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Last Step in the Expansion of Accountant Liability, The

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THE LAST STEP IN THE EXPANSION OF ACCOUNTANT LIABILITY

International Mortgage Company v. John P. Butler Accountancy Corp.[1]

The accountant's duty of care for negligent misrepresentation[2] has been at issue in an increasing number of lawsuits throughout the nation.[3] For decades most courts have held that an accountant's duty ran only to his client.[4] However, due to the combined effects of creative litigators, the perceived deep pockets of the accounting profession, the expanded theories of tort liability, and the increasing complexity of the financial world, a few courts have rethought their treatment of this issue.[5] One such court was the

1. 177 Cal. App. 3d 806, 223 Cal. Rptr. 218, *review denied*, 178 Cal. App. 3d 682h (1986).

2. This Note deals exclusively with the situation in which the accountant, acting in his role as a certified public accountant (CPA), performs his audit duties and in conjunction with carrying out these duties issues an unqualified opinion on the financial statement he has audited. In general, a CPA is an independent accountant, not an employee of the company he is performing the audit for, who has taken and passed national standardized examinations. For a listing of the standards an auditor must follow while performing an audit, see *infra* note 32.

3. "More lawsuits have been filed against accountants in the last decade and a half than in the entire previous history of the [accounting] profession." Minow, *Accountant's Liability and the Litigation Explosion*, J. ACCT., Sept. 1984, at 70, 76. As one scholar has noted:

> There has been a significant rise in the number of law suits brought against accountants in the past decade [1966-1976]. In 1966 it was reported that approximately 100 suits were in various stages of litigation. Wall St. J., Nov. 15, 1966, at 12, col. 6, at 13, col. 2. By 1973, "more than 500 companies ha[d] litigation or claims in process involving auditors." Hawes, *Truth in Financial Statements: An Introduction*, 28 VAND. L. REV. 1, 1 n.1 (1975).

Besser, *Privity? An Obsolete Approach to the Liability of Accountants to Third Parties*, 7 SETON HALL 507, 507 n.2 (1976).

4. H. Rosenblum Inc. v. Adler, 93 N.J. 324, ____, 461 A.2d 138, 142 (1983).

5. Wiener, *Common Law Liability of the Certified Public Accountant for Negligent Misrepresentation*, 20 SAN DIEGO L. REV. 233-34 (1983). Wiener predicts:

> Regardless of the cause [of the increased litigation in the area of accountants' liability,] . . . it is only to have been expected that when the accountant became high priest willing for a fee to translate, through the added mystique of computer software, the jargon of almost incomprehensible financial transactions into neat, tabulated and word-processed form he became targeted as the prime defendant when the [company] . . . he audited became bankrupt.

Id. at 234-35.

California Court of Appeals which recently held, in the case of *International Mortgage Company v. John P. Butler Accountancy Corp.*,[6] that privity is no longer a prerequisite to an accountant's liability for negligence to foreseeable third parties who rely on the accountant's financial statements.[7] In reaching this result, California now joins New Jersey[8] and Wisconsin[9] in abandoning the privity requirement and adopting the foreseeable user test as the basis for determining accountant's liability. These three states constitute the leading edge of a potentially major shift toward expanding the scope of accountant liability.

In *International Mortgage*, Westside Mortgage, Inc. (Westside), a company that arranges real estate financing, employed the firm of John P. Butler Accountancy Corp. (Butler) to conduct an annual audit for the year ending December 31, 1978. After completing the audit, Butler issued an unqualified opinion stating, among other things, that the financial statements were presented in conformity with generally accepted accounting principles. These statements showed Westside's net worth as $175,036.[10] The primary asset was a $100,000 note receivable, secured by a deed of trust. The note, however, was actually worthless because the mortgage securing it was wiped out by a senior lien holder in a trustee's sale held in 1977. Because the note receivable constituted 57 per cent of Westside's net worth, the erroneous valuation of the note was material to an accurate representation of Westside's financial position.[11]

International Mortgage Company (IMC) instituted negotiations with Westside in October 1979, for the purpose of buying and selling loans on the secondary market. In the course of negotiations, Westside provided IMC with copies of its 1978 audited financial statements. After reviewing the statements, IMC and Westside entered into a complex purchase agreement in December 1979.[12] Under the terms of their agreement the two parties were to buy and sell various governmental loans, including Federal Housing Administration (FHA) loans. To qualify for FHA business, Westside needed to maintain a net worth of at least $100,000, a fact that Butler knew of when

6. 177 Cal. App. 3d 806, 223 Cal. Rptr. 218, *review denied*, 178 Cal. App. 3d 682h (1986).

7. *International Mortgage*, 177 Cal. App. 3d at ___, 223 Cal. Rptr. at 227.

8. H. Rosenblum, Inc. v. Adler, 93 N.J. 324, 461 A.2d 138 (1983) (accountant has duty to all third parties whom the accountant should reasonably foresee as recipients of the audited financial statements, provided the statements are used for proper business purposes).

9. Citizens State Bank v. Timm, Schmidt & Co., 113 Wis. 2d 376, 335 N.W.2d 361 (1983) (accountant can be liable to a third party not in privity for foreseeable injuries resulting from negligent preparation of audited financial statements).

10. *International Mortgage*, 177 Cal. App. 3d at 809, 223 Cal. Rptr. at 219.

11. *Id.* at 810, 223 Cal. Rptr. at 219.

12. *Id.* at 809, 223 Cal. Rptr. at 219.

it conducted the 1978 audit. However, due to the erroneous valuation of the $100,000 note receivable and the deed of trust securing it, Westside was under-capitalized to deal in the FHA insured loan market as required by Westside's contract with IMC.[13]

In April 1980, Westside, pursuant to the original contract, agreed to sell FHA loans to IMC. However, Westside failed to deliver the necessary trust deeds to IMC, causing alleged damages of $475,293. In June 1980, Westside gave IMC a promissory note for the $475,293 and paid $40,000 on the note before defaulting on the balance.[14] When unable to recover the balance from Westside, IMC brought suit against both Westside and Butler to recover the alleged damages.[15] IMC alleged two theories of recovery against Butler, negligence and negligent misrepresentation based on Westside's 1978 financial statements which Butler had audited and issued without qualification.[16]

The parties stipulated that Butler had no knowledge of IMC and was unaware of IMC's receipt of and reliance upon Westside's financial statements. Butler moved for summary judgment, arguing that as a matter of law it did not owe a duty to IMC. The trial court granted the motion, finding that no duty of care existed.[17]

The California Court of Appeals, after rejecting both the privity[18] requirement and the foreseeable user test of the Restatement,[19] held that a certified public accountant does owe a duty of care to reasonably foreseeable third parties who rely on negligently audited and issued unqualified financial statements.[20] The case was then remanded to the trial court for a determination of whether Butler did in fact breach this duty.[21]

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13. *Id.* at 810, 223 Cal. Rptr. at 219.

14. *Id.*

15. IMC originally brought suit against Westside, its owners, principals and Butler, but only IMC's claim against Butler was before the court on appeal. *Id.* at 810 n.1, 223 Cal. Rptr. at 220 n.1.

16. *Id.* at 810, 223 Cal. Rptr. at 220.

17. *Id.*

18. *See infra* notes 37-46 and accompanying text.

19. *See infra* notes 48-61 and accompanying text.

20. *International Mortgage*, 177 Cal. App. 3d at 820, 223 Cal. Rptr. at 227.

21. *Id.* at 821, 223 Cal. Rptr. at 227. The question of what standard of care will be used by the courts in determining whether or not an accountant is negligent is beyond the scope of this Note. In general, however, the accountant's standard of care has been defined to be that of an ordinary reasonable accountant. *See, e.g.*, Bancroft v. Indemnity Ins. Co., 203 F. Supp. 49, 53 (W.D. La. 1962), *aff'd*, 309 F.2d 959 (5th Cir. 1962). Due to the nature of the accounting profession, specifically the aspect of self-regulatory principles, standards and procedures promulgated by the accounting profession itself, courts have held that an accountant's standard of care is determined by requirements of Generally Accepted Accounting Principles (GAAP) and Generally Accepted Auditing Standards (GAAS). *See infra* note 28. However, compliance with GAAP and GAAS does not necessarily immunize the accountant from liability. In United States v. Simon, 425 F.2d 796 (2d Cir. 1969), *cert. denied,*

It has been stated that "[t]here is an obvious lure in suing the accounting firms, for they are frequently the only solvent party left standing in the wake of [a business failure]."[22] The most common ground for recovery asserted against the accountant is negligent misrepresentation.[23]

Negligent misrepresentation involves the communication of information, by words or acts, that is inconsistent with the facts being represented.[24] The

397 U.S. 1006 (1970), the court held that the test for determining whether an accountant breached his duty of care was "whether the financial statements as a whole 'fairly presented the financial condition of [the company as of the audit date] . . . and whether [the financial statements] accurately reported the operations for [the] fiscal [year].'" *Simon*, 425 F.2d at 805 (quoting the trial court); *see also* Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979) (held that the accountant can no longer claim absence of negligence simply because he complied with GAAP and performed his audit in accordance with GAAS); Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, 378 F. Supp. 112, 121 (S.D.N.Y. 1974), *aff'd in part, rev'd in part*, 540 F.2d 27 (2d Cir. 1976) (held that the critical issue in determining whether or not an accountant is negligent is not whether the auditor's report satisfies accounting norms, but whether the report fairly presents the financial position of the audited company).

22. Minow, *supra* note 3, at 76; *see also* Wiener, *supra* note 5, at 234-35. Minow points out that it is no coincidence that the two greatest surges in litigation against accountants have occurred during times of enormous business failures, *i.e.*, during the recessions of the early 1970's and 1980's. Minow, *supra* note 3, at 76.

23. Although this Note is limited to the common law liability of accountants to third parties for negligent misrepresentation, it should be noted that accountants may be subjected to civil statutory liability under the Securities Exchange Act of 1934. Section 1 of the Securities Act of 1933 imposes liability on accountants for material misstatements or omissions in a registration statement filed with the SEC which has become effective. Section 12 of the Securities Act creates liability for any person who offers or sells a security in violation of the registration provisions of the Act or who offers or sells a security by means of a prospectus or oral communication which includes a false statement of a material fact or omits a material fact. Gruenbaum & Steinberg, *Accountants' Liability and Responsibility: Securities, Criminal and Common Law*, 13 LOY. L.A.L. REV. 247, 250 n.22 (1980). Section 18 of the Exchange Act imposes liability on any person who files or causes to be filed a materially false or misleading statement in any application, report or document filed with the SEC under the Securities and Exchange Act of 1934. Gruenbaum & Steinberg, *supra*, at 251 n.23. Section 17(a) of the Securities Act and section 10(b) of the Exchange Act impose liability on accountants via judicially implied private rights of action for damages to a third party due to defective financial statements required to be filed with the SEC. Gruenbaum & Steinberg, *supra*, at 250-51, 264-65.

24. Note, *H. Rosenblum, Inc. v. Adler: A Foreseeably Unreasonable Extension of an Auditor's Legal Duty*, 48 ALB. L. REV. 876, at 876 (1984). The Restatement defines negligent misrepresentation thus:

> One who, in the course of his business, profession or employment, or in any other transactions in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or

statement does not have to be a factual report for the tort to occur, and may consist of an expert opinion.[25] The communicator must possess either "knowledge or a reason to know . . . that the information is desired for a serious purpose [and] that the receiver intends to rely upon it."[26] Finally, the information or opinion must be false or erroneous due to the negligence of the informer, thereby causing the relying party to sustain personal injury or property damage.[27]

Applying this standard to the accountant performing his audit duties,[28] the tort occurs when the accountant fails to exercise that care which an ordinary reasonable accountant would exercise in conducting the audit.[29] The accountant's negligence must, in turn, misinform someone to whom the accountant owes a duty[30] (by way of the end product of the audit—a published

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competence in obtaining or communicating the information.
RESTATEMENT (SECOND) OF TORTS § 552(1) (1977); *see also* Mid-Central Fish Co. v. United States, 112 F. Supp. 792 (D. Mo. 1953), *aff'd*, National Mfg. Co. v. United States, 210 F.2d 263 (8th Cir. 1954), *cert. denied*, 347 U.S. 967 (1954) ("Negligent misrepresentation is a false statement made by one who has no reasonable ground for believing it to be true.").

25. H. Rosenblum, Inc. v. Adler, 93 N.J. 324, ___, 461 A.2d 138, 143 (1983). According to the Restatement, section 552(1) "applies not only to information given as to the existence of facts but also to an opinion given upon facts equally well known to both the supplier and the recipient." RESTATEMENT (SECOND) OF TORTS § 552 comment b (1977).

26. Russell v. First Nat'l Stores, 96 N.H. 471, 497, 79 A.2d 573, 579 (1951); *Rosenblum*, 93 N.J. at ___, 461 A.2d at 143; *see also* 23 AM. JUR. *Fraud and Deceit* § 126, at 917 (1939); 65 C.J.S. *Negligence* § 200, at 427 (1966).

27. RESTATEMENT (SECOND) OF TORTS § 552(1) (1977).

28. The goal of an audit is the rendering of an opinion on the truth and accuracy of a company's financial condition and results of operations in conformity with Generally Accepted Accounting Principles. AICPA, PROFESSIONAL STANDARDS, AU § 110.01 (1982). As one commentator has noted:

> Two principal bodies of rules govern the CPA's audit: (1) the CPA's review of the client's financial statements must be performed in accordance with the profession's established procedure, Generally Accepted Auditing Standards (GAAS); and (2) the CPA must ascertain that the financial statements are prepared in accordance with Generally Accepted Accounting Principles [(GAAP)], which are currently embodied in Financial Accounting Standards (FAS).

Note, *An Appraisal of Arthur Young: A Valuable Privilege for Accountants*, 48 ALB. L. REV. 109, 110 n.4 (1984).

29. *See supra* note 21.

30. The issue of to whom an accountant owes a duty of care is the subject of the remainder of this Note. A brief overview of the different views courts have taken on this issue may be helpful for a fuller understanding. One view taken is that the accountant owes a duty only to those persons with whom he is in privity. *See infra* notes 37-47 and accompanying text. The second view, taken by a majority of the courts, is that the accountant owes a duty to all persons for whose benefit and guidance he intends to supply the information or knows will be supplied with the

report of the financial condition of the company being audited,[31] along with the accountant's written opinion on the accuracy and fairness of that report).[32] Finally, the person or persons who receive the report, and to whom

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information. *See infra* notes 48-52 and accompanying text. The last view, held by a small number of courts, is that the accountant owes a duty of care to all persons whom the auditor should reasonably foresee as receiving the audit report. *See infra* notes 58-83 and accompanying text.

31. As stated in the Handbook of Modern Accounting:

> Audits of financial statements by independent public accountants are required by stock exchanges, regulatory bodies such as the Securities and Exchange Commission, many creditors, and others. Audited financial statements are of major importance because they involve an examination of the accounting system and records of a firm according to the generally accepted auditing standards of the accounting profession.

S. Davidson & R. Weil, Handbook of Modern Accounting 2-3 (2d ed. 1977). The audited financial statements make up the first part of the audit report. In discussing audited financial statements, Davidson and Weil state:

> According to Accounting Principles Board (APB) Statement No. 4 [1970], if financial statements are to present fairly the financial position and results of operations of an enterprise in conformity with generally accepted principles, they must include the following:
>
> 1. Balance Sheet
> 2. Income Statement
> 3. Statement of changes in retained earnings [(in the case of sole proprietorship & partnership forms of business there must be a statement of changes in Owner's Equity)].
> 4. Statement of changes in financial position.
> 5. Disclosure of changes in other categories of shareholders' equity.
>
> A balance sheet (or statement of financial position) presents the financial status of an enterprise at a particular time. It sets forth a firm's (1) assets, (2) liabilities, and (3) owner's equity.
>
> An income statement indicates the results of an enterprise's profit-directed activities during the period of time covered. It reports on the firms' revenues, expenses, gains, losses and the resultant net income (or loss).
>
> A statement of changes in retained earnings summarizes the transactions that occurred during the accounting period that affected retained earnings. Retained earnings represents the cumulative earnings of the enterprise that have not been distributed to the owners. Changes in retained earnings are brought about in recognition of income, the payment of dividends and the adjustment of income of prior periods. The statement of changes in retained earnings reconciles the retained earnings at the beginning of the period with those at the end.
>
> Changes in other owner's equity accounts may be reported in a variety of ways, including a separate statement. These changes are attributable to the issue and retirement of shares, stock dividends, stock splits, and any other adjustments that affect the interests of the owners.

S. Davidson & R. Weil, Handbook of Modern Accounting 2-2 to 2-3 (3d ed. 1983).

32. The second part of an audit report is the auditor's opinion on the fairness with which the financial statements "present financial position, results of operations,

the accountant owes a duty, must be injured as a foreseeable result of their reliance upon the false information contained in the report.

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and changes in financial position in conformity with generally accepted accounting principles." AICPA, PROFESSIONAL STANDARDS, AU § 10.01 (1982). An auditor must comply with the following GAAS standards as set forth by the AICPA, in order to express an opinion on the financial statement's fairness:

General Standards:

1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.
3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.

Standards of Field Work:

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
2. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.
3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

Standards of Reporting:

1. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.
2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.
3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
4. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.

AICPA, PROFESSIONAL STANDARDS, AU § 150.02 (1982). Upon completion of an examination as required by the above standard, an auditor can issue one of four opinions:

> When the auditor is satisfied that the statements do present fairly what they purport to present and are consistent with the statements of the prior years, he will issue [an] . . . unqualified, or "clean," opinion. . . . When either the scope or the findings of the audit are such that an unqualified opinion on the statements taken as a whole is not appropriate, the auditor will issue a qualified opinion, an adverse opinion, or a disclaimer of an opinion. . . .
>
> Any time a qualified opinion is issued, the nature of the qualification must be [fully disclosed, and should include] the reasons for the qualification, the subject of the qualification, and the effect of the item(s). . . .
>
> An adverse opinion is issued when there is sufficient information for

Traditionally, the key element in this equation of liability was duty, for without it there can be no liability.[33] In the accounting context, this duty arises whenever the accountant is hired by a company to conduct an audit. However, it has been said that in reality the term duty is just "a shorthand statement of a conclusion rather than an aid to analysis in itself [and is] only an expression of the sum total of those considerations of policy which lead the law to say that a particular plaintiff is entitled to protection."[34] In general, a court will find a duty where reasonable persons would recognize and agree that a foreseeable possibility of harm exists due to the negligent act of another.[35] However, in cases where the harm suffered is only economic in nature, some courts have become alarmed at the possibility of limitless liability and have developed more restrictive rules to limit the scope of a person's duty.[36]

The courts' earliest application of the duty doctrine to the accounting profession exemplifies their attempt to limit the scope of an accountant's duty. The view expressed by all jurisdictions at the time limited the accountant's duty to those persons with whom the accountant was in privity.[37] The most prominent expression of this view, and truly the starting point for any discussion of accountant liability to third parties, was that of Chief Judge Benjamin Cardozo in *Ultramares Corp. v. Touche, Niven & Co.*[38] In *Ultra-*

> the auditor to form an opinion and the opinion is that the statements taken as a whole do not present fairly the financial position and the results of operations. . . .
>
> When the auditor does not have sufficient information upon which to base an opinion, he will disclaim an opinion on the statements taken as a whole and include a paragraph stating all his reasons for the disclaimer.

CASHIN, HANDBOOK FOR AUDITORS 6-17 (1982).

33. *See* St. John Bank & Trust Co. v. City of St. John, 679 S.W.2d 399 (Mo. Ct. App. 1984) (first element required for a claim of actionable negligence is the existence of a duty on the part of defendant to protect plaintiff from injury); Pulka v. Edelman, 40 N.Y.2d 781, 358 N.E.2d 1019, 390 N.Y.S.2d 393 (1976) (before a person may be held liable to another for negligence, it must be shown that defendant owes a duty to plaintiff); Monroe v. New York, 67 A.D.2d 89, 414 N.Y.S.2d 718 (1979) (in order to recover for negligence, plaintiff must establish that defendant owed him a duty of care).

34. W. PROSSER, LAW OF TORTS § 53, at 325-26 (1971).

35. *Id.*

36. W. PROSSER & W. KEETON, PROSSER AND KEETON ON TORTS § 107, at 745 (1984).

37. For purposes of this Note, privity refers to privity of contract. For a detailed discussion of privity of contract, see Ralph Wolff & Sons v. New Zealand Ins. Co., 248 Ky. 304, 307, 58 S.W.2d 623, 624-25 (1933) (privity of contract is a relationship that exists between parties and implies mutuality of will and interaction of parties arising from contract).

38. 255 N.Y. 170, 174 N.E. 441 (1931). Although *Ultramares* is generally considered to be the most important case addressing the issue of accountant liability to third parties, and is normally brought up by all commentators when the topic of

mares, Fred Stern and Company (Stern) employed Touche to prepare and certify a balance sheet of the company. Thirty-two numbered copies of the certified financial statements were supplied to Stern to be used as the needs of the business dictated. The balance sheet, prepared by Touche, negligently overvalued Stern's assets, thus creating a misleading report of the company's financial condition.[39] Ultramares, who had loaned money in reliance upon the information contained in Stern's financial statements, successfully sued Touche in the lower courts for negligent misrepresentation. The New York Court of Appeals, with Judge Cardozo writing for an unanimous court, reversed the lower court's decision.[40] Cardozo absolved Touche by stating: "[I]f liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class."[41] Cardozo concluded that in the absence of acts constituting fraud,[42] an accountant could not be held liable to third parties lack-

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accountant liability is discussed, it is not the earliest case to discuss this issue. In Landell v. Lybrand, 264 Pa. 406, 107 A. 783 (1919), the Pennsylvania Supreme Court held that an accountant was not liable to a third party for misstatements in the financial statements upon which the third party relied on in purchasing stock. The court reasoned that in order for liability to attach there must be some breach of duty by the accountant (defendant). Since there existed no contractual relation between plaintiff and defendant, and since the plaintiff was unknown to the defendant, the court found no duty and therefore no breach. *Lybrand*, 264 Pa. at 408, 107 A. at 783.

39. *Ultramares*, 255 N.Y. at 173-74, 174 N.E. at 442. The financial statements as prepared by Touche listed the assets of Stern at $2,550,671.88 and the liabilities at $1,479,956.62, thus showing a net worth of $1,070,715.26. In reality, the corporation was insolvent. The plaintiff claimed that Touche was negligent in that the audit was not conducted properly so as to reveal the true financial condition of Stern. The trial court awarded the plaintiff $187,576.32, based upon the default of Stern on loans extended by Ultramares in reliance upon Touche's certification of Stern's financial condition. *Id.* at 173-74, 174 N.E. at 442-43.

40. *Id.* at 193, 174 N.E. at 451.

41. *Id.* at 179-80, 174 N.E. at 444. This famous quotation has been compared by one commentator to the "slippery slope" argument, which states that one reason for not allowing liability in this instance is that it will open the flood-gates to future claims in which there is no stopping point. Wiener, *supra* note 5, at 247. However, as Judge Cardozo stated: "The hazards of a business conducted on these terms [in which an accountant would be exposed to liability of limitless proportion] are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences." *Ultramares*, 255 N.Y. at 179-80, 174 N.E. at 444. It appears that Judge Cardozo was expressing concern over the chilling effect such a broad scope of liability would have on the accounting profession.

42. The subject of accountant liability for fraud is beyond the scope of this Note. A brief discussion of the elements of fraud in the accounting context, however, may be helpful in distinguishing this cause of action from negligent misrepresentation.

Fraud includes an intentional false representation of a present or past fact, action ing the requisite privity of contract and whose reliance on the audit report was not actually foreseen at the time it was prepared.[43]

From 1931 to the late 1960s, the *Ultramares* opinion dominated the law governing accountant liability to non-clients.[44] There have been many theories offered for the long-standing influence of *Ultramares*' restricted view. They have included the "logic of the holding [and] the status of [Judge] Cardozo."[45] Whatever the reason, it was not until the 1970s that a number of courts began to adopt the slightly broader scope of accountant liability as expounded by the Restatement (Second) of Torts.[46]

The Restatement drafters apparently sensed the growing concern expressed by many legal commentators over the ability of the accounting profession to hide behind the privity doctrine. As a result of this, and a study commenced in the early 1960s, they published section 552 of the Restatement (Second) of Torts in 1977.[47] It expanded "an accountant's liability to the

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in reliance thereupon by another, and injury resulting due to that reliance. Citizens Standard Life Ins. Co. v. Gilley, 521 S.W.2d 354, 356 (Tex. Ct. App. 1975). An accountant, however, may be liable for fraud even where there is lacking a deliberate intent to deceive or active fraud. State Street Trust Co. v. Ernst, 278 N.Y. 104, 112, 15 N.E.2d 416, 418 (1938). The *State Street Trust* court stated:

> A refusal to see the obvious, a failure to investigate the doubtful, if sufficiently gross, may furnish evidence leading to an inference of fraud so as to impose liability for losses suffered by those who rely on the balance sheet. In other words, heedlessness and reckless disregard of consequence may take the place of deliberate intention.

State Street Trust, 278 N.Y. at 112, 15 N.E.2d at 418-19.

43. *Ultramares*, 255 N.Y. at 189, 174 N.E. at 448.

44. Gormley, *The Foreseen, The Foreseeable, and Beyond — Accountant's Liability to Nonclients*, 34 DEF. L.J. 75, 78 (1985).

45. Wiener, *supra* note 5, at 236.

46. Comment, *Adjusting Accountant's Liability for Negligence*, 13 BALT. L. REV. 301 (1984). The majority of those cases involving the issue of accountant liability resolved on the basis of "the degree of wrong-doing" and "the relationship of the parties," have endorsed the Restatement's position. Gavin, Hicks & Decosimo, *CPA's Liability to Third Parties*, 157 J. ACCT. 84 (June 1984). The cases include: Merit Ins. Co. v. Colao, 603 F.2d 654 (7th Cir. 1979); Nortek Inc. v. Alexander Grant & Co., 532 F.2d 1013 (5th Cir. 1976); Briggs v. Strener, 529 F. Supp. 1155 (S.D. Iowa 1981); Shofstall v. Allied Van Lines, Inc., 455 F. Supp. 351 (N.D. Ill. 1978); Berkowitz v. Baron, 428 F. Supp. 1190 (S.D.N.Y. 1977); Coleco Indus. v. Berman v. Zelnick, Sobelman & Co., 423 F. Supp. 275 (E.D. Pa. 1976); Investors Tax Shelter Real Estate, Ltd. v. Laventhol, Krekstein, Horwath & Horwath, 370 So. 2d 815 (Fla. Dist. Ct. App. 1979); Bonhiver v. Graff, 311 Minn. 111, 248 N.W.2d 291 (1976); Spherex v. Alexander Grant & Co., 122 N.H. 898, 451 A.2d 1308 (1982); White v. Guarente, 43 N.Y.2d 356, 372 N.E.2d 315, 401 N.Y.S.2d 474 (1977); Dworman v. Lee, 83 A.D.2d 507, 441 N.Y.S.2d 90 (1981); Haddon View Inv. Co. v. Coopers & Lybrand, 70 Ohio St. 2d 154, 436 N.E.2d 212 (1982); United States National Bank of Oregon v. Fought, 291 Or. 201, 630 P.2d 337 (1981).

47. Section 552 holds an accountant liable for negligent misrepresentation for losses suffered:

person or limited classes of persons whose reliance upon the negligent misrepresentation [should have been] *foreseen* or [was] *specifically foreseen* by the accountant."[48] However, under the Restatement's view, liability is not extended to all parties whom the accountant might reasonably foresee as using the information.[49]

Liability under the foreseen use test is limited by two factors. "First, the loss must be sustained by a person or persons of a limited group 'for whose benefit and guidance' the informer knew or intended to be supplied the information."[50] Second, the loss encountered must be both the result of reliance upon the supplied information, and take place in a transaction in which the informer contemplated influencing or one "substantially similar" in nature.[51] Also, under this view, the plaintiff has the burden of showing that he falls within the specifically foreseen group.[52] These limitations have led the courts and many commentators to begin to search for a more equitable standard with which to determine to whom the accountant owes a duty of care.

The basic factual situations of the three recent cases which adopted the foreseeable user test are remarkably similar.[53] All involved situations where accountants were hired to perform an annual audit and had issued an unqualified opinion[54] stating that the financial statements fairly represented the

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> (a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it; and (b) through reliance upon it in a transaction that he intends the information to influence or knows that the recipient so intends or in a substantially similar transaction.

RESTATEMENT (SECOND) OF TORTS § 552(2)(a), (2)(b) (1977).

48. Gormley, *supra* note 44, at 77 (emphasis in original).

49. RESTATEMENT (SECOND) OF TORTS § 552 comments h, i, j, illustrations 5-7, 10 (1977).

50. Comment, *supra* note 46, at 308.

51. *Id.*

52. *Id.*

53. *See International Mortgage*, 177 Cal. App. 3d at 809, 223 Cal. Rptr. at 219; H. Rosenblum, Inc. v. Adler, 93 N.J. 324, ___, 461 A.2d 138, 141 (1983); Citizens State Bank v. Timm, Schmidt & Co., 113 Wis. 2d 376, 378, 335 N.W.2d 361, 362 (1983).

54. An unqualified opinion has been described as follows:

> The standard short-form unqualified opinion recommended by the American Institute of Certified Public Accountants consists of a statement describing the nature of the examination, usually referred to as the scope of the examination, and an expression of the auditor's opinion.
>
> Unqualified opinion. Wording for the standard short-form report follows:
>
> (Scope)
>
> We have examined the balance sheet of X Company as of (at) December 31, 19XX, and the related statements of income, retained earnings and changes in financial position for the year then ended. Our examination was

financial condition of the company and were prepared according to generally accepted accounting principles.[55] In each case a third party plaintiff relied on the accuracy of the financial statements before engaging in conduct that subsequently resulted in financial loss.[56] Finally, the plaintiffs in each case claimed that the negligence which allowed the mistaken information to go undetected was of the kind that could have been uncovered had the audit been performed according to generally accepted auditing procedures.[57]

All three courts reached the same conclusion: the scope of an accountant's liability is not limited to those in privity or those within a limited class of persons; there exists a duty to all foreseeable users of the unqualified financial statements.[58] The fundamental principle of the foreseeable user test

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> made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.
>
> (Opinion)
>
> In our opinion, the financial statements referred to above present fairly the financial position of X Company as of (at) December 31, 19XX, and the results of its operations and the changes in its financial position for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.
>
> Typically the report is addressed to the company whose financial statements are being examined or to its shareholders or board of directors.

S. DAVIDSON & R. WEIL, *supra* note 31, at 1-24. For a brief discussion of the other types of opinions an auditor may issue, see *supra* note 32.

55. AICPA, PROFESSIONAL STANDARDS, AU § 509.28 (1985).

56. *International Mortgage*, 177 Cal. App. 3d at 810, 223 Cal. Rptr. at 220 (plaintiff entered into agreement to buy and sell government loans with audited company which subsequently failed to fulfill its contractual obligation causing alleged damages of $475,293); *Rosenblum*, 93 N.J. at ___, 461 A.2d at 140 (plaintiffs allegedly relied on audited financial statements and acquired audited company's common stock in conjunction with sale of their business to the audited company; said common stock later found to be worthless); *Citizens State Bank*, 113 Wis. 2d at 378, 335 N.W.2d at 362 (plaintiff loaned $300,000 in reliance upon audited financial statements containing material errors; borrower subsequently forced into bankruptcy while still owing over $150,000 to plaintiff).

57. In *International Mortgage*, the error claimed was the valuation of a note receivable at $100,000, when in reality the note was worthless due to the mortgage securing the note being wiped out at a foreclosure sale of a senior lien. In *Rosenblum*, the error claimed was the failure to detect falsely recorded and non-existent assets as well as the omission of substantial liabilities which, when discovered, rendered the company insolvent. In *Citizens State Bank*, the error claimed was the failure to discover financial statements containing a number of material errors totalling over $400,000.

58. *International Mortgage*, 177 Cal. App. 3d at 820, 223 Cal. Rptr. at 227 ("An independent auditor owes a duty of care to reasonably foreseeable plaintiffs who rely on negligently prepared and issued unqualified audited financial statements."); *Rosenblum*, 93 N.J. at ___, 461 A.2d at 153 ("When the independent auditor furnishes an opinion with no limitations in the certificate as to whom the

is that an accountant should be fully liable for all foreseeable consequences of his acts. A number of policy arguments have been advanced by courts and commentators alike on both sides of the question as to whether or not the foreseeable user test is appropriate in the accounting context.

The issue of whether a particular person owes a duty to another is ultimately a question of fairness.[59] "The inquiry involves a weighing of the relationship of the parties, the nature of the risk, and the public interest in the proposed solution."[60] Once a balancing of the conflicting interests is done, it is apparent that fairness dictates the imposition of liability upon the accountant for his negligence to all foreseeable persons.

The relationship between the accounting profession and the public has changed dramatically from the time *Ultramares* was decided. At that time, "[t]he [accounting] profession . . . was in its infancy, professional standards were not rigorous and the typical audit entailed substantially less work. . . ."[61] Also, "the primary responsibility of an auditor [accountant] was to the owner of a business to report on the operation of that business and to detect fraud and embezzlement. . . ."[62] "The enactment of the [federal securities acts], however, marked a new beginning for financial reporting in the United

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company may disseminate the financial statements, he has a duty to all those whom the auditor should reasonably foresee as recipients from the company of the statements for its proper business purposes, provided that the recipients rely on the statements pursuant to those business purposes."); *Citizens State Bank*, 113 Wis. 2d at 386, 335 N.W.2d at 366 ("Liability will be imposed on . . . accountants for the foreseeable injuries resulting from their negligent acts unless, under the facts of the particular case, as a matter of policy to be decided by the court, recovery is denied on grounds of public policy.").

59. Goldberg v. Housing Auth. of Newark, 38 N.J. 578, 583, 186 A.2d 291, 293 (1962).

60. *Goldberg*, 38 N.J. at 583, 186 A.2d at 293; *see also* Harper v. Epstein, 16 Ill. App. 3d 771, 773, 306 N.E.2d 690, 691-92 (1974); Wall v. McGavok, 132 Ill. App. 2d 231, 234, 267 N.E.2d 765, 767 (1971); *Suter*, 81 N.J. at 172-73, 406 A.2d at 151; 2 F. HARPER & F. JAMES, LAW OF TORTS § 18.6, at 1052 (1956).

61. *See* Comment, *Adjusting Accountant's Liability for Negligence*, 13 BALT. L. REV. 301, 311 (1983) (quoting Volz, *Accountant's Liability to Third Persons: Resistance in Negligence*, 9 BARRISTER 31, at 31 (Fall 1982)); *see also* D. CAUSEY, DUTIES AND LIABILITIES OF PUBLIC ACCOUNTANTS 37-40 (rev. ed. 1982); Hallett & Collins, *Auditors' Responsibility for Misrepresentation: Inadequate Protections for Users of Financial Statements*, 44 WASH. L. REV. 139, 178 (1968); Note, *Accountants' Liability for Negligence — A Contemporary Approach for a Modern Profession*, 48 FORDHAM L. REV. 401, 405 (1979).

62. Wiener, *supra* note 5, at 250 ("As to the function of the audit itself there has indeed been a considerable change since 1931 in the relationship between accounting firms and third persons."); *see also* Ultramares v. Touche, Niven & Co., 255 N.Y. 170, 183, 174 N.E. 441, 446 (1931) (function of audit is primarily for the development of the business, and only "incidentally or collaterally" for use of third parties); D. CAUSEY, *supra* note 61, at 37-40; Volk, *supra* note 61, at 31; Comment, *supra* note 61, at 311.

States."[63] "Today, the audit of a company's financial statements is done largely for the benefit of third parties."[64] The responsibility of an accountant now

> is not only to the client who pays his fees, but also to investors, creditors and others who may rely on the financial statements which he certifies. . . . The public accountant must report fairly on the facts as he finds them whether favorable or unfavorable to his client. His duty is to safeguard the public interest, not that of his client.[65]

The accounting profession also recognizes this duty to third parties.[66] The American Institute of Certified Public Accountants emphasizes the profession's duty to the public. This duty has expanded due to the increased number of outside investors, the impersonal relationship between owners and management of companies, and governmental reliance on accurate accounting information.[67]

Due to the present role of the accounting profession, it becomes apparent that when a provider of information attests to the validity of that information and intends that it be used by third parties, equity demands that the provider

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63. Comment, *supra* note 61, at 313. One commentator has stated:

> The standards of the accounting profession became much more exacting following the stock market crash of 1929. . . . The Securities and Exchange Commission (SEC), established in the Securities Exchange Act of 1934, took the profession to task in a 1940 accounting release arising from the auditing practices uncovered in the McKesson & Robbins case [SEC Accounting Services Release No. 19, *In re* McKesson & Robbins, Inc. (1940), reprinted in 5 Fed. Sec. L. Rep. (CCH) § 72,020 (1977)].

Volz, *supra* note 61, at 32; *see also* G. PREVITS & B. MERINO, A HISTORY OF ACCOUNTING IN AMERICA 204-05 (1979); Comment, *supra* note 61, at 313.

64. Wiener, *supra* note 5, at 250. The SEC in a 1957 release stated, "The responsibility of a public accountant is not only to the client who pays his fee, but also to investors, creditors and others who may rely on the financial statements which he certifies." Volz, *Accountant's Legal Liability to Third Persons: Resistance in Negligence*, 9 Barrister 31, at 32 (Fall 1982) (quoting SEC Accounting Series Release No. 78, *In re* Touche, Niven, Baily & Smart (1957), reprinted in 5 Fed. Sec. L. Rep. (CCH) § 72,100, at 62,220 (1977)).

65. Fischer v. Kletz, 266 F. Supp. 180, 184 (S.D.N.Y. 1967) (quoting *In re* Touche, Niven, Baily & Smart).

66. Section 51.02 of PROFESSIONAL STANDARDS states: "The reliance of the public, the government and the business community on sound financial reporting and advice on business affairs . . . impose particular obligations on certified public accountants." AICPA, PROFESSIONAL STANDARDS, ET § 51.02 (1985).

67. Section 51.04 of PROFESSIONAL STANDARDS states: "The ethical code of the American Institute emphasizes the profession's responsibility to the public, a responsibility that has grown as the number of investors has grown, as the relationship between corporate managers and stockholders has become more impersonal, and as government increasingly relies on accounting information." AICPA, PROFESSIONAL STANDARDS, ET § 51.04 (1982).

be held responsible for any harm caused by inaccurate information to the very persons for whose use the information was intended.

Numerous policy considerations support holding accountants liable to all foreseeable persons. First, "[t]he negligent accountant should be the one to bear the loss caused by the negligence, as opposed to the innocent third party who [justifiably] relied upon the financial statements."[68] This is consistent "with [the] general social policy considerations suggesting that risk of loss should be imposed on the party best able to prevent its occurrence."[69] Most third party users of financial statements possess neither the financial resources nor the expertise needed to guard against the accountant's negligence.[70] Since the accountant is the preparer of the financial statements, it seems only "fair" that he should be responsible for the harm caused by his negligence.

Second, it is "the accountant [and not the third party, who] can better spread the cost of liability through . . . malpractice insurance."[71] Through the use of such insurance, accountants can effectively shift the risk of their negligence throughout the marketplace.[72] By passing the cost of insurance on to the client, and eventually the consuming public, the accountant is able to spread the cost of his negligence to all users of financial statement information, rather than placing the entire brunt of such negligence on a small number of innocent third parties. Those opposing the existence of liability insurance as a justification for expanding liability point to the prohibitive costs involved.[73] This argument, however, neglects to consider the effect of risk distribution[74] and the fact that accountants have apparently been able to obtain insurance or otherwise satisfy their financial obligations for liability

68. *See* Leibensperger, *The Erosion of Ultramares: Expansion of Accountant's Liability to Third Parties for Negligence*, 69 MASS. L. REV. 54, 56 (1984).

69. Wiener, *supra* note 5, at 253 (quoting Escola v. Coca Cola Bottling Co., 24 Cal. 2d 453, 462, 150 P.2d 436, 440-41 (1944) (Traynor, J., concurring)); *see also* A & M Produce Co. v. FMC Corp., 135 Cal. App. 3d 473, 493, 186 Cal. Rptr. 114, 126 (1982).

70. Wiener, *supra* note 5, at 252.

71. Leibensperger, *supra* note 68, at 56.

72. *See* Rusch Factors, Inc. v. Levin, 284 F. Supp. 85, 90-91 (D.R.I. 1968); Rosenblum v. Adler, 93 N.J. 324, 348 & n.11, 461 A.2d 138, 151-52 & n.11 (1983); Citizens State Bank v. Timm, Schmidt & Co., 113 Wis. 2d 376, 384, 335 N.W.2d 361, 365 (1983); *see also* Mess, *Accountants and the Common Law: Liability to Third Parties*, 52 NOTRE DAME L. REV. 838, 856 (1977).

73. *See Liability Lawsuits: The Profession Fights Back*, J. ACCT., May 1983, at 131. *But see Rosenblum*, 93 N.J. at 349-50 n.11, 461 A.2d at 151 n.11 (court noted defendant's claim that cost to insure against claims of all foreseeable users of audited financial statements would be astronomical, but held there was no data to support this argument either on or off the record).

74. Mess, *supra* note 72, at 856 ("While insurance is becoming difficult to obtain and expensive to maintain, the cost of the insurance can be effectively spread over a large segment of the public."); *see also* Comment, *supra* note 61, at 320.

imposed for misstatements of material facts under the Securities Act of 1933.[75]

Third, accountants should be held to the same degree of responsibility as those in other professions.[76] Opponents point out, however, that the accountant's lack of control over his client's records and the ultimate use to which the audit product is put distinguishes the accountant from other professions, and therefore requires a limited scope of liability.[77] This analysis is lacking in two respects. First, it misunderstands the role of the accountant when he is performing his audit duties. The goal of auditing is to verify the accuracy of a company's financial data, not to control the reporting of it.[78] Therefore, the amount of control an auditor has over his client's records is unimportant, the accountant only needs to control the way in which he conducts the audit. Second, the manner in which the audit product is used is taken into account in determining the reasonableness of the third party's reliance.[79] Thus, if the third party uses the audited financial report in an unrealistic manner or in a manner that was never intended either explicitly

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75. As stated in *Rosenblum:*

> Accountants have been able to obtain insurance covering their liability under the securities laws. While such liability is imposed under different circumstances, it is often easier to establish and can be similar in amount to that imposed here [when the accountant is held liable to all foreseeable users of the audited financial statements]. In 1976, a survey taken by the Practicing Law Institute indicated that accounting firms had little difficulty in obtaining insurance at a reasonable cost.

Rosenblum, 93 N.Y. at 349-50 n.11, 461 A.2d at 151 n.11; *see also* Levine & Marks, *Accountant's Liability Insurance Perils and Pitfalls*, J. ACCT., Oct. 1976, at 57.

76. Leibensperger, *supra* note 68, at 56.

77. *See* Note, *H. Rosenblum, Inc. v. Adler: A Foreseeably Unreasonable Extension of an Auditor's Legal Duty*, 84 ALB. L. REV. 876, 896-902 (1984). *See generally* Gormly, *The Foreseen, The Foreseeable and Beyond — Accountants' Liability to Nonclients*, 14 SETON HALL 528 (1984); Comment, *Accountant's Liability to the Third Party and Public Policy: A Calabresi Approach*, 39 SW. L.J. 689 (June 1985).

78. *See* United States v. Arthur Young & Co., 465 U.S. 805 (1984). In *Arthur Young*, the Court described the role of an auditor, stating:

> By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust. To insulate from disclosure a certified public accountant's interpretations of the client's financial statements would be to ignore the significance of the accountant's role as a disinterested analyst charged with public obligations.

Arthur Young, 465 U.S. at 817-18.

79. *See* RESTATEMENT (SECOND) OF TORTS § 552 (1977) (justifiable reliance upon the false information is necessary for a claim of negligent misrepresentation).

or implicitly by the auditor, the third party's reliance on the report will be unreasonable and liability will not attach.[80]

One final criticism levied at the foreseeable user standard is that it "introduces uncertainty since the accountant may not be able to predict whom a court might ultimately find to be within the class of reasonably foreseeable users of the financial statements."[81] However, the courts that have adopted this standard have indicated a list of factors which are to be taken into account in determining if a duty exists.[82] In addition, this problem of uncertainty is going to be present whenever a new standard of conduct is declared by the courts—in that adjudication is designed to answer specific questions about specific situations. Finally, as always legislators have the opportunity to step in and declare with specificity to whom an accountant owes a duty of care.[83]

The evolution of the accounting profession and the function of the audit has developed to the point where it is no longer equitable to limit the scope of accountant's liability. Due to the ability of the accounting profession to better spread the cost of liability, the idea that a broader scope of liability will make accountants more careful in the execution of their responsibilities, and the perceived equity of a negligent accountant bearing the loss caused by his own negligence, courts are no longer justified in holding the accounting profession to a different standard of liability than that applied to other professions.

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80. *Id.*

81. Leibensperger, *supra* note 68, at 56.

82. In Citizens State Bank v. Timm, Schmidt & Co., a Wisconsin court pointed out that there may be a number of factors that would justify not imposing liability even though it can be shown by the plaintiff that the defendant's negligence caused the injury. The court listed the following six factors:

> (1) The injury is too remote from the negligence; or (2) the injury is too wholly out of proportion to culpability of the negligent tort-feasor; or (3) in retrospect it appears too highly extraordinary that the negligence should have brought about the harm; or (4) because allowance of recovery would place too unreasonable a burden on the negligent tort-feasor; or (5) because allowance of recovery would be too likely to open the way for fraudulent claims; or (6) allowance of recovery would enter a field that has no sensible or just stopping point.

Citizens State Bank v. Timm, Schmidt & Co., 113 Wis. 2d 376, ____, 335 N.W.2d 361, 366 (1983) (citations omitted).

83. Wiener, *supra* note 5, at 236 n.10.