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Rhode Island Industrial-Recreational Building Authority v. Capco Endurance, LLC, 203 A.3d 494 (R.I. 2019)

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Tort Law. *Rhode Island Industrial-Recreational Building Authority v. Capco Endurance, LLC*, 203 A.3d 494 (R.I. 2019). The Restatement rule restricts an accountant or auditor's liability for negligence "to those third parties who the accountant [or auditor] actually knows will receive the information, and then, only for transactions that are the same as, or substantially similar to, the ones which the accountant [or auditor] actually knows will be influenced by the supplied information."[1]

FACTS AND TRAVEL

Plaintiff, The Rhode Island Industrial-Recreational Building Authority (IRBA), an insurer of bonds for limited liability companies,[2] brought a negligence action against Feeley & Driscoll, P.C. (Feeley), an accounting firm.[3] Feeley prepared a 2009 Audit Report concerning Capco Steel, LLC's and Capco Endurance, LLC's (collectively, Capco) annual financial statements.[4] IRBA asserted that Feeley negligently prepared the 2009 Audit Report and that IRBA subsequently relied upon this report when approving a temporary increase in Capco's revolving line of credit.[5]

In February of 2010, there were two separate transactions, relevant here.[6] First, Webster Bank (Webster) provided Capco with a twenty million dollar revolving line of credit and agreed to make a six million dollar term loan to Capco by purchasing six million dollars of bonds from the Rhode Island Industrial Facilities Corporation.[7] Second, IRBA agreed to insure the bonds up to the

1. R.I. Indus.-Recreational Bldg. Auth. v. Capco Endurance, LLC, 203 A.3d 494, 501 (R.I. 2019) (quoting N. Am. Specialty Ins. Co. v. Lapalme, 258 F.3d 35, 40 (1st Cir. 2001)).
2. *Id*. at 494.
3. *Id*. at 497.
4. *Id*.
5. *Id*.
6. *Id*.
7. *Id*.

amount of five million dollars.[8] In March of 2010, the original line of credit transaction involving Capco and Webster closed.[9] Prior to closing, Webster provided Capco with its "Summary of Committed Terms and Conditions" which required Capco to provide Webster with "annual CPA-prepared, audited consolidated financial statements" over the course of the term of the loan.[10] In April of 2010, "Feeley issued the 2009 Audit Report to Capco, wherein it indicated that Capco had earned a profit of $552,000 in 2009."[11] Thereafter, on June 15, 2010, the original bond transaction involving IRBA closed.[12]

In early 2011, "Capco sought to extend its revolving line of credit to twenty-three and a half million dollars for a period of six months."[13] In March of 2011, IRBA consented to Capco and Webster's request for the temporary extension.[14] In approving the first credit increase, IRBA asserted that it relied on the 2009 Audit Report.[15] In June of 2011, Capco's relationship with Feeley ended and Capco employed a new auditing firm.[16] This auditing firm indicated that Feeley's 2009 Audit Report was incorrect and Capco had lost approximately one and a half million dollars in 2009.[17] However, "Feeley [did] not concede that the 2009 Audit Report was erroneous or negligently prepared."[18]

In August of 2011, a second request was made to IRBA "to consent to a further extension of Capco's line of credit to over twenty-eight million dollars" and "to subordinate its security

8. *Id*.
9. *Id*.
10. *Id*.
11. *Id*.
12. *Id*. Capco did not provide IRBA with a copy of the 2009 Audit Report either at or before the closing on the original bond transaction. Therefore, the Court was not concerned with IRBA's reliance on the 2009 Audit Report as applied to the original line of credit transaction or the original bond transaction; "IRBA could not have relied on a document it did not have." *Id*.
13. *Id*.
14. *Id*. This is the first credit increase. "[F]or the purpose of the instant appeal, [the Court was] concerned only with IRBA's alleged reliance on the 2009 Audit Report with respect to the first credit increase." *Id*. at 497–98.
15. *Id*.
16. *Id*. at 498.
17. *Id*.
18. *Id*.

interest to that of Webster."[19] IRBA consented to both requests.[20] In March of 2012, "Capco failed to make required payments on the bonds, thus triggering IRBA's obligation as the insurer of five million dollars worth of the bonds."[21]

On May 1, 2013, IRBA filed the instant action alleging that Feeley negligently prepared the 2009 Audit Report.[22] In August of 2015, Feeley moved for summary judgment.[23] In a January 15, 2016 order by the hearing justice, the parties were given until February 29, 2016 to complete discovery.[24] Thereafter, on October 20, 2016, Feeley renewed its motion for summary judgment, which the hearing justice granted on March 3, 2017.[25] Since the Rhode Island Supreme Court (the Court) had not yet adopted a test to resolve the issue of whether a duty exists between an accountant or auditor and a third party, the hearing justice adopted "the Restatement approach" and held that Feeley did not owe a duty to IRBA.[26] On April 10, 2017, the hearing justice granted Feeley's renewed motion for summary judgment.[27] IRBA filed a timely notice of appeal.[28]

ANALYSIS AND HOLDING

The Court reviews the grant of a motion for summary judgment *de novo*.[29] When considering whether a duty of care exists between an accountant or auditor and a third party, courts have relied upon three alternative legal standards: (1) the near-privity test; (2) the Restatement rule; and (3) the reasonable foreseeability rule.[30] The Court, in agreement with the hearing justice and the parties,

19. *Id*.
20. *Id*. This is the second credit increase.
21. *Id*.
22. *Id*.
23. *Id*.
24. *Id*.
25. *Id*.
26. *Id*. at 498–99.
27. *Id*. at 499.
28. *Id*.
29. *Id*. (citing Newstone Dev., LLC v. East Pac., LLC, 140 A.3d 100, 103 (R.I. 2016)).
30. *Id*. at 500–01.

adopted the Restatement rule as its analytical approach.[31] The Restatement rule, in pertinent part, essentially "limits an accountant's liability for negligent misrepresentation to those third parties who the accountant actually knows will receive the information, and then, only for transactions that are the same as, or substantially similar to, the ones which the accountant actually knows will be influenced by the supplied information."[32] On appeal, IRBA restricted the focus of its argument to the language contained in section (2)(b) of the Restatement rule.[33] Therefore, the issue on appeal was whether IRBA relied on the 2009 Audit Report "in a transaction [where Feeley] intend[ed] the information to influence or [knew] that [Capco] so intend[ed] or in a substantially similar transaction."[34]

IRBA's first contention on appeal was that the Restatement rule was satisfied because

> it is reasonable to infer that [Feeley] knew when it issued the 2009 [A]udit [R]eport that . . . Webster and IRBA would be relying on Capco's audited financial statements . . . during the [t]ransaction for the purpose of making business

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31. *Id*. at 501–02.

32. *Id*. at 501 (quoting N. Am. Specialty Ins. Co. v. Lapalme, 258 F.3d 35, 40 (1st Cir. 2001)). The Restatement provides:

> "(1) One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.
>
> "(2) * * * the liability stated in Subsection (1) is limited to loss suffered
>
> "(a) by the person or one of a limited group of persons *for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it*; and
>
> "(b) through reliance upon it *in a transaction that he intends the information to influence or knows that the recipient so intends or in a substantially similar transaction*."

RESTATEMENT (SECOND) OF TORTS § 552 at 126–27 (1977) (emphasis in original).

33. *R.I. Indus.-Recreational Bldg. Auth.*, 203 A.3d at 502.

34. *Id*.

> decisions concerning their respective interests in the [t]ransaction.[35]

The Court rejected that argument because IRBA had essentially asked the Court to apply the reasonable foreseeability rule.[36] Utilizing the Restatement rule, the Court stated that an accountant's liability is limited to those transactions "that are the same as, or substantially similar to, the ones which the accountant *actually knows* will be influenced by the supplied information."[37] Further, "[t]he accountant's knowledge is to be measured at the moment [a report was] published, not by the foreseeable path of harm envisioned by [litigants] years following an unfortunate business decision."[38] Here, Feeley could not have intended that, at the time the 2009 Audit Report was issued, the report would influence a future transaction.[39] The Court ultimately declined to expose an accountant or auditor "to the broad scope of potential liability" that IRBA's proffered methodology would create.[40]

IRBA's second contention on appeal was that Feeley owed a duty of care to IRBA under the Restatement rule because the original line of credit and bond transactions and the first credit increase were "substantially similar."[41] The United States Court of Appeals for the First Circuit established that "transactions are substantially similar when the 'essential character'—the amount and terms of the credit—has not changed."[42] A two-step analysis is utilized to guide the substantial similarity analysis.[43] First, a court must consider, "from the [accountant or auditor's] standpoint, what risks he reasonably perceived he was undertaking when he delivered the challenged report or financial statement."[44] Here, in producing the 2009 Audit Report, there was a risk that IRBA would

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35. *Id*. at 502–03.
36. *Id*. at 503.
37. *Id*. (quoting *N. Am. Specialty Ins. Co.*, 258 F.3d at 40) (emphasis in original).
38. *Id*. (quoting Nycal Corp. v. KPMG Peat Marwick LLP, 688 N.E.2d 1368, 1372–73 (Mass. 1998)).
39. *Id*.
40. *Id*.
41. *Id*. at 504.
42. *Id*. (quoting *N. Am. Specialty Ins. Co.*, 258 F.3d at 41).
43. *Id*. at 505.
44. *Id*.

rely on the 2009 Audit Report in the original bond transaction.[45] However, the Court stated that "there is no basis in the record for concluding that Feeley could have reasonably perceived a risk that IRBA would thereafter agree to extend the line of credit, even temporarily."[46] Further, "increasing the line of credit increased the risk that IRBA would be called upon to make payment on the insured bonds."[47] Therefore, the essential character of the transactions had materially changed between the original line of credit and bond transactions and the first credit increase.[48]

The second step of the analysis requires "the court [to] undertake an objective comparison between the transaction of which the accountant had actual knowledge and the transaction that in fact occurred."[49] Here, although the transactions all involved a line of credit, the same three parties, and were of the same "general nature (e.g., bonds)," that "is not enough to render them substantially similar for purposes of the Restatement rule."[50] Further, the three and a half million dollar increase in the credit amount for Capco is not considered a "minor" variance between the two transactions.[51] Therefore, utilizing the Restatement rule, the Court concluded that the first credit increase was not substantially similar to the original line of credit and bond transactions.[52]

IRBA's third contention on appeal was that Feeley owed a duty of care to IRBA because "Feeley had 'authorized Capco to supply information contained in the 2009 [A]udit [R]eport to the parties to the [first credit increase], knowing that it would be used to influence [the first credit increase transaction].'"[53] IRBA argued that pursuant to the terms of the "Professional Services Agreement" between Feeley and Capco, Capco was required to provide Feeley with a copy of Capco's request for the first credit increase before submitting that request to Webster and IRBA.[54] Within that

45. *Id*.
46. *Id*.
47. *Id*.
48. *Id*.
49. *Id*.
50. *Id*. at 505–06.
51. *Id*. at 506.
52. *Id*.
53. *Id*.
54. *Id*.

request, Capco included information from the 2009 Audit Report.[55] Therefore, IRBA maintained that Feeley "authorized Capco to use the information contained in the 2009 [A]udit [R]eport for the purpose of persuading Webster and IRBA to agree to Capco's * * * request [for the first credit increase]."[56] The Court, however, remained unconvinced[57] because "Feeley did not actively participate in the first credit increase transaction, and the record contains no written consent to the use of the information in the 2009 Audit Report."[58] Further, the Court noted that the "Professional Services Agreement" referred "only to the *publication* of any 'report [by Feeley] on the financial statements being audited'" and did not contain any provision requiring Capco to "seek Feeley's approval for *any possible future use* of such a report."[59] Accordingly, the hearing justice appropriately granted summary judgment in Feeley's favor because Feeley did not owe a duty of care to IRBA.[60]

COMMENTARY

Although the hearing justice and both parties agreed that the Restatement rule was the best analytical approach,[61] IRBA alluded to the reasonable foreseeability rule in its first contention.[62] Specifically, IRBA argued that it was "reasonably foreseeable that IRBA might rely on the 2009 Audit Report for another transaction."[63] To bolster its argument, IRBA cited the "'wide-ranging' business relationship between Feeley and Capco."[64] Had the Court applied the reasonable foreseeability rule in addressing the issue of whether a duty of care exists between an accountant or auditor and a third party in a negligence action, the Court would

55. *Id*.
56. *Id*.
57. *Id*.
58. *Id*. at 507.
59. *Id*. (emphasis in original).
60. *Id*. at 508.
61. *Id*. at 500.
62. *Id*. at 503. Under the reasonable foreseeability rule, "an accountant may be held liable to any person whom the accountant could reasonably have foreseen would obtain and rely on the accountant's opinion, including known and unknown investors." *Id*. at 501 (quoting Nycal Corp. v. KPMG Peat Marwick LLP, 688 N.E.2d 1368, 1370 (Mass. 1998)).
63. *Id*.
64. *Id*. at 502.

have exposed accountants or auditors to a very broad scope of potential liability.[65] For instance, after an accountant or auditor provides a client with a piece of information, realistically, the accountant or auditor cannot control "the further dissemination" of the information.[66] Therefore, "[t]he foreseeable class of persons who can be adversely affected by reliance upon [an accountant or auditor's] advice or opinion can be so large as to make liability to third parties a ruinous and catastrophic kind . . . ."[67] Here, the Court utilized the Restatement rule in order to protect an accountant or auditor from a form of third party liability that would "unreasonably exceed[] the bounds of their real undertaking."[68]

CONCLUSION

The Rhode Island Supreme Court held that, pursuant to the Restatement rule, the hearing justice did not err in holding that Feeley did not owe a duty of care to IRBA[69] because: (1) Feeley could not have known that the 2009 Audit Report would influence a future transaction; (2) the first credit increase was not substantially similar to the original line of credit and bond transactions; and (3) Feeley did not authorize Capco to use the 2009 Audit Report to influence the first credit increase.[70] Accordingly, summary judgment was appropriately granted in Feeley's favor.[71]

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65. *Id*. at 503.
66. *Id*. at 501.
67. *Id*. at 503.
68. *Id*. at 502.
69. *Id*. at 508.
70. *Id*. at 495.
71. *Id*. at 508.