



## Alerts

### Accountant May Owe Duty of Care to Client's Creditors

September 28, 2011

*Professional Lines Alert*

Plaintiff sellers sold their franchise rights in certain restaurants to a buyer. As a part of the sale, the buyer executed a promissory note to the sellers. The asset purchase agreement between the sellers and buyer required buyer to provide audited financial statements to the sellers each year during which any of the debt remained outstanding. The sellers alleged that the buyer, through suspicious transactions and actions of its chief financial officer (CFO), became seriously delinquent with respect to its federal tax obligations. Specifically, it owed the Internal Revenue Service (IRS) more than \$1 million in taxes, plus penalties and interest. The CFO subsequently disappeared without notice, and the parties discovered suspicious deposits and withdrawals in the buyer's checking account, which appeared to have been part of a check-kiting scheme. The buyer later filed bankruptcy. The sellers argued that defendant auditor aided and abetted the CFO's wrongful conduct. A federal district court in Tennessee held that the auditor owed a duty of care to the sellers, which had become a creditor following the sale.

#### Questions Before the Court

Following are the issues considered by the court and how the court decided them.

*Issue 1:* Whether the accounting firm owed a duty of care to the sellers where it claimed that it did not know that the audit information was to be provided to the sellers.

Yes. The court held that such a duty existed because the accounting firm was aware that the buyer needed audited financial statements for its "lenders." The accounting firm admitted that the asset purchase agreement required the buyer to deliver its audited financial statements to an individual who was the seller's primary contact. An accountant's liability in this situation extends to those persons or class of persons as determined by current business practices who the accountant at the time the report is published should reasonably expect to receive and rely on the information. It was reasonable for the accountant (auditor) to expect that the sellers, who had become lenders to the buyer by virtue of the note, would receive and rely upon the information in the audit report.

*Issue 2:* Whether the auditor had a dispositive proximate causation defense on

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damages because the buyer never had the money to pay off the note.

No. The accounting firm claimed that the buyer never had the money to pay off the promissory note regardless of its conduct and thus that there was no proximate causation. The court found that there was a triable issue of fact because the sellers' expert had opined that cash flows from the business that was purchased were substantial enough for a two-year period that the buyer would have been able to satisfy its current obligations to the sellers and future cash flows would have continued to satisfy those obligations. The audit report had failed to disclose that the buyer owed back taxes and the CFO's wrongful conduct.

### **What the Court's Decision Means For Practitioners**

The accounting firm faced an uphill battle in trying to avoid liability under Section 577 of the *Restatement (Second) of Torts* (1977), which makes an accountant liable for providing false information for the guidance of others if he or she fails to exercise reasonable care or competence in obtaining or communicating the information. Liability extends to anyone with whom the accountant reasonably knows the client intends to share that information. The auditor here had clearly failed to report on the taxes owed to the IRS, and the court was easily convinced to construe the sellers to be "lenders" who were entitled to receive the audit report.

*Murphy v. Lattimore, Black, Morgan & Cain, PC*, 2011 WL 2420265 (N.D. Tenn. June 13, 2011)

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