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Accountant May Be Liable for Millions to Surety for Allegedly Misleading Audit

A Pennsylvania federal court held an accounting firm who prepared an audit for a surety's principal may be held liable for negligent misrepresentation. The court in *Platte River Ins. Co. v. Joseph P. Melvin Company, LLC*, 2020 WL 6747125 (E.D. Pa. Nov., 17, 2020) denied the firm's motion to dismiss the lawsuit, holding the complaint adequately demonstrated knowledge of how and by whom the financial information would be used and the probability of damages.

The Alleged (Mis)Use of GAAS and GAAP Principles

The accounting firm allegedly relied on unverified internal figures from its subcontractor client in preparing the subcontractor's 2017 Independent Auditor's Report, including a financial statement and related schedules. The accounting firm represented that the audit conformed with generally accepted auditing standards (GAAS) and generally accepted accounting principles (GAAP). Attached to the audit was a work in progress schedule (WIP) which "reflected that the subcontractor's construction contracts, as well as its recently-completed construction contracts, had been and were expected to remain generally profitable…"

Issuance of Bonds and Ultimate Default

Allegedly relying on these financial statements, the surety issued performance and payment bonds to the subcontractor for a construction project. Four months later, the accounting firm issued its 2018 Independent Auditor's Report for the subcontractor which reflected significant losses suggesting a $10 million adjustment for a loss in value "due to WIP / % Completion errors." Alarmed, representatives of the surety met with the subcontractor's owners, one of whom disclosed the accounting firm's reliance on unverified information and its suspicions that the accounting firm had issued misleading audits over the past two years. A few months after the meeting, the general contractor notified the surety that it declared its subcontractor in default and terminated. The general contractor demanded the surety "promptly and at the surety's expense take … action to have the work completed." The surety ultimately paid the general contractor $3.4 million to resolve the claim.

To recover its damages, the surety sued the accounting firm for negligent misrepresentation. The accounting firm moved to dismiss, alleging that the surety did not identify in its suit what was materially inaccurate with the financial information it provided, that the accounting firm was unaware the surety would rely on the financial information, and that the damages sought were only theoretical. The court denied the accounting firm's motion to dismiss.

Material Misrepresentations in Audit

Despite the accounting firm's claims to the contrary, the court held that the surety provided the necessary specificity in identifying the misrepresentation on which it relied. Beyond the $10 million value differential, the court evaluated the surety's claims on whether the financial statements and the schedules (i) fairly represented the subcontractor's financial condition and performance, (ii) were GAAPcompliant, and (iii) had been audited pursuant to GAAS. The court determined such representations were material and specific enough to survive the accounting firm's attempt to dismiss the lawsuit.

Foreseeability is Enough to Show Knowledge of Reliance

To elude liability, the accounting firm argued it had no actual knowledge that the surety, or any surety, would rely on its audit in determining whether to issue a performance and payment bond. Under applicable Pennsylvania law, however, the surety did not have to demonstrate "actual knowledge"— only reasonable foreseeability of reliance. The court noted that many of the accounting firm's clients were involved in the construction industry and that the accounting firm understood the financial considerations surety underwriters use in evaluating risk before issuing bonds. As a result, the accounting firm could reasonably anticipate the subcontractor using the accounting firm's misleading financial statements to secure surety bonds.

Amount of Release Adequate to Disregard Claim of Theoretical Damages

In its final attempt to dismiss the surety's negligent misrepresentation claim, the accounting firm alleged the surety could not adequately quantify the alleged damages caused by the accounting firm and any such calculation was merely speculation. In discounting the argument, the court cited the surety's Complaint which specified continuing significant expenses, including attorneys' fees, to mitigate and recover its loss, as well as the $3.4 million the surety spent to resolve the default and termination of the subcontractor.

Takeaways

The need to obtain bonding is one key for success throughout the construction process, from bidding to performing. Subcontractors must ensure the information provided to an accounting firm is objective and able to be demonstrated. While such due diligence may seem to be burdensome, simply communicating unverified accounting figures could easily lead to potential liability beyond that assigned to the surety.