The Accountant's Liability for Financial Reports
When Buying and Selling New Car Dealerships

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Absent a contractual relationship, under what circumstances, if any, is an accountant liable for the economic losses of a party relying upon a financial report prepared by the accountant?

Historically, accountants had very limited liability to third parties that may have relied upon financial statements prepared by the accountant for a client. Their exposure was limited to the same "privity-third party beneficiary" that applies to attorneys, which is: a plaintiff can recover in the absence of privity only when (1) the accountant committed fraud or (2) the plaintiff was a known and intended beneficiary. This rule was applied to accountants in the old case of ***Ultramares v. Touche***, 255 N.Y. 170, 174 N.E. 441 (1931).

In 1985, the Maryland Courts reaffirmed the privity rule with respect to attorneys, holding that an attorney's duty ran only to clients and specifically intended beneficiaries of the legal services. ***Flaherty v. Weinberg*, 303 Md. 116**.

Subsequently, in ***Credit Alliance Corp v. Arthur Anderson and Co***., 65 N.Y. 2d, 536, 483 N.E. 2d 110, 493 N.Y.S. 2d 435 (1985), the liability of accountants was expanded when the Court developed a three part test to determine an accountant's liability in malpractice cases.

It is interesting to note that the accountant's themselves widened the noose with respect to distinguishing themselves from attorneys when the AICPA themselves assumed a wider field of responsibility than attorneys when, in setting their own professional standards, they stated:

> A distinguishing mark of a profession is its acceptance of its responsibility to the public. The accounting profession's public consists of clients, credit grantors, governments, employers, investors, the business and financial community, and others who rely on the objectivity and integrity of certified public accountants to maintain the orderly functioning of commerce. This reliance imposes public interest responsibility on certified public accountants.

This self-imposed standard was one basis upon which the Maryland Court of Appeals, in ***Walpert, Smullian & Blumenthal, P.A. v. Katz***, the Court for accountant malpractice cases, expanded the accountant's exposure to liability when it adopted the three part test formulated by the Court in ***Credit Alliance Corp v. Arthur Anderson and Co***., 65 N.Y. 2d, 536, 483 N.E. 2d 110, 493 N.Y.S. 2d 435 (1985).

Interestingly enough, that same year (1985) the privity rule, with respect to holding that in legal malpractice cases an attorney's duties ran only to clients and specifically intended beneficiaries of their legal services (in the context of attorney malpractice cases), was reaffirmed by the Maryland court in ***Flaherty v. Weinberg***, 303 Md. 116.

In fairness to the AICPA, in addition to its self-imposed standards, in 1984 the United States Supreme Court, in ***United States v. Arthur Young and Co***. 465 U.S. 805 at 817-8, recognized that an independent auditor "assumes a public responsibility transcending any employment relationship with the client."

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In Walpert, the Maryland Court of Appeals the Court reviewed different tests employed by other courts to determine what, if any, duty an accountant has to a third party, in preparing a financial statement for his own client. These tests were:

1) ***THE TRADITIONAL (Ultramares) APPROACH***, holds that before a plaintiff could sue an accountant he had to have privity, or a relationship equivalent to privity;

2) ***THE FORESEEABILITY APPROACH*,** holds that an accountant is liable to a third party whose reliance on the accountant's services was reasonably foreseeable to the accountant; and

3) ***THE RESTATEMENT APPROACH***, holds that an accountant is liable to third party if he supplies information to a third parties that is actually foreseen as a user of the information for a particular purpose.

This latter test (the Restatement Approach) would appear to apply in Walpert because in that case Katz, the plaintiff and former president of Magnetics, hired Walpert (Magnetics accounting firm) to do personal tax returns and other accounting services for he and his wife and then, among other things, relied on Walpert's audit of Magnectic's financial statements (that substantially overstated Magnetics' accounts receivable and inventory) to provide Magnetics with in loans and guarantees which eventually cost Katz and his wife over $1.5 million when the company's assets were liquidated.

Katz sued Walpert claiming that in addition to relying upon Walpert's audited financial statements, the loans and guarantees were also made in reliance upon Walpert's assurances, over the course of several meetings held specifically for the purpose of deciding whether or not it was advisable for he and his wife to make the loans and guarantees, that the company would be able to repay the debt.

The trial court held that there was no privity with Katz and that Katz was not a specifically intended third-party beneficiary of the Walpert's services. However, the Court of Special Appeals reversed, holding that although Katz was not a third party beneficiary, Walpert's alleged knowledge of Katz's reliance on Walpert's financial statements and assurances was sufficient to give rise to a duty.

Walpert appealed the decision, arguing the Court of Special Appeals erred in accepting knowledge of third party reliance on the work product as a substitute for privity and that Maryland required link between the parties, extending beyond mere foreseeability of reliance.

The Court of Appeals rejected the tests of other jurisdictions and held an auditor's liability must be evaluated under the traditional approach (*Ultramares)*, but as elucidated by the three part test of *Credit Alliance Corp. v. Arthur Anderson and Co.*:

1) The accountant must have been aware the financial information was to be used for a particular purpose;

2) The accountant must have know at the time of the engagement that a particular third party would use the report for that purpose; and

3) There must have been some conduct on the part of the accountant linking him to the relying party that demonstrates the accountant's understanding of that party's reliance.

The facts that a dealership is for sale and the dealer uses the accountant's financial statements in selling the store, would not seem sufficient to hold the accountant liable for a buyer's reliance upon them unless the financial information was prepared for the specific purpose of showing potential buyers and the accountant knew, at the time of engagement, that a particular buyer would rely upon the information for the purpose making a purchase.

In addition, the accountant would have to perform some act linking him to the buyer that would show that the accountant understood the buyer was going to rely upon the information.

In other words, the accountant's exposure to liability by the buyer is in the accountant's own hands. The tricky part, however, is that the accountant's action must merely demonstrate he understands the third party will rely; not that he "induced" the reliance.

Consequently, whenever an accountant is required to supply information with respect to the negotiation of a sale of his or her client's dealership, it may be wise to include a disclaimer similar to the one used by our company:

> **LIMIT OF LIABILITY.** The liability of Advising Automobile Dealers LLC, its employees and/or subcontractors, hereinafter collectively referred to as "AAD", is limited to the client and to the retainer fee collected. Further, there is no accountability, obligation, or liability to any third party. If this report is placed in the hands of anyone other than the client, the client shall make such party aware of all limiting conditions and assumptions of the assignment and related discussions. AAD assumes no responsibility for any costs incurred to discover or correct any deficiencies of any type present in the dealership; physically, financially, or otherwise.
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> **INFORMATION USED.** No responsibility is assumed for accuracy of the information furnished by work of others, the client, his or her designee, or public records. We are not liable for such information or the work of possible subcontractors. Be advised that some of the people associated with AAD and possibly signing this report are independent contractors. The comparable data relied upon in this report has been confirmed with one or more parties familiar with the transaction or from affidavit or other sources though reasonable; all are considered appropriate for inclusion to the best of our factual judgment and knowledge. An impractical and uneconomic expenditure of time would be required in attempting to furnish unimpeachable verification in all instances, particularly as to financial, structural and other information. It is suggested that the client consider independent verification as a prerequisite to any transaction involving sale, lease, or other significant commitment of funds.

It should also be noted that the Court in Walpert did not make it clear whether or not it intended its test to apply to claims involving non-audited information although, under the facts of Walpert, it would seem that Katz would still have a claim based upon the fact that Walpert had the meetings with Katz and knew that Katz was relying upon the information to make his decision to loan money to the company and to guarantee debt of the company.

As usual, lawyers are in a different class in that the *Walpert* test appears to be limited to accountants because the court specifically contrasted the special duties and obligations of accountants to those of attorneys.

On the other hand, it is comforting for accountants to know that courts have held that a seller's accountant, even upon discovery that its client's financial statements were misleading at the time they were given out, and even though they were included in a prospectus, had no duty to correct them. ***In re North American Acceptance Corp. Securities Cases***, 513 F.Supp. 608 (N.D. Ga. 1981).

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Author's Note: A thorough reading of the Katz case left me of the opinion that the case was an example of the old adage: "Hard cases make bad law." George Katz was the owner and former president of Magnetics, a printing supplies and press repair business.

In 1987, his health deteriorated, and he relinquished ownership of the business to his wife and two sons, equally, and control of the business to his son Philip, but remained financially involved in that he received

an annual salary of $5,000, his wife received $20,000 annually and they both received another $120,000 annually for rent.

WS&B was retained by Philip as Magnetics' accountants and it prepared financial statements for the periods ending 4/30/89; 4/30/90; 4/30/91 and 4/30/92.

Katz and his wife loaned Magnetics $425,000 in 1990; pledged $150,000 in 1992 and, in the same year executed a limited payment of $1,000,000 to Magnetics and signed an indemnity deed of trust and security agreement securing a debt previously incurred by Magnetics.

In June of 1993 an independent audit found that reported inventory and accounts receivable had been inflated by Magnetics and the bank called its loan, resulting in the liquidation of the company.

The Katzes sued alleging their loss was WS&B's fault for taking their son's word for the value of the inventory and receivables and for not obtaining independent confirmation of those items. According to the Katzes, the overstated receivables were a result of a mathematical error which went undetected for years.

WS&B maintained that the Katzes' damages were a result of a fraudulent financing scheme perpetrated by their son Philip (who was convicted for the scheme and who served a two year sentence in the federal penitentiary for it.)

In the original filing, the Circuit Court for Baltimore City concluded that, under the circumstances of the case, there was no privity between the accountant and the plaintiff and, therefore, the plaintiff was not the intended beneficiary of the accountant's contract; consequently, there was no duty owed by WS&B to the plaintiff. (In support of the matter, an affidavit was submitted that stated WS&B was not asked to express an opinion on the advisability of the plaintiffs, or anyone else lending money to Magnetics, nor did it express an opinion as to whether the plaintiffs should secure Magnetics' debt.

In an unpublished opinion, the Court of Special Appeals reversed the Circuit Court, holding that there was sufficient evidence from which a trier of fact could find that a duty was owed to the plaintiffs. It was this latter opinion that the Supreme Court of Maryland affirmed.

Having dealt with car dealers over four decades, it would seem to me that the former owner and president of a business should have a better feel (than would an outside accountant) for whether or not his son had inflated inventory and receivables of a business with which he (the dad) was intimately familiar.

Unfortunately for WS&B, they were up against an elderly couple, in ill health, that lost a substantial part of their retirement, with no visible means of recouping it other that WS&B. More unfortunately, this case set a new vulnerability for accountants.

Taken in the best light of the Katzes who alleged they relied upon WS&B's representation of the company's financial position in making their loans and guarantees, the facts remain that the Katzes were knowledgeable in the specific business (the father owned it, operated it for years and turned it over to his family); they never used WS&B while George Kataz was president; the Katzes knew that WS&B was hired by their son to represent the company; they had the opportunity to retained their own legal counsel, accountants and advisors before committing to risk their retirement with $425,000 in loans, $150,000 in pledges and $1,000,000 in personal guarantees – and they chose not to obtain their own advisors.

Prior to Katz, the Maryland Supreme Court held, in **Martens Chevrolet, Inc. v. Seney**, 292 Md. 328, 236-37, 439 A.2d 534, 539 (1982), that the principal elements of the tort of negligent misrepresentation may be outlined as follows:

1. the defendant, owing a duty of care to plaintiff, negligently asserts a false statement;
2. the defendant intends that his statement will be acted upon by the plaintiff;
3. the defendant has knowledge that the plaintiff will probably rely on the statement, which, if erroneous, will cause loss or injury;
4. the plaintiff, justifiably takes action in reliance on the statement; and
5. the plaintiff suffers damage proximately caused by the defendant's negligence.

In light of the court's statements in the Martens case, one wonders if the court would have reached the same conclusions in the Katz case if the plaintiff were a 35-year old multi-millionaire who was as experienced in the business as George Katz and who was healthy and not that materially affected by the monetary loss. One would think not, especially in light of the fact that the experienced investor had the opportunity to retain his own counsel before risking $2,000,000 and chose to save the fees instead.

In the author's opinion, the second lesson to be learned from the case (other than the law) is that there is more to a lawsuit than the law. The defendant must consider the status and condition of the plaintiff and put the same efforts into obtaining a settlement as preparing for a lawsuit because, in the end, it generally holds true that: a bad settlement is better than a good lawsuit.

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