accounting, Tax & Advisory of Kansas City, Inc., et al.* (36 Kan. App. 2d 660 (2006); 142 P.3d 749; 2006 Kan. App. LEXIS) should spark renewed interest in the standard of liability for accountants to third parties. Careful consideration of this "shield" statute should offer some stress reduction to accounting professionals in Kansas and cause accountants in other states to seek similar statutory protection where the law remains uncertain or adverse.

The plaintiff in this case, Sparks, was a former minority shareholder of Alexico Corporation. Sparks claimed that CBIZ

* Pittsburg State University, Pittsburg, Kansas
& University of South Alabama, Mobile, Alabama

(the defendant) was guilty of professional negligence (i.e. malpractice) while handling Alexico's accounts, so Sparks filed a derivative action against CBIZ. CBIZ filed a motion for partial summary judgment, claiming that Sparks lacked standing to pursue his derivative claim since Sparks was not a stockholder when the lawsuit was commenced. The Kansas case of *Richards v. Bryan*, 19 Kan. App. 2d 950, 879 P.2d 638 (1994) in the Kansas Court of Appeals established what has come to be called the "close corporation exception." This exception allowed Sparks the right to proceed and gave permission for an interlocutory appeal. On appeal, CBIZ raised two important points: (1) they claimed the close corporation exception recognized in *Richards* applies only when an existing minority shareholder files suit against a majority shareholder for breach of a fiduciary duty, and (2) since Sparks did not directly engage CBIZ to perform professional accounting services, liability was precluded.

The Kansas Court of Appeals remanded the case with direction to the District Court to grant summary judgment in favor of CBIZ. The court was largely persuaded by the fact that Sparks' cause of action was derivative in nature. The Kansas Court of Appeals held that, notwithstanding the *Richards* case, *Sparks'* action was limited to suits against "majority directors, officers, or directors for breach of a fiduciary duty." Since CBIZ was neither a director nor an officer, CBIZ was not liable to Sparks. The Kansas court went on to hold that there was a second compelling reason why Sparks could not proceed against CBIZ. That compelling reason was K.S.A. 1-402. K.S.A. 1-402 provides that:

No person, proprietorship, partnership or registered firm authorized to practice as a certified public accountant . . ., or any employee, agent, partner, officer, shareholder or member thereof, shall be liable to any person or entity for civil damages resulting from acts, omissions, decisions or other conduct amounting to negligence in the rendering of professional accounting services unless: (a) The plaintiff *directly engaged* such person, proprietorship or registered firm to perform the

professional accounting services; or (b) (1) the defendant knew at the time of the engagement, or the defendant and the client mutually agreed after the time of the engagement, that the professional accounting services rendered the client would be made available to the plaintiff, who was identified in writing to the defendant; and (b) (2) the defendant knew that the plaintiff intended to rely upon the professional accounting services rendered the client in connection with specified transactions described in writing. (Emphasis added by the Court.)

Sparks did not allege (and could not prove) that CBIZ had any knowledge that the professional accounting services would be made available to him, or that he intended to rely upon the accounting services, or that he directly engaged CBIZ. The court in essence held that the failure to allege and prove the facts necessary to qualify for section (b) (1) of K.S.A. 1-402 acts as a bar to a lawsuit.

SIGNIFICANCE OF THE SPARKS CASE

The significance of the Kansas ruling in the Sparks case and the interpretation of the Kansas statute can be seen in a brief analysis of accountants' liability. A standard for public accountants' liability to third persons that has been adopted in some states and by some Federal courts was based on a holding in a 1931 New York Court of Appeals case. In *Ultramares v. Touche, Niven & Co.* 255 N.Y. 170; 174 N.E. 441; 1931 N.Y. LEXIS 660; 74 A.L.R. 1139, the now famous Judge Cardozo wrote the opinion for the majority. In that case the defendants were employed by Fred Stern & Co. to prepare and certify a balance sheet on the condition of its business. Touche, Niven & Co. knew at the time of the engagement that Stern would exhibit the balance sheet to various banks, creditors, stockholders, and purchasers in the ordinary course of its business. Touche, Niven & Co. even prepared 32 copies certified with serial numbers as counterpart originals. The balance sheet was prepared based upon an audit. The

balance sheet stated that the assets of the corporation were \$2,550,671.88 and that the liabilities, other than capital and surplus, totaled \$1,479,956.62. In reality, Fred Stern & Co. was insolvent. The plaintiff was engaged as a factor and was asked by Stern to loan money. Plaintiff requested and received the balance sheet prepared by Touche, Niven & Co. Plaintiff then made a series of loans to Stern. The initial loans were paid back, and subsequent loans were made. Finally, Stern defaulted on three of the loans in the amount of \$100,000, \$25,000, and \$40,000. These loans were never satisfied due to Stern's bankruptcy.

The plaintiff factor (Ultramares Corporation) claimed that Touche, Niven & Co. were negligent in the preparation of the financial documents that the plaintiff relied upon to justify making the loans. The Court of Appeals held that there was no question that the financial documents were negligently made. The question was whether Ultramares Corporation could rely on these documents since the Corporation was not in "privity of contract" with the accountants and did not retain them. The court held that:

Public accountants owe to their employer a duty, imposed by law, to make their certificate without fraud and a duty, growing out of contract, to make it with the care and caution proper to their calling. Fraud includes the pretense of knowledge when knowledge there is none. It may also include the expression of an erroneous opinion where the supporting grounds are so flimsy as to indicate that there was no genuine belief back of it. To creditors and investors to whom the employer may exhibit the certificate, the accountants owe a like duty to make it without fraud where there is notice in the circumstances of its making that the employer did not intend to keep it to himself. Liability for negligence, however, is bounded by the contract, and is to be enforced between the parties by whom the contract has been made.

In other words without privity of contract with the accounting firm, Ultramares Corporation was without relief.

The “privity” rule of accountants’ liability to third persons has long been the law in New York. The New York court continued to recognize it in *Credit Alliance Corp. et al. v. Arthur Andersen & Co.* 65 N.Y. 2nd 536; 483 N.E. S. 2nd 435; 1985 N.Y. Lexis 15157. The rule was more recently enunciated in the case of *Security Pacific Bus. Credit, Inc. v. Peat Marwick Main & Co.*, 79 N.Y. 2d 695, 586 N.Y.S. 2d 87 (Ct. App. 1992), 597 N.E. 2d 1080. In this case, the New York court held that:

The Defendant accounting firm cannot be held liable to ... an institutional lender which lacks a contractual or other direct business relationship with defendant, for alleged negligence committed in [an] audit of financial statements of its client allegedly relied on by plaintiff in loaning [money] since plaintiff has failed to demonstrate the existence of a relationship between itself and defendant ...sufficiently approaching privity ...

The court concluded by saying:

Despite those who clamor for extending the degree of liability for accountants to third parties for negligent preparation of the audit or statements, it is perhaps wise to recall the remarks of Judge Cardozo in *Ultramares*: “If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath cover of deceptive entries, may expose accountants to liability in an indeterminate amount for an indeterminate time, to an indeterminate class.”

LIABILITY TO THIRD PARTIES

In 1982, the Ohio Supreme Court reviewed a very significant case that began the shift away from the *Ultramares* doctrine. In *Haddon View Investment Co. et al. v. Coopers & Lybrand*, 70 Ohio St. 2d 154; 436 N.E. 2d 212; 1982 Ohio LEXIS 659; 24 Ohio Op. 268, the court held that an accountant could be held liable to a third party (not in privity) for malpractice if the third party’s reliance could be foreseen by the accountant. This

case gave birth to the "foreseeability standard" for accounting liability.

In *Haddon View*, the Ohio court acknowledged that the *Ultramares* case was the leading case in determining the common law of accountants' liability. The Ohio court went on to note that, "more recently, however, a growing number of courts have declined to employ a strict privity rule to bar third parties from recovery for accountants' professional negligence." These recent cases allowed recovery by a foreseen plaintiff or one who is a member of a limited class whose reliance on the accountant's representation is specifically foreseen. The Court bolstered its position by citing cases from Minnesota, California, and other states.

The Ohio Supreme Court rejected an application of *Ultramares* that would bar recovery to an innocent third party who foreseeably relied on an accountant's report. To require a plaintiff in such a situation to be in privity with the defendant-accountant would ignore the fact that accountants make reports on which people other than their clients foreseeably rely in the ordinary course of business. The Court went on to state that the accountant's duty to prepare reports using generally accepted accounting principles extends to any third person to whom the accountant understands the reports will be shown for business purposes. The Court, therefore, held that an accountant may be held liable by a third party for professional negligence when that third party is a member of a limited class whose reliance on the accountant's representation is specifically foreseen.

It is interesting to note that there was a dissenting opinion. The dissent stated, "In abandoning the doctrine of privity the majority's decision needlessly extends the limits of accountants' liability and leaves the accountant open to unlimited and indefinite liability to third parties." The dissent also pointed out that in the typical accountant-client contractual relationship, the client, not third parties, exercises control over what work is to be done and the purposes for which it is to be used. The dissent went on to say that since it is the client who controls the work and for whose

benefit the work is performed by the accountant, the accountant should be held “legally responsible only to the client for any errors in the work.” The majority's decision in this case formed the foundation for holding accountants’ liable to *any* reliant third party. This in effect gave a free ride to non-paying parties. One could argue that parties not in privity with the accountant rely on the accountant’s work at their own peril. Finally, the dissent said that “to extend liability to third persons not in privity with the accountant places an enormous burden on the accounting profession which is not justified by a countervailing increase in public benefit.”

In 1996 in another third-party liability case, the Appellate Court of Illinois in *Chestnut Corp. v. Pestine, Brinati, Gamer, LTD et. Al.* 281 Ill. App. 3rd 719; 667 N.S. 2d 543; 1996 Ill. App. Lexis 409; 217 Ill. Dc, 454 was asked to interpret the liability of an accountant to third persons with whom the accountant was not in privity, but this time a state statute was in question. The Illinois court relied on Illinois statute, Public Accounting Act, 225 ILCS 450/30.1. In the court case, Chestnut Corporation was an investor in other businesses. The defendants were accountants. Chestnut was interested in investing in Alphatype Corporation, and in the course of its analysis, asked for and received financial statements prepared by or reviewed by Pestine, Brinati, Gamer, LTD. Principals of Chestnut Corporation interviewed the accountants and discussed the financial statements. In the course of the conversation, the defendants stated that the financial statements were accurate. Chestnut then made a 1.3 million dollar investment in Alphatype. Subsequently, Alphatype lost the investment money and filed for bankruptcy. The lawsuit disclosed that the value of the inventory was less than represented on the financial statements and the value of the accounts receivable was overstated. Chestnut Corporation claimed that it should be able to rely on the statements and that the accountants owed a duty of care to them. The Illinois Court held that the basis of liability for accountants in that state began with an analysis of *Brumley v. Touche, Ross & Co.*, 123 Ill. App. 3d 636, 463 N.E.2d 195, 79 Ill. Dec. 57 (1984). The Court

acknowledged that (due to the *Ultramares* case) for many years an accountant was liable in damages for his work only to his client.

Since the time of the *Ultramares* doctrine, a line of cases developed in Illinois that held a professional responsible to "non-privity" parties. The cases of *Rozny v. Marnul*, 43 Ill. 2d 54, 250 N.E.2d 656 (1969) and *Pelham v. Griesheimer*, 92 Ill. 2d 13, 440 N.E.2d 96, 64 Ill. Dec. 544 (1982) were examined by the lower Court. *Rozny* involved a decision whereby a person not in privity could recover against a surveyor, and in *Pelham*, a similar holding provided recovery for a party not in privity with an attorney. Based upon the rationale in *Rozny* and *Pelham*, the lower court held that an "accountant owed a duty to third parties who relied on his report or opinion if the accountant was acting at the direction of or on behalf of his client to benefit or influence [the] third-party."

After these cases, the Legislature in Illinois sought to clarify the matter with Section 30.1 of the Illinois Public Accounting Act. The Act provides that:

No person, partnership or corporation licensed or authorized to practice under this Act or any of its employees, partners, members, officers or shareholders shall be liable to persons not in privity of contract with such person, partnership or corporation, for civil damages resulting from acts, omissions, decisions or other conduct in connection with professional services performed by such person, partnership or corporation, except for: (1) such acts or omissions, decisions or conduct that constitute fraud or intentional misrepresentations, or (2) such other acts, omissions, decisions or conduct, if such person, partnership or corporation was aware that a primary intent of the client was for the professional services to benefit or influence the particular person bringing the action; provided, however, for the purposes of this subparagraph 2, if such person, partnership or corporation (i) identifies in writing to the client those persons who are intending to rely on the services, and (ii) sends a copy of such

writing or similar statement to those persons identified in the writing or statement, then such person, partnership or corporation or any of its employees, partners, members, officers or shareholders may be held liable only to such persons intended to so rely, in addition to those persons in privity of contract with such person, partnership or corporation.

In the *Chestnut* case, Pestine, Brinati, Gamer, LTD claimed (on appeal) that they had no duty of care to the plaintiff because they were not in privity of contract and there was nothing in writing that would indicate that the plaintiff was relying on the representations made by them.

The *Brumley* Court held, "A third party may state a cause of action under the statute even though there is no writing." Therefore, under the state statute, the *Chestnut* Court held that if the accountants knew that Alphatype intended for Chestnut Corporation to rely on the financial statements prepared by the accounting firm, liability to the third party could exist. The decision amounted to a reversal of the rationale of *Ultramares*. The court specifically held that "absent a clear signal from the legislature or the Supreme Court," *Ultramares* provides "a useful background as one measures the statute's meaning." In other words, the law had evolved to provide for third party liability of accountants in a similar way as lawyers and surveyors. The *Brumley* and *Haddon* decisions certainly provided a paradigm shift from the long standing *Ultramares* doctrine. The fact that it involved only the law of two states offered little comfort to accounting professionals who were wondering what the extent of their liability to third parties would be on work they had prepared primarily for clients.

Barbara Grzincic, writing in the *Daily Record* (Baltimore, MD) on November 24, 2000, said that states had adopted a "foreseeability" standard similar to the one set out in *Brumley* and *Haddon*. This was appalling to professionals who had relied on the *Ultramares* doctrine as a standard of professional liability. The Grzincic article does not identify the states that had adopted this

view. Grzincic was commenting on the 2000 case of *Walpert, Smullian & Blumenthal V. Katz, et al.* 361 Md. 645; 762 A.2d 582; 2000 Md. LEXIS 696. In that case, the Maryland Court of Appeals reviewed the issue of when, if ever, an accountant is liable for economic losses of a party who relied on a financial report prepared by the accountant in the absence of a contractual relationship with that party.

In *Walpert V. Katz*, the accountants noted that apparently three standards of third-party liability had evolved with respect to accountants' malpractice: (1) the privity standard, first articulated in *Ultramares...*; (2) the more liberal foreseeability standard; and, (3) the 'reasonably foreseeable' standard adopted by three States. The accountants argued that Maryland had adopted the "privity" standard. The court said, "Where the failure to exercise due care creates a risk of economic loss only, courts have generally required an intimate nexus between the parties as a condition to the imposition of tort liability." The court then launched into a long, detailed analysis of nearly every case that had been before it that dealt with the issue of "intimate nexus."

In finally reviewing the privity theory, the court reasoned that, "the reason for the requirement is to limit the defendant's risk exposure to an actually foreseeable extent, thus permitting a defendant to control the risk to which the defendant is exposed." The Maryland court acknowledged that a significant number of cases follow the *Ultramares* decision, under which a third party will be denied relief for an auditor's negligence in the absence of a relationship with the auditor that constitutes privity. The Maryland court, however, determined that the majority of the jurisdictions, by the time of this case, were following a foreseeability standard. The Maryland court carefully evaluated the pros and cons of the approaches. At the end of the long opinion, the Maryland Court abandoned the *Ultramares* standard in favor of a foreseeability standard.

CONCLUSION

Over time, the standard for accountants' liability has changed. Largely, the standards are based upon court-made law. Every accounting professional should be aware of the standards of liability as the standards are applied in each individual state. Essentially, each state now has a different standard. The significance of the (Kansas) *Sparks* case is that the legislature can still save the day in setting public policy when it comes to professional liability. The Kansas statute provides a bright line standard for professionals. It is now easy (in Kansas) to understand the extent of professional liability. The accounting professional is liable to those who directly engage the firm and to those who the accounting professional knows at the time of the engagement intend to rely on the services. Furthermore, the accountant has the protection of requiring a written record of those transactions. Accountants and other professionals in other states should push for legislation similar to the Kansas statute.

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