August 1, 2008

Professional Liability Practice

Fourth Circuit Limits Accountants Duty to Third Parties, Reverses US$2.5 Million Judgment Against Grant Thornton LLP

In a significant victory both for accounting firm Grant Thornton LLP ("Grant Thornton") and the accounting profession in general, the United States Court of Appeals for the Fourth Circuit (*Ellis v. Grant Thornton*, No. 07-1352, decided Jun. 25, 2008, petition for hearing denied Jul. 22, 2008) reversed a negligent misrepresentation judgment in a ruling that limited the duty owed by accountants to third parties. Grant Thornton was represented on appeal by Mayer Brown.

The September 1999 collapse of the First National Bank of Keystone (in West Virginia) prompted the suit against Grant Thornton that was the subject of this appeal. After years of investigation, Keystone and the Office of the Comptroller of the Currency entered into agreement that resulted in Keystone retaining Grant Thornton to audit its 1998 year-end financial statements. In March 1999, Gary Ellis, the plaintiff, was deciding whether to take the job as president of Keystone after a merger eliminated his position as president of another bank. Plaintiff claimed that in evaluating his job prospects, he relied to his detriment on an audit report, draft audit reports and oral statements about Keystone's financial statements that Grant Thornton made available to him, at the request of Keystone. Plaintiff eventually signed on as the president of Keystone, and after Keystone became insolvent, he asserted a negligent misrepresentation claim against Grant Thornton. Following a bench trial, the district court (Southern District, West Virginia) awarded him nearly $2.5 million in damages.

On appeal, the Fourth Circuit reversed, repudiating the district court's finding that Grant Thornton owed plaintiff a duty of care under West Virginia law. Analyzing the scope of Grant Thornton's duty under the Restatement (Second) of Torts §552, which West Virginia and many other jurisdictions have adopted, the Fourth Circuit held that the plaintiff had failed to demonstrate that Grant Thornton owed him a duty as a potential employee. In so ruling, the panel reaffirmed the proper scope of an accountant's responsibilities in at least two key ways.

First, the court recognized that a potential employee, such as plaintiff, was not the intended recipient of an audit report that Grant Thornton delivered to the Board of Directors, and which was not intended for third-party use, as was plainly stated in the report itself. As the court noted, Grant Thornton "was hired to conduct an audit for the benefit of Keystone and the OCC," but not "to go over with each potential employee the soundness of Keystone's financial condition." Plaintiffs' attempted reliance on Grant Thornton's statement further ignored "the fact that any release of information … was done at the behest of Keystone."

Second, the court correctly analyzed the scope of Grant Thornton's representation and its effect on the risks it assumed. The court held that no duty existed, in part, because Grant Thornton lacked any awareness, *at the time of engagement or during the auditing process*, that potential employees would be reviewing or relying on the report. To create a duty to potential employees where none was intended, the

court wrote, the transaction would have to undergo a material change "from an audit undertaken to benefit Keystone and the OCC to one intended to benefit potential employees." The court refused to enlarge the circle of liability to encompass this situation, where Grant Thornton was "not aware … that its audit was being performed for the benefit of potential employees" and had no interest in whether the plaintiff accepted the job. Critically, the fact that the audit partner on the audit engagement had conversations with the potential employee about the audit prior to the time that the audit report was issued did not create a duty to the employee.

Because many jurisdictions have adopted §552, the Fourth Circuit's decision may have far-reaching implications for accountants and auditors. The panel's confinement of an auditor's duty of care to those situations where an accountant actually intends to guide or influence a third party prevents a runaway expansion of liability to peripheral individuals and entities. The decision curtails, if not destroys, the ability of employees and potential employees to sue an accountant on claims of a negligent audit and sharply limits the types of contacts between the auditing firm and a third party that are sufficient to create a duty to that third party.

For inquiries related to this alert, please contact Stanley J. Parzen (sparzen@mayerbrown.com), who argued this case on behalf of Grant Thornton LLP before the Fourth Circuit, or Jeffrey A. Berger (jberger@mayerbrown.com), who assisted with the Fourth Circuit briefing and authored this alert.

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