Pennsylvania
CPA JOURNAL
Fall 2013 | Volume 84, Number 3

Liability Lessons

Practitioners: Beware the Family Affair

By Jonathan S. Ziss, JD

CPAs who work with families and family businesses must be mindful that conflicts of interest and preserving client confidentiality can be a cause for concern. A breach of confidentiality by a practitioner would violate state law, would likely be deemed an ethics violation (discreditable act), and could result in adverse action against one's license. By issuing all the necessary engagement letters and by minding the Code of Ethics, practitioners can meet their clients' needs while mitigating their own professional risk, such as action against one's license, exposure to civil damages, and impairment of one's reputation.

The following scenario is drawn from several actual cases in which these guidelines were not scrupulously adhered to.

The Spamm Family is reasonably well-off due to the success of the family business, SpammCo Enterprises. The business was founded in 1957 by twin brothers Adolph and Rudolph Spamm. Adolph passed away in 2005, at the age of 75, leaving behind his widow Gertie and their only child, Arnold. Rudolph continued to show up for work until the age of 80, in 2010.

Rudolph, a creative type, was the pair's marketing genius; Adolph was the financial wizard. Rudolph's two daughters are both independent artists. Arnold serves as president and CEO of SpammCo.

In 1999, Arnold divorced his wife and mother of his four children, only to remarry the family's long-time nanny. His mother, Gertie, was deeply upset with Arnold, and she never forgave what she saw as a betrayal. Still, Arnold served as trustee of the Adolph Spamm Family Trust.

Abner Smith, CPA, managing partner of a firm of 20 professionals, is the trusted CPA for SpammCo. For many years the firm prepared the corporate tax returns and reviewed the financial statements for SpammCo. Smith also had a seat on the board. In addition to providing services to SpammCo, Smith prepared tax returns for Gertie, Arnold, and Rudolph's daughters. He is also a co-trustee with Arnold on the family trust.

This level of entanglement – fraught as it is with the possibility of conflicts and broken confidences – is not at all uncommon, as families tend to work with a given firm or CPA across all of their interests, business and personal. Yet, a surprising level of naiveté can be found amongst practitioners, who rely on goodwill, informal family accord, friendship, and tradition to insulate them against frank ethical dilemmas.

Rudolph died in 2011, and his nephew Arnold bought out his cousins' shares of SpammCo and those of his mother, Gertie. Smith provided guidance concerning the valuation of the company's stock based on a formula in the shareholders' agreement. After running the company successfully for another 18 months, Arnold arranged to sell the company to the private equity firm Blackstone for considerably more per share than he had paid to his relatives.

Gertie, shocked by the sale of SpammCo and by the windfall for her son and his second wife, fired off a handwritten complaint to the State Board of Accountancy in which she accused Smith, her son, his lawyer, and Blackstone of conspiring to steal from the family. The cousins were copied on the complaint, which suggested that they held the same opinion as Gertie.

Smith received news of the complaint glumly, but he made the correct decision to immediately call his insurance broker and his lawyer. He met with his lawyer, who asked to see all engagement letters. Smith assumed he meant the letters for tax preparation and the review of financials. Frustrated, the lawyer demanded to see all the engagement letters, including those for the trust engagements, the valuation engagement, and any work done in connection with the sale to Blackstone. The clarification was met with silence.

The lawyer proceeded to ask who the client was in connection with Arnold's purchase of his family's SpammCo stock. Smith explained that the bill was paid by the company, so he assumed the company was the client. The lawyer asked if he had spoken with the twins during the sale process. Smith said he explained to them what was happening and what the tax implications were. The lawyer asked if he advised the twins to get independent advice from their own lawyer or accountant before agreeing to the purchase price of the stock. This, too, was answered with silence. So was the follow-up question as to whether he advised Gertie to get her own advisor.

Smith quickly understood where the scenario was heading. Without engagement letters for the trust, valuation, and sale work, he left himself exposed to a perceived conflict of interest of favoring Arnold and SpammCo over his other clients, despite his best of intentions and without any overreaching by anyone that he was aware of. He also left himself exposed to a malpractice claim concerning the 2011 valuation, which to the sellers now appears suspiciously low based on the value of the Blackstone deal. On top of it all was the contention that he had breached accountant-client privilege by discussing the business of one client with another, without clear permission to do so. In Pennsylvania, unlike many states, accountant-client communications are protected by a statutory privilege (63 P.S. Section 9.11a).

Smith may have dodged some bullets. He fortunately had kept careful time and billing records of his work in connection with the 2011 valuation, showing that he simply confirmed the arithmetic of the formula used in the shareholder agreement and that he had expressed no opinion. He also found an e-mail in which he wrote to the twins and to Gertie that if they had any questions at all about the valuation of their stock they should either ask Smith or seek independent advice, adding, "You need to satisfy yourselves before you sign anything."

Upon re-reading his tax engagement letters, Smith was reminded that he had included the line, "Additionally, because our firm represents a number of Spamm family parties, conversations and other communications between another family party and our firm are not considered confidential and are available to the other party. In fact, our firm may be required to disclose any oral or written communications between our firm and one family party to the other party."

A carefully presented and well-documented response to Gertie's complaint to the Board was prepared, and Smith is awaiting its opinion on the matter.

It should be a best practice at every firm to issue an engagement letter whenever asked to consult on a valuation or any additional work from an existing client. Likewise, partners must pay close attention to situations in which a client could reasonably perceive a conflict of interest, which is a special concern when working with a family business. Adding caveats that discuss intrafamily conflicts, along with clear waiver language, also should be a standard consideration in all family business engagements.

Jonathan S. Ziss, JD, is a partner with Goldberg Segalla LLP in Philadelphia. He can be reached at jziss@goldbergsegalla.com.