Approved January 30, 1987
Date

MINUTES OF THE SENATE COMMITTEE ON JUDICIARY.

The meeting was called to order by Senator Robert Frey
Chairperson at

10:00 a.m./~~p.m.~~ on January 29, 1987 in room 514-S of the Capitol.

All members were present ~~except~~: Senators Frey, Hoferer, Burke, Feleciano, Gaines, Langworthy, Parrish, Steineger, Talkington, Winter and Yost.

Committee staff present:

Mike Heim, Legislative Research Department
Jerry Donaldson, Legislative Research Department
Gordon Self, Office of Revisor of Statutes

Conferees appearing before the committee:

Ron Smith, Kansas Bar Association
John Frieden, Kansas Society of Certified Public Accountants

Ron Smith, Kansas Bar Association, requested a bill be introduced concerning a change to the Crime Victim Reparations Act. Following his explanation, Senator Burke moved to introduce the bill. Senator Langworthy seconded the motion, and the motion carried.

Ron Smith requested a bill be introduced that would change K.S.A. 2232-11 concerning taking a deposition in a criminal matter. Following his explanation, Senator Burke moved to introduce the bill. Senator Talkington seconded the motion, and the motion carried.

Ron Smith requested a bill be introduced that would allow partnerships the right to sue in our courts. Following his explanation, Senator Burke moved the bill be introduced. Senator Talkington seconded the motion, and the motion carried.

Ron Smith requested a bill be introduced concerning the Model Periodic Payment Judgements Act. Following his explanation, Senator Burke moved to introduce the bill. Senator Parrish seconded the motion, and the motion carried.

Ron Smith requested a bill be introduced concerning local option mediation of disputes. Following his explanation, Senator Burke moved to introduce the bill. Senator Yost seconded the motion, and the motion carried.

Senate Bill 25 - Limitations on liability of certified public accountants.

Ron Smith, Kansas Bar Association, testified he mailed a copy of the draft bill to Kansas lawyers who work with or represent CPAs, or who are JD-CPAs. One person he heard from felt this was the right direction to go. Most of the lawyers are very concerned with this legislation. They don't think our tort system needs to be changed to conform to requirements of California. This is a conservative state. He stated the KBA opposes the bill. The association has deep concerns that this statute creates dual standards of practice for Kansas CPAs, immunizes even those CPAs who do not insure themselves, creates considerable uncertainty about the responsibility of CPAs and third parties under this act which cannot be answered short of litigation, and is an answer to insurance problems of Kansas CPAs that is not based on Kansas litigation experience. A copy of his presentation is attached (See Attachment I).

John Frieden, Kansas Society of Certified Public Accountants, stated he is engaged in commercial litigation. He wants to make absolutely

Senate Bill 25 continued

clear, this is not immunity legislation; it is simply a codification. He said all that is necessary is to place in writing the third party they are relying on. He feels it is very good legislation and he is surprised at opposition to it. A copy of his presentation is attached (See Attachment II).

The chairman stated he talked to the insurance commissioner's office asking for testimony on this bill concerning the impact on liability insurance. The consensus was it would not be possible to give testimony on the impact because it would take five years to get any information collected.

The meeting adjourned.

A copy of the guest list is attached (See Attachment III).

GUEST LIST

COMMITTEE: SENATE JUDICIARY COMMITTEE DATE: 1-29-87

NAME (PLEASE PRINT)	ADDRESS	COMPANY/ORGANIZATION
Bob Harbert	Topeka	KTLA
M. Hacker	"	Cap-Journal
Gene Johnson	Topeka	Ks ASAP Assn
K. B. Wickliff	Lawrence	Intern Senator Molich
Ted Fay	Topeka	KID
PATRICIA HEINSTALL	TOPEKA	OJA
Jim Clark	TOPEKA	KCDAA
Joni Turner	Topeka	KLSI
Lynn Van Dalsem	Topeka	KLSI
Jim McBride	Topeka	Director
George Barbee	Topeka	Ks Consulting Engrs
Kevin McInde	Topeka	Ks Society of CPAs
T.C. Anderson	Topeka	KSCPA
J.C. Fielden	topeka	Ks Society of CPAs
Ron Smith	KBA	Lyons

Attch. III.
Sen. Judiciary
1-29-87

1-29-87

KANSAS BAR ASSOCIATION

1200 Harrison
P.O. Box 1037
Topeka, Kansas 66601
(913) 234-5696

January 22, 1987
SB 25

Mr. Chairman. Members of the Senate Judiciary Committee. I am Ron Smith, KBA Legislative Counsel.

I. KBA opposes SB 25. Granting statutory immunity for the proper and foreseeable reliance of a consumer or business on the workproduct of a professional is an inappropriate use of the police power of the state.

II. Granting immunity from liability in clear cases of negligence is much different than enacting legislation with true "reform."

III. The concept of changing Kansas tort law in response to litigation in California that has not been adopted as Kansas law is inappropriate.

IV. The more prudent public policy is to determine what legislation is needed based in light of actual language of a case, should one be handed down in the future.

KBA has several major concerns about this bill:

1. Why should this change be enacted in Kansas when it is clearly NOT Kansas tort law that has caused the insurance problems CPAs now face?

2. How do Kansas attorneys represent their CPA clients and advise them as to the bill's ramifications?

3. How do Kansas attorneys represent our other business clients who must deal with potential CPA negligence,

Attch. I
Senate Judiciary
1-29-87

either as primary clients of CPA firms, or as secondary claimants under this act?

4. Will the bill help, hinder or unduly burden the business climate and economic development this state wants to foster?

It seems logical that legislation offered as "CPA tort reform" is appropriate only if the tort system in Kansas is the direct cause of the problem. You've heard proponents say CPAs are paying high premiums in Kansas, yet actual frequency and severity of claims against CPAs in the past decade are low. Why these Kansas CPAs are charged in this manner is best answered by CPA insurers, not the tort system.

While this bill was an interim committee recommendation, no evidence was offered to the interim committee that Kansas litigation against local CPAs was a major problem. Kansas CPAs are much like Kansas Day Care Centers -- they are experiencing insurance rate increases that are unjustified based on Kansas litigation. There are other options for the Kansas CPAs, such as self-insurance through their Kansas Association, or a risk retention plan.

Kansas is a conservative state, with a generally conservative judiciary and juries. Many of our tort laws, such as the comparative negligence statute, are among the half-dozen most restrictive in the country. To say that a profession must have changes in Kansas law because of what happens in California is to believe that Kansas law is

based on California's constitution, or that case holdings adopted in California are automatically "good law" in Kansas. This is untrue.

As you might imagine, lawyers and CPAs often work closely together, often for each other, or in conjunction with each other on various projects. In December, I sent many Kansas lawyers who work with or represent CPAs, or who are JD-CPAs a copy of the draft bill and asked for their comments. In addition to Mr. Hayse's comments, I want to bring you their response to SB 25:

1. SB 25 is not tort "reform." It is the creation of immunity for the negligent work of CPAs unless a plaintiff can sustain certain evidentiary burdens. Not only must a plaintiff who is not in contractual privity with the CPA demonstrate that he or she was identified in writing to the CPA as one relying on the accuracy of the accounting service [Section 1(b)(1)], but the plaintiff must also show the CPA actually knew the plaintiff intended to rely on the services being rendered.

> Some accounting services include creation of "computer programming" software for business clients. The business clients then use the software to work with their own customers. If the program is negligently put together, and the math doesn't add up, and customers are overcharged, how is a CPA client going to know which third-party customers he'll be dealing with to give notice, and allow the customer to protect himself?

2. Some of the biggest end-users of professional accounting services are Kansas businesses. When one business wants to buy anoth-

I

er, they rely on audits of CPA firms to establish correct values. Many of these business sales are conducted out of state, and on fast-track time schedules. Businesses are not going to want to do business with Kansas CPAs if they find they have to work with cumbersome letters of engagement that must be repeatedly updated every time a new purchaser comes on the scene. It is the business community that potentially stands to be left holding the bag by this bill. To the extent that SB 25 is anti-business, it possibly may drive sophisticated business clients of CPAs to the Big Eight firms. This is especially true in metropolitan Kansas City where there is competition from Missouri-based CPAs.

> Examples: If I were a bank's attorney and this law passes, in addition to everything else a bank requires before making a loan, I might advise the bank to require businessmen to have an appropriately financial statements or audits prepared by CPAs to show the the bank is a "named" end-user of a CPA audit or financial statement as a condition of lending the money. If there is any ambiguity in the engagement letter from the CPA, the bank will hold the loan until an appropriate unambiguous letter is obtained.
>
> A business asks for an audit from the CPA to secure a loan at a bank. If the engagement letter does not list the bank from which the loan is taken, and the business later defaults on the loan, and the bank determines that it granted the loan based on reliance on the audit which was negligently prepared, current Kansas law allows the bank to hold both the CPA and the business liable for the money damages. The bank can look to either defendants for satisfaction. With this statute--even though it was the CPA's negligence upon which the loan was made--the bank can look to either defendant for satisfaction only if the bank is (1) identified in writing as an "end-user" of the audit, and the bank must show the CPA actually knew the bank was relying on the audit.

I

CPAs are routinely employed to audit a bank's financial condition. The audit report is formally addressed to the directors of the bank (the client). However, the bank's directors routinely utilize these audits as supporting documentation for such things as making application for D&O insurance for the bank's officers. If SB 25 is enacted, the bank's insurance company cannot hold the accounting firm responsible for negligence occurring in that audit unless the carrier is identified "in writing" in the CPA's engagement letter. What impact do you think this will have on D&O Insurance of banks and other corporations?

Subsection (b)(1) places the burden of avoiding the limitation of the statute on either the client contracting for CPA services, or all those who might reasonably rely on the CPA's services, such as mainstreet businesses. In many instances, this is asking businessmen to be clairvoyant as to who he may do business with who may rely on the CPA services. Further, there is no affirmative duty in the bill requiring the business client of the CPA to list end users of the services. If the CPA client doesn't voluntarily do so, the law effectively immunizes the CPA against the reasonable foreseeable consequences of negligence to the third-party businesses.

Will extra charges be made by CPAs every time a change is made for the business that is the foreseeable "end-user" of a CPA's workproduct? If so, businesses in Kansas will not find this practice very palatable. Not only would there be additional costs involved, but also the attendant time delay in being able to obtain the loan.

3. The stated purpose of the bill is to codify Koch Industries v. Vosko, 494 F.2d 713 (10th Cir., 1974). In Vosko, the "rendition of professional accounting services" in question consisted of "preparing financial statements of a corporation for use in sales of stock to a particular potential purchaser." The privity limitation of Vosko is both realistic and foreseeable. SB 25 does not just

I

codify the activity described in this case. It codifies any form of professional accounting services.

4. If this law passes, lawyers must advise their their CPA clients how to implement the law. What services do we advise them are to be included in "professional accounting services?" Does this include data processing, computer programming, financial planning, or bank holding company work? What is a "specified transaction"? (line 37) With what degree of specificity is the transaction to be defined?

> Put yourself in the shoes of the lawyers advising the CPA and the bank in the following transaction. A client of a CPA seeks a business audit for use with Bank XX to get a loan for capital reorganization purposes, and that's what the engagement letter says. The reorganization efforts do not work out, but the bank agrees to obtain a reorganization in connection with a merger agreement with Company Z, with funds provided by Bank XX. The CPA is negligent in the audit, and the loan is defaulted. Bank XX sues the CPA client business, and the CPA. You're the CPA's lawyer? Does the CPA have immunity under SB 25 even though the audit relied upon by Bank XX inlcuded Bank XX as an "end-user," but the "specified transaction" is not in the form initially contemplated in the engagement letter? You're the bank's attorney. Does the bank have a case against the CPA? Or only the now penniless borrower?

5. There is no statutory requirement that CPA's obtain liability insurance. The immunization under this act applies to those CPAs not carrying insurance. Why should public policy grant this reward?

6. Every negligent person in Kansas currently is liable for the reasonable foreseeable consequences of negligence -- except certain

I

professions which have rules on privity of contract determined by common law cases such as Koch Industries. This legislation expands the common law exceptions for one profession to allow a form of self-determined immunity. If CPAs choose not to recognize and acknowledge certain end-users of their professional services, they've limited their liability.

7. Let's look at the real world that this bill creates. A CPA audited financial statement has a lot in common with a policy of liability insurance. There are more provisions and notes of disclaimer in the audit report than there are affirmations.

(a) SB 25 creates more fee-producing work for CPAs. A separate, specially prepared financial statement may be required for each creditor or person who may at some point rely on the financial information concerning the CPA's client. Accountants thus not only achieve significant immunity from tort liability, they spawn legislation that is what one lawyer called "feather-bedding in the truest sense of the word."

(b) What would a Johnson County attorney advise his Kansas business client looking for CPA services? How much reliance should a Kansas business place in a Kansas CPA's audit statement of another business -- specially if the business did not contract with the CPA for the audit? Would you better protect your Kansas client if you advised them to rely only on opinions from Missouri CPAs, since if the audit is negligently prepared, at least there is recourse against the Missouri CPA?

Can non-members of the Kansas Society of CPAs residing in Missouri take advantage of this law for audits prepared for Kansas clients?

(c) Does the selection by the CPA of an attorney to handle some legal matters of a CPA client constitute "professional accounting services" under this act? Or, does the lawyer's selection of a CPA to handle accounting matters of the lawyer's client

I

constitute profesional accounting services? If so, if the lawyer's only negligence was hiring an negligent CPA, who causes injury to unforseen parties relying on the combined legal-accounting work product, does the immunity in this bill benefit the lawyer?

In Kansas, generally, one professional cannot be held liable for the negligence of another professional, except in limited circumstances such as surgeons being responsible for the acts of an anesthesiologist during an operation under the "captain of the ship" doctrine. The Kansas courts specifically decline to hold referring physicians responsible for the acts of a specialist under the vicarious liability theory. However, there are cases in other states that hold physicians accountable for the acts of other physicians. This law is unsettled in other professional referrals, however. SB 25 might create Catch-22 situations where the CPA engaging legal services of a lawyer for an accounting client would leave the CPA shielded from liability unidentified third parties for his own negligence, and shielded against vicarious liability for negligence of the lawyer, but the lawyer, while free of personal negligence, is vicariously liable for the negligence of the CPA.

8. How will the Supreme Court read lines 24-27 and define "negligence?" There is no distinguishing part of this bill that makes exception from immunity for harm to unforeseen third parties caused by a breach of fiduciary duties by a CPA? Is the CPA immunized for intentional negligence to unforeseen third parties?

A CPA is hired to be executor of a will which creates a large estate for the benefit of the "heirs" of the deceased. Most of the heirs are named in the will. Some aren't. With a little discussion, the CPA could have determined which undisclosed heirs there unnamed. The CPA makes improvident investments, causing considerable loss to all the heirs on the theory of breach of fiduciary duties. It could be that under the CPA liability contract,

I

> breach of fiduciary duties is not covered. But under SB 25, lines 33-37, is the CPA to be immunized against those heirs who were not listed in the will regardless of whether the peril is insured? Do we create a system where part of the heirs can recover, and part cannot? Does the act overturn the common law duties of fiduciaries in probate courts if that fiduciary is a CPA?

The point, Mr. Chairman, is that this legislation, far from solving CPA litigation problems in Kansas merely raises a whole batch of new questions.

Conclusion

KBA has deep concerns that this statute creates dual standards of practice for Kansas CPAs, immunizes even those CPAs who do not insure themselves, creates considerable uncertainty about the responsibility of CPAs and third parties under this act which cannot be answered short of litigation, and is an answer to insurance problems of Kansas CPAs that is not based on Kansas litigation experience.

1-29-87

LAW OFFICES OF
FRIEDEN & FORBES
CAPITOL TOWER
400 S.W. 8TH STREET SUITE 409
P.O. BOX 639
TOPEKA, KANSAS 66601

JOHN C. FRIEDEN
RANDALL J. FORBES
KEVIN M. FOWLER

TELEPHONE
AREA CODE 913
232-7266

January 29, 1987

Senate Judiciary Committee
State Capitol Building
Topeka, Kansas 66612

Re: Senate Bill No. 25

Dear Mr. Chairman and Members of the Committee:

In Koch Industries, Inc. v. Vosko, 494 F.2d 713 (10th Cir. 1974), the Tenth Circuit Court of Appeals unquestionably reaffirmed the general rule in Kansas that a certified public accountant is not liable for negligence to any party other than his or her own client. 494 F.2d at pages 724-725. Any doubt concerning the continued vitality of this so-called "rule of privity" was quelled by the Kansas Court of Appeals in Western Surety Co. v. Loy, 3 K.A.2d 310, 312, 594 P.2d 257 (1979), when it observed that "the question of privity of contract is of importance in a suit against a certified public accountant by a third person (nonclient) who has relied on an audit report of the certified public accountant (Annot., 46 A.L.R.3d 979) . . ." Therefore, it clearly appears that the rule of privity articulated in Koch Industries still prevails in Kansas to insulate certified public accountants from liability for negligence to nonclients.

Unfortunately, the well-reasoned "rule of privity" pertaining to the liability of certified public accountants is being eroded elsewhere throughout the United States. Senate Bill No. 25 is designed to prevent such judicial abrogation of existing law and sound principles of liability in the State of Kansas.

Senate Bill No. 25 further serves the public policy of this State by defining the limited class of nonclients or third parties who may maintain a cause of action against certified public accountants under the so-called "near-privity rule" articulated by Justice Cardozo in the landmark case of Ultramares Corp. v. Touche, 255 N.Y. 170, 174 N.E. 441 (1931). The requirement in Section 1, paragraph (b)(1) of the bill that such third parties

Attach. II
Sen. Judiciary
1-29-87

must be identified in writing to the certified public accountant defines the limited class of nonclients to whom the CPA may be potentially liable for negligence and clarifies the right of any such designated party to sue the CPA for negligence in the rendition of professional accounting services.

Very truly yours,

Kevin M. Fowler
FRIEDEN & FORBES

KMF:sb

II