

opinion

BY GREGORY R. SARACINO



The dangers of fiduciary duty

AS ANY EXPERIENCED DOCTOR or lawyer may tell you, occasional malpractice claims are inevitable by-products of a busy and long-lasting practice.

Many accountants, on the other hand, will proudly affirm that they have sustained long, rewarding careers without being sued. The recession, in exposing Ponzi schemes and other instances of misconduct, coupled with memories of Enron, has cast a spotlight — or, depending on who's doing the talking, a shadow — on the actions of accounting firms. As such, the paradigm has changed. Accountants are under more scrutiny by their clients than ever before. This scrutiny often translates into mistrust and accusation, which in turn translate into lawsuits.

My evidence for this is simply the increase in malpractice cases landing on my desk that don't feature doctors or lawyers as defendants, but rather accounting firms — large and small. And like any evolving area of litigation, lawyers for the claimants will unearth a host of innovative ways in which to plead a case. Some old avenues of attack are modified; others are invented. In an alarming trend, plaintiffs invariably allege that the defendant accountant not only acted negligently, but also breached a fiduciary duty allegedly owed to the client.

So what does this fiduciary duty mean, anyway? Does an accountant always owe such a duty to a client? Unfortunately, answers to these questions are not entirely clear. Luckily, courts are churning out fresh law on the issue.

But before we look to legal authority, let's examine what it traditionally means to be a fiduciary. *Black's Law Dictionary*, in a baffling manner, uses almost an entire page defining the cryptic term. One buried line of text appears to embody a cogent definition for our purposes: "A person holding the character as

a trustee, or a character analogous to that of a trustee, in respect to the trust and confidence involved in it and the scrupulous good faith and candor which it requires."

That's quite a helping of legalese, I'll admit, but we're getting there. The late, esteemed New York Judge Benjamin Cardozo clarifies the concept: "A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive."

Indeed, the fiduciary relationship itself is difficult to define. The Connecticut Supreme Court, for example, has specifically refused to define a fiduciary relationship in precise detail and in such a manner as to exclude new situations, choosing instead to leave the bars down for situations in which there is a justifiable trust confided on one side and a resulting superiority and influence on the other.

So what duty does a fiduciary owe to its principal? The New York Pattern Jury Instructions provide that a fiduciary owes an undivided loyalty and may not act in a manner contrary to the interests of the principal. The instructions further provide that, "[A] person acting in a fiduciary capacity is required to make truthful and complete disclosures to those to whom a fiduciary duty is owed and the fiduciary is forbidden to obtain an improper advantage at the other's expense."

Thus, in order to establish a breach of this duty, a plaintiff must prove the existence of a fiduciary relationship, misconduct by the defendant and damages that were directly caused by the defendant's misconduct. Of course, it is a basic tenet of tort law that one standing in a fiduciary relationship with another is subject to liability to the other for harm resulting from a breach of duty imposed by the relationship.

WHAT IT MEANS FOR ACCOUNTANTS

Is there a fiduciary relationship owed to a client? Let's first consider the following: Officers and directors of a corporation stand in a fiduciary relationship to the corporation and owe their unqualified loyalty to the corporation. Similarly, the board of directors of a condominium owes a fiduciary duty to a condominium owner. A real estate broker, as agent for an owner, owes a fiduciary duty

to act in the best interests of the principal. Of course, an attorney stands in a fiduciary relationship to her client. Courts have held that even spouses stand in a fiduciary relationship to each other!

So, does the accountant owe their client a fiduciary duty? In light of the above it seems that naturally they would; it is a professional relationship, after all, and there is indeed some semblance of trust between the professional and client. But lo and behold, the answer is a qualified "no," there is generally no fiduciary duty owed.

Absent allegations suggesting a relationship of special trust or dependence beyond the typical commercial reliance of one company on the services of another, an accounting firm's client cannot establish an actionable claim for breach of fiduciary duty. If a client justifiably places a special trust and confidence in the accountant, an accountant may be found to be a fiduciary.

Obviously a client has a great deal of trust in their accountant to begin with; otherwise, no relationship would exist at all. But courts hold that subjective trust alone is not enough to transform arm's-length dealing into a fidu-

ciary relationship. Courts will generally reject claims alleging a breach of fiduciary duty citing the basic legal principal: The duty owed by an accountant to a client is generally not fiduciary in nature.

Accountants wear different hats, of course. Sometimes they are retained to prepare tax returns; other times they are retained to perform reviews of financial statements. It seems axiomatic enough that no fiduciary duty exists in these circumstances. Well, what if the accounting firm is retained to perform an audit? The Washington Court of Appeals has held that, absent special circumstances, an auditor is not a fiduciary of its client, as an independent auditor's primary duty is to the public and this is inconsistent with a fiduciary status. New York and Connecticut law establish that an independent auditor engaged to present an audit opinion as may be required by securities laws owes no duty to third-party shareholders.

In a North Carolina case, a client's allegations against her accountant to investigate a proposed merger involving the client and failure to advise regarding the merger were

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"Quick, Henson — seal the exits, call the police, and get a pathologist in here to determine the exact time he left the payroll!"

YOUR TURN: TELL US WHAT YOU THINK

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LETTERS

M&B on point

I WAS PLEASANTLY SURPRISED to see the column on page 16 of the June 7-20, 2010, issue of *Accounting Today* by Miller and Bahnson pointing out that, "A culture of deception is embedded deep in our profession, even to the point that few grasp its existence."

Their point was also made in an article in the same issue, titled "Acc'ting, biz groups object to Brown Amendment."

It would appear from the latter article that the American Institute of CPAs and other accounting organizations object to a proposed law that requires that reports submitted to the Securities and Exchange Commission "record all assets and liabilities of the issuer on the balance sheet of the issuer."

At a time where financial statements have become nearly useless to investors and likely played a large part in the current economic crises, I find it ridiculous that any CPA could object to recording all assets and liabilities of the issuer on the balance sheet of the issuer! If you read the language of our opinion (presents fairly, in all material respects, the financial position of the company) financial statements should always include "all assets and liabilities" regardless of arcane rules created by misguided intellectuals.

CPAs need to wake up and take charge of their profession before it is too late.

*John W. Meara, CPA, ABV, CFE, CFF
Meara Welch Broune PC
Kansas City, Mo.*

No mobile apps?

I READ THE TOP NEW PRODUCTS OF 2010 (June 12-July 18, 2010, page 20). I think it was a worthwhile article; however, I was disappointed that there were no mobile devices or mobile apps mentioned anywhere in this

article. You can't pick up a major newspaper without reading about how mobile devices and mobile apps are changing our world. Have you heard of the iPhone or the iPad and their related apps? Both are without a doubt the biggest technology game-changers in the last decade. They've become major mainstream products and are used day in and day out by CPAs. Your omission of these devices and the many tax, accounting and finance apps that run on them seems to indicate that you're out of touch with where technology in our profession is headed.

*Todd Blome, CPA
Lincoln, Neb.*

Another response to Bose

A LETTER FROM HARRY BOSE, CPA (June 7-20, 2010, page 9), got my blood pressure up. It is disheartening to see an experienced small-firm practitioner suggest that Congress raise the top marginal income tax rate to 90 percent to restore "a progressive tax system" to support a functioning democracy.

Mr. Bose blames what he finds as a top-heavy concentration of wealth on Ronald Reagan.

Let's start with a few things Mr. Bose and I agree on. I too believe the Alternative Minimum Tax must be indexed. It's too late to even think about eliminating the AMT, but I support a redesign of the AMT to sweep in taxpayers with incomes over \$1 million. Currently, one of the illogical consequences of the AMT is its phase-out for high rollers.

I, like Mr. Bose, find spending on lobbyists and campaign contributions unsettling. My solution is not to vote for anyone who is currently in office, since they are all doing a terrible job. Let's throw the bums out and,

while we're at it, make them join the Social Security system.

Here's where I disagree with Harry Bose.

He argues that our current 35 percent top rate is not high enough and refers to the glory days of 70 percent and 90 percent tax rates. In those days, anyone with a decent financial advisor invested in tax shelters. Even a simple real estate investment generated huge depreciation deductions. The 1986 Act not only did away with that type of fun, but also brought in IRC 469, which effectively removed the tax benefits from investing in loss-generating activities.

Reaganomics successfully put more money in the hands of taxpayers and reduced government spending. History has shown that government is inefficient and the current bunch in Washington is spending money so fast, no tax increase will plug the leak.

Mr. Bose complains about the high cost of Social Security. Is he suggesting the rate be lowered? Social Security is quickly going broke. In 2013, taxpayers with adjusted gross income over \$200,000 (single) or \$250,000 (joint) will be paying more into Medicare on earned and investment income. That sounds like more tax on successful taxpayers to me.

Recently, *The Wall St. Journal* told us that the top 1 percent of U.S. earners pay 40 percent of total tax collections and the top 5 percent account for more than 60 percent of tax revenues. When is enough enough?

In January 2011, the top rate goes to 39.6 percent and in 2013, a 3.8 percent tax on investments, which is part of the insane Health Care Act, will bring the top marginal rate up to 43.4 percent. The taxpayers who are already paying a majority of the tax will pay even more. How are these same taxpayers expected to invest and build their own companies when more than half of their income is being taken for taxes? Don't forget about sales tax, the inevitable value-added tax that's coming,

and heavy real estate taxes. What successful Americans pay in total taxes today far exceeds what they paid when the federal income tax rates were higher.

A serious problem with Americans is our impatience. Those who argue that Reagan's tax cuts were bad fail to look at the unprecedented economic boom our country and most of the world enjoyed during the Clinton and early Bush years. Reaganomics was not designed to achieve instant results, but half a generation later, our economy showed what giving more money to successful taxpayers can do. After a historic strong economy, it took some greed along with some bad planning and a total failure of our regulators to bring on our current economic disaster. Will higher tax rates save us? I sincerely doubt it.

Finally, Mr. Bose suggests that *Accounting Today* should not be political and should "be about tax planning and accounting standards." Accounting is dull enough already, and I applaud your continued political thoughts and attacks. Although I rarely agree with *The New York Times* editorials, I look forward to reading them daily. *Accounting Today* is independent of any regulatory or membership organization and, in my opinion, is more readable with some strong opinions.

Mr. Bose expressed concern about having so much wealth concentrated with so few and expressed his concern about our failing democratic system. On the contrary, I strongly believe that the current administration is undoing most of what my generation (age 64) worked so hard to build. I am disgusted with what they are doing to get votes from a majority of our population that pays no income tax. That situation will only get worse and will end democracy as we know it. I hope I am wrong.

*Doug Stives, CPA
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West Long Branch, N.J.*

Fiduciary

FROM PAGE 8

held to be general malpractice claims, not claims for breach of fiduciary duty.

What if the accountant serves as a "business advisor?" Now it starts getting tricky. In one case, an accounting firm agreed to serve as a business advisor to recommend improvements in internal accounting controls, operating controls and policies. The plaintiff argued that the accountant breached fiduciary duties by failing to disclose that it lacked the expertise necessary to perform the services for which it was retained, and that it

lacked expertise to make final decisions on technical issues. The court in that instance held that the firm's engagement was not sufficient to create a fiduciary relationship.

But this business advisor concept can go both ways. If an accountant renders personal, financial or investment advice to the client, a duty will arise, thus exposing the accountant to a potential claim.

In a Texas case, *Dominguez v. Brackey Enterprises*, evidence was sufficient to support a finding that an accountant had a fiduciary relationship with two client investors who gave money to a seafood broker pursuant to the accountant's advice. The accountant

worked for the investors' corporation and was a social friend with one investor. However, the evidence established that the accountant breached his fiduciary duty to his investors when he advised the investors to advance \$59,000 to the seafood broker because the accountant was a shareholder, officer and director of the seafood broker and made various assurances concerning the broker to secure an investment. The accountant in that case didn't stand a chance.

The *Dominguez* case teaches another lesson as well: The accountant involved with the seafood transaction was held personally liable for losses suffered by investors when they

advanced money to the seafood broker.

SPECIAL CIRCUMSTANCES

Of course, there are other instances where the fiduciary duty will certainly arise, and accountants should be aware of what the courts call "special circumstances." A fiduciary duty is often found when the accountant is directly involved in managing their clients' investments, assets or internal business operations. This will occur when substantial control over a portion of the client's business is surrendered to the accountant, or simply when money or property belonging to a client is

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PAC

FROM PAGE 1

in Congress this November, accounting PACs are showing few signs of resuming their previous lopsided support for Republicans.

At the same time, during a period when incumbents from both parties are drawing fire from an angry electorate, political fundraisers for the accounting profession are showing little interest in supporting challengers for their seats, in part out of a reluctance to irritate incumbent senators and House members.

That's not to say political newcomers were cut off altogether. Republican businessman Tim Burns received \$5,000 from the Deloitte PAC during his unsuccessful campaign for the seat of the late Pennsylvania Congressman John Murtha; Massachusetts Republican Scott Brown collected \$1,000 from the American Institute of CPAs' PAC in his successful bid for the late Ted Kennedy's Senate seat; and Democrat Martha Coakley, who lost to Brown earlier this year, received \$2,500 from the Ernst & Young PAC.

In each case, however, the non-incumbent recipient of industry PAC funds was vying for an already vacant House or Senate seat.

Meanwhile, Tea Party candidates — including Sarah Palin's "Momma Grizzlies," such as California Senate hopeful and former Hewlett Packard CEO Carly Fiorina, and

Kentucky Senate hopeful Rand Paul — had yet to receive a dime from accounting PACs as of the mid-June filings.

Here's where the accounting PACs stand heading into this fall's elections:

► **The AICPA:** The institute's PAC has donated \$418,353 to federal candidates, with 57 percent of the funds going to Republicans. Top recipients include GOP House Whip Eric Cantor of Virginia, and Republican Senate candidates Roy Blunt of Missouri and Michael Castle of Delaware, each of whom received the maximum \$10,000 contribution.

► **Deloitte:** The industry's largest and most active fundraising organization has so far contributed \$844,000 to congressional hopefuls. Republicans received 54 percent of the total, with Blunt and Castle each collecting \$10,000 for their Senate races, and an equal amount going to a number of House candidates, including Republicans Spencer Bachus of Alabama and Shelley Moore Capito of West Virginia, and Democrats David Price of North Carolina and Steny Hoyer of Maryland.

► **Ernst & Young:** E&Y's PAC made \$524,500 in contributions to candidates through mid-June and channeled 60 percent of this money to Republicans. Among those receiving the \$10,000 maximum from Ernst & Young's PAC: Sen. Charles Schumer, D-N.Y., and GOP Senate candidate Rob Portman of Ohio.

► **PricewaterhouseCoopers:** PwC's PAC

doled out more than \$1 million to 2010 candidates, with Democrats on the receiving end of nearly half (47 percent). Recipients at the \$10,000 level included Utah's Republican Senator Robert Bennett (before he fell victim to the Tea Party movement), and fellow GOPers Sen. Mike Crapo of Idaho and Illinois House candidate Judy Biggert, as well as Democrats Sen. Blanche Lincoln of Arkansas, and Rep. Brad Ellsworth of Indiana.

► **KPMG:** The KPMG PAC has so far contributed roughly \$640,000, with 53 percent going to Republicans. Major recipients (\$10,000 each) include Democratic House candidates Carolyn Maloney of New York, Paul Kanjorski in Pennsylvania, and Mike Ross of Arkansas, and, on the GOP side, Reps. Jeb Hensarling and Lamar Smith, both of Texas, and Rep. Thad McCotter of Michigan.

► **Grant Thornton:** GT's PAC paid out \$106,000, with 56 percent going to GOP hopefuls. Top recipients (\$5,000 each) include Schumer and Republican House candidates Eric Cantor of Virginia, Spencer Bachus of Alabama, and California's Kevin McCarthy.

► **National Society of Accountants:** The society's small PAC has paid out \$14,500 so far to candidates in this year's elections. Democrats received 93 percent of these funds, with House members John Lewis of Georgia (\$5,000) and New York's Nydia Velazquez (\$4,500) taking the lion's share. **AT**

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Fiduciary

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entrusted to the accountant.

In a New York case, accountants were held liable for aiding and abetting the breach of fiduciary duty by the board member defendants in view of the plaintiffs' showing that the accountants had complete knowledge of the misuse of condominium funds and were indispensable to the board member defendants in their efforts to conceal the misuse of those funds.

In another case, the plaintiff accused his accountant of falsely certifying that it had conducted each of its audits in compliance with generally accepted auditing standards. This allegation survived the defendant's motion to dismiss and the court allowed the merits of the breach of fiduciary duty claim to be meted out at trial.

So how is this risk avoided? Sometimes it cannot be. An accountant may be exposed to a potential claim for breach of fiduciary duty even if she acts entirely ethically and in accordance with law. In other words, it does not require any criminal or unethical conduct on the part of an accountant for her to be sued on a fiduciary theory. Every engagement is unique, and whether the duty

arises is based on the terms of that particular engagement.

Thus, a practitioner should be keenly aware of the type of services that are to be provided. Of course, it's not advisable for an accountant to immediately cease serving as a financial advisor to a client if that relationship has already been established. Often, certain engagements by their very nature will call for more than the mere preparation of tax returns. But one should at the very least stop and consider the engagement and the risks inherent therein, and, more important, consider potential risks when a new engagement is entered.

I cannot stress enough the importance of a written and signed engagement letter that spells out the exact terms of the accountant/client relationship. Indeed, whenever a new assignment arises, even with a long-standing client, drawing up a fresh engagement letter is good practice. These letters generally serve as authoritative evidence as to the scope of the assignment. In the letter, spell out the scope of the services to be provided, and stick to it throughout the engagement. If circumstances require the scope be modified, simply draft a new letter. As a preliminary matter, a claimant cannot sustain a claim for breach of fiduciary duty if the accountant did not

contract for the types of things that will give rise to such a duty.

Of course, the accountant should strictly adhere to the terms of the engagement or risk exposure to claims that exceed that of ordinary negligence. And with regard to negligence claims, one must not forget that accountants have a duty to perform within the scope of their professional accounting standards, which generally go beyond simple auditing and bookkeeping.

Finally, if a claim is brought against an accountant for breach of a fiduciary duty, that practitioner should advise their attorney to consider extinguishing the claim with a motion to dismiss, if the engagement letter and subsequent actions show that no such duty could possibly arise. The accountant should instruct the attorney to get any frivolous breach-of-duty claim out of the way early, as dealing with it will only serve to complicate the litigation discovery process.

As discussed above, lawyers who draft accounting malpractice complaints will use every tool in their arsenal to elicit a swift recovery for their clients. Luckily, the courts have armed accountants and their attorneys with tools to protect against baseless claims for an alleged breach of the often-cryptic fiduciary duty. **AT**