

Civil Litigation: Using a Referee to Resolve Complex Accounting Issues

This short article explains how it is possible and why it is advisable to appoint an impartial accountant to make binding findings about the key accounting disputes in a civil litigation.

The Problem Stated

The appointment of impartial accountant is appropriate in a surprisingly wide range of cases. Many if not most civil lawsuits concern financial dealings between feuding litigants, and very often these disputes raise complicated questions of accounting and financial analysis.

Accountants are often the only professionals who have the analytical skills required in order to resolve these questions in a proper, thorough, efficient manner. Sometimes judges and lawyers simply lack the competence needed to solve the accounting issues. In such cases, each litigant usually must hire its own expert accountant, and eventually the court must evaluate the competing opinions of these expert accountants. It is expensive, time-consuming and sometimes very unsatisfactory, with hostile lawyers untrained in accounting trying to cross-examine and discredit one another's accounting analysis.

There is a place for such cross-examination, and in some cases it is best to have a contest between competing accountings or valuations before a verdict can be fairly reached, particularly where the accounting dispute is inextricably linked to a dispute over the proper meaning of an underlying contract or over a disputed course of business dealings.

In such cases the accounting analysis will often shed light on the underlying dispute. Suppose a two partners have a dispute as to whether one of them was supposed to contribute a part of his own copyright royalties to the partnership. The competing accountings will likely allow the trier of fact to grasp the underlying dispute much better, and a thorough cross-examination of each accountant will assist this work enormously. "Why, Mr. Smith, did you have the firm's bookkeeper track Mr. Jones' copyright royalties if he was not required to contribute a percentage of them to the firm under the partnership agreement?"

But in most cases that raise complex accounting issues, there is a better way to solve them to rely on expensive hired guns and endless cross-examination, much of it hackneyed, laborious, and unedifying (I am sure many trial judges would understand this last point only too well).

What is this better way? The use of an impartial certified public accountant, who is appointed as a referee under Section 638 or 639 of the California Code of Civil Procedure, and who conducts an audit of agreed-upon issues and then delivers his findings in accordance with a specific procedure and timeline. These findings, if approved by the Court after the parties have had one

final opportunity to challenge them, then become binding findings of fact. The parties remain free to argue at trial over the significance of these findings, but not over the findings themselves.

Appointment By Agreement: Section 638

Litigants can agree to stipulate to the appointment of such an independent expert accountant. The procedure is as follows. The stipulation will be made under Section 638 of the Code of Civil Procedure, which states the following:

A referee may be appointed upon the agreement of the parties filed with the clerk, or judge, or entered in the minutes, or upon the motion of a party to a written contract or lease that provides that any controversy arising therefrom shall be heard by a referee if the court finds a reference agreement exists between the parties:

- a. To hear and determine any or all of the issues in an action or proceeding, whether of fact or of law, and to report a statement of decision.
- b. To ascertain a fact necessary to enable the court to determine an action or proceeding.

California Code of Civil Procedure, § 638.

This statute thus authorizes opposing litigants to negotiate and file a stipulation, by which they agree to appoint a referee to resolve "any or all of the issues in an action" and to "ascertain a fact necessary to enable to the court to determine an action". The statute thus authorizes the litigants to appoint a referee to resolve specified accounting issues, but these issues themselves have to be clearly stated in the authorizing stipulation, and I have found that it is always necessary that the stipulation set forth a specific procedure and protocol according to which the referee will resolve the specified accounting issues.

Often the litigants will be predisposed to appoint a referee under Section 638, but they will be unable to agree on the specific accounting questions or their wording. It is best in such a case for the attorneys and their expert advisors to take great care to negotiate a fair, reasonable listing of the specific questions, even if it takes enormous time and effort to reach a result. If the parties simply cannot agree on the listing of the accounting questions to be decided, then perhaps the presiding judge can help move along the process by giving them "guidance" in an in-chambers conference at which the specifics of these questions are finally worked out. In some cases the entire process might break down irreparably, and then the parties will be back at square one, with each side requiring its own expert accountant, and with the court burdened with the unhappy task of listening to competing accountings and then reaching its own accounting conclusions after the evidence has been submitted. It is often this unpleasant prospect that finally prods everyone in the case, not least the overworked judge, to strive to put into place a proper, fair-minded stipulation under Section 638 by which a referee is appointed to resolve specified accounting issues in a specified manner.

But the judge's participation in this procedure is not compulsory, and the parties have authority under Section 638 to reach a stipulation, file it, and then implement it on their own. In our

experience this is never advisable. The presiding judge should be included in the process and informed at the earliest possible date that the parties are trying to work out the appointment of an impartial accountant as a Section 638 referee (this can be usually done at the first case management conference).

In complex accounting cases, moreover, the judge should not be a mere passive recipient of the referee's findings. Rather, I recommend that the stipulation require the referee to issue his "proposed findings" to the court, whereupon each litigant has a specified time within which to submit written objections to the court, challenging part or all of the referee's proposed findings. The court can then reject these objections and adopt the proposed findings as binding findings of fact, or it can modify these findings and adopt them, or it can remand the matter to the referee with specific instructions. This might require one or more remands to the special referee for further work. When finally the court adopts the findings, they become binding findings of fact, and the stipulation itself should state that each litigant will then have the prerogative to argue over the significance of such findings of fact so far as the law otherwise allows.

If a referee is appointed in the royalties/partnership hypothetical given above, he might for example make the following findings: (1) the partnership kept meticulous records of the one partners' royalties; (2) the amount of royalties in question was \$1,845,057.14 during the specified period that the referee examined; and (3) the partner who earned these royalties systematically paid over to the partnership 14.8% of them up until October, 2005. But the two opposing partners will still be free at trial to argue over the significance of these findings, but not over the above facts themselves, which will be settled for once and all upon the trial court's adoption of the referee's proposed findings. The larger point is this: Every case turns on its own facts and has its own dynamic, but in cases that involve complicated accounting issues, the appointment of an accountant under Section 638 will often help to streamline a complicated litigation and allow technical accounting issues to be resolved impartially and in an economical, nononsense manner.

I recommend that the accountant hired under the stipulation be one who is a certified public accountant with at least five years of experience handling complex accounting issues that arise in commercial transactions or real estate transactions. Where applicable, the accountant should employ GAAP - generally accepted accounting principles.

The stipulation should allow each litigant to conduct such discovery as it is entitled to conduct under the discovery statutes, and to share this discovery as it wishes with the referee. Each litigant can otherwise make such additional submissions of information and argument to the referee as it wishes, so long as it serves copies simultaneously on all the other litigants.

Most importantly, the stipulation and accompanying Court order should authorize the referee to require each litigant to answer his questions and provide whatever information and documents he requests (perhaps subject to a protective order so that the information will be used only for the litigation and will be destroyed or returned at the close of the litigation). The referee should also have the power to subpoena witnesses and documents.

The stipulation should set forth a timeline by when (1) the parties must make all their submissions to the referee, and (2) the referee must complete his gathering of information and evidence. The referee should then have a deadline by which he must circulate his penultimate findings to the parties, who then will have a specified time for challenging, commenting on or seeking clarification of these penultimate findings. The referee, after considering and perhaps incorporating these comments, will then issue his "proposed findings", which each party can then try to challenge or have revised in court. The proposed findings will become binding findings of fact when finally the court adopts the proposed findings (perhaps after its own modification or remand to the referee).

Appointment by the Court under Section 639

If the parties cannot agree on the appointment of an accountant under Section 638, one of them might make a motion to the Court for such an appointment under Section 639 of the California Code of Civil Procedure, which in pertinent part states the following:

1. "When the parties do not consent, the court may, upon the written motion of any party, or of its own motion, appoint a referee in the following cases...
2. "When the trial of an issue of fact requires the examination of a long account on either side; in which case the referees may be directed to hear and decide the whole issue, or report upon any specific question of fact involved therein.
3. "When the taking of an account is necessary for the information of the court before judgment, or for carrying a judgment or order into effect.
4. "When a question of fact, other than upon the pleadings, arises upon motion or otherwise, in any stage of the action."

California Code of Civil Procedure § 639.

Section 639 thus authorizes a litigant to move the court to appoint an impartial accountant over the other side's objection, so that this accountant can act as a referee who can make binding finding of fact.

Even so, I strongly recommend that any such motion request that the court adopt the very procedures and protocol that I recommend willing parties use in their stipulations: With a Section 639 accountant, the procedures should be the same as with a Section 638 accountant; the only difference is that the court orders the parties to follow this procedure rather than approving a stipulation jointly submitted by them (and I always recommend that Section 638 stipulations be submitted to the presiding judge for approval even though the statute does not require such approval).

When the court issues an order appointing an accountant under Section 639, it must be certain to include specific findings, statements and information, all of which the movant will have been expected to provide in a carefully worded proposed order. Before making a motion for appointment under Section 639, a conscientious practitioner will closely review Section 639

itself and make sure that his proposed order and motion papers properly provide all the required information.

Lastly, Section 639 requires the court to make provision for paying the referee in accordance with specified requirements. I also strongly recommend that a stipulation made under Section 638 do the same. Typically, the parties will jointly bear the expense, and the referee will require security deposits or a lien against property with sufficient equity to support his likely charges. The work can be expensive, even very expensive, but the alternatives can be more expensive.

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