

IN THE COURT OF APPEALS OF TENNESSEE
EASTERN SECTION

FILED

April 16, 1997

Cecil Crowson, Jr.
Appellate Court Clerk

APPLIED COATINGS, INC.) KNOX COUNTY
) 03A01-9610-CV-00313
Plaintiff - Appellant)
)
v.) HON. DALE C. WORKMAN,
) JUDGE
)
PUGH & COMPANY, P. C.)
)
Defendant - Appellee) VACATED AND REMANDED

DAVID S. CLARK OF OAK RIDGE FOR APPELLANT

DEAN B. FARMER and W TYLER CHASTAIN OF KNOXVILLE FOR APPELLEE

O P I N I O N

Goddard, P. J.

This is a suit by Plaintiff, Applied Coatings, Inc., seeking damages from Defendant, Pugh & Company, P. C., the auditor it employed. The suit, which grew out of an audit the Defendant prepared for the year ending on March 31, 1991, advances two theories, the first negligence and the second breach of contract.

Although this case was consolidated with another case below, the Trial Judge granted the Defendant a summary judgment and made this judgment final pursuant to Rule 54 of the Tennessee Rules of Civil Procedure.

The grant of summary judgment was in response to a motion filed by the Defendant contending summary judgment should be granted upon three separate grounds:

(1) The Plaintiff can show no reliance upon the financial statements of Pugh & Company because the Plaintiff had information that the audit report contained financial statements that were inaccurate at the time of receipt, based upon information withheld from the auditors.

(2) The acts of Michael Slover intervened so as to proximately cause the loss of the Plaintiff.

(3) The Plaintiff fails to state a cause of action because any claim for damages are speculative, based upon impermissible inferences, and not proximately caused by the acts of the Defendant, Pugh & Company.

Because the Trial Court did not specify upon which ground the motion was sustained even when requested by post-judgment motion to do so, and because all three grounds have been briefed by the parties, we will address them in order.

Before discussing the merits of the case, it is well to keep in mind the teachings of *Byrd v. Hall*, 847 S.W.2d 208, 210 (Tenn. 1993) on summary judgments:

In determining whether or not a genuine issue of material fact exists for purposes of summary judgment, courts in this state have indicated that the question should be considered in the same manner as a motion for directed verdict made at the close of the plaintiff's proof, i.e., the trial court must take the strongest legitimate view of the evidence in favor of the non-moving party, allow all reasonable inferences in favor of that party, and discard all countervailing evidence. Then, if there is a dispute as to any material fact or any doubt as to the conclusions to be drawn from that fact, the motion must be denied. ("[I]f the mind of the court entertains any doubt whether or not a genuine issue exists as to any material fact it is its duty to overrule the motion.") *Doolley v. Everett*, 805 S.W.2d 380, 383 (Tenn. App. 1990). The court is not to "weigh" the evidence when evaluating a motion for summary judgment. ("Summary judgment is not ordinarily the proper procedure for determining whether a prima facie case has or has not been overcome by countervailing evidence."); *Rollins v. Winn Dixie*, 780 S.W.2d 765, 767 (Tenn. App. 1989). The court is simply to overrule the motion where a genuine dispute exists as to any material fact. The phrase "genuine issue" contained in Rule 56.03 refers to genuine factual issues and does not include issues involving legal conclusions to be drawn from the facts. The critical focus is limited to facts deemed "material", which is to say those facts that must be decided in order to resolve the substantive claim or defense at which the motion is directed. [Citations omitted.]

As already noted, the complaint alleges two separate theories of recovery--negligence and breach of contract. It is the Plaintiff's theory that the Defendant should have verified certain accounts receivable with those entities shown on the Plaintiff's books to be indebted to the Plaintiff and had the Defendant done so, it would have discovered that one of the Plaintiff's employees, Michael Slover, was embezzling substantial funds from the Plaintiff which could have been prevented, or at least reduced, had the accounts receivable been verified.

A letter agreement prepared by the Defendant and signed by the parties contained the following provisions:

We will audit the Company's balance sheet as of March 31, 1991, and the related statements of income and retained earnings and cash flows for the year then ended, for the purpose of expressing an opinion on them. Our audit will be conducted in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

Our procedures will include tests of documentary evidence supporting the transactions recorded in the accounts, tests of the physical existence of inventories, and direct confirmation of receivables and certain other assets and liabilities by correspondence with selected customers, creditors, legal counsel and banks. At the conclusion of our audit, we will request certain written representations from you about the financial statements and matters related thereto.

The Defendant had prepared audits for the Plaintiff in prior years. However, in those years, accounts receivable were not verified because most, if not all, of the Plaintiff's contracts were with government entities, which made verification not feasible.¹

¹ The Plaintiff's brief explains the reason thusly:

In previous years, Pugh had not confirmed receivables because Applied Coatings was almost exclusively a state department of transportation contractor and the unique accounting methods employed by the state and therefore its contractors precluded conventional confirmation.

After Hurricane Hugo struck in the Fall of 1989, the Plaintiff opened an office in South Carolina, and most of its work there was with private contractors whose accounts receivable were subject to verification.

As to the first ground for summary judgment, the Defendant asserts that the Plaintiff did not rely upon any financial statements received from the Defendant to its detriment because all of the acts of misfeasance on the part of the Plaintiff's employee, Mr. Slover, occurred before the financial statements were delivered to the Plaintiff and that by that time, the Plaintiff knew of Mr. Slover's operations.

It has never been the insistence of the Plaintiff that it relied upon financial statements received from the Defendant, but rather that the Defendant was guilty of negligence in not preliminarily seeking accounts receivable verification. It is further the Plaintiff's position that reliance on financial statements is not a required element for accounting malpractice.

With regard to the malpractice feature, the Plaintiff submitted an affidavit of Gregg Mason, one of its former employees who was before that an employee of the Defendant, which stated in part the following:

1. My name is Gregg Mason and I am a citizen and resident of the State of Tennessee.

2. I am a certified public account[ant] duly licensed and authorized to practice accounting by the State of Tennessee.

3. I am a former employee of Applied Coatings, Inc., having been employed there at all times relevant herein.

4. I am also a former employee of the Defendant, Pugh & Company, P.C., having worked there in the capacity of a certified public accountant immediately prior to assuming employment with Applied Coatings, Inc.

5. I am familiar with the facts of this case and the circumstances surrounding the litigation of it.

6. I am familiar with the applicable standards of care for an audit such as the one performed by Pugh & Company for Applied Coatings, Inc., for the fiscal year 1991.

7. It is my opinion that Pugh & Company was engaged by Applied Coatings, Inc., to perform an audit according to Generally Accepted Accounting Principles and other applicable standards for the fiscal year 1991.

8. It is my opinion that accountants and accounting firms once engaged owe their clients a duty of reasonable care aside from any other contractual duties.

9. It is my opinion that the performance of Pugh & Company failed to meet a standard of reasonable care for fiscal year 1991 in that among other things Pugh & Company failed to engage in direct third-party confirmation of accounts receivable, failed to engage in sufficient alternate procedures testing of receivables and, therefore, failed to discover and inform its client that receivables from the South Carolina office of Applied Coatings were grossly inaccurate.

We conclude that, contrary to the Defendant's insistence, reliance upon the financial statements is not a prerequisite for prosecuting a malpractice action. In reaching this conclusion, we are aware of *Delmar Vineyard v. Timmons*, 486 S.W2d 914 (Tenn. App. 1972), which the Defendant cites in support

of its insistence. We believe this case, however, is distinguishable on the facts because in that case there had been a plenary hearing below and the appeal was predicated upon a preponderance of the evidence inquiry. Here, we must view the evidence in a light most favorable to the Plaintiff.

Moreover, we note that even if the Defendant's major premise is valid, it would be no defense to the Plaintiff's breach of contract theory.

Before leaving this point, we recognize that the Defendant insists that the major part, if not all of the employee's defalcations, had occurred prior to its receiving a list of the accounts receivable from the Plaintiff, or certainly before it would have had time to have verified them. Proof on this point is not entirely clear in that there are several dates identified when the lists were furnished for verification. In any event, we do not find that the proof as to this point is undisputed.

As to the second ground, it is true that unforeseeable intervening causes may insulate wrongdoers from their negligence. This rule, however, requires that the intervening cause be unforeseeable. In the present case, it is clear that one purpose of an audit, particularly the verification feature, is to uncover misappropriation of accounts receivable by an employee, and it is clearly foreseeable that employees can and do commit such

criminal acts. Finally as to this point, we observe that intervening cause is likewise not a defense in breach of contract actions.

With regard to the speculative nature raised in ground three, we are frank to say that the proof as to damages in the present record leaves much to be desired. However, it is clear upon viewing the proof in a light most favorable to the Plaintiff that had the Defendant met the standard expected of auditors and not breached its contract at least some, although perhaps not all, of the loss occasioned by the embezzlement could have been averted.

In any event, we are disinclined to sustain the Trial Court's granting summary judgment because the Plaintiff has failed to show the precise damage suffered, which in large part would depend on the date the Defendant should have begun its verification of accounts receivable.

Finally as to this issue, we note that the Plaintiff would be entitled to recover at least nominal damages if it sustains its breach of contract theory. *Bradford & Carson v. Montgomery Furniture Co.*, 115 Tenn. 610, 92 S.W. 1104 (1906); *Gay & Taylor v. American Cas. Co.*, 53 Tenn.App. 120, 381 S.W.2d 304 (1963).

For the foregoing reasons, the judgment of the Trial Court is vacated and the cause remanded for further proceedings not inconsistent with this opinion. Costs of appeal are adjudged against the Defendant.

Houston M Goddard, P. J.

CONCUR:

Herschel P. Franks, J.

Don T. Murray, J.