

FIDELITY AND SURETY

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In this day and age of commercial suretyship, surety underwriters rely heavily upon information provided by accounting firms as to the financial condition of the bond principal. This is particularly true in reference to accounting information provided to the surety concerning the financial condition of bonded contractors. The surety underwriter utilizes financial information prepared by accounting professionals in a number of ways.

POTENTIAL SURETY RECOVERY FROM ACCOUNTANTS WHO PROVIDE INCORRECT FINANCIAL INFORMATION

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Initial Decision to Issue Bonds or Decline Suretyship¹

When initially contacted by a contractor or the contractor's agent, surety underwriters will uniformly request submission of financial information including certified audits where available. Several years of financial information will be requested so that the surety underwriter can ascertain the past history and financial trends. Initially, the surety underwriter will be addressing the most basic question: Whether or not the contractor meets the necessary criteria for issuance of surety bonds. It is not uncommon for surety underwriters to request additional information from the contractor and/or the contractor's accounting professional. Most commercial sureties have specific underwriting criteria which will be utilized in making the initial decision whether or not suretyship should be provided.

At the same time, the surety underwriter will also be considering what bonding program should be provided. Financial information will aid the underwriter in making a determination concerning the size of potential bonded projects and an aggregate bonding limit. Financial information provided by the contractor will also be utilized to ascertain whether or not bid bonds should be provided and ultimately whether or not performance/payment bonds will be issued. The financial information of the contractor as prepared by the accounting professional probably is the most significant determining factor relating to whether or not the surety elects to provide a bond program to the contractor.

¹ The author acknowledges the help and research for this paper provided by Leah N. Wilson, an Associate in the Frost Brown Todd Indianapolis firm.

Financial Information is Needed by the Surety to Evaluate Any Continuing Bond Program

After the surety begins to issue bonds for a contractor, it is critical that current and up to date financial information be provided. This is particularly important during the early stages of any bonding relationship between a surety and the contractor. If favorable financial information is being provided, the contractor may request that the surety expand the pre-approved bond program. Taking that action, significantly increases exposure to the surety. Yearly audited financial reports are generally required. It is also common that quarterly financial reports be provided to the surety underwriter so that current and up to date information can be considered in the underwriting process.

Financial Information is Utilized by the Surety in Evaluating the Status of Claims

If the surety receives claims from unpaid subcontractors and suppliers or performance bond claims from owners, the surety will undertake an immediate review of financial information to ascertain the financial condition of the bonded contractor. Questions will be raised as to why payments are not being made in a timely fashion to subcontractors and suppliers. The financial condition of the contractor is also critical when performance bond claims are asserted by the bond obligee/owner which may relate to whether or not the contractor is in a position financially to complete the bonded project. The financial condition of the contractor will also bear upon any determinations made by the surety and its legal staff concerning whether or not the bonded contractor is in a position to honor its

indemnity obligations and assume the defense of the surety should litigation be filed.

Financial Information is Needed to Evaluate the Surety's Response to Claims and Address Indemnity Obligations

The commercial surety will often have indemnity, both corporate and perhaps personal, as set forth in a master surety agreement or broad form indemnity agreement. Financial information provided by the contractor's accounting professional will be utilized to evaluate whether or not the contractor is in a position to honor its financial obligations, including payments to unpaid subcontractors and suppliers and completion of bonded construction projects. The surety will utilize financial information to ascertain whether or not the bonded contractor is in a position to provide collateral or assign assets for the protection of the surety.

Discussion/Legal Authority

Sureties must be able to rely upon financial information provided by the contractor and its accounting professionals. It is also reasonable to expect that accountants and CPAs will be aware that bonds are often required by statute as to contractors doing public work. A bid bond is usually part of the basic documentation needed by a contractor in submitting a bid on any public project and many commercial projects. Depending upon the circumstances, the accounting firm may have direct or indirect involvement with questions raised by the surety underwriter. Quarterly financial information as to the overall condition of the contractor is often requested and job specific information may be provided. Usually, the accounting professional provides accurate information – however, there have been instances where

accounting errors occur which ultimately are causative factors in a loss to the surety. Therefore, it is critical to understand what rights a surety may have when incorrect financial information is provided by the bonded contractor's accounting professional.

The majority of jurisdictions follows The Restatement (Second) of Torts and allows certain third parties to make claims for relief against an accountant under a theory of negligent misrepresentation. *See Rest. 2d of Torts § 552 (1977)*. Some jurisdictions still require strict privity of contract to establish an accountant's duty to another, leaving third parties with limited recourse. A minority of jurisdictions disregards the privity doctrine and allows a third party plaintiff to proceed on a theory of simple negligence. *Biakanja v. Irving*, 320 P.2d 16, 18 (1958) (holding all reasonably foreseeable third parties could institute suits against a professional for negligence). In any event, an analysis of the law regarding an accountant's liability to third parties must begin with a review of Justice Cardozo's opinions in *Glanzer v. Shepard*² and *Ultramares Corp. v. Touche & Co.*³

The court's opinion in *Glanzer v. Shepard* led the movement away from the strict privity standard for third party liability when it comes to purely economic injuries. 135 N.E. 275 (1922). In *Glanzer*, Cardozo held public weighers liable to a buyer of beans for breach of a duty to weigh the beans carefully. *Id.* The law imposes a duty toward the buyer because the plaintiff's use of the certificates of weight was not an indirect or collateral consequence of the action of the weighers. *Id.* It was a consequence which, to the weigher's knowledge, was the end and aim of the transaction. *Id.* The service rendered by

² *Glanzer v. Shepard*, 135 N.E. 275 (1922).

³ *Ultramares Corp. v. Touche & Co.*, 174 N.E. 441(1931).

the defendant in *Glanzer* was primarily for the information of a third person and reliance was specifically foreseen. *Id.* Thus, the weigher owed Glanzer a duty of care despite the lack of privity. *See id.*

The *Ultramares* opinion paved the way for third parties to bring a claim against accountants based on the accountant's duty to conduct his trade without fraud. *Ultramares*, 174 N.E. at 444. In *Ultramares*, the auditors at Touche gave a rubber importer, Fred Stern and Company, an audit certificate, but failed to discover that management had falsified entries to overstate accounts receivable. *Id.* at 443. The auditors knew that the accounts would be used to raise money and for that purpose supplied thirty-two certified copies of the statements, one of which *Ultramares* relied upon and loaned Stern money. *Id.* at 442-43. Stern declared bankruptcy the following year. *Id.* at 443. *Ultramares* sued Touche for the amount of the Stern debt, declaring that a careful audit would have shown Stern to be insolvent. *Id.*

The *Ultramares* court held that accountants are not liable for negligence to those who rely on its certificates because of honest blunder, but are not excused from consequences of reckless misstatement. *Id.* at 448. Cardozo qualified the accountant's duty by narrowing the class of persons to whom the duty is owed to persons that the accountant knew or should have known would use the fraudulent work product to their prejudice. *Id.*

The *Ultramares* standard remains in New York. In *White v. Guarante*, a New York court allowed recovery for a third party when a limited partner suffered damages as a result of an accountant's allegedly negligent audit prepared for the plaintiff's limited partnership. 372 N.E.2d 315 (1977). The court reasoned that the plaintiff was part of a

settled and particularized class that the defendant knew would use the report. *Id.* at 319. In New York, a third party not in privity may bring an action for negligence against an accountant when the accountant knew that a client planned to present the financial statements to a known party for a particular purpose. *See Credit Alliance*, 483 N.E.2d 110, 119-20 (1985).

The drafters of the Restatement (Second) of Torts concluded that a satisfactory middle ground existed between a standard of strict privity and a standard of foreseeability, specifically in the context of a professional duty to supply correct information for the guidance of others in business transactions. Restatement (Second) of Torts § 522(2)(a)(1977). The Restatement established a two-pronged concept of duty restricting an accountant's liability to known or intended classes of third parties: (1) the duty only extends to a person or limited class of persons that the professional intends or knows will use the misleading information, and (2) the duty only exists for the type of transaction that the professional intends to influence. *Id.*

In *Seedkem, Inc. v. Safranek*, defendant-accountant was retained by Agri-Products for the purpose of maintaining their books and preparing their regular financial statements. 466 F.Supp 340 (1979). Defendant was aware or should have been aware that the financial statements prepared by him would be issued by Agri-Products to businesses extending credit to Agri-Products, including plaintiff, and that the financial statements would be relied upon by businesses such as plaintiff. *Id.* The Nebraska court denied defendant's motion to dismiss and stated that although there were no reported cases where an accountant's liability was founded on the circumstances presented, there needed to be

further discovery to ascertain whether any express representations were actually made between the parties or any understandings existed between those involved. *Id.* at 345.

In *Ryan v. Kanne*, the Iowa Supreme Court reasoned that although in this profession there's a distinction between certified audits and uncertified audits, it is clear that accountants must perform those acts they have agreed to do under the contract and which they claim have been done in order to make the determination set forth and presented in their report. 170 N.W.2d 395 (Iowa 1969). The accountant's liability must be dependent upon their undertaking, not their rejection of dependability through disclaimers such as issuing an uncertified statement. *Id.* at 404. Thus, accountants cannot escape liability for negligence by a general statement that they disclaim its reliability. *Id.*

A minority of jurisdictions disregards the strict privity standard and follows a foreseeability standard, allowing all foreseeable third parties to establish a claim against an accountant. *Biakanja*, 320 P.2d at 18. In California, the *Biakanja* decision supplanted the strict privity standard in all third party claims of professional negligence and required a case-by-case balancing approach. *Id.*; see also *International Mortgage Company v. John P. Butler Accountancy Corporation*, 177 Cal.App.3d 806, 813 (1986).

Conclusion

It is not uncommon for a surety's claim department to question why the underwriting

department elected to initiate bonding of a contractor which later becomes insolvent and/or bankrupt leading to massive surety losses. One of the explanations may relate to inaccurate, or incomplete, financial information being provided to the surety. Given the present commercial climate, surety underwriters must rely upon information provided by the contractor's accounting professionals. The degree of reliance is somewhat based upon whether or not the financial records represent a certified audit versus lesser standards of review. The surety is much more at risk if the assets of the bonded contractor are overstated or liabilities inaccurately reported. When addressing potential claims against a contractor's accounting professionals, it is normal for a surety to retain a forensic accountant to examine the financial information which had been submitted to the surety. Expert testimony of that type will aid the surety in ascertaining whether or not a claim exists and, if so, the strength of any potential claim against the accounting professional. As noted herein, case authority exists which will support a surety's claim against the contractor's accounting professional under certain circumstances. Sometimes recovery from a claim of that type may be the only potential recovery available to a surety under circumstances where the contractor and bond indemnitors are either insolvent or bankrupt. Therefore, sureties must be aware of what rights they have concerning circumstances where incorrect financial information is provided to the surety by the contractor's accounting professionals.



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