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Compliance with Professional Standards Reduces Risk of Liability for Negligence

By Attorney John Hughes

The California Court of Appeal issued an important decision for the defense of accounting malpractice cases in the case of National Medical Transportation Network vs. Deloitte & Touche. Specifically, this decision emphasizes that compliance with professional standards significantly reduces the risk of liability for negligence. Because of the importance of this decision, I thought I should bring it to your attention.

The facts of the case were these:

Plaintiff hired Deloitte as its independent auditor as part of an overall effort to attract new investment. After an unsuccessful effort to resolve disputes with plaintiff's management about the need for adjustments to the company's financial statements, Deloitte resigned without issuing an audit opinion. The plaintiff was then able to hire successor auditors but ultimately lost a potential \$10 million dollar capital investment.

Plaintiff sought to hold Deloitte responsible for this lost investment by claiming that Deloitte committed professional negligence by withdrawing as auditor prematurely. Plaintiff claimed that Deloitte thereby breached the engagement contract by not issuing an audit opinion and negligently interfered with plaintiff's prospective business relationship with both potential successor auditors and the potential investor. In response to these claims, Deloitte maintained that under the relevant professional standards, it had good reason to resign from the engagement. Deloitte argued that professional standards required its resignation because of its determinations that plaintiff's management was uncooperative, made unreliable financial representations, and impaired Deloitte's independence by making threats.

Unfortunately, at trial the judge gave a jury instruction which did not mention good cause, but rather indicated that Deloitte's resignation was wrongful if it was found to be unduly prejudicial to plaintiff's interests and occurred before the plaintiff has a reasonable opportunity to engage a successor auditor. Following this instruction, the jury awarded the plaintiff almost \$10 million dollars in damages against Deloitte.

On appeal, the Court of Appeals reviewed the evidence presented at trial in detail. During the trial, the plaintiff's expert testified that Deloitte had resigned prematurely without sufficient "competent evidential matter." Deloitte's expert testified that its resignation was permissible under professional standards once Deloitte lost faith in the integrity of plaintiff's senior management and therefore, could no longer complete its audit. Deloitte's expert also testified that its resignation was required under professional standards once its independence was compromised by threats made to it.

The Court of Appeals accepted Deloitte's argument that when an accountant's resignation is permitted or required by professional standards, the accountant may resign regardless of

the effect on the client's interests and regardless of whether or not the client has retained a successor accountant. The Court found that the trial court's instructions misstated the professional standards applicable to Deloitte as an auditor. Under those professional standards, an auditor may properly resign where permitted or required regardless of whether such resignation may jeopardize the client's interest. In fact, under those professional standards, an auditor permitted or required to resign is not even obligated to give the client a reasonable opportunity to employ a successor auditor. This result is dictated by the public responsibilities, which auditors have, to maintain their independence which transcends their employment relationship with their clients.

This case's greatest significance is its confirmation that an accountant's liability generally should be governed by whether or not he or she complied with professional standards rather than another set of rules devised by the law. A growing number of courts have come to recognize that there is no rationale for imposing a separate legal standard by which an accountant's conduct should be measured which is different from the ethical obligation which an accountant has to comply with the standards of his or her own profession. Thus, although compliance with professional standards is not an absolute guaranty against legal liability, accounting malpractice plaintiffs will be hard pressed to establish negligence in the face of uncontradicted expert testimony that the accountant's conduct complied with professional standards.

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John practices business litigation and has extensive trial and appellate experience in courts throughout the country. He assists liability insurers with complex claims and coverage matters. He also represents insurers in coverage and bad faith litigation in state and federal courts. Many of his engagements have concerned financial institutions, particularly banks, investment advisers, mutual funds, venture capital funds, and insurance and securities brokers. These cases have involved claims under ERISA, the Investment Company and Investment Advisers Acts of 1940, federal and state securities laws and state law on negligence and breach of fiduciary duty.

John also represents clients involved in accounting malpractice litigation concerning both auditing and tax preparation services. He speaks frequently on the subject of accounting malpractice before both legal and accounting professional groups. He has been quoted on the subject of accounting liability in *The Wall Street Journal*. Through recognition of his knowledge in the area, John has been retained by two major regional accounting firms to advise them on risk management issues. His involvement in these cases (which has been instrumental in creating new legislation) has been noted in professional journals. He has also written numerous articles on accountant liability, which have appeared in a variety of national journals.