

Carter v Carlis

2004 NY Slip Op 30274(U)

May 3, 2004

Supreme Court, New York County

Docket Number: 604047/2002

Judge: Karla Moskowitz

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SUPREME COURT OF THE STATE OF NEW YORK – NEW YORK COUNTY

PRESENT: Hon. KARLA MOSKOWITZ PART 03
Justice

-----X
Carter et al INDEX Nos. 0604047/2002
MOTION DATE _____
-against- MOTION SEQ. NO. 5
Carlis et al MOTION CAL. NO. _____
-----X

The following papers, numbered 1 to _____ were read on this motion to/for _____

Notice of Motion/ Order to Show Cause – Affidavits – Exhibits _____
Answering Affidavits – Exhibits _____
Replying Affidavits _____

PAPERS NUMBERED
FILED
JUN 07 2004
COURT

Cross-Motion: Yes No

It is ordered that:

Motion is decided in accordance with the accompanying decision and order.

OFFICE

MOTION/CASE IS RESPECTFULLY REFERRED TO
JUSTICE
DATED: _____

J.S.C. Dated: May 3, 2004



KARLA MOSKOWITZ J.S.C.

Check one: FINAL DISPOSITION ON-FINAL
DISPOSITION

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: IAS PART 3

-----X

Donald C. Carter, Lagomar Studios, LLC and Lauren-
Steph Properties Inc.,

Plaintiffs,

- against -

Stephen Carlis, Lawrence Meistrich and Reznick,
Fedder & Silverman, P.C.

Defendant

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Index No. 604047/2002

DECISION AND ORDER

FILED
JUL 29 2004
CLERK
COURT OFFICE

MOSKOWITZ, KARLA J:

The court described this case in a decision and order dated July 2, 2003 (the “prior order”) and presumes familiarity with the prior order.

The prior order dismissed this action against defendant Reznick Fedder & Silverman LLP’s (Reznick or the accountants). The court dismissed the fraud claim for failure to plead with particularity and the negligent misrepresentation claims against the accountants for lack of privity.

Now, plaintiffs Donald C. Carter (“Carter”), a private investor, Lagomar Studios LLC (“Lagomar”) and Lauren-Steph Properties, Inc. (“Lauren-Steph”), a family trust that Carter manages have amended their complaint prompting this second motion to dismiss. For the following reasons, the court holds that plaintiffs have now pled fraud against Reznick sufficient to satisfy the requirements of CPLR 3016(b). The negligent misrepresentation claims still fail, however, for failure to allege privity.

Background

Reznick audited The Shooting Gallery's ("TSG") financial statements for the years 1997 through 1999. The financial statements portrayed a positive image of TSG's financial health. In the course of its audit, Reznick certified that each statement reflected in all material respects the actual financial condition of TSG in accordance with "generally accepted accounting principles" ("GAAP"). Plaintiffs claim that, in making their investments, they relied on the financial statements that Reznick had audited.

However, despite the positive portrayal in TSG's financial statements, TSG was in terrible financial shape. For example, TSG had **an** operating loss of more than \$21 million for 1999. The financial statements that Reznick had audited reported only a \$1 million loss for the same period. Further, TSG had **an** accumulated deficit of \$23 million in 1999. TSG's financial statements reported only a \$1.5 million deficit. Plaintiffs allege that they failed to discover the true facts about TSG's financial health because of a massive fraud that mainly Stephen Carlis ("Carlis") in tandem with Reznick perpetrated upon them. Carlis held various positions with **TSG**, including that of chief financial officer. Carlis has never responded to the complaint and is in default.

Discussion

Accountants may be liable to third parties without deliberate or active fraud.

A representation certified as true to the knowledge of the accountants when knowledge there is none, a reckless misstatement, or **an** opinion based on grounds so flimsy **as** to lead to the conclusion that there was no genuine belief in its truth, are all sufficient upon which to base liability. (*Curiale v. Peat, Marwick, Mitchell & Co.*, 214 AD2d 16, 28) citing *State Street Trust Co. v. Ernst*, 278 **NY** 104).

In addition, although CPLR 3016(b) requires that "the circumstances constituting the

wrong shall be stated in detail,” when the “facts surrounding the fraud are peculiarly within the knowledge of the other party,” courts recognize that it would be impossible for the plaintiff to state in detail all of the circumstances of the fraud. (See *Jered Construction Corp., New York City Tr. Auth.*, 22 NY2d 187; *see also, Augustan v. Spry*, 282 AD2d 489,490).

Here, plaintiffs have alleged that Reznick failed to follow its own audit procedures and failed to note serious violations of Generally Accepted Accounting Principles (“GAAP”) despite their awareness of these violations. For example, Reznick failed to verify independently the financial information that Carlis or TSG provided about many aspects of TSG’s business, including cash flow, despite knowing that Stephen Carlis had unfettered control over TSG’s business. (Second Amended Complaint [“SAC”] ¶¶ 63 and 69). Reznick failed to make further investigation, or at the very least, qualify its audit report, despite knowing that TSG reported profits year after year even though TSG had significant negative cash flow—a highly suspicious circumstance. (SAC ¶ 62). The accountants allegedly allowed Carlis and TSG to fabricate numbers and issued an unqualified opinion from those numbers, even though Reznick had requested supporting documentation. Despite failing to receive that supporting documentation, Reznick let its unqualified opinion stand. (SAC ¶ 69-71 and ¶ 76). Further, Reznick never reported that it found it impossible to trace certain revenues because TSG’s books were so disorganized. (SAC. ¶ 65).

In addition, Reznick never mentioned in its audit report that TSG had guaranteed millions of dollars on behalf of its subsidiaries, a circumstance that TSG should have reported as a contingent liability. Reznick allegedly knew about these guarantees because it maintained copies in its own files of the loans, leases and other contracts that TSG had guaranteed. (SAC. ¶ 67).

Another allegation demonstrating that Reznick took TSG's word at face value was that Reznick never made any attempt to confirm that third parties actually owed what TSG said they owed. (SAC ¶ 73). Finally, Reznick knew, but intentionally or recklessly disregarded information that it received on April 8, 1998, that Carlis was manipulating TSG's reported results to make the company seem more profitable than it actually was by replacing Carter with TSG as an investor in a film called *Illtown*. (SAC ¶ 68).

These allegations are adequate to state a claim for accounting fraud because they tend to demonstrate that Reznick's opinion was "based on grounds so flimsy as to lead to the conclusion that there was no genuine belief in its truth." (*Curiale*, supra, 214 AD2d at 28.) The Appellate Division, First Department, has sustained complaints with substantially similar allegations. (**See, e.g.** *Foothill Capital Corp. v. Grant Thornton LLP*, 276 AD2d 437; *Simon v. Ernst & Young*, 223 AD2d 506; *Ambassador Factors, et al., v. Kandel & Co.*, 215 AD2d 305. **See also** *Fidelity and Deposit Company of Md. v. Arthur Andersen & Co.*, 131 AD2d 308 [acceptance of client's estimates of certain revenue without independent verification supported surety company's claim for fraud against accountants who had certified client's financial statement]).

However, plaintiffs have still not alleged sufficient linking conduct to state a claim for negligent misrepresentation. Reznick's performed its audit for TSG. It did not undertake to perform the audit pursuant to any direct duty it owed to plaintiffs. (*See Houbigant Inc. v. Deloitte & Touche LLP*, 303 AD2d 92, 95).

Accordingly, it is


ORDERED THAT Defendant Reznick's motion to dismiss the second amended complaint is denied, except that the second cause of action for negligent misrepresentation is

dismissed; and it is further

ORDERED THAT the remainder of the action is severed and shall continue.

The parties are directed to attend a status conference on May 19, 2004 at noon by phone.

Dated: May 3, 2004



J.S.C.

FILED
JUN 17 2004
NEW
COUNTY CLERK'S OFFICE