

***THE LAW OF ACCOUNTANT LIABILITY IN THE  
DISTRICT OF COLUMBIA, MARYLAND, AND VIRGINIA***

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## INTRODUCTION

This outline identifies elements of the law governing the liability of accountants in the District of Columbia, Maryland, and Virginia. Its focus is case law that specifically addresses accountant matters—cases where a defendant must comply with professional standards that apply to accountants. It also notes relevant statutes and regulations.

In some relevant areas of the law in one or more of these jurisdictions, authorities or provisions do not specifically address accountants. Where those legal areas are important, this outline identifies principles that apply fairly directly to claims against accountants, in particular drawing on more general principles governing professional liability matters.

This outline identifies the primary principles and the issues that most commonly arise in accounting malpractice cases brought under state law, which is the primary source of the law of negligence. This outline does not discuss any actions under federal law, including federal securities laws, nor does it address actions under state securities laws. These constitute substantial topics in their own right. Because it does not address liability under federal law, this outline does not address the Racketeering Influenced and Corrupt Organizations Act (“RICO”). Although it remains possible for accountants to become liable under RICO, this is unusual in light of the United States Supreme Court’s decision in *Reves v. Ernst & Young*, 507 U.S. 170, 175-176, 185-186 (1993) (holding that outside accountants ordinarily do not “participate[e]” in the “conduct” of the affairs of a client as RICO requires), and the Private Securities Litigation Reform Act of 1995 (the PSLRA), which eliminated securities fraud as a predicate act for a private cause of action under RICO (*see* Pub. L. 104-67, tit. 1, § 107, 109 Stat. 737 (codified at 18 U.S.C. § 1964(c) (2006))).

**DISTRICT OF COLUMBIA**

## DISTRICT OF COLUMBIA

### LONG-ARM JURISDICTION

#### A. Long-Arm Jurisdiction Statute

In the District of Columbia, jurisdiction lies over any actor “transacting any business,” “contracting to supply service . . . causing tortious injury in the District of Columbia by an act or omission in the District of Columbia” or “causing tortious injury in the District of Columbia by an act or omission outside the District of Columbia if he regularly does or solicits business, engages in any other persistent course of conduct, or derives substantial revenue from goods used or consumed, or services rendered, in the District of Columbia.” D.C. Code § 13-423 (2001) (link available at [www.dccouncil.washington.dc.us](http://www.dccouncil.washington.dc.us)) (“Personal jurisdiction based upon conduct”).

#### B. Case Summaries

No reported long-arm jurisdiction cases involve accountants.

*See generally Env'tl. Research Int'l, Inc. v. Lockwood Greene Engineers, Inc.*, 355 A.2d 808 (D.C. 1975) (stating that Congress intended to provide the District of Columbia with a long-arm statute similar to those of Maryland and Virginia, and in interpreting the statute, courts look for guidance to background of the Uniform Act and of Maryland and Virginia statutes as interpreted by their courts).

## CLAIMS

#### A. Accounting Malpractice

##### 1. Elements Of Accounting Malpractice

“To succeed in a professional malpractice claim [against an accountant] in the District of Columbia, a plaintiff must prove by a preponderance of the evidence:

- (1) what is the standard of skill and care that reasonably competent professionals follow when acting under the same or similar circumstances;
- (2) that the defendant did not follow that standard of skill and care; and
- (3) that by not following that standard of skill and care, the defendant’s conduct was a proximate cause of injury to the plaintiff.”

*Drabkin v. Alexander Grant & Co.*, 905 F.2d 453 (D.C. Cir. 1990) (addressing a negligence claim against an auditor and reversing denial of jury verdict for absence of proximate causation) (see case summary below). *See also The Plan Committee v. PriceWaterhouseCoopers, LLP*, 335 B.R. 234 (D.D.C. 2005) (addressing a negligence claim

against an auditor and denying motion to dismiss based on, among other things, contributory negligence and statute of limitations) (see case summary below); District of Columbia Standardized Jury Instruction No. 9-3 (“Professional Liability – Elements of Claim”).

## **2. Requirement For Expert Testimony To State A Claim For Malpractice**

District of Columbia courts have not addressed the need for expert testimony in the context of accountant liability. Cases addressing other professional malpractice claims, however, require expert testimony to establish the applicable professional standard of care. *See* Standardized Jury Instructions For The District Of Columbia § 9.08 (“Standard Of Care Determined By Expert Testimony”). *See also O’Neil v. Bergan*, 452 A.2d 337, 341 (D.C. 1982) (addressing legal malpractice claim).

## **3. Proximate Cause**

### **a. General Rule**

“An injury or damage is proximately caused by an act or failure to act whenever it appears from a preponderance of the evidence that the act or failure to act played a substantial part in bringing about the injury or damage. Moreover, it must be shown that the injury or damage was either a direct result or a reasonably probable consequence of the act or failure to act.” Standardized Jury Instructions For The District Of Columbia, No. 5.12 (“Proximate Cause Defined”).

“A proximate cause of an injury is a cause which is a substantial factor in bringing about the injury. The defendant’s conduct must have such an effect in producing the harm that a reasonable person would regard the conduct as a cause of the harm. Moreover, it is a cause that produces an injury directly, in a natural and continuous sequence of events. There can be multiple proximate causes.” *Id.*

“If the plaintiff would have sustained the same injury even if the defendant’s conduct had not been negligent, then the defendant’s conduct is not a substantial factor in causing the harm.” Standardized Jury Instructions For The District Of Columbia, No. 9.04 (“Professional Liability—Proximate Cause—Substantial Factor”).

### **b. General Rule As Applied To Accounting Malpractice Claims**

Often, accounting-malpractice plaintiffs contend that an auditor’s or accountant’s negligence caused various business losses, typically on the theory that those running the business would have made different decisions had they had additional information, and would have avoided the loss at issue. To state a claim under this theory, the plaintiff must connect the alleged failure to some business decision that the claimant would have made differently if it had possessed additional information from the accountant. In these cases, courts evaluate the sufficiency of the causal connection between the alleged negligence and the alleged injury. *See The Plan Committee v. PriceWaterhouseCoopers*, 335 B.R. at 240.

There is no proximate causation if the plaintiff already knew the facts that it alleges the auditor failed to discover and pass along to the client. *See Drabkin v. Alexander Grant*, 905 F.2d 453, 454-56 (D.C. Cir. 1990).

**c. Case Summaries**

***The Plan Committee v. PriceWaterhouseCoopers*, 335 B.R. 234 (D.D.C. 2005).**

**Facts:** The plaintiff was a creditors' committee suing on behalf of an audit client that had failed. The plaintiff alleged that the auditor had failed to flag certain information about the audit client's revenue. The plaintiff alleged that if defendant had "complied with its professional standards of care with respect to its audits [the failed au-dit client] would have taken actions to avoid insolvency and bankruptcy" because [the audit client] would have recognized its financial troubles." 335 B.R. at 240 (denying auditor's motion to dismiss).

**Held:** The court denied the auditor's motion to dismiss, holding that the plaintiff had stated a claim for professional negligence and that, in this case, the defenses of contributory negligence and statute of limitations could not be decided on a motion to dismiss. Contributory negligence could not be decided on a motion to dismiss because the plaintiff alleged that it had acted reasonably, and the statute of limitations defense could not be decided because of factual issues relating to the discovery rule and when the running of the limitations period had commenced. *Id.*

***Drabkin v. Alexander Grant & Co.*, 905 F.2d 453 (D.C. Cir. 1990).**

**Facts:** An audit client failed and the bankruptcy trustee sued the company's auditors. The trustee contended that, had the auditor told the company's board certain additional information about the client company's weak financial condition, the directors would have taken "corrective action" or else "would have filed for bankruptcy protection earlier than it did." 905 F.2d at 454-55.

The trustee contended that, had the auditor told the company's board certain additional information about the client company's weak financial condition, the company's board would have taken "corrective action" or else "would have filed for bankruptcy protection earlier than it did." *Id.* at 454-55. In particular, the plaintiff claimed that the firm failed to make specific note of the corporation's failure to pass on to the I.R.S. payroll taxes withheld from employees. Instead, the corporation used these funds to meet its cash needs. Plaintiff also contended that the financial statements grossly overstated the value of the corporation's inventory, where accurate figures would have showed the corporation to be much worse off than it appeared. The trustee argued that accurate audits would have prompted company action to cure or mitigate the company's basic economic problems.

The audited financial statements showed losses of \$4.4 million and \$2.8 million for the relevant time periods. Further, the audited financial statements contained "going

concern” qualifications that warned that (1) the corporation was in danger of failing, and (2) the balance-sheet asset valuations would not be fully realized in the event of a shutdown.

The jury returned a verdict in favor of plaintiff on all three counts and awarded plaintiff \$11 million. The trial court denied the firm’s motion for judgment notwithstanding the verdict. The firm appealed.

**Held:** Reversed. The plaintiff had not established proximate causation, because the evidence showed that the board did know certain negative information about the company’s condition and had not acted. *Id.* at 456-57. Therefore there was “no evidence of a causal relation between the accountant’s failures and the client’s damages.” *Id.* at 457 (citing *Bastian v. Petren Resources Corp.*, 892 F.2d 680, 685 (7th Cir. 1990)), and the alleged deficiencies in the audit statements were not the proximate cause of the corporation’s financial difficulties. (Note that *Bastian* is a leading case that emphasizes the importance of the link between the nature of wrong (or the risk at issue) and the nature of the harm. *See* 892 F.2d at 685.)

## **B. Claims By Third Parties—Negligent Misrepresentation**

### **1. Background: Differences Between Negligence And Negligent Misrepresentation**

Claims against accountants often are brought by third-parties—parties who are not the accountant’s client. Typically the third party alleges that it relied on a statement made by the accountant about the accountant’s client. In the District of Columbia, a third-party claim is for negligent misrepresentation rather than negligence or malpractice. Where negligence or professional malpractice is based on a breach of a professional duty owed to a client, negligent misrepresentation is based on an independent duty to avoid making misstatements on which certain third parties rely. As the U.S. District Court for the District of Columbia explained, addressing a professional negligence claim against an auditor, a professional malpractice claim “does not have as an essential element a material misstatement of fact made by the defendant. Instead, the material misstatements are identified as the result of the breach of the defendant’s duties. An essential element of the negligence claim is not the material misstatement per se, but the breach of a duty of care.” *The Plan Committee v. PriceWaterhouseCoopers*, 335 B.R. at 240. (For an influential discussion of the similarities and differences between professional negligence and negligent misrepresentation claims, see *Bily v. Arthur Young & Co.*, 834 P.2d 745, 768-73 (Cal. 1992).) Accordingly, negligent misrepresentation tends to emphasize the importance of reasonable reliance by the third party. *See, e.g., Redmond v. State Farm Ins. Co.*, 728 A.2d 1202, 1208-09 (D.C. 1999) (analyzing reasonable reliance).

### **2. Elements Of Negligent Misrepresentation**

“Negligent misrepresentation requires that the defendants made statements that they knew or should have known were false, and that they knew or should have known

would induce reliance on the part of [the third party], and that did induce such reliance.” *Sherman v. Adoption Ctr. of Washington, Inc.*, 741 A.2d 1031, 1037 (D.C. 1999) (addressing alleged malpractice by adoption agency) (citing *Hall v. Ford Enterprises, Ltd.*, 445 A.2d 610, 612 (D.C. 1982)); *see also Redmond v. State Farm Ins. Co.*, 728 A.2d 1202, 1207 (D.C. 1999) (addressing alleged malpractice by insurer for failure to disclose limitations on coverage at the time it entered insurance contract).

### **3. Background: Three Approaches To The Existence Of A Duty To A Third Party**

In third-party claims, a critical threshold issue is whether the accountant owes a duty of care to the third party—that is, whether sufficient connection exists between the accountant and the third party to permit the third party to sue the accountant. Jurisdictions follow one of three approaches. The narrowest approach requires privity, the broadest (which is difficult to find) would extend the auditor’s liability to all foreseeable users of the financial statements, and an intermediate approach extends liability beyond parties in privity to a certain limited group of financial-statement users. The intermediate approach is set out most prominently in Restatement (Second) of Torts § 552 (1975). This approach extends liability to members of a “limited group of persons for whose benefit and guidance [the accountant] knows that the [accountant’s client] intends to supply [the audit information].” *Id.* Unlike the “near-privity” rule, the Restatement rule does not require that the identity of specific parties who rely on an audit report be known to the auditor, only that the parties be members of a limited group known to the auditor.

District of Columbia cases follow a variation of the near-privity requirement. *See Hogue v. Hopper*, 728 A.2d 611, 615 n.4 (D.C. App. 1999). Under this rule, an accountant can be liable to third parties whose identities are known to the accountant as parties intended to receive and rely on the audit report. This approach initially was set out in New York cases beginning with *Ultramares Corp. v. Touche*, 174 N.E.441, 442 (N.Y. 1931). In *Ultramares*, a third party lender who relied on an audit report was not permitted to sue the auditor. Although the accountant knew that its report would be used by its client for the purpose of obtaining financing, the auditor did not know the identity of the particular third party to whom the client might show the report. *Id.* at 446-47.

Similarly, in *Thornton v. Little Sisters of the Poor*, 380 A.2d 593 (D.C. 1977), the court applied the Ultramares doctrine and held that an action against a title abstracter “exists only in favor of the real parties to the employment contract or their privies.” *Id.* at 596. The court went on, quoting a statement in *Prosser* (§ 88 at 543-44 (2d ed. 1955)), that “mere reasonable anticipation that the statement will be communicated to others, or even knowledge that the recipient intends to make a commercial use of it in dealing with unspecified strangers, is not sufficient to create a duty of care toward them.” 380 A.2d at 596.

(Note, however, that in at least one negligent-misrepresentation case the D.C. Court of Appeals did cite the Restatement (Second) of Torts, though for its statement of the

element of “reasonable reliance.” See *Redmond v. State Farm Ins. Co.*, 728 A.2d 1202, 1207 (D.C. 1999).)

#### 4. Case Summary

##### ***Hogue v. Hopper*, 728 A.2d 611 (D.C. 1999).**

**Facts:** Plaintiff, an attorney and stockholder in a law firm, sued defendants, an accountant and his accounting firm, alleging professional negligence, breach of fiduciary duty and breach of contract. Plaintiff’s former law firm had retained the individual defendant to provide accounting services in connection with that firm’s merger with another law firm. Plaintiff alleged that the individual defendant negligently audited and prepared the firm’s year-end balance sheets and income statements and prepared the partnership’s income tax return, all to plaintiff’s detriment. 728 A.2d at 612-13. The accountant obtained summary judgment below on collateral estoppel grounds.

**Held:** On the collateral estoppel issue, the court affirmed in part and reversed in part. *In dictum*, it addressed the scope of duty to a third party. Relying on law from other jurisdictions, including New York, the Court stated that “an accountant may be held liable to stockholders of a closely held corporation if the accountant knew, or, arguably, if the accountant should have known, that the stockholders would rely on the accountant’s representations. The requirement for accountant liability is that the plaintiff justifiably and detrimentally relies on the accountant’s undertaking.” The court cited two cases, *Coleco Inc. v. Berman*, 423 F. Supp. 275, 309-10 (E.D. Pa. 1976), *aff’d* in pertinent part, 567 F.2d (3d Cir. 1977), and *White v. Guarante*, 372 N.E.2d 315 319 (N.Y. 1977), that apply the near-privy approach and expressly discuss that rule’s origins in *Ultramares Corp. v. Touche*, 174 N.E.441, 442 (N.Y. 1931). See *Hogue*, 728 A.2d. at 615 n.4.

#### C. Breach Of Fiduciary Duty

District of Columbia law appears to be consistent with the generally established rule that an auditor does not owe a fiduciary duty to its client.

The general rule in the District of Columbia is that a fiduciary duty does not arise from a contractual relationship, but may exist “where circumstances show that the parties extended their relationship beyond the limits of the contractual obligations to a relationship founded upon trust and confidence.” *Paul v. Judicial Watch, Inc.*, 543 F. Supp. 2d 1, 6 (D.D.C. 2008) (citing *Steele v. Isikoff*, 130 F. Supp. 2d 23, 36 (D.D.C. 2000)).

Professional standards relating to auditors, however, require independence from the client. See AICPA Professional Standard (AU) § 220 (“Independence”). Section 220.02 provides that an auditor “must be without bias with respect to the client since otherwise he would lack that impartiality necessary for the dependability of his findings . . . .” See also *United States v. Arthur Young & Co.*, 465 U.S. 805, 817-18 (1984) (stating that the auditor’s function “demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust”).

It is possible in certain circumstances—presumably not circumstances involving an auditor, who must be independent—in which an accountant that provides certain extensive services could owe a fiduciary duty to a client. See *Cafritz v. Corporation Audit Co.*, 60 F Supp 627, 628, 631 (D.D.C. 1945) (holding that, under District of Columbia law, an accounting company owed a fiduciary duty to a client where the accounting company had been employed for a number of years to maintain the client's books and records).

***Cafritz v. Corporation Audit Co.*, 60 F. Supp. 627 (D.D.C. 1945).**

**Facts:** Plaintiff sued defendants, an accounting firm and the estate of one of the firm's members, for discovery and accounting. Plaintiff alleged that he had retained defendants for a number of years to serve as an expert accountant, to keep and maintain certain books of record for himself and for several corporations in which plaintiff was an officer and stockholder, to undertake certain responsibilities involving the cash of certain of the entities, and to serve as secretary of several of the entities. These services included keeping the books used in connection with plaintiff's account at the Bank of Commerce & Savings ("BC&S"). *Id.* at 628-29.

Plaintiff alleged that defendants caused themselves to be paid a total of \$36,134.75 out of the BC&S account. Plaintiff further alleged that the individual defendant caused \$8,400 of plaintiff's money to be paid into a bank account belonging to a corporation that the individual defendant controlled. Plaintiff demanded an accounting, and defendants refused. *Id.* at 634.

**Held:** An accountant can owe a fiduciary duty where, among other things, "there is a confidence reposed on one side and the resulting superiority and influence on the other." *Id.* at 631. In this case, for reasons including that the plaintiff had entrusted money to the accountant, the accountant did owe such a duty. *Id.* at 634. Where a defendant occupies a fiduciary relationship with plaintiff, the defendant bears the burden to show that he has performed his trust and the manner of performance. When a fiduciary is under a duty to account and fails to do so, the only inference to be drawn is that he could not satisfactorily explain the transaction without an admission of guilt. *Id.* at 631.

**D. Deepening Insolvency Claims**

**1. Background**

"Deepening insolvency" involves the theory that, had an accounting firm brought certain information to the attention of an audit client, that client would have filed for bankruptcy sooner than it did, thus avoiding losses that the client suffered between the date the auditor should have alerted the client to this information and the actual date of bankruptcy. The losses frequently include operating losses and additional borrowings. Some plaintiffs have alleged that deepening insolvency is an independent cause of action while others have advanced it as a theory of damages. See an overview in Sabin Willett, *The Shallows of Deepening Insolvency*, 60 *The Business Lawyer* 533 (February 2005); see

also *Bondi v. Grant Thornton (In re Parmalat Securities Litigation)*, No. 04 Civ. 9771, 2005 WL 1670246, at \*17-18 (S.D.N.Y. July 18, 2005) (discussing cases).

Consistent with *In re Greater Southeast Community Hospital Corp.*, the case law generally reveals a trend to reject the theory as the basis of a cause of action. See, e.g., *In re CitX Corp.*, 448 F.3d 672 (3d Cir. 2006); *Trenwick Amer. Litig. Trust v. Ernst & Young LLP*, 2006 WL 2434228, at \*28-\*29 (Del. Ch. Aug. 10, 2006). As a theory of damages, some courts reject deepening insolvency, see *Kirschner v. Grant Thornton LLP*, 2009 WL 996417 (S.D.N.Y. April 14, 2009), while others have found it a viable theory of damages for a negligence claim, *Thabault v. Chait*, 541 F.3d 512, 522-23 (3d Cir. 2008) (applying New Jersey law).

## 2. District Of Columbia Law

The District of Columbia has not recognized an independent claim for deepening insolvency, and the Bankruptcy Court has held that District of Columbia law would not do so. See *Alberts v. Tuft (In re Greater Southeast Community Hospital Corp.)*, 333 B.R. 506, 516 (Bankr. D.D.C. 2005); see also *Alberts v. Tuft (In re Greater Southeast Community Hosp. Corp.)*, Adv. Proc. No. 04-10459 (Bankr. D.D.C. Sept. 21, 2006), op. at 7-14 (further explaining the court's earlier decision holding that deepening-insolvency is not an independent cause of action but can be a valid theory of damages). Also, based upon *Drabkin (supra, in Section 3c)*, causation would be difficult for plaintiff to prove.

## 3. Case Summary

***Alberts v. Tuft (In re Greater Southeast Community Hospital Corp.)*, 333 B.R. 506 (Bankr. D.D.C. 2005).**

**Facts:** On behalf of failed company, trustee brought “deepening insolvency” claims against company’s two law firms for failing to inform the company of the consequences of its deepening insolvency and for negligently preparing certain opinion letters. *Id.* at 515-16, 528-29. (The trustee also asserted deepening-insolvency claim against the failed company’s directors and officers. *Id.* at 515-16.)

**Held:** The court dismissed the deepening-insolvency claims, explaining as follows:

Counts X-XII of the Complaint plunge this court into the on-going debate over the existence and nature of the so-called “deepening insolvency” cause of action. Briefly stated, the theory “refers to the ‘fraudulent prolongation of a corporation's life beyond insolvency,’ resulting in damage to the corporation caused by the increased debt.

*Id.* at 516 (citation and internal quotation marks omitted). The court then predicted that the theory would not be adopted in the District of Columbia.

The District of Columbia courts have not yet recognized a cause of action for deepening insolvency, and this court sees no reason why they should . . . . [I]f officers and directors can be shown to have breached their fiduciary duties by deepening a corporation's insolvency, and the resulting injury to the corporation is cognizable . . . . that injury is compensable on a claim for breach of fiduciary duty . . . .

*Id.* at 517 (citation and internal quotation marks omitted). Accordingly, it explained:

[The deepening-insolvency claims against the directors and officers and against the Law Firm Defendants [are] really just a re-packaging of its separate malpractice claim.

*Id.* (citation and internal quotation marks omitted). Finally, the court concluded, “[t]here is no point in recognizing and adjudicating ‘new’ causes of action when established ones cover the same ground.” *Id.*

## **DAMAGES**

### **A. Measure Of Damages**

Damages are limited to the actual monetary loss sustained by the plaintiff proximately caused by the accountant's negligence. *See* Standardized Civil Jury Instructions For The District Of Columbia § 12.01 (“Damages—Jury To Award”). The plaintiffs must prove damages with reasonable certainty. Damages cannot be based on speculation. *See id.* § 12.03 (“Burden of Proof—Speculative Damages”).

## **DEFENSES**

### **A. Statute Of Limitations**

#### **1. Limitations Period**

In the District of Columbia, the statute of limitations governing an accounting malpractice claim is three years from the date the plaintiff knew or should have known of the injury and its cause. D.C. Code § 12-301(8).

#### **2. Commencement Of The Limitations Period**

##### **a. The Discovery Rule**

##### **i. The Rule**

The District of Columbia is a “discovery rule” jurisdiction. Under the discovery rule, a “cause of action accrues when the plaintiff knows or by the exercise of reasonable

diligence should know “(1) of the injury, (2) its cause in fact, and (3) of some evidence of wrongdoing.” Further, “it is only necessary that the plaintiff have inquiry notice of the existence of a cause of action” for the statute of limitations to begin to run. *The Plan Committee v. PriceWaterhouseCoopers*, 335 B.R. at 252 (internal quotation marks and citation omitted).

## **ii. Determining Applicability Of The Rule**

At least one court assumed, for purposes of a motion to dismiss, that the discovery rule could apply to a claim against an auditor. That court held that the question whether the discovery rule applies depends on “four factors: (1) the justifiable reliance of a plaintiff on the professional skills of those hired to perform their work; (2) the latency of the deficiency; (3) the balance between the plaintiff’s interest in having the protection of the law and the possible prejudice to the defendant; and (4) the interest in judicial economy.” *The Plan Committee v. PriceWaterhouseCoopers*, 335 B.R. at 252 (internal quotation marks and citation omitted).

## **iii. Commencement Of The Limitations Period**

“Whether a plaintiff exercised reasonable diligence is a highly fact-bound issue and requires an evaluation of all of the plaintiff’s circumstances.” *The Plan Committee v. PriceWaterhouseCoopers*, 335 B.R. at 253.

### **b. The Adverse-Domination Rule**

The statute of limitations is tolled for the period during which an entity is controlled by wrongdoers. *BCCI Holdings v. Clifford*, 964 F. Supp. 468, 481 (D.D.C. 1997) (on motion to dismiss claim against attorneys, adverse domination is sufficiently pleaded).

## **3. Imputation**

Imputation can be relevant to contributory negligence and statute of limitations defenses.

### **a. The Rule**

“As a general rule, knowledge acquired by a corporation’s officers and directors or agents is properly attributable to the corporation itself.” *BCCI*, 964 F.2d at 478 (citing *FDIC v. Ernst & Young*, 967 F.2d 166, 170-71 (5th Cir. 1992), other citations omitted). The case cited by the *BCCI* court, *FDIC v. Ernst & Young*, 967 F.2d 166, 1709 (5th Cir. 1992), is a leading auditor-liability case that illustrates these arguments. On the imputation defense in the context of a claim against an auditor, the most heavily-cited case, cited in *In re Latin Investment Corp.*, 168 B.R. 1, 5 (D.D.C. Bankr. 1993), is *Cenco, Inc. v. Seidman & Seidman*, 686 F.2d 449 (7th Cir.), *cert. denied*, 459 U.S. 880 (1982).

## **b. The Adverse-Interest Exception**

“[T]here will be no imputation of knowledge if the officer or agent is adversely interested to the corporation.” *BCCI*, 964 F.2d at 478 (internal quotation marks omitted, citing *FDIC v. Ernst & Young*, 967 F.2d at 170, other citations omitted). “The adverse interest exception applies only to fraud *against* the corporation, not to fraud *on behalf of* the corporation,” *BCCI*, 964 F.2d at 478-79 (emphasis in original) (citing *FDIC v. Ernst & Young*, 967 F.2d at 171, other citations omitted), and where the agent acts “solely” in his or her own interest. *BCCI*, 964 F.2d at 479; see also *In re Latin Investment Corp.*, 168 B.R. 1, 5 (D.D.C. Bankr. 1993) (the fraud is not imputed to the corporation if it “did not benefit the [corporation] in any way”). (For a leading case that explains this exception in the context of a claim against an auditor, see *Crazy Eddie v. Peat Marwick Main & Co.*, 802 F. Supp. 804, 817 (E.D.N.Y. 1992).)

## **B. Contributory Negligence**

### **1. The Defense**

The District of Columbia adheres to the older (and now minority) rule of contributory negligence, instead of comparative negligence. In the District of Columbia, the defendant is not liable for the plaintiff’s injuries if the plaintiff’s own negligence is a proximate cause of the plaintiff’s injuries. Contributory negligence is unreasonable conduct that falls below the standard to which a plaintiff should conform for his or her own protection. See Standardized Jury Instructions For The District Of Columbia § 5.5 (“Contributory Negligence Defined”).

“The defendant must establish contributory negligence by a preponderance of the evidence.” *Id.*

### **2. Imputation**

As noted above in Part A.3 of the “Defenses” subsection, imputation can provide the basis for a defense of contributory negligence.

### **3. A Possible Limitation On The Contributory-Negligence Defense: The Audit-Interference Rule**

The District of Columbia has not adopted or rejected the audit-interference limitation on contributory-negligence defenses. The United States District Court for the District of Columbia declined to say, on a motion to dismiss, whether the audit-interference rule applies. See *The Plan Committee v. PriceWaterhouseCoopers*, 335 B.R. at 251.

## **MULTIPLE DEFENDANTS**

No reported cases address accountants, but see the following statements of more general principles.

## **A. Joint And Several Liability**

In the District of Columbia, joint tortfeasors are jointly and severally liable for a claimant's compensatory damages, which cannot be apportioned among tortfeasors. *Remeikis v. Boss & Phelps, Inc.*, 419 A.2d 986, 992 (D.C. 1980) (claim by home purchaser against inspector and real estate agent). Liability for punitive damages is several, and is apportioned by relative fault. *Id.*

## **B. Contribution**

Joint tortfeasors that pay more than their pro rata share have a right of contribution. *See, e.g., Berg v. Footer*, 673 A.2d 1244, 1230-44 (D.C. 1996) (medical malpractice claim).

# **EVIDENTIARY ISSUES**

## **A. Accountant-Client Privilege**

The District of Columbia has not adopted an accountant-client privilege. No such privilege exists under federal law. *See, e.g., Couch v. United States*, 409 U.S. 322, 335 (1973) (“no confidential accountant-client privilege exists under federal law, and no state-created privilege has been recognized in federal cases”); *United States v. Arthur Young*, 465 U.S. 805, 815-17 (1984).

## **B. Speculative Testimony Not Permitted**

A witness cannot testify about what he or she would have done had the facts been different. That testimony would be impermissibly speculative. *See Drabkin*, 905 F.2d at 456 (director testimony about what director would have done had the auditor brought additional facts to the board’s attention was speculative and self serving, though trial court had permitted the director to testify about what he “could” have done had he received additional information).

# **OTHER MATTERS**

## **A. Auditor’s Obligation With Respect To Client’s Compliance With GAAS**

For discussion by the court (Judge Sporkin) of an auditor’s obligation to refuse to accede to a client accounting practice that is contrary to accounting principles (here, addressing client’s booking of certain profit), *see Lincoln Savings and Loan Ass’n v. Wall*, 743 F. Supp. 901 (D.D.C. 1990).

In that case, the Federal Home Loan Bank Board had appointed a conservator, then a receiver, to take over the S&L’s management, after concluding that the S&L was in an unsafe and unsound condition, and that there had been a substantial dissipation of assets or earnings due to violations of law, rules or regulations, or to unsafe or unsound practices

including accounting practices, and ultimately was insolvent. Plaintiffs, the S&L and its owner, challenged this action and sought to regain operational control.

Among several other issues in the case, S&L management had planned to book a profit of \$59 million from a certain transaction. The auditors believed the entry would not comply with GAAS and refused to concur in the proposed treatment. The court commended the auditor for maintaining its position with respect to the transaction. 743 F. Supp. at 918; *see also id.* at 918 n.25.

## **B. Professional Liability Insurance Coverage: Applicability Of “Intentional Acts” Exclusion**

Where an accounting firm client sued the firm for negligence, the firm’s insurer contended that an “intentional acts” exclusion applied. Although the client obtained a negligence verdict against the firm, a fact issue remained about whether the firm’s conduct was intentional and therefore within the exclusion. *See Britamco Underwriters, Inc. v. Nishi, Papagjika & Associates, Inc.*, 20 F.Supp 2d 73 (D.D.C. 1998) (addressing applicability of “intentional acts” exclusion in accounting firm’s professional liability policy).

**Facts:** Plaintiff, the defendant accounting firm’s professional insurance carrier, brought a declaratory judgment action against the accounting firm’s client, seeking an order that the insurance policy did not cover a judgment against the accounting firm. In the underlying suit, the accounting firm’s client had sued the accounting firm for professional malpractice and won a \$1 million judgment. *Id.* at 74.

The client then sought payment of this judgment from the accounting firm’s carrier, leading the carrier to seek the declaratory judgment. The client filed a counter-claim for payment of the judgment. The client eventually moved for summary judgment on the insurer’s declaratory judgment claim and the client’s counter-claim. In the motion for summary judgment, client invoked the doctrines of issue preclusion, waiver, election, and estoppel. *Id.* at 75-76.

**Held:** The issue was whether the underlying claim fell within a policy exclusion for intentional acts of the accounting firm. The issue of whether the accounting firm’s actions were “intentional” was not litigated in the underlying litigation, which went to the jury on the issue of negligence alone. Therefore, the doctrine of issue preclusion did not bar the insurer from seeking a declaratory judgment. *Id.* at 76-77.

On the remaining issues of waiver, estoppel, and election, the court held that the client could prevail at the summary judgment stage only if it introduced uncontroverted evidence that the carrier: (1) knew or should have known that the accountants breached the insurance policy, and (2) failed to give notice or adequately reserve its rights to either the “intentional acts” or “policy limits” defenses raised in this action. Both of these were questions for the jury to decide. Client’s motion for summary judgment was denied. *Id.* at 77-78.

## MARYLAND

## MARYLAND

### LONG-ARM JURISDICTION

#### A. Long-Arm Jurisdiction Statute

In Maryland, jurisdiction lies where an actor “[t]ransacts any business or performs any character of work or service in the state,” or “contracts to supply . . . services” in Maryland, or “causes tortious injury” in the state “by an act or omission in” Maryland. Md. Cts. & Jud. Proc. § 6-103 (2002 & Supp. 2008) (“Cause of action arising from conduct in State or tortious injury outside State”).

#### B. Case Summary

Where an out-of-state accountant prepared federal and Maryland state returns for Maryland residents and visited plaintiff in Maryland, jurisdiction lay in Maryland. *Baker & Kerr, Inc. v. Brennan*, 26 F. Supp.2d 767 (D. Md. 1998) (denying motion to dismiss for lack of personal jurisdiction).

#### ***Baker & Kerr, Inc. v. Brennan*, 26 F. Supp.2d 767 (D. Md. 1998).**

**Facts:** Maryland corporation sued Pennsylvania certified public accountant for malpractice, breach of contract, and conspiracy in United States District Court for the District of Maryland. Accountant had prepared Maryland state and federal tax returns for plaintiff and corporation’s officers, who were Maryland residents. Accountant also had prepared additional financial reports for the Maryland business, frequently communicated with officers in Maryland, and frequently visited plaintiff’s Maryland office. Defendant accountant filed motion to dismiss for lack of personal jurisdiction. *Id.* at 768-69.

**Held:** The Court denied accountant’s motion to dismiss. The Pennsylvania accountant had established sufficient and purposeful contacts with Maryland to satisfy due process and sustain exercise of personal jurisdiction over accountant under Maryland long-arm statute. Assertion of personal jurisdiction comported with fair play and substantial justice, because accountant should have reasonably foreseen being hailed into Maryland court as a result of activities within the forum. Maryland had significant interest in protecting citizens from accountant’s alleged tortious activities. *Id.* at 769-70.

### CLAIMS

#### A. Accounting Malpractice

##### 1. Elements

“In Maryland, in order to establish a cause of action for negligence, a plaintiff must prove: a duty owed to the plaintiff or to a class of which the plaintiff is a part; a breach of that duty; a causal relationship between the breach and the harm; and damages suffered.”

***Walpert Smullian & Blumenthal, P.A. v. Katz*, 361 Md. 645, 655, 762 A.2d 582, 587 (2000). *Accord Shofer v. Stuart Hack Company*, 124 Md.App. 516, 723 A.2d 481 (1998), cert. den. 354 Md. 331, 731 A.2d 440 (*Shofer III*).**

“Professional malpractice is one genre of negligence. . . . [P]laintiff must prove that defendant, whether a physician, lawyer, architect, accountant, or pension administrator, breached the standard of care applicable to other like professionals similarly situated.” *Shofer*, 124 Md. App. at 529, 723 A.2d at 487. See MPJI-CV 27:9 (Maryland Model Jury Instruction (4th ed.) at 719) (“A [professional] is negligent if he or she does not use that degree of care and skill that a reasonably competent professional person acting in similar circumstances, would use.”).

## **2. Requirement For Expert Testimony To State A Claim For Professional Malpractice**

In professional malpractice cases, expert testimony on the standard of care is required where the standard is not obvious to the layperson. See, e.g., *Fishow v. Simpson*, 55 Md. App. 312, 318, 462 A.2d 540, 544 (1983) (addressing attorney malpractice claim).

## **3. Reasonable Reliance**

Where a plaintiff’s reliance was not reasonable, plaintiff’s conduct can negate proximate cause and constitute contributory negligence. See *Wegad*, 326 Md. at 418, 605 A.2d at 128 (“a client is contributorily negligent if it unreasonably relies on the advice of its accountant”)

## **4. Proximate Cause**

“For the plaintiff to recover damages, the defendant’s negligence must be a cause of the plaintiff’s injury.” MPJI 19:10 (“Causation”). “[N]egligence is the proximate cause of an injury when the injury is the natural and probable result of the negligent act or omission.” *Medina v. Meilhammer*, 62 Md. App. 239, 247, 489 A.2d 35, 39, cert. denied, 303 Md. 683, 496 A.2d 683 (1985). See also *Shofer*, 124 Md. App. at 532, 723 A.2d at 488 (citing *Peterson v. Underwood*, 258 Md. 9, 17 264 A.2d 851 (1970)) (the plaintiff must show that any damage was “directly attributable to [the defendant’s] actions”); *Shofer*, 124 Md. App. at 532, 723 A.2d at 488 (“The injury must also be a foreseeable one.”). See citations collected at MPJI-CV 19:10 (“Causation”).

A cause is not the proximate cause where other events were causes of the injury or damage. See, e.g., *Stratton v. Sacks*, 99 B.R. 686, 696-97 (D. Md. 1989).

Causation is negated if the client already knew the facts that it alleges the auditor failed to discover and report to the client. See, e.g., *EF Hutton Mortgage Corp. v. Pappas*, 690 F. Supp. 1465, 1473-75 (D. Md. 1988) (granting summary judgment for auditor on, among other grounds, lack of proximate causation where plaintiff was aware of the information it alleged that the auditor should have disclosed); cf. *Stratton v. Sacks*, 99 B.R. 686, 696-97 (D.

Md. 1989) (granting summary judgment for auditor on negligence and breach of contract claims by client's bankruptcy trustee on the ground of lack of proximate causation, because the client's losses "were essentially caused by [the majority shareholder's] fraudulent conduct and by the negligence of the other officers and agents").

## 5. Case Summaries

### **Re First American Mortgage Company ("FAMCO") Litigation: *E.F. Hutton Mortgage Corp. v. Pappas*, 690 F. Supp. 1465, 1468-73 (D. Md. 1988).<sup>1</sup>**

**Facts:** FAMCO originated mortgage loans and sold them in the secondary market; it often continued to service the loans that it sold. E.F. Hutton purchased mortgage loans from FAMCO. FAMCO, which Hutton relied on to service the loans, defrauded Hutton of much or all of the value of the loans. *Id.* at 1467-68. Hutton sued Ernst & Whinney ("E&Y"), which had audited FAMCO's financial statements, asserting claims for negligence, fraud, and aiding and abetting fraud. *Id.* Hutton argued that it would not have purchased loans from FAMCO if E&Y had required FAMCO to disclose additional information about its recordkeeping relating to serviced loans. *Id.* at 1473. E&Y moved for summary judgment.

**Held:** With respect to the fraud and aiding-and-abetting claims, the court held that the plaintiffs had failed to produce "clear and convincing" evidence of fraudulent acts on part of accounting firm partners. There was no evidence to suggest partners knew or aided fraud by mortgage company officer, and a failure to comply with GAAS does not, without evidence that the auditor acted "recklessly or . . . with an intent to deceive," support an action against an auditor for fraud. *Id.* at 1471; *see also id.* at 1471-73.

With respect to the negligence claim, the court granted summary judgment based on absence of proximate cause and on contributory negligence. Any negligence by the financial-statement auditor was not the proximate cause of Hutton's losses from the purchased loans because E&W's audit related to FAMCO's financial condition and made no mention of the quality of the loans that Hutton purchased. *Id.* at 1473. "Hutton's losses were caused essentially by the poor quality of the mortgage loans it purchased, by the fact that the loans were not properly serviced, and by fraudulent conduct of FAMCO." *Id.* at 1473. (This suggests a requirement that the harm suffered by the plaintiff correspond to the nature of the wrong alleged.)

Moreover, to the extent that FAMCO's overall financial condition was relevant, causation still could not be established, because the financial statements did show that FAMCO was financially weak. *Id.* at 1474. (The court assumed that Hutton owed a duty to

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<sup>1</sup> The FAMCO scandal led to at least three reported cases involving professionals: (1) a lawsuit by FAMCO's bankruptcy trustee against FAMCO's outside accountant (which was not the financial-statement auditor), *Stratton v. Sacks*, 99 B.R. 686 (D. Md. 1989), *aff'd*, 900 F.2d 25 (4th Cir. 1990); (2) a lawsuit by FAMCO's bankruptcy trustee against FAMCO's attorney, *Stratton v. Miller*, 113 B.R. 205 (D. Md. 1989), *aff'd*, 900 F.2d 251 (4th Cir. 1990); and (3) a third-party claim against FAMCO's auditor (Ernst & Whinney), *E.F. Hutton Mortgage Corp. v. Pappas*, 690 F. Supp. 1465 (D. Md. 1988).

Hutton but did not reach the question, *id.* at 1473.) The court concluded that there was no causation. *Id.* at 1473-75.

In addition, Hutton was contributorily negligent. Hutton did not review the documents relating to loans it purchased, did not demand delinquency reports, and generally did not take action after it learned that FAMCO's loan servicing paperwork was "in total disarray." *Id.* at 1476-77.

**Re First American Mortgage Company ("FAMCO") Litigation: *Stratton v. Sacks*, 99 B.R. 686 (D. Md. 1989), *aff'd*, 900 F.2d 255 (4th Cir. 1990).**

**Facts:** Stratton was trustee for the bankrupt FAMCO. Stratton sued FAMCO's outside accountant (not its auditor, which was Ernst & Whinney, *see Stratton v. Pappas*) for negligence and breach of contract. The contract between accounting firm and mortgage company provided for preparation of basic financial statements and tax returns and administering certain payroll and general ledger entries. The accounting firm did not perform audit or review services and disclaimed responsibility for disclosing errors, irregularities or illegal activities in business records. The accounting firm did suspect certain irregularities, but raised its concerns only with the president himself, who was carrying out the fraud. The trustee alleged that the accounting firm should have discovered the fraudulent activities of the president and brought them to the attention of others at the company.

**Held:** Summary judgment for the defendants based on absence of proximate cause and on contributory negligence. Any negligence by the accountants was not the proximate cause of any injury to FAMCO because the trustee had not shown—"it is mere conjecture to conclude"—that the fraud would have been stopped had the accountants brought irregularities to the attention of other FAMCO stockholders and directors. *Id.* at 696. In fact, it was the fraudulent activities that "kept FAMCO in business." *Id.*

In addition, FAMCO was contributorily negligent. FAMCO officers committed a number of fraudulent acts, and "did not exercise due care in performing their assigned duties as agents of the corporation." Also, other employees were negligent in failing to identify and stop the frauds. The court held that "the negligent acts of such officers are chargeable to [the company] itself under the theory of respondeat superior because they were "done within the scope of his employment and in furtherance of the employer's business." *Id.* at 694. The trustee argued that the contributory negligence defense is available only if plaintiff's negligence contributed to accountant's failure to perform duties; the court noted that the Court of Appeals had not adopted this limitation and, in any event, FAMCO had interfered with the accountant. *Id.* at 695. Thus, the court concluded, applying Maryland law, the "doctrine of contributory negligence is a complete bar to any recovery by the Trustee in this case." *Id.*

***Shofer v. Stuart Hack Company*, 124 Md. App. 516, 532, 723 A.2d 481, 488 (1999), *cert. den.* 354 Md. 331, 731 A.2d 440 (*Shofer III*) (absence of advice about tax effect of**

**plaintiff's decision was not the cause of plaintiff's loss where the plaintiff took the action at issue for other reasons).**

**Facts:** Plaintiff was a small business owner, and defendant was the administrator of the business's pension plan. Plaintiff alleged that the administrator had advised him that he could borrow money from the plan but had not told him that this borrowing would have negative tax effects. 124 Md. App. at 523-24, 723 A.2d at 485-86. At trial, the court found that defendant's conduct was not the cause of plaintiff's injury and that plaintiff was contributorily negligent. 124 Md. App. at 522, 723 A.2d at 484. The plaintiff appealed.

**Held:** The Court of Special Appeals affirmed, holding that the plaintiff had not discharged its "burden" to "establish a reasonable probability or likelihood that the defendant's acts caused the plaintiff's injury." 124 Md. App. at 532, 723 A.2d at 488. The Court of Special Appeals concluded that the plaintiff had not given the defendant sufficient information about the plaintiff's intention to borrow from the plan so that the defendant could have foreseen the consequences of the loans that the plaintiff took; the plaintiff's conversation with the administrator about possible borrowing from the plan had been only a brief one. 124 Md. App. at 532-33, 723 A.2d at 488-89. Plaintiff, who was a sophisticated businessman, then had failed to inform the plan administrator and his own accountant when he actually took loans. *Id.* The court also noted that the plaintiff would have taken the loans regardless of advice from the defendant. The court also affirmed the trial court holding that the plaintiff had been contributorily negligent. He had failed to tell the defendant that he actually was taking the loans or the extent of the loans and had failed to consult a tax accountant about the tax consequences. 124 Md. App. at 533-34, 723 A.2d at 489-90.

## **B. Claims By Third Parties—Negligent Misrepresentation**

### **1. Background: Differences Between Negligence And Negligent Misrepresentation**

See the discussion in the District of Columbia section, above. In *Walpert Smullian & Blumenthal, P.A.*, 361 Md. at 655, 762 A.2d at 587, the Maryland Court of Appeals stated that negligent misrepresentation is a "variety" of negligence.

### **2. Elements Of Negligent Misrepresentation**

"The principal elements of the tort of negligent misrepresentation . . . may be outlined as follows:

- (1) the defendant, owing a duty of care to the 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."

***Walpert Smullian & Blumenthal, P.A. v. Katz*, 361 Md. 645, 656-57, 762 A.2d 582, 588 (2000) (citations and internal quotation marks omitted).**

### **3. Standing: Existence Of A Duty To The Third-Party**

#### **a. Background**

See the discussion, in the District of Columbia section above, of the three approaches to the scope of accountant liability to third parties. The Maryland Court of Appeals described these three approaches in detail in *Walpert Smullian & Blumenthal, P.A. v. Katz*, 361 Md. 645, 673-80, 762 A.2d 582, 598-601 (2000).

#### **b. Duty Requirement**

Maryland follows the "New York" rule, which originated in the New York case of and *Ultramares Corp. v. Touche*, 174 N.E. 441, 442 (N.Y. 1931), as reaffirmed by *Credit Alliance Corp.*, 483 N.E.2d 110, 118 (1985) (cited in *Walpert Smullian & Blumenthal, P.A. v. Katz*, 361 Md. at 658, 674, 762 A.2d at 589, 597). This rule permits a non-client to sue an accountant only if the non-client's reliance on the accountant is known to and intended by the accountant, and if there is some conduct by the accountant linking him/her to the non-client, thus showing the accountant's understanding of the non-client's reliance. *Walpert Smullian & Blumenthal, P.A. v. Katz*, 361 Md. 645, 673-81, 762 A.2d 582, 598-601 (2000); see generally discussion at *Walpert Smullian & Blumenthal, P.A.*, 361 Md. at 658-94, 762 A.2d at 589-608 (discussing at length the basis for this rule and the scope of the accountant's duty).

### **4. Case Summary**

***Walpert Smullian & Blumenthal, P.A. v. Katz.*, 361 Md. 645, 680-81, 762 A.2d 582, 601 (2000).**

**Facts:** Plaintiffs George and Shirley Katz made or guaranteed loans for a company. George Katz had previously been the owner and president of the company but was not the owner at the time of the loans. The company failed. The Katzes sued the company's auditor, alleging that the company's audited financial statements had overstated the company's assets. The Katzes alleged that they had relied on the audited financial statements. They also alleged that George Katz had met with the auditor and discussed the company's financial condition before deciding to make the loan and guarantee. 361 Md. at

694, 762 A.2d at 608. The trial court had granted summary judgment for Defendants on the ground that Maryland law required privity or its equivalent and there was no evidence from which a tier of fact could find that the accountant owed a duty to the plaintiffs. The Court of Special Appeals had reversed, agreeing with the trial court's statement of the legal standard but concluding that the record contained sufficient evidence to create issues of fact. 361 Md. at 647-48, 762 A.2d at 583.

**Held:** The Court of Appeals affirmed. Addressing the test for a duty, the court chose to apply the "New York" rule, following the New York cases of *Credit Alliance Corp.* and *Ultramares*. The court explained that this rule permits a suit by a non-client against accountants if the accountants "are aware that the financial reports they prepare are to be used for a particular purpose or purposes, that a known party or parties are intended to rely on those reports for that purpose or purposes and they have a relationship with that party that indicates that they understand that party's reliance." 361 Md. at 692, 762 A.2d at 608 (citing *Credit Alliance*, 483 N.E.2d at 118). "[T]he required linking conduct, while that of the accountant, must be such that evinces the accountant's knowledge of the plaintiff's reliance, and, thus, its liability exposure" but there is no "requirement that the accountant "either directly convey the audit report to the third party or otherwise act in some manner specifically calculated to induce reliance on the report." 361 Md. at 692, 762 A.2d at 608 (citation and internal quotation marks omitted). Thus, the Court found sufficient facts to rule out summary judgment.

### **C. Breach Of Fiduciary Duty**

An auditor does not owe a fiduciary duty to its client. See *Carnegie Int'l Corp. v. Grant Thornton, LLP*, No. 24-C-00-002639 (Circuit Court for Baltimore City, Memorandum Opinion, April 6, 2005) at 40-41.

### **D. Deepening Insolvency**

See the discussion of deepening insolvency in the District of Columbia section, above. No Maryland court, or court addressing Maryland law, has addressed deepening insolvency.

### **E. Fraud**

#### **1. Elements**

The plaintiff must offer "clear and convincing" proof of the following: 1) a "false representation" by the accountant; 2) that the accountant "knew that the representation was false or made the representation with such reckless indifference to the truth as to impute knowledge and intent to defraud;" 3) that the accountant made the representation "for the purpose of deceiving the plaintiff;" 4) "that plaintiff reasonably relied upon" the representation; and 5) "that the plaintiff suffered damage resulting directly from" the representation. *E.F. Hutton Mortgage Corp. v. Pappas*, 690 F. Supp. 1465, 1470 (D. Md. 1988).

## 2. Case Summary

***E.F. Hutton Mortgage Corp. v. Pappas*, 690 F. Supp. 1465 (D. Md. 1988).**

See summary above in “Claims” at Section A.5.

### DAMAGES

#### A. Measure Of Damages

As a general rule, the plaintiff is entitled to actual damages proximately caused by the defendant’s negligence and proven with reasonable certainty. In professional liability cases, this does not appear to include benefit-of-the-bargain damages. *See generally* MPJI 10:1 (“[Damages] Introductory Statement”); MPJI 19:10 (Definition [of proximate cause]).

#### B. Availability Of Damages For Mental Anguish Or Of Punitive Damages

Physical injury is prerequisite for recovery of compensatory damages for mental anguish. Actual malice is prerequisite to recovery of punitive damages. *H&R Block, Inc. v. Testerman*, 275 Md. 36, 338 A.2d 48 (1975).

#### C. Case Summary (Availability Of Damages For Mental Anguish)

***H&R Block, Inc. v. Testerman*, 275 Md. 36, 338 A.2d 48 (1975).**

**Facts:** Plaintiffs brought action for compensatory and punitive damages under theories of breach of contract and negligence against defendant tax preparer for errors in 1967 and 1968 tax returns. Plaintiff sought compensatory damages, punitive damages, and an award for mental anguish.

**Held:** The Courts Of Appeals held that actual malice is prerequisite to recovery of punitive damages, and were not recoverable here because no malice was shown. Negligence arose out of contractual relationship and defendants’ conduct did not indicate any ill will or evil motive against plaintiffs. The Court disallowed recovery for mental anguish, because there was no evidence of any physical injury. The Court affirmed entry of trial court judgment for compensatory damages, penalties assessed by IRS and the legal and accounting costs that plaintiffs had been required to incur.

## DEFENSES

### A. Statute Of Limitations

#### 1. Limitations Period

The limitations period is three years. *See* Md. Code Ann., Cts. & Jud. Proc. § 5-101 (2002 & Supp. 2008) (“Three-year limitation in general”). *See also* *Edwards v. Demedis*, 118 Md. App. 541, 552, 703 A.2d 241, 245 (1997) (applying three-year limitations period in accountant malpractice matter).

#### 2. Commencement Of The Limitations Period

##### a. The Discovery Rule

Maryland follows the discovery rule, under which “a cause of action accrues when a claimant knows or should have known of the wrong. The discovery rule, as applied in Maryland, is clearly distinguishable from the maturation of harm rule applied in some jurisdictions. A legal wrong must be sustained, but a precise amount of damages need not be known. A cause of action accrues when knowledge of facts and circumstances are [sic] sufficient to put a claimant on notice to make inquiry.” *Edwards v. Demedis*, 118 Md. App. 541, 553, 703 A.2d 241, 246 (1997) (citations and internal quotation marks omitted) (affirming summary judgment for defendants, based on statute of limitations, on malpractice claim).

##### b. Tolling Of The Limitations Period: Continuous Representation Doctrine

Continuous representation doctrine: In a claim against an attorney, once a cause of action accrues, then continuing events do not necessarily toll statute of limitations even if negligent acts repeated. Fraud may prevent acquisition of knowledge sufficient to constitute inquiry notice, but there was no evidence of fraud in this case. *Edwards v. Demedis*, 118 Md. App. 541, 703 A.2d 241 (1997). *See also* *Leonhart v. Atkinson*, 265 Md. 219, 289 A.2d 1 (1972) (applying discovery rule to affirm summary judgment for accountant on statute of limitations); *Feldman v. Granger*, 255 Md. 288, 292-93, 257 A.2d 421, 424 (1969) (applying discovery rule to claim against accountant and affirming summary judgment for accountant).

A common issue in accounting malpractice cases is whether successive audits trigger the doctrine and therefore toll the statute. Decisions vary, but for a heavily-cited discussion of the application of the continuous-representation doctrine to accounting malpractice, see *Williamson v. PricewaterhouseCoopers LLP*, 2007 N.Y. slip op. 4719, 2007 N.Y. LEXIS 1455 (June 7, 2007) (holding that the doctrine did not apply and therefore the running of the limitations period was not tolled). *Williamson* sets out the purpose of the rule and describes its roots in medical malpractice.

### 3. Case Summaries

#### ***Edwards v. Demedis*, 118 Md.App. 541, 703 A.2d 241 (1997).**

**Facts:** Plaintiff investors filed claims for malpractice against attorney and financial planner for tax advice concerning rollover from retirement account on October 17, 1995. In November 1990, plaintiffs received notice of IRS position and knew as early as spring of 1991 that tax deficiency may have been related to defendant's advice. Plaintiffs received inquiry notice no later than October 8, 1992, when IRS issued statements showing deficiency and balance due from receipt of transfer refund and rollover into IRA. Defendants continued to argue that tax advice was correct and advised plaintiffs not to accept IRS settlement offer. Plaintiffs' refund suits were not successful. Trial court entered summary judgment in favor of defendants.

**Held:** The Court of Special Appeals held that 1) plaintiffs' cause of action accrued more than three years before the filing of suit; 2) continuous representation did not toll the period of limitations; and 3) there was no legally sufficient evidence of constructive fraud.

Rejecting bright line "discovery rule" that cause of action accrues upon receipt of notice of IRS deficiency, the Court held that cause of action accrues when 1) all elements of claim for negligence come into existence and 2) claimant acquires knowledge sufficient to make inquiry and reasonable inquiry would have disclosed the existence of the allegedly negligent act and harm. Once the cause of action accrued, continuing events did not toll statute of limitations even if negligent acts repeated. Fraud may prevent acquisition of knowledge sufficient to constitute inquiry notice, but there was no evidence of fraud in this case. The harm from prospective IRS action was not speculative. Entry of judgment in favor of defendants was affirmed.

#### ***Leonhart v. Atkinson*, 265 Md. 219, 289 A.2d 1 (1972).**

**Facts:** Plaintiff taxpayers alleged that their accounting firm provided negligent tax advice. The statute of limitation was three years. Plaintiffs had filed suit more than three years after they received an IRS notice of tax deficiency, but within three years of the final order in their appeal of that deficiency to the Tax Court. The trial court granted summary judgment for the accountant on the statute of limitations. 265 Md. at 219-21, 289 A.2d at 2-3.

**Held:** Affirmed. Under the discovery rule, the statute began to run when the plaintiff received IRS notice of tax deficiency, not on the later date when the assessment was affirmed by the Tax Court and the plaintiff had exhausted his challenge to the IRS position. The test is "when the wrong is discovered or when with due diligence it should have been discovered;" the test is not "the maturation of the harm." 265 Md. at 224-26, 289 A.2d at 4-5.

## **B. Contributory Negligence**

### **1. The Defense**

“Maryland is one of a minority of states in the nation which has not adopted the comparative fault doctrine. Under Maryland law, contributory negligence is an all-or-nothing proposition which completely bars recovery of damages by a person whose fault contributes to that damage, no matter how slight that fault may be.” *E.F. Hutton Mortgage Co. v. Pappas*, 690 F. Supp. 1465, 1475-76 (D. Md. 1988) (citations omitted). *Accord Stratton v. Sacks*, 99 BR 686, 692-93 (D. Md. 1989); *Wegad v. Howard Street Jewelers, Inc.*, 326 Md. 409, 413-14, 417, 605 A.2d 123, 125-26, 128 (Ct. App. 1992).

“[T]he defendant has the burden of proving by a preponderance of the evidence . . . that the plaintiff’s negligence was a cause of plaintiff’s damage or loss.” *Wegad v. Howard Street Jewelers, Inc.*, 326 Md. 409, 413, 417, 605 A.2d 123, 125-26, 128 (Ct. App. 1992).

For cases applying contributory negligence defense in claims against accountants, see *E.F. Hutton Mortgage Corp. v. Pappas*, 690 F. Supp. 1465, 1476-77 (D. Md. 1988); *Wegad v. Howard Street Jewelers, Inc.*, 326 Md. 409, 413-14, 417, 605 A.2d 123, 125-26, 128 (Ct. App. 1992).

### **2. Case Summaries**

***Wegad v. Howard Street Jewelers, Inc.*, 326 Md. 409, 413-14, 417, 605 A.2d 123 125-26, 128 (Ct. App. 1992).**

**Facts:** Accountant’s client, a jewelry store, brought malpractice action against accountant (who had not conducted an audit) for failure to detect and report embezzlement by client’s employee. Client challenged trial court’s instructions to jury on law of contributory negligence.

**Held:** Court of Appeals upheld trial judge’s instruction on contributory negligence, which stated that client may not unjustifiably or unreasonably rely on accountant’s advice. Thus, the client’s contributory negligence may bar the client’s claim against the accountant. The Court found scope of accountant’s undertaking must be considered in determining extent to which client may rely on accountant’s advice. “The client . . . should not be permitted an absolute and unqualified right to rely on the accountant’s advice and thereby be completely insulated from responsibility for his or her own shortcomings.” 326 Md. at 417, 605 A.2d at 128. The court also indicated that the same conduct could constitute unreasonable reliance. 326 Md. at 418, 605 A.2d at 128.

### **FAMCO Cases.**

See summary above in “Claims” at Section A.6.

### **3. Imputation**

Imputation can be relevant to contributory negligence and statute of limitations defenses.

#### **a. The Rule**

“An employer is responsible for the employee’s wrongful conduct if done within the scope of his employment and in furtherance of the employer’s business, even though done in a wrongful or forbidden manner.” *Stratton v. Sacks*, 99 B.R. at 694 (citation omitted).

#### **b. The Adverse-Interest Exception**

##### **i. The Exception**

“Maryland agency law . . . provides that knowledge of an agent whose interests are adverse to the principal cannot be imputed to the principal.” *Hecht v. Resolution Trust Corp.*, 333 Md. 324, 635 A.2d 394 (addressing claim by RTC against former directors of savings and loan).

##### **ii. Controlling Person Exception To The Adverse-Interest Exception**

Even where a corporation’s agent engages in conduct that is contrary to the company’s interests, the conduct will be imputed to the company if the agent is “in substantial control of the affairs of the corporation.” *Stratton v. Sacks*, 99 B.R. at 694 n.9 (citation omitted).

### **4. A Possible Limitation On The Contributory-Negligence Defense: The Audit-Interference Rule**

The Court of Appeals has not adopted or rejected the rule, adopted in certain other jurisdictions, “that the contributory negligence of a client is a defense in a suit brought against an accountant only where the client’s negligence prevented the accountant from performing his duties.” *Stratton*, 99 B.R. at 695 (citations omitted).

In *Stratton v. Sacks*, the court held that, even if the audit-interference limitation did apply, the accountant’s contributory-negligence defense still would prevail. In that case, the client had, among other things, “misrepresented facts to [the accountant] and otherwise caused false information to be entered in FAMCO’s books” and the client’s president had “assured” the accountants that “irregularities were not occurring.” *Id.* at 695.

*See also Wegad*, 326 Md. at 418, 605 A.2d at 128 (“The scope of the accountant’s undertaking has a bearing on how much a client is entitled to rely on the professional’s advice. The degree to which a client has a right to rely on this advice should be considered when deciding if that client exercised reasonable care.”).

## MULTIPLE DEFENDANTS

No reported cases address accountants, but see the following statements of more general principles.

### A. Joint And Several Liability

Joint tortfeasors are jointly and severally liable; each must assume and bear the responsibility for the misconduct of all. *See Cooper v. Bikle*, 334 Md. 608, 640 A.2d 1120 (1994) (“the case law of this State clearly provides that a plaintiff has the right to bring an action against alleged joint tortfeasors either collectively *or* individually if the plaintiff so chooses. The plaintiff is under no obligation to join any and all potential tortfeasors when such parties are jointly and severally liable for the plaintiff’s injuries”) (addressing fraud claim brought by representative of estate).

### B. Contribution

A joint tortfeasor who pays more than his or her pro rata share has a right of contribution against other joint tortfeasors who have not paid their pro rata share. Md. Code Ann., Cts. & Jud. Proc. § 3-1402 (2002 & Supp. 2008).

## EVIDENTIARY ISSUES

### A. Accountant-Client Privilege

#### 1. The Rule

According to the Maryland Code:

[U]nless expressly permitted by a client or the personal representative or successor in interest of the client, a licensed certified public accountant or firm may not disclose: (1) The contents of any communication made to the licensed certified public accountant or firm by a client who employs the licensed certified public accountant or firm to audit, examine, or report on any account, book, record, or statement of the client; (2) Any information that the licensed certified public accountant or firm, in rendering professional service, derives from: (i) A client who employs the licensed certified public accountant or firm; or (ii) The material of the client.

Maryland Code, Cts. & Jud. Proc., § 9-110(b) (2002 & Supp. 2008) (“Privileged Communications—Accountants”) (see § 9-110 for definitions, exceptions, and related provisions).

The privilege is limited to documents that have been kept confidential between client and accountant. *Vellone v. First Union Brokerage Svcs, Inc.*, 203 F.R.D. 231, 233-35 (D. Md. 2001).

For cases applying this privilege when asserted in response to a subpoena, *see, e.g., Vellone*, 203 F.R.D. 231, 234-35 (D. Md. 2001) (collecting cases and discussing the policies underlying the privilege); *Sears, Roebuck & Co. v. Gussin*, 350 Md. 552, 714 A.2d 188 (1997) (affirming circuit court order quashing subpoena); *In Re A Special Investigation # 202*, 53 Md. App. 96, 101, 103-04, 452 A.2d 458, 460, 462 (1982) (holding that accountant-client privilege does not apply in the context of a state grand-jury subpoena; discussing the purpose of the accountant-client privilege).

The privilege, which is a creation of state law, applies in state cases and in federal court where state law governs a claim. *See Vellone*, 203 F.R.D. at 232.

## 2. Case Summary

### ***Vellone v. First Union Brokerage Svcs, Inc.*, 203 F.R.D. 231 (D. Md. 2001).**

**Facts:** Plaintiffs served document subpoenas on accounting firms for documents relating to defendants, which were clients of the accounting firms. The firms opposed the subpoenas on the basis of the accountant-client privilege. *Id.* at 232.

**Held:** Because the court's jurisdiction was based on diversity, the Maryland law of accountant-client privilege governed. *Id.* First, the privilege applies only to "*confidential communications*" between client and accountant. *Id.* at 234 (emphasis in original). Next, "a client may not immunize otherwise discoverable materials from the reach of another party by transferring possession of those materials to an accountant. *Id.* at 235 (citations omitted). Accordingly, materials such as tax returns, bank statements and so on were not privileged. Next, the language in Section 9-110(b) of the Md. Code, Courts and Judicial Proceedings, stating that the privilege extends to "[a]ny information that . . . derives from" client material applies only to information that was derived from a *confidential communication* with the client." *Id.* at 235 (emphasis in original). Therefore documents such as draft tax returns and certain handwritten notes were not protected. *Id.* Finally, the court held that the firms had waived the privilege by failing to comply with the requirement of Fed. R. Civ. P. 26(b) (5) that they describe the withheld documents with sufficient particularity to enable the other party to assess the applicability of the privilege. *Id.*

## OTHER MATTERS

Application of prior-knowledge exclusion in professional negligence insurance policy.

***Westport Ins. Corp. v. Albert*, 208 Fed. Appx. 222 (4th Cir. 2006) (applying Md. law).**

**Facts:** A testator designated an attorney and accountant, named Albert, as personal representative for her estate. The will also directed that the bulk of the estate be distributed to heirs including the testator’s nephew, named Burtoff. After the testator’s death, and certain actions by Albert in connection with the estate, Burtoff sent Albert a letter requesting that he stop “wasting” estate funds. Albert then filed a petition in court seeking to remove Albert as personal representative. 208 Fed. Appx. at 223-34. The petition alleged that Albert had enriched himself at the expense of the estate, accused him of malfeasance, and made other similar allegations. *Id.* at 224 (citation omitted).

For insurance coverage, Albert’s practice was to purchase successive annual professional liability policies. The relevant policy contained a “Prior Knowledge Exclusion,” which excluded from coverage “any act, error, omission [or] circumstance . . . occurring prior to the effective date” of the policy if the “insured at the effective date knew or could have reasonably foreseen that such act, error, omission [or] circumstance . . . might be the basis of a claim.” *Id.* at 223-24.

After Burtoff wrote to Albert and filed the petition to remove him, Albert filed his annual renewal application with the insurer. After that time, Burtoff filed a lawsuit against Albert. The insurer then filed an action against Albert seeking a declaration that the prior-knowledge exclusion applied. The district court granted summary judgment for the insurer. *Id.* at 225.

**Held:** Affirmed. The allegations in the petition to remove Albert would have put any reasonable accountant on notice of a possible malpractice claim, so that the prior-notice exclusion applied to relieve the insurer of a duty to defend. Referring to the petition, the court stated that “[a]ccusations of that sort should have put a reasonable accountant on notice that Burtoff could next file a claim for damages.” *Id.* at 226.

## **RICO**

As noted in the Introduction to this outline, auditors generally cannot be held liable under RICO. Still, accountants can be liable under RICO if they engage in other activities that constitute more active involvement in their clients’ affairs.

### ***Lust v. Burke*, 876 F. Supp. 1474 (D. Md. 1994).**

**Facts:** Plaintiff investors brought federal action against numerous defendants, including an accountant, alleging RICO violations. Plaintiffs alleged that defendants knowingly and intentionally sold them various fraudulent investments and otherwise defrauded them. Some individual defendants moved to dismiss claim under Federal Rule 12(b) (6), arguing that Complaint failed to allege that individual defendants had “some part in directing the enterprise’s affairs.” 876 F. Supp. at 1478-79 (citing *Reves v. Ernst & Young*, 570 U.S. 170, 113 S. Ct. 1163 (1993)).

**Held:** The complaint sufficiently alleged that accountant had acted as principal and directly participated in management and operation of fraudulent investment schemes in violation of RICO statute. In particular, the accountant had served as a partner in at least two of the partnerships that formed part of the RICO enterprise. (By contrast, wife and son of defendant financial advisor only signed false/forged documents without knowledge of or further participation in fraudulent investment schemes. The Court held that these defendants, who played very minor, isolated role were entitled to dismissal of RICO claims.) 876 F. Supp. at 1478-79, 1481.

## VIRGINIA

### LONG-ARM JURISDICTION

#### A. Long-Arm Jurisdiction Statute

Under the primary relevant provisions of Virginia’s long-arm statute, jurisdiction in Virginia lies as follows.

- A. A court may exercise personal jurisdiction over a person, who acts directly or by an agent, as to a cause of action arising from the person's:
  - 1. Transacting any business in this Commonwealth;
  - 2. Contracting to supply services or things in this Commonwealth;
  - 3. Causing tortious injury by an act or omission in this Commonwealth;
  - 4. Causing tortious injury in this Commonwealth by an act or omission outside this Commonwealth if he regularly does or solicits business, or engages in any other persistent course of conduct, or derives substantial revenue from goods used or consumed or services rendered, in this Commonwealth . . . .

§ 8.01-328.1 (“When personal jurisdiction over person may be exercised”).

#### B. Case Summary

Where the “[a]ccountant’s financial statements were prepared in Virginia, but they were delivered to [the client] in Rhode Island where, allegedly, reliance on them an subsequent injury took place,” the law of Rhode Island governs claims against the accountant. *Rhode Island Hospital Trust National Bank v. Swartz, Bresenoff Yavner & Jacobs*, 455 F.2d 847 (4th Cir. 1972) (citing *Atlantic Coast R. Co. v. Withers*, 192 Va. 493, 65 S.E.2d 654 (1951)).

## CLAIMS

#### A. Accounting Malpractice

##### 1. Elements

A cause of action for professional malpractice “requires the existence of a [contractual] relationship which gave rise to a duty, breach of that duty by the defendant . . . and that the damages claimed by the plaintiff client must have been proximately caused by the defendant attorney’s breach.” *Cox v. Geary*, 271 Va. 141, 152, 624 S.E.2d 16, 22 (Va. 2006) (quotation marks and citation omitted) (addressing legal malpractice claim).

## 2. Requirement For Expert Testimony To Establish Prima Facie Case

In accounting malpractice cases, “expert testimony is required to establish the appropriate professional standard, to establish a deviation from that standard, and to establish that such a deviation was the proximate cause of the claimed damages.” This is because “[t]he definition of ‘generally accepted auditing standards’ and the application of that definition to the facts of a particular case, are matters beyond the common knowledge of laymen.” *Seaward Int’l v. Price Waterhouse*, 239 Va. 585, 391 S.E.2d 283 (1990). See also Virginia Model Jury Instruction No. 35.050 (“Proof of Negligence: Expert Testimony”).

## 3. Proximate Cause

A defendant’s negligence must be a but-for and a proximate cause of the plaintiff’s injuries. “The proximate cause of an event is that act or omission, which, in natural and continuous sequence, unbroken by an efficient intervening cause, produces the event, and without which that event would not have occurred.” See, e.g., *Beale v. Jones*, 210 Va. 519, 522, 171 S.E.2d 851, 853 (1970); see also *Duvall, Blackburn, Hale & Downey v. Siddiqui*, 416 S.E.2d 448, 450 (Va. 1992). See discussion in *Michie’s Jurisprudence*, 1 M.J., Negligence Section 20 (1995) (the damage must “follow the wrong”).

In a negligence claim against an auditor brought under Virginia law, the Fairfax County Circuit Court ruled that the alleged negligence of an auditor was not the proximate cause of the audit client’s continuing losses from operations where the company had lost money for years. (See *Xybernaut Corp. v. Grant Thornton*, (Circ. Ct. Fairfax Cnty CL 2007-3577) Hr’g Tr. (Oct. 23, 2008) at 53; see also *id.* at *passim.*) The court found *Christians v. Grant Thornton LLP*, 733 N.W.2d 803 (Minn. Ct. App. 2007), a strongly persuasive statement of the proximate cause requirement in an accounting malpractice case in a manner congruent with Virginia law. See *Christians*, 33 N.W.2d at 813 (holding that an accountant’s negligence that enabled the company to raise more money was not the proximate cause of the company’s losses, rather, the proximate cause was the “thousands of decisions in the course of managing” the company).

## 4. Case Summary (Expert Witness Requirement)

***Seaward International v. Price Waterhouse*, 239 Va. 585, 391 S.E.2d 283 (1990).**

**Facts:** Price Waterhouse (“PW”) audited client’s financial statements. After PW issued its audit report, Seaward (without PW’s participation) prepared and filed tax returns. The IRS later concluded that Seaward did not qualify for certain tax deferrals taken on its return. Seaward paid a substantial additional tax amount. Seaward sued PW for professional malpractice on the theory that PW “had failed to investigate Seaward’s records in sufficient depth” to discover that certain “calculations” in Seaward’s records “were incorrect.” 239 Va. at 589, 391 S.E.2d at 286. Seaward’s liability expert could not identify a specific document that the auditor should have reviewed. Although the jury found for Seaward, the trial court set the verdict aside due to absence of evidence that

records existed that PW should have looked at and that would have indicated a calculation error. 239 Va. at 586-588, 391 S.E.2d at 284-286.

**Held:** The court first restated the basic requirement for expert testimony in professional liability cases: “Unless a malpractice case turns upon matters within the common knowledge of laymen, expert testimony is required to establish the appropriate professional standard, to establish a deviation from that standard, and to establish that such a deviation was the proximate cause of the claimed damages.” 239 Va. at 592, 391 S.E.2d at 287 (citations omitted). That requirement applies in audit malpractice cases, the court explained, because “[t]he definitions of generally accepted standards, and the application of that definition to the facts of a particular case, are matters beyond the common knowledge of laymen.” *Id.* In this case, however, Seaward’s expert had not carried this burden. She was unable to identify a specific document that existed at Seaward, which PW should have reviewed, and that would have revealed the error at issue. Accordingly, the Supreme Court affirmed. 239 Va. at 592, 391 S.E.2d at 288.

## **B. Claims By Third Parties**

### **1. Elements**

In Virginia, a claim by a third party against an accountant is a professional malpractice claim. *See Musselman*, 240 F. Supp.2d at 548; *Ward*, 246 Va. at 320, 435 S.E.2d at 629; *see also Premier Cap. Mgmt v. Cohen*, No. 02 C 5368, 2004 WL 2203419, at \*6 (N.D. Ill. Sept. 29, 2004) (addressing Virginia law and noting that Virginia does not recognize a cause of action for negligent misrepresentation).

### **2. Standing Of Third Party, Or Existence Of Duty To Third Party**

Virginia law stands near the strict end of the privity spectrum identified in the District of Columbia section, above. In Virginia, “privity of contract is an essential element” of a claim by a third party against an accountant. The leading case addresses liability to third parties under the demanding rubric of third-party beneficiary law, requiring that a third party prove that it was a “third party beneficiary” of the contract for the accountant’s services. *Ward v. Ernst & Young*, 246 Va. at 234, 435 S.E.2d at 631; *Bank of Am. v. Musselman*, 240 F. Supp. 2d 547, 553-54 (E.D. Va. 2003); *see also Waterside Capital Corp. v. Hales, Bradford & Allen, LLP*, 2009 WL 794922 (4th Cir. Jan. 26, 2009) (unpublished opinion) (applying Virginia law, reaffirming strict-privity requirement in professional malpractice cases).

A party is a third-party beneficiary where “the contracting parties ‘clearly and definitely intended the contract to confer a benefit upon him.’” *Bank of Am. v. Musselman*, 240 F. Supp. 2d at 554 (quoting *Ward*, 246 Va. at 330, 435 S.E.2d at 634 (bracket and additional citation omitted)).

However, “a third party who claims to be the beneficiary of a contract between others need not be named in the contract.” *Kelley vs. Griffin*, 252 Va. 26, 29, 471 S.E.2d 475,

477 (1996). (Note that courts in other states have rejected attempts to assert third-party beneficiary claims arising from “an ordinary, white-bread audit engagement contract.” *Mariani v. Price Waterhouse*, 82 Cal. Rptr.2d 671, 681 (Ct. App. 1999) (affirming dismissal of third-party beneficiary claim); *see also Venturtech II v. Deloitte Haskins & Sells*, 790 F. Supp. 576, 583 (E.D.N.C. 1992) (rejecting shareholder third-party beneficiary claim because it “would make every venture capital investor an intended beneficiary of every auditing engagement between an accounting firm and its client”).)

### 3. Case Summaries

#### ***Bank of Am. v. Musselman*, 240 F. Supp. 2d 547 (E.D. Va. 2003).**

**Facts:** The defendant accounting firm audited the financial statements of a corporation (ECS) that was in the business of collecting delinquent student loans. Bank of America made asset-based loans to ECS, relying in large part on ECS’ reported work-in-process (WIP) for collateral. The reported values of WIP were included in the audit reports of the defendant accountants. ECS defaulted on the loans. The bank sued the accounting firm, asserting that it relied upon the audit reports to extend the loans that the audit reports were materially in error, and that therefore the Bank should recover.

**Held:** The court granted summary judgment in favor of the defendant accounting firm on the issue of privity. The third party could not, as required, offer evidence that it was a “third party beneficiary” of the contract between the accountant and the accountant’s client. The court explained that “the essence of a third-party beneficiary claim is that others have agreed between themselves to bestow a benefit upon the third-party” and focused on the parties’ “overriding intent.” *Id.* at 554 (citation omitted). It was not sufficient to show that the accounting firm knew of the existence of the bank loan as well as of a provision in the lending agreement requiring an audit. *Id.* at 556-57. There was no evidence that ECS had advised the accountants that the “overriding intent” of retaining the accountants was to provide the Bank with required audit reports. Therefore, the Bank was at best an incidental beneficiary when it received the audit reports, and not entitled to sue the accounting firm. The court distinguished *Ward* on the ground that in *Ward v. Ernst & Young* the audit client was a sole-shareholder corporation, the third party who sought to sue the accountant was that sole shareholder, and the only reason for hiring the accountant was to enable this shareholder to sell his stock. *Id.* at 555.

#### ***Ward v. Ernst & Young*, 246 Va. 317, 435 S.E.2d 628 (1993).**

**Facts:** Plaintiff was the sole shareholder of company that retained Ernst & Young to assist in preparing a worksheet that calculated` deferred revenue and review related financial statements. Based in part on accounting figures that depended on the worksheet and on the financial statements reviewed by Ernst & Young, the shareholder sold a portion of his shares. According to the plaintiff, it was later discovered that Ernst & Young had miscalculated deferred revenue, leading to an overstatement of the value of the plaintiff’s shares. The plaintiff sued Ernst & Young for breach of contract and professional negligence.

**Held:** The Court specifically rejected the Restatement and foreseeability approaches to liability to third parties, stating that Virginia follows the strict privacy rule. As a third party to the contract between the accountant and the company, the only claim that plaintiff could bring against the account was a third-party beneficiary claim. To support that claim, he was required to show that the parties to the contract “clearly and definitely intended it to confer a benefit upon him.” 246 Va. at 330, 435 S.E.2d at 634 (citation omitted). Here, testimony stated that Ernst & Young knew that the plaintiff would rely on the its work in this specific transaction to sell his stock, knew some details of that stock-purchase agreement, and had explained the deferred-revenue topic to the purchaser of the plaintiff’s stock. The court also noted that the plaintiff was the sole shareholder of the accountant’s client. Therefore, sufficient evidence existed to create a question of fact as to whether the contracting parties—the accounting firm and its client—had intended to benefit the plaintiff. The trial court’s grant of defendant’s motion for summary judgment was reversed.

***Waterside Capital Corp. v. Hales, Bradford & Allen, LLP*, 2009 WL 794922 (4th Cir. Jan. 26, 2009) (unpublished opinion).**

**Facts:** The plaintiff had lent money to a company. The borrower company failed. The plaintiff sued the borrower’s auditor, asserting several theories including professional negligence. The district court dismissed based on lack of privity.

**Held:** Affirmed. Under Virginia law, “privity is a prerequisite for malpractice liability” (citing *Ward v. Ernst & Young*, 246 Va. 317, 323-24, 435 S.E.2d 628, 631 (1993)).

## **C. Breach Of Fiduciary Duty**

### **1. Accountant Generally Does Not Owe A Fiduciary Duty**

“[T]here is a fiduciary relationship when special confidence has been reposed in one who in equity and good conscience is bound to act in good faith and with due regard for the interests of the one reposing the confidence.” *Allen Realty Corporation v. Holbert*, 227 Va. 441, 446, 381 S.E.2d 592, 595 (1984).

An accountant does not, absent special circumstances, owe a fiduciary duty to a client, although “there is no reason that, depending on the facts, an accountant may not be held to be a fiduciary . . . .” *Allen Realty Corporation v. Holbert*, 227 Va. 441, 447, 381 S.E.2d 592, 595 (1984).

### **2. Case Summary**

***Allen Realty Corporation v. Holbert*, 227 Va. 441, 381 S.E.2d 592 (1984).**

**Facts:** Plaintiff, a real-estate company, hired defendant accounting firm to provide accounting services and business advice and to assist in the company’s liquidation. The accounting firm’s employee received an offer on certain of the plaintiff’s property but did

not disclose the offer to the plaintiff. The plaintiff ultimately sold the property to an unrelated party for a price lower than the undisclosed offer. The accounting firm's employee had withheld the offer in an effort to direct the plaintiff to accept a lower offer from a company with which his friend and his wife were affiliated. The plaintiff sued the accounting firm and the accountant involved, asserting claims including breach of fiduciary duty. Both defendants filed demurrers, which the circuit court sustained. With respect to the fiduciary duty claim, the court concluded that the plaintiff had not alleged sufficient facts to support the existence of a fiduciary relationship. 227 Va. at 445-47, 318 S.E.2d at 594-95.

**Held:** The Supreme Court reversed. With respect to the fiduciary-duty claim, it held that under certain circumstances an accountant can be held to be in a fiduciary relationship with a client. 227 Va. at 447, 318 S.E.2d at 595 (citing *Cafritz v Corporation Audit Co.*, 60 F. Supp. 627, 628, 631 (D.D.C. 1945)). Here, the plaintiff had sufficiently alleged that the accounting firm had been engaged to assist in the liquidation of the plaintiff; it was not necessary also to specifically allege that the plaintiff had specifically employed the accounting firm to receive and transmit offers. 227 Va. at 447, 318 S.E.2d at 595.

The court also held that an accounting firm can be held liable for its employee's misconduct even if the firm does not approve or know of the misconduct as long as the employee's misconduct was within the scope of employment. 227 Va. at 448, 318 S.E.2d at 596.

#### **D. Deepening Insolvency Claims**

Virginia state courts have not addressed the issue in a reported opinion. *In re James River Coal Co.*, 360 B.R. 139 (Bankr. E.D. Va. 2007), however, the United States Bankruptcy Court for the Eastern District of Virginia predicted that Virginia courts would not recognize the tort of deepening insolvency, but would recognize deepening insolvency as a theory of damages. The court explained that this cause of action would circumvent the business judgment rule and "fundamentally transform" Virginia law: "The Board of Directors must remain free to exercise its good faith business judgment that will allow it to pursue strategies the board views as sound to turn it around." *Id.* at 179.

#### **E. Constructive Fraud Claims**

In Virginia, constructive fraud "requires proof . . . by clear and convincing evidence that a false representation of material fact was made innocently or negligently, and the injured party was damaged as a result of . . . reliance upon the misrepresentation." *Richmond Metropolitan Authority v. McDevitt Street Bovis, Inc.*, 56 Va. 553, 559, 507 S.E.2d 344, 347 (1998) (citation and internal quotation marks omitted).

However, for a claim for constructive fraud to lie, "the duty tortiously or negligently breached must be a common law duty, not one existing between the parties solely by virtue of the contract." *Richmond Metropolitan Authority v. McDevitt Street Bovis, Inc.*, 56 Va. 553, 559, 507 S.E.2d 344, 347 (1998) (citation and internal quotation marks omitted) (affirming

summary judgment for defendant because the “allegations of constructive fraud are nothing more than allegations of negligent performance of contractual duties”).

## **DAMAGES**

### **A. Measure Of Damages**

The proper measure of damages is the difference between what the plaintiff bargained for and what the plaintiff received. *See Duvall, Blackburn, Hale & Downey v. Siddiqui*, 243 Va. 494, 498, 416 S.E.2d 448, 450 (1992) (addressing legal malpractice).

Where the plaintiff is a business, “the measure of damages is the diminution in value of the business by reason of the wrongful act.” *Saks Fifth Avenue, Inc. vs. James, Ltd.*, 272 Va. 177, 188, 630 S.E.2d 304, 311 (2006) (citation and internal quotation marks omitted).

It “is equally well-settled that prospective profits are not recoverable in any case if it is uncertain that there would have been any profits at all, or if the projected profits are so contingent, conjectural, or speculative that the amount thereof cannot be proved with a reasonable degree of certainty.” *Saks Fifth Avenue*, 272 Va. at 188-189, 630 S.E.2d at 311 (quotation marks omitted).

### **B. Proof Of Damages**

A plaintiff must prove damages with reasonable certainty. *Saks Fifth Avenue, Inc. v. James, Ltd.*, 272 Va. 177, 188-89, 630 S.E.2d 304, 311 (2006); Virginia Model Jury Instructions (Civil), Instr. No. 9.020 (2007) (modified).

### **C. Punitive Damages**

Because a professional malpractice claim is an action for breach of contract, though one “sounding in tort,” punitive damages are not available. *See O’Connell v. Bean*, 263 Va. 176, 180, 556 S.E.2d 741, 742-43 (2002) (addressing attorney malpractice claim).

## **DEFENSES**

### **A. Statute Of Limitations**

#### **1. Limitations Period**

In Virginia, a professional malpractice claim is based in contract; therefore the period of limitations for contracts is applied. The limitations period is five years for a written contract and three years for an oral contract. Va. Code § 8.01-246(2) and (4) (2001 & Supp. 2009).

Although an action for professional negligence sounds in tort, it is an action for breach of contract, because without a contract no duty between the parties would have

existed. *See, e.g., Ward v. Ernst & Young*, 246 Va. 317, 325-26, 435 S.E.2d 628, 632 (1993) (claim against auditor); *Olyear v. Kerr*, 217 Va. 88 225 S.E.2d 398 (1976); *see also Sensenbrenner v. Rust*, 236 Va. 419, 425, 374 S.E.2d 55, 58 (1998) (holding that the law of contracts provided the “sole remedy” for a “purely economic loss”); *Va. Timberline LLC v. Land Mgmt Group, Inc.*, 471 F. Supp. 2d 630, 632-633 (E.D. Va. 2006) (summarizing cases); Va. Code Ann. §§ 8.01-243, 8.01-246 (2001 & Supp. 2009).

In Virginia, a five-year statute of limitation applies to written contracts, while a three-year statute of limitation applies to oral contracts. *See* Va. Code Ann. § 8.01-246 (2001 & Supp. 2009). If the complaint does not allege that the contract was in writing, the three-year period shall be applied. *MacLellan v. Throckmorton*, 235 Va. 341, 367 S.E.2d 720, 721-22 (1988).

For a fraud claim, the limitations period is two years. Va. Code § 8.01-249(1) (2001 & Supp 2009).

## **2. Commencement Of The Limitations Period**

For a professional malpractice claim against an accountant, the limitations period begins to run when the accountant finishes the engagement at issue. *See Boone v. Weaver Co., Inc.*, 235 Va. 157, 365 S.E.2d 764 (1988). The discovery rule does not apply to professional liability claims. *See VMI v. King*, 217 Va. 751, 759, 232 S.E.2d 895, 900 (1977) (relied on in *Boone*, 235 Va. at 161, 365 S.E.2d at 766 (“We have followed the general rule that the applicable period of limitation begins to run from the moment the cause of action arises rather than from the time of discovery of injury or damage, and we have said that difficulty in ascertaining the existence of a cause of action is irrelevant.”)). *See also Comptroller v. King*, 217 Va. 751, 760, 232 S.E.2d 895, 900 (1977) (“the applicable period of limitation begins to run from the moment the cause of action arises rather than from the time of discovery of injury or damage, and . . . difficulty in ascertaining the existence of a cause of action is irrelevant”).

A cause of action for fraud accrues when the fraud “is discovered or by the exercise of due diligence reasonably should have been discovered.” Va. Code § 8.01-249(1).

## **3. Case Summary**

***Boone v. Weaver Co., Inc.*, 235 Va. 157, 365 S.E.2d 764 (1988).**

(Professional negligence claims are governed by the statute of limitations for contract claims; the “continuing undertaking” doctrine applies to accountants).

**Facts:** Plaintiff hired an accounting firm to render accounting and tax services in connection with a corporate acquisition. The accounting firm gave the advice about the transaction in 1976. It recommended the structure of the deal and advised that the transaction would be free of tax consequences. Then, until 1980, the accounting firm assisted in the preparation of tax returns relating to the transaction. During this time, the

IRS audited the company and assessed additional taxes, interest and penalties. The plaintiff filed suit in 1981, alleging malpractice in connection with the tax advice on the transaction. The accountants moved for summary judgment, arguing that the statute of limitations had begun to run at the time of the transaction in 1976 and therefore the limitations period, whether for three or five years, had expired. The trial court denied the motion on the ground that “the accounting and tax services rendered by DP constituted a continuing undertaking which did not terminate until August 1980, when the statute of limitations began to run.” The case went to trial, where the plaintiff recovered a judgment. The accounting firm appealed. 235 Va. at 160, 365 S.E.2d at 765.

**Held:** First, the court agreed with the trial court that the statute of limitations for breach of contract actions to a professional malpractice claim against an accountant. The statute of limitations is three years if the agreement to perform services was oral and five years if the agreement was in writing.

Second, the court addressed when the statute of limitations began to run. It stated that, generally, the statute begins to run when the accountant finished the particular services at issue. Here, however, the continuing undertaking doctrine tolled the statute until the end of the engagement. 235 Va. at 163, 365 S.E.2d at 766 (“The reasons expressed . . . for the application of the foregoing rule to the relationship of physician and patient, and . . . for its application to the relationship of attorney and client, apply with equal force to the relationship of accountant and client.”). The court rejected the accounting firm’s argument that “[t]he preparation of tax returns . . . was an entirely separate and discrete undertaking.” It held that “Here . . . the defendants gave continuing or recurring attention to the matter in question over a period of time. During that time, the client relied on the defendants’ advice and on the defendants’ efforts to extricate the client, or to avert or minimize the damage.” 235 at 163, 365 at 766.

## **B. Contributory Negligence**

### **1. The Defense**

Like the District of Columbia and Maryland, Virginia adheres to the older (and now minority) rule of contributory negligence rather than comparative negligence. The starting point in Virginia is that, although professional malpractice claims lie in contract, they are treated as tort claims for certain purposes and “are governed by the same principles applicable to other negligence actions.” The defense of contributory negligence is available because a breach of the contractual duty constitutes negligence. *See Lyle, Siegel, Croshaw & Beale, P.C. v. Tidewater Capital Corp.*, 249 Va. 426, 432, 457 S.E.2d 28, 32 (1995) (addressing legal malpractice claim).

Contributory negligence is a complete defense. *See Cox v. Geary*, 271 Va. 141, 152-53, 624 S.E.2d 16, 22 (2006) (addressing legal malpractice claim); *see also Lyle, Siegel, Croshaw & Beale, P.C. v. Tidewater Capital Corp.* 249 Va. 426, 432, 457 S.E.2d 28, 32 (1995) (addressing legal malpractice claim).

The burden to establish a contributory negligence defense lies on the defendant. *Gravitt v. Ward*, 258 Va. 330, 335, 518 S.E.2d 631, 634 (1999) (“When a defendant in a negligence action relies on the contributory negligence of the plaintiff, the burden rests on the defendant to show such negligence was a proximate, direct, efficient and contributing cause of the injuries unless such negligence is disclosed by the plaintiff’s own evidence or may be fairly inferred from all the circumstances.”).

## **2. Imputation**

Imputation can be relevant to contributory negligence and statute of limitations defenses.

### **a. The Rule**

“As a general rule, the knowledge of an agent is imputed to his principal.” *Allen Realty Corporation v. Holbert*, 227 Va. 441, 446, 381 S.E.2d 592, 594 (1984) (citation omitted). *See also Vaughn v. Va. Real Estate Comm’n*, 7 Va. Cir. 301, 1986 WL 401826, at \*3 (Cir. Ct. of Warren Cnty. Aug. 25, 1986) (“It is an elemental principle of law with some specific exceptions that at least in purely civil matters knowledge had by an agent or employee is by imputation known by the principal or employer.”).

As a result, negligence by a corporation’s agents, such as officers or employees, is chargeable to the corporation, which can only act through its officers, directors and agents. *Allen Realty Corporation v. Holbert*, 227 Va. 441, 451, 381 S.E.2d 592, 597 (1984) (“a principal is liable for negligent acts that its agent commits within the scope of his employment”) (citation omitted). *See* citations collected at *Michie’s Jurisprudence* § 233 (“Torts of Officers and Agents”); *Michie’s Jurisprudence* § 235 (addressing knowledge of agents of corporation); *see also Zombro v. Suntrust Bank*, 2008 WL 1752211, at \*10 (Bankr. E.D. Va. Apr. 14, 2008) (charging a bank with knowledge of the discharge of a debt as reflected in its records) (“The bank is charged with the knowledge of the contents of its own records. The failure to properly review the bank’s own records is not an excusable mistake.”).

“In Virginia, the doctrine of *respondeat superior* imposes tort liability on an employer for the negligent acts of its employees, *i.e.*, servants . . . .” *Sanchez v. Medicorp. Health Sys., Inc.*, 270 Va. 299, 306, 618 S.E.2d 331, 334 (2005) (collecting cases); *see also Michie’s Jurisprudence*, 1 M.J., Corporations, § 157 (“Knowledge acquired by employees within the scope of their employment is imputed to the corporation.”).

### **b. The Adverse-Interest Exception**

An agent’s knowledge will not be imputed where the agent acts adversely to the principal’s interest. *Allen Realty Corporation v. Holbert*, 227 Va. 441, 446, 381 S.E.2d 592, 594-95 (1984) (in lawsuit by client against accounting firm, declining to impute knowledge of client’s employee to client); *see also Doe v. Nat’l Security Agency*, 165 F.3d 17, 1998 WL

743665, at \*2 (4th Cir. 1998) (per curiam) (addressing Virginia law; collecting cases) (addressing claim under federal Privacy Act).

## **MULTIPLE DEFENDANTS**

No reported cases address accountants, but see the following statements of more general principles.

### **A. Joint And Several Liability**

Virginia imposes joint and several liability on joint tortfeasors. Va. Code Ann. § 8.01-443 (2001 & Supp. 2009). Thus, any joint tortfeasor against whom a judgment is entered is liable to the plaintiff for the entire judgment, regardless of the tortfeasor's degree of fault.

### **B. Contribution**

Joint tortfeasors have a right to contribution in cases of negligence with no moral turpitude. Va. Code Ann. § 8.01-34 (2001 & Supp. 2009). A joint tortfeasor who settles is not subject to contribution from the others, and is not entitled to contribution unless the settlement specifically discharges all joint tortfeasors from liability. Va. Code Ann. § 8.01-35.1 (2001 & Supp. 2009).

## **EVIDENTIARY ISSUES**

### **A. Accountant-Client Privilege**

Virginia does not recognize the accountant-client privilege.