

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF WASHINGTON

METROPOLITAN MORTGAGE &
SECURITIES CO., INC. and SUMMIT
SECURITIES, INC.

Plaintiffs,

v.

PRICEWATERHOUSECOOPERS, LLP

Defendant.

No. CV-05-290-FVS

ORDER DENYING MOTION TO
DISMISS

BEFORE THE COURT is Defendant's Motion to Dismiss, Ct. Rec. 18. The Court heard oral argument on this matter on December 13, 2005. Plaintiffs were represented by Parker Folse; Defendant was represented by Robert Varian.

I. BACKGROUND

Defendant served as Plaintiffs' independent auditor in connection with the financial statements Plaintiffs issued for fiscal years ending September 30, 1999 and 2000. On February 4, 2004, Plaintiffs filed for bankruptcy. On September 21, 2005, Plaintiffs filed this action against Defendant, alleging that the 1999 and 2000 financial statements audited by Defendant violated Generally Accepted Accounting Principles ("GAAP"), standards of professionalism, and standards of field work. Plaintiffs' Complaint asserts claims for professional negligence, negligent misrepresentation, and breach of contract. Pursuant to Federal Rule of Civil Procedure 12(b), Defendant moves to dismiss these claims. First, Defendant contends Plaintiffs' claims

1 are barred by Washington's three-year statute of limitations. Second,
2 Defendant alleges Plaintiffs' claims are barred by the doctrine of *in*
3 *pari delicto* and imputation. Third, Defendant contends Plaintiffs'
4 claims fail because they cannot establish causation, damages or
5 injury. Finally, Defendant contends Plaintiffs' negligent
6 misrepresentation claim must be dismissed because Plaintiffs cannot
7 establish they reasonably relied on Defendant's audits or reports.

8 **II. DISCUSSION**

9 **A. Applicable Standard**

10 Federal Rule of Civil Procedure 12(b)(6) provides that an action
11 will be dismissed for failure to state a claim upon which relief may
12 be granted. A court will grant dismissal only if "it appears beyond
13 doubt that the plaintiff can prove no set of facts in support of his
14 claim which would entitle him to relief." *Conely v. Gibson*, 355 U.S.
15 41, 45-46, 78 S.Ct. 99, 2 L.Ed.2d 80 (1957). When the legal
16 sufficiency of a complaint's allegations are tested with a motion
17 under Rule 12(b)(6), "[r]eview is limited to the complaint."
18 *Cervantes v. City of San Diego*, 5 F.3d 1273, 1274 (9th Cir. 1993).
19 All factual allegations set forth in the complaint are taken as true
20 and construed in the light most favorable to the plaintiff. *Epstein*
21 *v. Wash. Energy Co.*, 83 F.3d 1136, 1140 (9th Cir. 1996). The Court
22 must give the plaintiff the benefit of every inference that reasonably
23 may be drawn from well-pleaded facts. *Tyler v. Cisneros*, 136 F.3d
24 603, 607 (9th Cir. 1998). However, the Court is not required to
25 accept as true unreasonable inferences, conclusory allegations that
26 are contradicted by documents referred to in the complaint. *Steckman*

1 *v. Hart Brewing Inc.*, 143 F.3d 1293, 1295 (9th Cir. 1998). As a
2 general rule, the Court "may not consider any material beyond the
3 pleadings in ruling on a Rule 12(b)(6) motion. *Lee v. City of Los*
4 *Angeles*, 250 F.3d 668, 688 (9th Cir. 2001).¹

5 **B. Jurisdiction**

6 Since federal jurisdiction in this case is based on diversity of
7 citizenship, the Court must apply the substantive law of the State of
8 Washington. *Erickson v. Desert Palace, Inc.*, 942 F.2d 694, 695 (9th
9 Cir 1991) (citing *Erie R.R. v. Tompkins*, 304 U.S. 64, 58 S.Ct. 817, 82
10 L.Ed. 1188 (1938)).

11 **C. Statute of Limitations**

12 For the reasons discussed herein, the Court concludes that
13 Plaintiffs' breach of contract claim is governed by the six-year
14 statute of limitations for written contracts, RCW 4.16.040(1).
15 Further, the Court concludes Plaintiffs' claims for professional
16 negligence and negligent misrepresentation, governed by the three-year
17 statute of limitations, are not time-barred.

18 1. Six-Year Statute of Limitations

19 Defendant contends all of Plaintiffs' claims sound in tort and
20 are therefore governed by Washington's three-year statute of
21 limitations. See RCW 4.16.080. Plaintiffs contends their breach of
22 contract claim is governed by the six-year statute of limitations
23 applicable to actions based "upon a contract in writing, or liability
24

25 ¹ Although Defendant sought judicial notice of several
26 documents in its written submissions, Defendant appeared to
withdraw its request during oral argument. Thus, the Court does
not rule on Defendant's Request for Judicial Notice.

1 express or implied arising out of a written agreement." RCW
2 4.16.040(1).

3 In deciding whether an action sounds primarily in contract or
4 tort, the Court must examine the essential allegations of the
5 complaint. *Yeager v. Dunnavan*, 26 Wash.2d 559, 562, 174 P.2d 755
6 (1946). "When an act complained of is a breach of specific terms of
7 the contract, without any reference to the legal duties imposed by law
8 upon the relationship created thereby, the action is in contract."
9 *Id.* On the other hand, when a contract for services forms a
10 relationship between the parties and, in attempting to perform the
11 promised services, one of the parties violates a duty imposed by law
12 as a result of the relationship, then the action sounds in tort. *Id.*
13 In such cases, the contract is considered merely the "inducement" of
14 the relationship that gave rise to the legal duty, and the basis of
15 the claim is the breach of the duty, not a breach of the contract.
16 *Id.*

17 Defendant relies on *Davis v. Davis Wright Tremaine, L.L.P.*, 103
18 Wash. App. 638, 14 P.3d 146 (Div. 1, 2000), to argue that Plaintiffs'
19 claim for breach of contract actually sounds in tort and is therefore
20 governed by the three-year statute. In *Davis*, Division One of the
21 Washington State Court of Appeals held that the six-year limitations
22 period did not apply to the plaintiff's claim that his attorney, who
23 had been retained to represent the plaintiff in the purchase of an
24 ophthalmology practice, committed legal malpractice by failing to
25 properly perform legal services contracted for by the parties. *Davis*,
26 103 Wash. App. at 641, 14 P.3d 146 (2000). The attorney sent the

1 plaintiff a letter of engagement stating, in part, that the law firm
2 "will do our best to provide you with prompt, high quality legal
3 counsel." A separate document enclosed with the letter stated that
4 "[the law firm] will at all times act on your behalf to the best of
5 our ability." *Id.* at 642, 14 P.3d 146. The plaintiff later sued his
6 attorney for legal malpractice, asserting claims for negligence and
7 breach of contract based on allegations that his attorney had failed
8 to conduct due diligence to check for claims against the seller of the
9 practice *Id.* at 643, 14 P.3d 146. The plaintiff argued his breach of
10 contract claim was governed by the six-year statute of limitations
11 because his action was based on the attorney's breach of the terms of
12 the letter of engagement. *Id.* at 645, 14 P.3d 146. The Court of
13 Appeals disagreed, holding that the action was not based on a contract
14 in writing because the agreement at issue did not contain any express
15 promises that served as the basis for the pending claims. *Id.* at 652,
16 14 P.3d 146. Further, the court held that the plaintiff's claims were
17 not based upon "a liability express or implied arising out of a
18 written agreement" because the attorney's duty to comply with the
19 relevant standard of care arose "from sources external to the
20 agreement." *Id.* at 654, 14 P.3d 146. Because the plaintiff's claim
21 was based on implied duties of counsel to client rather than the
22 written agreement itself, the six-year statute of limitation did not
23 apply. *Id.*

24 In the present action, Defendant relies on *Davis* to argue that
25 the gravamen of Plaintiffs' breach of contract claim is actually
26 Defendant's alleged negligence and that therefore, the three-year

1 statute of limitations for tort actions must apply. However, the
2 terms of Defendant's engagement letters stand in stark contrast to the
3 engagement letter in *Davis*. For example, Defendant expressly promised
4 in its 1999 and 2000 engagement letters that it would:

5 (1) "plan and perform the audit to obtain reasonable
6 assurance about whether the financial statements are free of
material misstatements"

7 (2) examine "evidence supporting the amounts and disclosures
in the financial statements"

8 (3) assess "accounting principles used and significant
9 estimates made by management"

10 (4) evaluate "the overall financial statement presentation"

11 (5) "consider [Plaintiff's] internal control over financial
12 reporting"

13 (6) design the audit to obtain reasonable assurance of
14 detecting errors or fraud "that would have material effect
15 on the financial statements"

16 (7) communicate to the board of directors "any significant
17 deficiencies relating to internal control over financial
18 reporting identified during [the] audit" and "any illegal
19 act, material errors, or evidence that fraud may exist
20 identified during [the] audit."

21 Complaint, at ¶¶ 73-78. Plaintiffs' Complaint expressly alleges it
22 has suffered damages as a result of Defendant's breach of each of
23 these specific provisions.

24 Thus, unlike *Davis*, Plaintiffs' claim for breach of contract does
25 arise from specific provisions of the agreement and does not depend
26 entirely on importing implied tort duties of care extraneous to the
obligations of the written agreement. Plaintiffs' breach of contract
claim is not based solely on Defendant's agreement to perform the
audit in accordance with auditing standards generally accepted in the
United States. Rather, Plaintiffs' Complaint specifically alleges it
has suffered damages as a result of Defendant's breaches of the

1 specific terms of the 1999 and 2000 agreements. To conclude that
2 Plaintiffs' claim sounds only in tort would effectively render the
3 written agreement between the parties meaningless and unenforceable.
4 Thus, the Court determines Plaintiffs' breach of contract claim is
5 governed by the six-year statute of limitations. Even if Plaintiffs'
6 claim accrued when Defendant issued its audit reports in November 1999
7 and December 2000, the six-year statute of limitations expires no
8 earlier than November 2005 and December 2006. Thus, Plaintiffs'
9 breach of contract claim is not barred by the statute of limitations.

10 2. Three-Year Statute of Limitations

11 _____RCW 4.16.080 prescribes a three-year statute of limitation on
12 tort claims (i.e., professional negligence and negligent
13 misrepresentation). Defendant argues Plaintiffs' claims for negligent
14 misrepresentation and professional negligence began to run on November
15 19, 1999, and December 28, 2000, the date of Defendant's audit
16 opinions, and are therefore barred by the three-year statute of
17 limitations. Plaintiffs argue the discovery rule applies to their
18 claims and they did not, and in the exercise of due diligence, could
19 not have discovered the alleged material deficiencies in Defendant's
20 1999 and 2000 audit reports until the time immediately preceding
21 Plaintiffs' bankruptcy filings in February 2004.

22 Under Washington's discovery rule, a cause of action does not
23 accrue and the statute of limitations does not start to run "until a
24 party knew or should have known the essential elements of the cause of
25 action--duty, breach, causation and damages." *Niven v. E.J. Bartells*
26 *Co.*, 97 Wash. App. 507, 514, 983 P.2d 1193 (Div. 1, 1999) (citation

1 omitted). "The determination of when the plaintiff discovered or
2 through the exercise of due diligence should have discovered the
3 factual basis for a cause of action is a factual question for the
4 jury." *Crisman v. Crisman*, 85 Wash. App. 15, 23, 931 P.2d 163 (1997)
5 (citing *Samuelson v. Community College Dist. No. 2*, 75 Wash. App. 340,
6 346, 877 P.2d 734 (1994)). "A motion to dismiss based on the running
7 of the statute of limitations period may be granted only if the
8 assertions of the complaint, read with the required liberality, would
9 not permit the plaintiff to prove that the statute was tolled."
10 *Supermail Cargo, Inc. v. United States*, 68 F.3d 1204, 1206 (9th Cir.
11 1995) (citation and internal quotation omitted). A "complaint cannot
12 be dismissed unless it appears beyond doubt that the plaintiff can
13 prove no set of facts that would establish the timeliness of the
14 claim." *Id.* at 1207 (citation omitted).

15 Plaintiffs' Complaint expressly alleges that the accounting
16 irregularities in question were discovered only when Paul Sandifur
17 resigned as Metropolitan's president, CEO, and Chairman of the Board
18 and Plaintiffs filed for bankruptcy in February 2004. Complaint, at
19 ¶ 10. Further, Plaintiffs contend there is a genuine issue of fact as
20 to when Plaintiffs suffered a cognizable injury flowing from
21 Defendant's alleged negligence and as to when Plaintiffs learned about
22 the injury. See *Richardson v. Denend*, 59 Wash. App. 92, 96, 795 P.2d
23 1192 (1990) (explaining that the discovery rule has consistently been
24 applied by Washington courts "to toll the statute of limitations until
25 the plaintiff discovers, or should have discovered, his or her damage
26 or injury resulting from the professional malpractice."). Defendant

1 argues that because Paul Sandifur and other members of Plaintiffs'
2 former management, who were responsible for preparing the financial
3 statements, actively concealed Plaintiffs' financial condition in
4 those statements, Plaintiffs must be deemed to have been aware of
5 their own misconduct at the time it occurred. Therefore, Defendant
6 contends Plaintiffs must be deemed to have been aware of Defendant's
7 alleged failure to detect violations of auditing principles at the
8 time its reports were issued. Thus, Defendant argues Plaintiffs'
9 claims are time-barred because the statute of limitations on
10 Plaintiffs' claims began to run on the date Defendant issued the audit
11 reports, November 19, 1999, and December 28, 2000.

12 The Complaint, however, does not allege, with the exception of
13 Paul Sandifur, that Plaintiffs were aware of accounting irregularities
14 that Defendant failed to detect. And, with respect to Paul Sandifur,
15 Plaintiffs have not alleged he was aware that Defendant's conduct
16 constituted a breach of applicable accounting standards of care.
17 Additionally, with respect to Plaintiffs' allegation that the audited
18 financial statements failed to conform to GAAP, Plaintiffs
19 specifically allege the 1999 and 2000 statements "violated standards
20 concerning recognizing gains on related party transaction, reporting
21 gains on commercial real estate transactions, recognizing loan fees
22 and interest income, and relying on overly optimistic appraisals in
23 valuing real estate in assessing the carrying value of assets."
24 Complaint, at ¶ 21. Plaintiff cites two transactions as examples: the
25 Koa Timber Transaction and the FLIP Tax Shelter. Plaintiffs'
26 Complaint does not allege that Defendant was deceived with respect to

1 these transactions or assets in the financial reports.

2 Defendants claiming the action is time-barred have the initial
3 burden of showing the absence of an issue of material fact. *Niven*, 97
4 Wash. App. at 514, 983 P.2d at 1197 (citation omitted). Here,
5 Defendant has not shown on the basis of the Complaint's allegations
6 that Plaintiffs will never, under any state of facts, be able to prove
7 they could not have discovered their tort claims against Defendant
8 until February 2004. Accepting as true Plaintiffs' allegations, the
9 Court assumes, for purposes of this motion to dismiss, that
10 Plaintiffs' claims for negligence and negligent misrepresentation did
11 not accrue until February 2004. The actual determination of when
12 Plaintiffs discovered or through the exercise of due diligence should
13 have discovered their cause of action is a factual question for the
14 jury. *Crisman*, 85 Wash. App. at 23, 931 P.2d 163. Thus, the Court
15 cannot rule, as a matter of law, that these claims are barred by the
16 statute of limitations. Accordingly, Defendant's motion to dismiss on
17 this basis is denied.

18 ***D. Doctrine of In Pari Delicto***

19 Defendant contends Plaintiffs' claims must be dismissed under the
20 doctrine of *in pari delicto*. "The general rule of *in pari delicto* is
21 that when the parties are of equal guilt, the defendant will prevail."
22 *Walsh v. Brousseau*, 62 Wash. App. 739, 745, 815 P.2d 828 (Div. 1,
23 1991) (citing *Goldberg v. Sanglier*, 96 Wash.2d 864, 882, 639 P.2d 1347
24 (1982) ("The maxim 'in pari delicto potior est conditio defendentis'
25 declares that the defendant will prevail when the parties are of equal
26 guilt.")). "Where the parties are not equally culpable, the defense

1 of in pari delicto is not appropriate." *Goldberg*, 96 Wash.2d at 883-
2 84, 639 P.2d 1347.

3 Defendant bases its reliance on this defense on the fact that
4 Sandifur concealed the financial performance of the Plaintiff
5 companies. Plaintiffs' Complaint does allege this fact, but it also
6 alleges the companies' financial statements failed to conform to
7 applicable accounting principles and did not fairly present the true
8 financial condition of the Plaintiff companies. See Complaint, at ¶¶
9 3, 12-14, 18. Whether both parties are indeed of "equal guilt" is a
10 factual issue that precludes granting a motion to dismiss. Whether
11 Defendant is as blameworthy as Sandifur and Plaintiffs' management is
12 an issue of fact that cannot be decided based on the Complaint alone.
13 Therefore, the Court denies Defendant's motion to dismiss under the
14 doctrine of *in pari delicto*.

15 ***E. Causation, Damage & Injury***

16 To survive a motion to dismiss, Plaintiffs need only allege a
17 basis for concluding that Defendant's breach of its duties, "in a
18 direct sequence unbroken by any new independent cause, produce[d] the
19 injury complaint of, and without which such injury would not have
20 happened." *Fisher v. Parkview Progs., Inc.*, 71 Wash. App. 468, 476
21 (1993). Defendant argues Plaintiffs' claims should be dismissed
22 because they cannot establish proximate cause, damage, or injury.
23 Specifically, Defendant contends Plaintiffs' claimed injuries are
24 self-inflicted and therefore, Plaintiffs cannot establish Defendant
25 was the proximate cause of a compensable injury to Plaintiffs.

26 Here, taken as true, Plaintiffs' allegations are sufficient to

adequately plead causation to survive a motion to dismiss. Plaintiffs' Complaint alleges that if Defendant had discharged its duties, damages to Plaintiffs would have been averted, despite the companies' deficient internal controls and accounting systems. The Complaint alleges that independent directors and officers and regulators were unaware of the companies' true financial condition because they relied on the allegedly inaccurate audit reports. Further, Plaintiffs allege that Defendant's failure to alert them of those and other deficiencies prevented independent directors, officers, and regulators from acting to save the companies. See Complaint, at ¶¶ 14, 43-44, 51-52, 57-59, 62, 68-69. Furthermore, Defendant's argument ignores the possibility that "[t]here may be more than one proximate cause of an injury...[a]nd the concurrent negligence of a third party does not break the chain of causation between original negligence and the injury," *Travis Bohannon*, 128 Wash. App. 231, 242, 115 P.3d 342 (Div. 3, 2005), because Plaintiffs do not allege that deficiencies in their internal controls and accounting systems were the sole cause of Plaintiffs' damages.

Thus, the Court concludes Plaintiffs' Complaint does not support a lack of proximate cause as a matter of law. Whether Plaintiffs can ultimately establish proximate cause is an issue of fact not ripe for resolution in a motion to dismiss. Accordingly, Defendant's motion to dismiss is denied on this basis.

F. Reliance

To prove a claim for negligent misrepresentation under Washington law, Plaintiffs must show reasonable reliance. *ESCA Corp. v. KPMG*

1 *Peat Marwick*, 135 Wash.2d 820, 959 P.2d 651, 654 (1998). Defendant
2 moves to dismiss Plaintiffs' negligent misrepresentation claim,
3 arguing Plaintiffs cannot show they justifiably relied on the
4 allegedly inaccurate audit reports because they had sufficient prior
5 notice that the financial statements relied upon by Defendants to
6 create the audit reports were inaccurate. Defendant alleges the
7 Complaint shows just the opposite—that if anything, Defendant over-
8 relied on Plaintiffs' management's misrepresentations in certifying
9 the financial statements audited by Defendant. Defendant relies in
10 large part on *Smolen v. Deloitte, Haskins & Sells*, 921 F.2d 959 (9th
11 Cir. 1990).

12 In *Smolen*, the sellers of a business brought suit against their
13 auditors for negligent misrepresentation after the company adjusted
14 its financial statements to account for grossly overstated inventory.
15 921 F.2d at 961-63. The district court dismissed the claim on summary
16 judgment. On appeal, the plaintiffs argued that because they relied
17 on the financial misstatements in connection with selling the company,
18 they were entitled to recover the value lost on the company's sale
19 price after the adjustment to inventory. *Id.* at 963. The Ninth
20 Circuit affirmed the district court, concluding that "[e]xtensive
21 evidence ... established that *Smolen* did not actually rely" on the
22 audit reports and that the plaintiffs' prior knowledge of the
23 overstatements gave them "sufficient notice" of the misstatements in
24 their financial statements "and thus made any reliance by appellants
25 unreasonable." *Id.* at 964-65.

26 Here, Plaintiffs' Complaint does not allege Plaintiffs were aware

1 of Defendant's alleged wrongdoing or that Plaintiffs knew Defendant's
2 audits of the companies' financial statements allegedly violated GAAP
3 and GAAP. Although the Complaint alleges Sandifur concealed the
4 Plaintiff companies' financial condition, it does not allege, as
5 Defendant contends, that Plaintiffs engaged in fraudulent business
6 activities. Rather, the Complaint alleges that the Plaintiff
7 companies were plagued with accounting irregularities, inexperience,
8 and internal control deficiencies; that independent directors and
9 officers did not know the true gravity of the companies' financial
10 condition; and that those directors and officers trusted Defendant and
11 justifiably relied on its representations to reveal the true condition
12 of the companies' finances. See Complaint, at ¶¶ 4, 13, 14, 69.
13 Assuming the truth of Plaintiffs' allegations, the Court cannot
14 conclude Plaintiffs had sufficient prior notice that the information
15 Defendant relied upon was incorrect such that any reliance by
16 Plaintiffs was unreasonable. Thus, the Court concludes that
17 Plaintiffs' allegations are sufficient to adequately plead reasonable
18 reliance and Defendant's motion to dismiss on this basis is denied.
19 Accordingly,

20 **IT IS HEREBY ORDERED** that Defendant's Motion to Dismiss, **Ct. Rec.**
21 **18**, is **DENIED**.

22 **IT IS SO ORDERED.** The District Court Executive is hereby
23 directed to enter this Order and furnish copies to counsel.

24 **DATED** this 21st day of December, 2005.

25 s/ Fred Van Sickle
26 Fred Van Sickle
United States District Judge