

IN THE UNITED STATES DISTRICT COURT  
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

MEDICAL CONSULTANTS	:	CIVIL ACTION
NETWORK, INC.	:	
Plaintiff,	:	
	:	
v.	:	
	:	
CANTOR & JOHNSTON, P.C,	:	
TERRY CANTOR, C.P.A.,	:	
and GORDON JOHNSTON C.P.A.	:	
Defendants	:	No. 99-0528

**MEMORANDUM AND ORDER**

McLaughlin, J.

December, ,2000

This is an action by Medical Consultants Network, Inc. (“MCN”), against an accounting firm, Cantor & Johnston, P.C. and its principals, Terry Cantor and Gordon Johnston, to recover damages for professional malpractice and negligent misrepresentation arising out an audit of a business whose assets were being purchased by MCN.

Both parties have submitted motions *in limine*. Defendants have moved *in limine* pursuant to Fed. R. Evid. 702 to preclude the expert testimony of plaintiff’s damages witness, Neil J. Beaton, C.P.A. Plaintiff has moved *in limine* to preclude evidence and argument concerning plaintiff’s alleged contributory negligence. Defendants have submitted a cross-motion *in limine* to preclude evidence and argument concerning defendants’ alleged negligence.

On December 14, 2000, the Court held an evidentiary hearing concerning the admissibility of Neil J. Beaton’s testimony, and asked for additional briefing on the proper

measure of damages in the case. The Court rules as follows on these motions.

- Defendants’ motion to preclude the testimony of Neil Beaton is granted. Some of Mr. Beaton’s proposed testimony is irrelevant to the proper measure of damages. The remainder of his testimony is inadmissible under Rule 702 because it is neither reliable nor based upon sufficient facts or data.
- Plaintiff’s motion to preclude evidence of its alleged contributory negligence is granted; but some of that evidence may be relevant to the question of plaintiff’s justifiable reliance on defendants’ alleged negligent misrepresentations.
- Defendants’ motion to preclude evidence pertaining to its alleged negligence is denied for two reasons. Defendants’ motion is in substance a motion for summary judgment on the negligence claim a year too late. In any event, at this stage, plaintiff has established sufficient evidence of “privity” to defeat even a timely motion for summary judgment.

## **I. BACKGROUND**

Medical Consultants Network (“MCN”), a Seattle corporation, is a provider of disability management services, including independent medical examinations, case management and vocational rehabilitation services. Cantor & Johnston, P.C. (“Cantor & Johnston”), was a Pennsylvania professional organization engaged in the business of providing professional accounting and auditing services. Terry Cantor and Gordon Johnston are certified public accountants, and each was a 50% shareholder in Cantor & Johnston.

In 1997, Dr. Brian Grant, President of MCN, inquired about purchasing the business of

Villanova Rehabilitation Consultants, Inc. (“VRC”). VRC was in the business of providing services to manage workers’ compensation and disability insurance claims for public and private employers. At the time, the President and sole shareholder of VRC was Patricia Maloney.

Negotiations between Dr. Grant and Ms. Maloney resulted in the execution of an Asset Purchase Agreement between MCN, VRC, and Ms. Maloney dated February 1, 1998. According to the agreement, the total purchase price consisted of a base purchase price of \$2,522,000 plus an additional sum to be determined by an analysis of the net income of VRC for the twelve months ending January 31, 1998. This component of the purchase price would derive from VRC’s Closing Income Statement which was to be audited by VRC’s historical C.P.A., Cantor & Johnston in consultation with Dr. Brian Grant.

Cantor & Johnston was retained to conduct an audit of VRC’s records in accordance with Generally Accepted Auditing Standards (“GAAS”) and to calculate the final component of the purchase price in accordance with Generally Accepted Accounting Principles (“GAAP”). The report was sent to MCN on April 9, 1998. MCN subsequently bought the assets of VRC for a total purchase price of \$5,965,693.00. MCN operated the newly purchased company as Villanova Health Corporation (“VHC”).

MCN filed suit in February 1999, alleging that the defendants negligently misrepresented the status of VRC and negligently prepared the auditor’s report upon which MCN relied in proceeding with the purchase of VRC’s assets and establishing a final purchase price.

## II. DISCUSSION

### A. Defendants' Motion to Exclude the Testimony of Neil J. Beaton

The defendants argue that the testimony of Neil J. Beaton, plaintiff's expert witness on damages, is admissible under Fed. R. Evid. 702. Mr. Beaton's expert report presented three components of damages:

1. Overpayment of purchase price. Mr. Beaton opined that the entire purchase price of \$5,965,693.00 was a proper component of damages for two reasons. First, Mr. Beaton assumed that had the audit report been correct, the plaintiff would not have bought VRC. Secondly, Mr. Beaton opined that "there is no current value to VHC's operating assets, and hasn't been since at least December 31, 1998."

2. Subsequent Operating Income shortfalls. Mr. Beaton first calculated the plaintiff's monthly minimum operating income expectation for the first year after the purchase. He then took the six-month period between February to July 1998 and determined the monthly operating income of the new company. He subtracted the latter number from the former and multiplied by 24. Twenty-four represented the number of months between the plaintiff's purchase of the company and an assumed "refund date" of January 31, 2000.

3. Diversion of Management. Mr. Beaton estimated that plaintiff's employees spent 900 hours dealing with the problems of the new company. He estimated the cost to the plaintiff by multiplying the hourly wage rate of the employees by the number of hours each spent on the problems of VHC.

Mr. Beaton presented an alternative measure of damages as the purchase price multiplied by the plaintiff's borrowing interest rate of 7.78% multiplied by 22 months (the date between delivery of the audit report and some assumed "refund date") plus the management diversion number from above.

Mr. Beaton testified at the hearing held on December 14, 2000. The Court requested briefing on the proper measure of damages in the case and asked the plaintiff to reevaluate the relevance of the various components of the damages based on the proper measure of damages. The parties gave their views on these issues on December 20, 2000.

The parties agree that the proper measure of damages is set forth in Section 552 of the Second Restatement of Torts: "(a) [t]he difference between the value of what he has received in the transaction and its purchase price or other value given for it; and (b) [p]ecuniary loss suffered otherwise as a consequence of the plaintiff's reliance upon the misrepresentation." REST 2d TORTS § 552B. This is the same as the measure of damages for fraudulent misrepresentation actions. Id. at comment a. The value of the item acquired is generally determined by the market value at the time of the transaction. Kauffman v. Mellon National Bank & Trust Co., 366 F.3d 326 (3d Cir. 1966); Neuman v. Corn Exchange Nat'l Bank & Trust Co., 356 Pa. 442; 51 A.2d 759, 766 (1947); Edward J. Debartolo Corp. v. Coopers & Lybrand, 928 F. Supp. 557, 566 (W.D. Pa. 1996). Only in special circumstances, like market inflation or depression, is the value of an article not determined by its market value at the time of acquisition.<sup>1</sup>

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<sup>1</sup> This type of damages is at times referred to as "actual loss,' and not the benefit, or value, of that bargain." David v. L.A. Presidential Management II, L.P., No. 98-6556, 2000 WL 1207157 \* 3 n. 12 (E.D. Pa. Aug. 22, 2000)(citing Delahanty v. First Pennsylvania Bank, NA, 318 Pa. Super. 90, 117, 464 A.2d 1243, 1257 (1983)). See also, Bobin v. Sammarco, No. 94-5115, 1995 WL 303632 (E.D. Pa. May 18, 1995); Torres v. Borzelleca, 641 F. Supp. 542, 546

Counsel for the plaintiff conceded that under this rubric, subsequent operating income shortfall should not be included as an element of damages. It would be a component of “expectation” damages that are not permitted under the law. There are, therefore, only two components of Mr. Beaton’s testimony left to consider: overpayment of the purchase price; and diversion of management.

The Court holds that Mr. Beaton’s testimony described as “overpayment of the purchase price” is inadmissible for two reasons. First, the witness compares the purchase price with the value of the purchased company as of December 31, 1998. However the comparison between what was paid and what was received generally must be made on the date of acquisition. Neither party has argued that any different date should be applied here. The transaction closed on February 1, 1998, at the latest. Mr. Beaton’s testimony, therefore, is not relevant.

Mr. Beaton’s testimony demonstrated why courts require the comparison to be made at the time of the acquisition. Making the comparison after the plaintiff has had control of the company raises serious causation questions. Is the company worth so little because it was worthless at the time of the acquisition or because of events after the acquisition, unrelated to the defendants’ alleged illegal conduct? Mr. Beaton could not answer such questions.

The second reason why Mr. Beaton’s testimony on the purchase price is inadmissible is because his report did not give, as required by Rule 26, “a complete statement of all opinions to be expressed and the basis and reasons therefor.” The only statement in the report about the value of the company is: “[b]ased on our analysis of VHC, we have determined that there is no

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(E.D. Pa. 1986). “Actual loss” is generally defined as the difference between the actual value of the property at the time of the transaction and its purchase price. Edward J. Debartolo Corp. v. Coopers & Lybrand, 928 F. Supp. 557, 566 (W.D. Pa. 1996).

current value to its operating assets, and hasn't been since at least December 31, 1998." At the hearing, Mr. Beaton explained that the basis for his conclusion that VHC had no residual value was a discounted cash flow analysis he performed. Mr. Beaton testified that he considered "large operating losses, a substantial amount of debt and very few prospects of improvement for the future." The expert report however, does not include an explanation or reference to the analysis discussed at the hearing. Therefore, Mr. Beaton's report does not comply with the requirements of Rule 26 and for that reason as well, his testimony on the topic he described as overpayment of purchase price is inadmissible.

With regards to management diversion costs, Mr. Beaton's testimony is inadmissible because it is neither necessary nor reliable. The testimony is unnecessary because the only thing Mr. Beaton did was multiply each employee's hours by his or her hourly rate. One does not need accounting expertise to do that. Nor is an accounting expert necessary to tell the jury that consequential damages are an appropriate measure of damages. The Court will instruct the jury on the proper measure of damages that may include consequential damages. The testimony is also unreliable because Mr. Beaton was not able to establish a causal connection between the management time claimed in his calculation and the defendants' alleged wrongdoing. If evidence of management time spent dealing with problems at VHC is to be presented to the jury, it must be through witnesses who can lay a foundation for its admissibility. Such witnesses must be able to explain, among other things, how the time spent relates to any wrongdoing by the defendants.

B. Plaintiff's Motion to Exclude Plaintiff's Contributory Negligence

Plaintiff has moved *in limine* to preclude defendants from introducing evidence concerning MCN's alleged contributory negligence in connection with its purchase of VRC and from arguing a theory of contributory negligence in any opening or closing statements to the jury.

Under Pennsylvania law, a party's contributory negligence is not a defense to an action against an accountant for professional negligence unless that contributory negligence impeded the accountant from performing its obligations satisfactorily - - the so called "audit interference rule." Jewelcor Jewelers and Distributors, Inc. v. Corr, 373 Pa. Super, 536, 551-52, 542 A.2d 72, 79-80 (Pa. Super. 1988) (adopting the holding in National Surety Corp. v. Lybrand, 256 A.2d 226, 235 (N.Y. App. Div. 1939)); accord, In re Jack Greenberg, Inc., et. al. v. Grant Thornton LLP, 212 B.R. 76, 92 (E.D. Pa. 1997). Because defendants do not contend that plaintiff impeded them from fulfilling their professional responsibilities, contributory negligence is not a defense.

Defendants argue that the Pennsylvania audit interference rule does not apply in an action by a third party purchaser like the plaintiff because there is no privity in such a situation. That argument is identical to the argument defendants make in their motion to preclude evidence of their negligence. As explained in the next section of this memorandum, the Court finds that there is sufficient evidence of privity in the record of this case.

Although evidence of plaintiff's negligence may not be admitted to show plaintiff's contributory negligence, evidence of plaintiff's negligence may be relevant to plaintiff's negligent misrepresentation claim. To establish a cause of action for negligent misrepresentation, a plaintiff must demonstrate "(1) misrepresentation of a material fact; (2) the representor must either know of the misrepresentation, or must make the misrepresentation

without knowledge as to its truth or falsity; (3) the representor must intend the representation to induce another to act on it; and (4) injury must result to the party acting in justifiable reliance on the misrepresentation.” Gibbs v. Ernst, 538 Pa. 193, 647 A.2d 882, 890 (Pa. 1994). The Court will not rule at this stage on whether any particular piece of evidence is relevant to justifiable reliance. Those decisions must await trial.

C. Defendants’ Cross-Motion to Preclude Evidence of Defendant’s Alleged Negligence

Defendants argue that evidence of their alleged negligence should not be permitted at trial because there is no privity between them and the plaintiff. The motion *in limine* is in essence a motion for summary judgment. The deadline for submission of motions for summary judgment was at the close of discovery, December 3, 1999. Defendants are a year late. Even if timely, however, their motion would be denied.

In Guy v. Liederbach, 501 Pa. 47, 459 A.2d 744 (Pa. 1983), an attorney malpractice action, the Pennsylvania Supreme Court upheld the “strict privity” rule, but also noted that there must be, “at the very least ... a specific undertaking on the attorney’s part to perform a specific service for a third party coupled with the reliance of the third party and the attorney’s knowledge of that reliance in order for the third party to bring suit. Id. at 744.

Plaintiff has presented sufficient evidence to fulfill this requirement. The Independent Auditor’s Report prepared by the defendants was addressed to both the sole stockholder of VRC and to the president of MCN. The report also included the statement that it was “intended solely for the information and use of the stockholder of Villanova Rehabilitation Consultants, Inc., and the President of Medical Consultants Network, Inc. and should not be used for any other

purpose.” (Plf.’s Opp. To Def. Cross-Mot. at 2). The Auditor’s report on its face meets the privity requirement delineated in Guy - - a specific undertaking on the professional’s part to perform a specific service for a third party.

Williams Controls, Inc. v. Parente, Randolph, Orlando, Carey & Assoc., 39 F. Supp.2d 517 (M.D. Pa. 1999), cited by defendants, is distinguishable. There the accountant, Parente, was not identified, directly, or indirectly, in the Asset Purchase Agreement. In this case, the Asset Purchase Agreement specifically mentions “Seller’s historical CPA.” There, the audited financial statements and audited closing balance sheet were prepared by Parente and sent to the seller, who thereafter provided the reports and balance sheet to the buyer. In this case, Cantor & Johnston transmitted the Auditor’s Report directly to MCN, the buyer. The Court, therefore, denies the defendants’ motion.

An appropriate order follows.

IN THE UNITED STATES DISTRICT COURT  
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MEDICAL CONSULTANTS NETWORK,	:	CIVIL ACTION
Plaintiff,	:	
	:	
v.	:	
	:	
CANTOR & JOHNSTON, et. al.,	:	
Defendant,	:	NO. 99-528

ORDER

AND NOW, this day of December, 2000, for the reasons stated in the Memorandum of today's date, it is HEREBY ORDERED that, upon consideration of defendants' Motion to Preclude the Expert Testimony of Neil J. Beaton (Docket #36 ), and after a hearing in limine pursuant to F.R.E. 702, said motion is GRANTED; upon consideration of plaintiff's Motion in Limine to Preclude Evidence and Argument Concerning Plaintiff's Alleged Contributory Negligence (Docket #35 ), said motion is GRANTED IN PART and DENIED IN PART; upon consideration of defendants' Cross-Motion in Limine to Preclude Evidence of and Argument Concerning Defendants' Alleged Negligence (Docket # 40), said motion is DENIED.

BY THE COURT:

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Mary A. McLaughlin, J.