

Conflicted Financial Professionals

By Albert S. Frank, LL.B.

In the 1980s I stopped practicing law in Alberta and moved to Ontario. As part of getting qualified to practice law in Ontario I had to write exams on several legal subjects. Each of the exams had an ethics question on it, and in almost every case the ethics question involved a conflict of interest. This shows just how seriously the legal profession has taken the issue of conflict of interest.

In recent years conflict of interest issues have become increasingly important for financial professionals as well. They typically owe fiduciary duties to their clients and could owe additional duties to others, who are not their clients. The growing size of firms increases the chance that the interests of one client will conflict with those of another, just because there are more clients. Moreover, the push for multi-disciplinary firms that include lawyers tends to extend the rigorous ethical standards of the legal profession over the whole firm.

Auditors

Years ago I handled a lawsuit for a minority shareholder who was unhappy about how he had been treated by management. I was able to uncover the remarkable fact that, unknown to my client, management had

given all – or almost all – of its liquid assets to another company, one that the majority owned 100%. This was not shown in the audited financial statements!

Management had returned the assets on the last day of the business year. The next day they removed them again. Management took this and other steps with the deliberate intention of concealing from our client the removal of the assets.

When I cross-examined the accountant responsible for the audited financial statements – a partner with a major accounting firm – he admitted that the second removal of the funds should have been noted as a material subsequent event. His explanation was that his subordinates working on the file, who obviously knew of the improper asset transfers, had not told him about them. Apparently they had become so closely associated with management and its interests that they forgot their duties to others who might see and rely on the statements, including our client.

I would cheerfully and confidently have sued the accounting firm, but it turned out to be unnecessary. My cross-examinations of the accounting partner, the company president and another company officer led to a quick settlement.

Nor should accountants think that they can reliably avoid conflict of interest problems by noting on the financial statements that they are for limited – perhaps purely internal – purposes. Such a disclaimer could be disregarded by a court where the accountant could have foreseen that the statements would be relied upon by others interested in the financial position of the business, such as potential creditors or persons considering buying the business.

In-House Professionals

An accountant, actuary, or other professional who works for a company obviously owes a duty to that company. But what if management wants the professional to help conceal management improprieties or to create a falsely positive picture of the company for the outside world? The interests of management would then conflict with the interests of others. Such things happen more often than you might think. In my years as a lawyer, professional clients have repeatedly complained to us of being put in such conflicts.

Under the circumstances of a particular case the professional might well owe a duty to actual and potential shareholders, lenders and other creditors. Keeping your job could be a small consolation for being reported to your professional regulator and being personally sued for negligence or fraud.

Investment Advisors and Analysts

If a stockbroker (or other professional) puts the client's money into a mutual fund (or other investment) that has been a poor performer for many years, the professional might or might not have a negligence problem. The professional can probably escape liability if there was any reasonable basis for making that investment, even if the result was bad. Whether or not there is such a reasonable explanation, however, the professional typically would not have an ethical problem.

But what if the professional owns shares in the mutual fund company (or other investment), or has some other close connection? In that case there could be an ethical problem based on the obvious conflict between the fiduciary duty to the client and the professional's interest in the mutual fund company. The professional could be disciplined by the regulatory authorities.

As a litigator I would be dubious about a case against a professional who merely made bad investments, but the existence of a conflict would definitely encourage me to sue the professional. The conflict would undermine the professional's defence.

As for stock analysts, their conflict of interest has become notorious. They routinely fail to

be as negative as they should about companies they cover, because a "sell" recommendation could cost the analyst's firm future corporate finance work for the company being covered. Thus they prefer the interests of the companies being covered over those of the investors relying on their recommendations. If investors can find out in advance of such conflicts, they should refuse to buy such analysts' reports.

Conclusion

You have to take conflict of interest seriously, and have policies in place to deal with it. A good starting point would be to read the chartered accountants' Conflict of Interest Task Force report released in November of 2000, and to discuss the issues with your lawyer.

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The above article originally appeared in the mid-October, 2001 issue of ***The Bottom Line*** under the title "Conflicting views - Watching Your Interests."

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Research has NOT been done to see if this article is still good law. Also, this is general information that might not apply to your particular situation.

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