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Are CPAs Liable for Bad Investment Advice?

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The Advice and the Lawsuit

Joe Letke was a CPA in Illinois and was the principal in a small accounting firm, Letke & Associates. Mark Rauner hired Joe's accounting firm in 2006 and 2007 to perform accounting services for Mark personally and for Mark's construction company. In early 2007, Joe told Mark about a potential real estate investment opportunity that had materialized because the buyer had not been able to obtain financing to close the transaction.

Joe and Mark later formed an LLC with six other investors. The LLC then purchased a controlling interest in a holding company with subsidiaries that owned real estate in Illinois, Indiana, and Michigan. The purchase price was paid through issuance of a promissory note for $48.75 million to the seller, Gierczyk Holding Company. The note was personally guaranteed by Joe, Mark, and the other six investors.

During the following months, the LLC encountered difficulties in obtaining financing for the individual properties. In August 2007, the LLC sent Gierczyk a notice of default for breach of Gierczyk's obligations under the purchase agreement. This was done likely as a "preemptive strike," as Gierczyk filed suit in October 2007 seeking to collect the full amount of the $48.75 million note then in default from Joe, Mark, and the other six investors who had signed personal guarantees.

In March 2012, Mark sued Joe and his accounting firm for breach of fiduciary duty, negligent misrepresentation, and common law fraud. The suit alleged that Joe and his firm had failed to perform adequate due diligence when advising Mark about the investment potential of the real estate properties. Mark further claimed that he was entitled to rely on the professional expertise of Joe and his firm in evaluating the risk of the investment.

The trial court ruled that Joe and his firm had provided "professional services" to Mark, including due diligence on the value of the properties, the status of the properties' financing, and advising Mark on the investment and financial liability potential arising from the transactions.

In spite of this finding, the trial court ruled in favor of Joe and his accounting firm. In October 2015, the appeals court ruled in favor of Joe and his accounting firm.

How could Joe and his firm have won if the services they provided were "professional services" on which Mark was entitled to rely? The answer: the statute of limitations for claims against CPAs and firms for an "act or omission in the performance of professional services" is two (2) years from the time the person knew or reasonably should have known of the act or omission.

In reaching its decision, the appeals court cited a 2015 Illinois Supreme Court case, Brunton v. Kruger. In that case, the question was whether the CPA-client privilege applied when the CPA had performed estate planning services. The plaintiff argued that the privilege did not apply because the definition of "professional services" in the Illinois Public Accountancy Act referenced (1) reporting on financial statements, (2) other attest engagements, and (3) use of "professional skills" in accounting, management, financial or consulting services, compilations, internal audit, preparing tax returns, bookkeeping, or representation of taxpayers.

The Illinois Supreme Court did not buy this rationale, however. In the words of the appeals court:

> "In *Brunton*, our supreme court rejected this narrow interpretation. The court noted that, while the Act defines certain accountancy activities as being within the purview of public accountants (creating and auditing financial statements, preparation of tax returns, and rendering opinions based upon examinations of financial statements), the Act does not purport to be an exhaustive list of services that fall within the professional services provided by public accountants. The court, noting that the list of 'accountancy activities' contained in the Act was not intended to be exhaustive, held that public accountants use their 'professional skills or competencies' to provide 'professional services' beyond those enumerated in the Act." [Emphasis added]

Alaska Public Accountancy Statutes and Regulations

AS 08.04.005 of the Alaska Public Accountancy Statutes (December 2015), provides that:

> "It is the policy of the state and the purpose of this chapter to promote the reliability of information that is used for guidance in financial transactions or assessing the financial status or performance of commercial, noncommercial, and governmental enterprises." [Emphasis added]

The definition of “engagement” in 12 AAC .04.990(14) is also relevant:

> “’engagement’ means an agreement between a client and a licensee regarding the performance of professional services and the services performed under the agreement.”

These provisions of the Alaska Public Accountancy Statutes and Regulations support a broad interpretation of the scope of services provided by CPAs. For example, “guidance in financial transactions” is a very general term, while the definition of “engagement” references the performance of professional services “under the agreement.” You can see that a judge could be persuaded that investment advice such as that rendered by Joe would be encompassed within “guidance in financial transactions” so that an Alaska CPA would be liable for providing investment recommendations for a client.

AICPA Code of Professional Conduct

ET section 0.400.40 defines “professional services” as follows:

> “Include all services requiring accountancy or related skills that are performed by a member for a client, an employer, or on a volunteer basis. These services include, but are not limited to <u>accounting, audit and other attest services, tax, bookkeeping, management consulting, financial management, corporate governance, personal financial planning, business valuation, litigation support,</u> educational, and those services for which standards are promulgated by bodies designated by Council.” [Emphasis added]

By including terms such as “financial management” and “personal financial management” in the definition, the Code of Professional Conduct arguably would be interpreted to encompass client investment advice within the scope of professional services.

Points to Consider and Conclusion

Here are some points you might consider about Joe’s case:

- As you can see from the case facts, Joe was a co-investor with his client in the LLC. This was not a focus of the trial or appeals court, but you can see that this situation was filled with actual and potential conflicts of interest. If Joe wanted to invest, he should have instructed Mark to hire another firm to perform the required due diligence and related professional services.

- The trial court found that Joe and his firm had provided professional services to Mark. What do you suppose would have happened if Mark had filed suit within two years of the LLC's formation? While there is no way to know with certainty, the statute of limitations defense would have disappeared and Joe could have faced a far different result at trial.

For this reason, CPAs need to be careful when asked to "eyeball" a potential investment for a client. Is this service within the scope of a signed engagement agreement? If not, the CPA should document the expanded scope of the engagement or prepare a new engagement agreement covering the services to be rendered. A CPA who agrees to conduct due diligence on a client's investment opportunity should ensure

- the scope of investigation is appropriately documented and followed,
- the investigation is adequate to address the investment's actual and perceived risks and rewards,
- that the suitability of the investment is discussed in contemplation of the client's investment objectives and risk tolerance, and
- that conclusions are based on known facts, that any open issues that could not be ascertained – and the possible impact of those open issues – are noted and described, and any investigation limitations imposed by third parties or the client are appropriately described.

Many CPAs in Joe's position – even if not investing alongside a client – will decline to review a client's investment opportunity. While a client might be offended by a refusal to informally "help out," that might be preferable to being sued subsequently for failing to properly "due diligence" an investment opportunity. While this is a personal choice, practitioners should consider their own "risk mitigation" if clients seek their "informal" advice about potential investment opportunities.
