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Judge: U.S. Mobile auditors not liable to investors

BY PETER GEIER
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A Howard County judge applied a landmark Court of Appeals decision to rule for Maryland's oldest independent certified public accounting firm in an $8 million lawsuit by 13 investors.

Administrative Judge Diane O. Leasure ruled that **Stegman** & Co. of Towson could not be liable to investors in the since-defunct **U.S. Mobile Services** Inc. based on two audits the investors allegedly relied on, because Stegman neither knew nor had direct dealings with the investors.

"Faced with the prospect of a company that was defunct," said Joseph F. Cunningham, Stegman's Arlington, Va.-based attorney, "a broker and promoter who was gone, company officers immune from suit and the Arthur Anderson scandal fresh in mind, the investors looked around and thought, 'Why not sue the accounting firm?'"

In addition, U.S. Mobile changed its business practices in an unforeseeable way after the audits were performed, Cunningham said — but Leasure didn't need to address that issue because she found the accounting firm could not be liable to the investors as a matter of law.

As such, the case is of particular interest in that Leasure applied the Court of Appeals' holding in *Walpert, Smullian & Blumenthal P.A. v. Katz et al.* for the first time since the opinion was issued in November 2000, Cunningham said.

In *Walpert*, the court found that accountants could be liable to third parties in certain limited circumstances — circumstances Leasure fou[illegible]lac[illegible]e.

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Peter F. Axelrad, the Annapolis-based lawyer representing the 13 plaintiffs, expressed respect for Leasure but said the judge "construed *Walpert* to the facts of that case in a way we respectfully disagreed with."

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>
> *Joseph Cunningham*

"We're carefully evaluating the Walpert case and Judge Leasure's analysis" in considering an appeal, Axelrad said.

'Battle of the millionaires'

Cunningham said Stegman had prepared only two audits for U.S. Mobile — 1996 and 1997 — both in May 1998.

But U.S. Mobile later changed the way it collected receivables, writing off 30 percent of its bad debt rather than the industry standard of 10 percent — a move Stegman could in no way anticipate from its past practice, Cunningham said.

In 1999, U.S. Mobile "gave up its efforts to collect the accounts receiv[illegible] and [illegible]ted the plaintiffs' loans [illegible] s[illegible]ck," Leasure wrote in the opini[illegible]m[illegible] attorneys last week. "Th[illegible] pla[illegible]tiffs' status changed from [illegible]tors [illegible] stockholders, and they were no longer in a position to demand repayment of the loans previously made to the company," which dissolved in late 2000.

This left the investors out of the $2.75 million they originally put up.

The ensuing litigation was "the battle of the millionaires," Cunningham said, noting that the investors included David Barger, president and founder of **Jet Blue Airlines**, as well as venture capitalist James W. Harpel, the caption plaintiff in the suit.

Rounding out the list were L. Michael Belmont; his brother, Richard Belmont; Joseph Giamanco; A. Michael Jackson and his wife, Laura Burrows-Jackson; Herschel Langenthal for the F. Langenthal Trusts Partnership II; Richard M. Maser; Kenneth W. Miller Jr.; Jerry Ruyan; Dr. Charles A. Salzburg; Bruce Sholk for **S.K.** L.P.; and Lawrence Twill for the Ashwood Pension Plan.

Cunningham and his associate, Joseph W. Santini, said the plaintiffs later amended their complaint to include prospective earnings and interest, nearly doubling their original demand of about $4 million to almost $8 million.

The *Walpert* court held that accountants may be held liable for negligence to non-contractual parties when they are aware that the financial reports they pre-

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pare are to be used for a particular purpose, that a known party is intended to rely on those reports for that purpose, and they have a relationship with that party which indicates they understand that party's reliance.

In *Walpert*, the Court of Appeals rejected the Restatement (Second) of Torts' "foreseeability" approach, then used in 28 states, to determine an accountant's liability to third parties. It opted instead to follow the standard used in New York and elsewhere, which requires contractual privity "or its equivalent."

Chief Judge Robert M. Bell cited the New York Court of Appeals' decision in a 1985 case, *Credit Alliance Corp. v. Arthur Anderson & Co.*, which requires evidence of some conduct by the accountant "that links them to the third party and 'evinces the accountant's understanding of that party's reliance,'" Bell wrote.

In *Walpert*, the court said the evidence was sufficient to support a finding against the accounting firm.

Leasure, however, held that the plaintiffs had not met the *Walpert* standard in suing Stegman — which was founded in 1915 by Edward J. Stegman, who served for more than 30 years as chairman of the Maryland State Board of Accountancy.

"It's a good opinion for us," Cunningham said, "but it didn't seem like a walk in the park when it started."

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