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LIABILITY TO NON-CLIENTS: THE ACCOUNTANT'S ROLE AND RESPONSIBILITY

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The expansion of legal liability, especially in the professional service and manufacturing industries, has been a major characteristic of American civil law in this century.¹ A rare exception to this development has involved the

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1. See O'Brien, *The Legal Environment of the Accounting Profession*, 25 DUQ. L. REV. 283 (1987) where the author notes, "[t]he days when professions were largely autonomous, self-regulated and immune from significant external legal influences are over." *Id.* at 283. "The liability of all professionals is expanding at an unprecedented pace, as legal theories that would have been unthinkable twenty years ago are pursued with relish." *Id.* at 283 n.2. Another commentator notes, "[p]rofessions once seemingly inviolate from litigation are no longer sacrosanct. The age old axiom that physicians bury their mistakes while attorneys . . . file theirs away has little relevance in modern day America." Mess, *Accountants and the Common Law: Liability to Third Parties*, 52 NOTRE DAME L. REV. 838, 838 n.1 (1977) (citing Eizenstat & Speer, *Accountants' Professional Liability: Expanding Exposure*, 22 FED. INS. COUNS. Q. 7 (1972)). See also Cotchett, *Liability of Accountants and Lawyers*, 23 TRIAL 28, 29 (April 1987). "[T]he trend of judicial decisions dealing with professional liability has been toward holding professionals responsible to third-party non-clients . . ." *Id.* If increased litigiousness is any measure, a virtual explosion of liability is taking place. In 1982 there were 206,193 civil lawsuits filed in federal court, twice the number filed in 1974, and three and a half times the number filed in 1960. Federal appeals jumped sevenfold between 1960 and 1982. The number of state suits increased by 22% between 1977 and 1982, and state appeals increased by 32% in the same period. Minow, *Accountants' Liability and the Litigation Explosion*, 58 J. ACCT. 70 (1984). These developments have been attributed to the combined result of creative litigators, deep pockets, expanded theories of tort liability, consumer awareness, and commercial greed. Weiner, *Common Law Liability of the Certified Public Accountant for Negligent Misrepresentation*, 20 SAN DIEGO L. REV. 233, 234 (1983). See also Comment, *Liability to Third Parties for Economic Injury: Privity as a Useful Animal, or a Blind Imitation of the Past*, 12 SW. L.J. 87, 113-16 (1981) [hereinafter Comment, *Privity*]. For cases that have expanded liability in the professional services and manufacturing industries, see *Molien v. Kaiser Found. Hosp.*, 27 Cal. 3d 916, 923, 616 P.2d 813, 817, 167 Cal. Rptr. 831, 835 (1980) (physicians); *J'Aire Corp. v. Gregory*, 24 Cal. 3d 799, 804-05, 598 P.2d 60, 63, 157 Cal. Rptr. 407, 409 (1979) (general contractors); *Tarasoff v. Regents of Univ.*, 17 Cal. 3d 425, 434-35, 551 P.2d 334, 342-43, 131 Cal. Rptr. 14, 22-23 (1976) (psychiatrists); *Greenman v. Yuba Power Prods., Inc.*, 59 Cal. 2d 57, 62, 377 P.2d 897, 900, 27 Cal. Rptr. 697, 700 (1963) (tool manufacturers); *Lucas v. Hamm*, 56 Cal. 2d 583, 589, 364 P.2d 685, 687, 15 Cal. Rptr. 821, 823 (1961) (notaries public); *Huber, Hunt & Nichols, Inc. v. Moore*, 67 Cal. App. 3d 278, 301, 136 Cal. Rptr.

accounting profession: courts have insulated accountants from liability to any parties beyond their direct clients.² Changes in the law are now occurring, however, that will significantly affect the legal responsibility of accountants.³

The legal controversy focuses on the fairness of permitting those entities that lack privity of contract with the accountant to recover damages for negligent misrepresentation.⁴ A typical scenario begins when a third party who is interested in doing business with a company — extending credit, buying stock or writing an insurance policy — relies on an audit of the business provided by the accountant in reaching a positive decision. Unknown to the third party, the

603, 617 (1977) (architects); *M. Miller Co. v. Central Contra Costa Sanitary Dist.*, 198 Cal. App. 2d 305, 308, 18 Cal. Rptr. 13, 15 (1961) (engineers); *MacPherson v. Buick Motor Co.*, 217 N.Y. 382, 390, 111 N.E. 1050, 1053 (1926) (car manufacturers). *See also* *United States v. Kubrick*, 444 U.S. 111 (1979) (applying negligence standard to physicians); *Maggipinto v. Reichman*, 607 F.2d 621 (3d Cir. 1979) (applying negligence standard to dentists); *Nauman v. Harold K. Beecher & Assoc.*, 24 Utah 2d 172, 467 P.2d 610 (1970) (applying negligence standard to architects). *See generally* RESTATEMENT (SECOND) OF TORTS §§ 284, 289, 291 (1981).

2. *See infra* note 11.

3. There has been an expansion in the scope of an accountant's civil liability for negligence as most jurisdictions now concede that at least under certain circumstances the accountant has some legal responsibility to third parties. The pivotal issue is to which third parties a duty is owed. *See infra* notes 10-14; *see also* Annotation, *Liability of Public Accountant to Third Parties*, 46 A.L.R. 3d 979, 984-96 (1972). There has also been a dramatic rise in the number of lawsuits brought against accountants. *Minow, supra* note 1, at 76 (accountants had been largely unaffected by any growing litigation concerns, "but the proliferation of lawsuits against them since the 1970's have drawn accountants into the midst of the legal thicket"); Collins, *Professional Liability: The Situation Worsens*, J. ACCT., Nov. 1985, at 60 ("A recent study notes that since 1980, the eight largest accounting firms alone have paid nearly \$180 million in settling audit-related litigation."). Eight large international accounting firms dominate the business of auditing large publicly held companies. These CPA firms, commonly known as the "Big Eight," are (in alphabetical order): Arthur Andersen Co., Arthur Young Co., Coopers & Lybrand, Deloitte Haskins & Sells, Ernst & Whinney, Peat, Marwick, Mitchell & Co., Price Waterhouse & Co., and Touche Ross Co. M. STEVENS, *THE BIG EIGHT 2* (1981). "[C]lients of the Big Eight account for 94 percent of all sales, 94 percent of all profits, 90 percent of all income taxes paid, 94 percent of all people employed, and 94 percent of all assets owned by New York Stock Exchange members." *Id.* at 8. *See* J. SCHWARTZ, *CORPORATE POLICY: A CASEBOOK* 216 (1978) ("The need for credibility and the large staffs necessary to audit a major corporation have been the primary factors in the development of a high degree of concentration in the [accounting] profession."); *see also* Fiflis, *Current Problems of Accountants' Responsibilities to Third Parties*, 28 VAND. L. REV. 31, 33-34 (1975); Griffin, *The Beleaguered Accountants: A Defendant's Viewpoint*, 62 A.B.A.J. 759, 759 (1976); Note, *New York Upholds Ultramares and Delineates Three-Part Test Which Noncontractual Parties Must Satisfy to Hold Accountants Liable in Negligence*, 17 TEX. TECH L. REV. 1025, 1026-28 (1986) [hereinafter Note, *New York Upholds Ultramares*].

4. RESTATEMENT (SECOND) OF TORTS § 552 (1977) defines "negligent misrepresentation" by a professional as the failure "to exercise reasonable care or competence in obtaining or communicating the information" for the guidance of others in business

audit was performed in a negligent⁵ fashion, missing significant errors in the accounting procedures of the company or perhaps even failing to detect fraud by management, resulting in the overvaluation of the business. If the company subsequently falters and the third party bears a loss, should the party be able to recover from the accountant when the audit was done negligently? Or must the third party bear the loss since she had not paid the accountant for the service?

Twenty years ago there was an easy answer to these questions: third parties, almost without exception, were unable to recover damages in suits against accountants for negligence.⁶ But changes in the accountant's role in commercial transactions⁷ and in the maturing of accounting as a profession⁸ have led

5. Negligence has been defined as "conduct which falls below the standard established by law for the protection of others against unreasonable risk of harm; it is [a] 'departure from the conduct expectable of a reasonably prudent person under like circumstances.'" BLACK'S LAW DICTIONARY 930-31 (5th ed. 1979).

6. See *Rusch Factors, Inc. v. Levin*, 284 F. Supp. 85, 90 (D.R.I. 1968) ("No appellate court, English or American has even held an accountant liable in negligence to reliant parties not in privity."); see also *Citizens State Bank v. Timm Schmidt & Co.*, 113 Wis. 2d 376, 335 N.W.2d 361 (1983); Brodsky & Swanson, *The Expanded Liability of Accountants for Negligence*, 12 SEC. REG. L.J. 252 (1984); Note, *Accountants' Liabilities for False and Misleading Financial Statements*, 67 COLUM. L. REV. 1437 (1967).

Exceptions to this general rule lie in the area of securities regulation. "Reckless behavior has been recognized as sufficient to hold an accountant liable to investors under § 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934." *McLean v. Alexander*, 599 F.2d 1190, 1197 (3d Cir. 1979).

7. The duties and responsibilities of accountants have expanded considerably in the past fifty years. The profession itself now recognizes that an accounting statement is no longer merely a tool for management, but rather an instrument for investment decision-making by the general public. See Comment, *Auditors' Responsibility for Misrepresentation: Inadequate Protection for Users of Financial Statements*, 44 WASH. L. REV. 139, 178 (1968). "Under present conditions, the principal effect of the auditor's opinion to management is to meet the requirements of, and influence the actions of, third parties with whom the auditor has no contract." *Id.* In the present business environment, financial information can be presented in such a complex fashion with such sophisticated methodology that potential users must rely on accountants to put the data into a usable form. "[L]ike the mysteries of ancient Egypt, you need an elite priesthood to define and interpret what appears in the financial statements." *Id.* Weiner reports that the Director of the Office of Management and Budget confessed, "[n]one of us really understands what's going on with all of those numbers . . ." Weiner, *supra* note 1, at 235 (quoting W. Greider, *The Education of David Stockman*, ATL, Dec. 1982, at 38). For an excellent analysis of the historical development of the accountant's role in society, see J. CAREY, *THE RISE OF THE ACCOUNTING PROFESSION* (1969), J. DAVIES, *CPA LIABILITY — A MANUAL FOR PRACTITIONERS 1* (1983). See also Fiflis, *supra* note 3, at 105-06; and Mess, *supra* note 1, at 838-40, 855-57. See generally Besser, *Privity? — An Obsolete Approach to the Liability of Accountants to Third Parties*, 7 SETON HALL 507 (1976); Burton, *The Evolutionary Revolution in Public Accounting*, 52 BROOKLYN L. REV. 1041 (1987); Weiner, *supra* note 1, at 236-46; Note, *Accountants' Liability for Negligence — A Contemporary Approach for a Modern Profession*, 48 FORDHAM L. REV. 401, 401-08 (1979) [hereinafter Note, *Con-* Published by University of Missouri School of Law Scholarship Repository, 1988

courts to reevaluate this view.⁹ The issue is governed by state law, for the state determines the situations in which a plaintiff can recover compensation from a defendant in tort. The legal system does not now provide a consistent response. The accountant's liability, if any, to third parties depends on the particular state's law that governs the transaction. The judiciary is usually responsible for the final determination, since state legislatures seldom pass laws stating specifically the conditions under which an accountant can be sued.

Currently, three significantly different standards determine the extent of an accountant's liability to non-clients for negligence:¹⁰ 1) the traditional

temporary Approach]; Note, *Negligent Misrepresentation and the Certified Public Accountant: An Overview of Common Law Liability to Third Parties*, 18 SUFFOLK U.L. REV. 431, 431-33 (1984) [hereinafter Note, *Negligent Misrepresentation*]; Note, *Torts - Accountant's Liability - An Independent Auditor Who Furnishes a Financial Statement Owes a Duty to All Those Whom the Auditor Should Reasonably Foresee as Recipients of that Opinion; One Who is Not in Privity with the Auditor But Who Relies on Such Statements May Recover in Negligence*, 29 VILL. L. REV. 563, 581 (1983-1984) [hereinafter Note, *Accountants' Liability*]. For a judicial discussion of the change in the role of the accountant, see *H. Rosenblum, Inc. v. Adler*, 93 N.J. 324, 345, 461 A.2d 138, 149 (1983); *Spherex, Inc. v. Alexander Grant & Co.*, 122 N.H. 898, 903-04, 451 A.2d 1308, 1311-12 (1982); *Haddon View Inv. Co. v. Coopers & Lybrand*, 70 Ohio St. 2d 154, 157, 436 N.E.2d 212, 214-15 (1982); Note, *New York Upholds Ultramares*, *supra* note 3, at 1026-28. See generally *infra* notes 165-66.

8. Accounting is no longer a fledgling profession in need of judicial protection. See Bradley, *Auditor's Liability and the Need for Increased Accounting Uniformity*, 30 LAW & CONTEMP. PROBS. 898, 921 (1965) ("in the light of the economic maturation of the independent accounting profession . . . dependence on . . . judicial solitude seems ill-advised"); *All Eyes on Accountants*, TIME, April 21, 1986, at 61 (annual revenues of the accounting profession approximate \$10 billion, 60% of which is derived from audit work); see also Weiner, *supra* note 1, at 236 n.10; Note, *Contemporary Approach*, *supra* note 7, at 404 n.23 where the author notes that by 1981 the eight largest domestic firms audited 80% of the companies traded on the New York and American stock exchanges and themselves grossed over 6 billion.

9. Bradley, *Liability to Third Persons for Negligent Audit*, 1966 J. BUS. L. 190, 196 ("The legal duties of the auditor ought to be coextensive with his professional pretensions. He aspires to more than being a rubber stamp for management, so his legal duties ought to go beyond that status. . . .").

10. See Gormley, *The Foreseen, the Foreseeable, and Beyond - Accountants' Liability to Nonclients*, 14 SETON HALL 528 (1984) for a thorough analysis of the meaning, application, and inconsistencies of the current doctrine. For even a further standard, in which the court uses a balancing test to determine the defendant accountant's liability, see *Alumna Kraft Mfg. Co. v. Elmer Fox & Co.*, 493 S.W.2d 378 (Mo. Ct. App. 1973); *Raritan River Steel Co. v. Cherry, Beckaert & Holland*, 79 N.C. App. 81, 339 S.E.2d 62 (1986). In the latter case the factors considered by the court were the extent to which the transaction was intended to affect the plaintiff; whether it was foreseeable that failure to discover and disclose that the accountant's client had a substantial negative net worth would harm creditors who extended credit relying on the defendant's audit; whether the plaintiff had suffered injury; and whether the defendant's negligence was the proximate cause of plaintiff's injury. Based on these factors, the court found that plaintiff had stated a cause of action for negligent misrepresentation. See also Achampong, *Common Law Liability of Accountants for Negligence to Non-contractual Parties: Recent Developments*, 91 DICK. L. REV. 677, 687 nn.74, 75

perspective of *Ultramares Corp. v. Touche Ross & Co.*¹¹ allows negligence actions only by parties in privity of contract or in a situation "so close as to approach that of privity";¹² 2) under the Restatement (Second) of Torts standard a person or a limited class of persons who the auditor can be foresee as parties who will (and do) rely upon financial statements are allowed recovery;¹³ and 3) the "reasonably foreseeable" standard permits all parties who are reasonably foreseeable recipients of financial statements for business purposes

(1987) for an argument that this is "in effect, a traditional negligence standard couched in different terms," especially considering the fact the plaintiff was not specifically foreseen. The balancing test was first used in *Biakanja v. Irving*, 49 Cal. 2d 647, 320 P.2d 16 (1958) to determine the liability of a notary public. See generally *Weiner*, *supra* note 1, at 255-56; Note, *Negligent Misrepresentation*, *supra* note 7, at 442-43.

11. 255 N.Y. 170, 174 N.E. 441 (1931). In elegant language, Justice Cardozo's opinions singled out accountants for the protection of the privity doctrine, while recognizing that the privity requirement had disappeared in most other areas. This decision prevailed for over thirty years in every jurisdiction in which the issue arose. *Citizens State Bank v. Timm, Schmidt & Co.*, 113 Wis. 2d 376, 379, 335 N.W.2d 361, 364 (1983) (citing *Weiner*, *supra* note 1, at 236); see also *Besser*, *Privy? An Obsolete Approach to the Liability of Accountants to Third Parties*, 7 SETON HALL L. REV. 507, 516 (1976). Seven jurisdictions currently apply or cite this standard favorably, requiring privity or a relationship between the parties sufficiently approaching privity: Colorado (*Stephens Indus. Inc. v. Haskins & Sells*, 438 F.2d 357 (10th Circuit 1971)); Delaware (*McLean v. Alexander*, 599 F.2d 1190 (3d Cir. 1979)); Florida (*Investors Tax Sheltered Real Estate, Ltd. v. Lawenthol, Krekstein, Horwath & Horwath*, 370 So. 2d 815 (Fla. Dist. Ct. App. 1979); see also *Canaveral Capital Corp. v. Bruce*, 214 So. 2d 505 (Fla. Dist. Ct. App. 1968); *Investment Corp. v. Buchman*, 208 So. 2d 291 (Fla. Dist. Ct. App. 1968)); Indiana (*Toro Co. v. Krouse, Kern & Co., Inc.*, 827 F.2d 155 (7th Cir. 1987)); Kansas (*Koch Indus., Inc. v. Vosko*, 494 F.2d 713 (10th Cir. 1974); see also *Western Sur. Co. v. Loy*, 3 Kan. App. 2d 310, 595 P.2d 257 (1979)); New York (*Credit Alliance Corp. v. Arthur Andersen & Co.*, 65 N.Y.2d 536, 483 N.E.2d 110, 493 N.Y.S.2d 435 (1985)); Oregon (*United States Nat'l Bank v. Fought*, 46 Or. App. 635 P.2d 754 (1980)).

12. 255 N.Y. at 182-83, 174 N.E. at 446.

13. The text of the RESTATEMENT (SECOND) OF TORTS § 552 (1977) appears *infra* note 130. Fifteen jurisdictions have adopted or favorably cited the Restatement, recognizing an auditor's liability to a foreseen third party: Georgia (*Badische Corp. v. Caylor*, 257 Ga. 131, 356 S.E.2d 198 (1987)); Hawaii (*In re Hawaii Corp.*, 567 F. Supp. 609 (D. Hawaii 1983)); Iowa (*Ryan v. Kanne*, 170 N.W.2d 395 (Iowa 1969)); Kentucky (*Ingram Indus., Inc. v. Nowicki*, 527 F. Supp. 683 (E.D. Ky. 1981)); Minnesota (*Bonhiver v. Graff*, 311 Minn. 111, 248 N.W.2d 291 (1976)); Missouri (*Tiffany Indus., Inc. v. Harbor Ins. Co.*, 536 F. Supp. 432 (W.D. Mo. 1982); 999 v. *Cox & Co.*, 574 F. Supp. 1026 (E.D. Mo. 1983)); Nebraska (*Seed Kem, Inc. v. Safranek*, 466 F. Supp. 340 (D. Neb. 1979)); New Hampshire (*Spherex Inc. v. Alexander Grant & Co.*, 122 N.H. 898, 451 A.2d 1308 (1982)); North Dakota (*Bunye Corp. v. Eide*, 372 F. Supp. 1058 (D.N.D. 1974)); Ohio (*Haddon View Inv. Co. v. Coopers & Lybrand*, 70 Ohio St. 2d 154, 436 N.E.2d 212 (1982)); Pennsylvania (*Eisenburg v. Gagnon*, 766 F.2d 770 (3d Cir. 1985)); Rhode Island (*Rusch Factors, Inc. v. Levin*, 284 F. Supp. 85 (D.R.I. 1968)); Texas (*Shatterproof Glass Corp. v. James*, 466 S.W.2d 873 (Tex. Civ. App. 1971)); Utah (*Milliner v. Elmer Fox & Co.*, 529 P.2d 806 (Utah 1974)). See also *Brumley v. Touche Ross & Co.*, 123 Ill. App. 3d 636, 641-42, 463 N.E.2d 195, 199-200 (1984).

to recover as long as they rely on the statements for those business purposes.¹⁴

This diversity of opinion is demonstrated by the most recent decisions on the issue. In *Toro Co. v. Krouse, Kern & Co.*,¹⁵ the United States Court of Appeals for the Seventh Circuit, applying Indiana law, used *Ultramares* as the basis for its decision to deny recovery to a plaintiff who was unable to demonstrate either a contractual relationship with the accountant or evidence of any contact with the accountant indicating a knowledge of the plaintiff's reliance.¹⁶ On the other hand, the Mississippi Supreme Court in *Touche Ross & Co. v. Commercial Union Insurance Co.*¹⁷ upheld recovery for Commercial Union, a company completely unknown to the defendant accountant, holding the accountant should have reasonably foreseen that an entity such as the plaintiff might rely on the audit.¹⁸

An understanding of the role and responsibility of the certified public accountant in the twentieth century is necessary to understand the current status of accountant's liability to third parties.

THE ROLE AND RESPONSIBILITY OF THE ACCOUNTANT

Although certified public accountants are often involved in a number of aspects of their clients' businesses, including management consulting, executive recruiting, and performing a number of tax services; their primary source of revenue is auditing.¹⁹ The accountant's special function is to scrutinize the financial statements²⁰ prepared by a business and express an opinion as to the

14. Four states have adopted this standard: California (*International Mortgage Co. v. John P. Butler Accountancy Corp.*, 177 Cal. App. 3d 806, 223 Cal. Rptr. 218 (1986)); Mississippi (*Touche Ross & Co. v. Commercial Union Ins. Co.*, 514 So. 2d 315 (Miss. 1987)); New Jersey (*Rosenblum v. Adler*, 93 N.J. 324, 461 A.2d 138 (1983)); Wisconsin (*Citizens State Bank v. Trimm, Schmidt & Co.*, 113 Wis. 2d 376, 335 N.W.2d 361 (1983)).

15. 827 F.2d 155 (7th Cir. 1987).

16. *Id.* at 161.

17. 514 So. 2d 315 (Miss. 1987).

18. *Id.* at 322-23.

19. See Fiffis, *supra* note 3, at 34 n.14 where the author notes that the audit function makes up approximately 70-80% of an accounting firm's revenues. See also A. ARENS & J. LOEBBECKE, *AUDITING: AN INTEGRATED APPROACH* chs. 7, 9 (3d ed. 1984); Hagen, *Certified Public Accountants' Liability for Malpractice: Effect of Compliance with GAAP and GAAS*, 13 J. CONT. L. 65, 66 (1987); Note, *Contemporary Approach*, *supra* note 7, at 401-02.

20. The four basic financial statements are: (1) the balance sheet, (2) the income statement, (3) the statement of retained earnings, and (4) the statement of changes in financial position. The balance sheet shows the financial position of an entity at a particular moment in time, usually the end of the accounting period, e.g., December 31. The income statement reports the results of operations, i.e., the earnings or losses, of the entity for a given period of time, e.g., one year. The statement of retained earnings shows the sources and uses of either cash or working capital of the entity for a certain time period. See *HANDBOOK OF ACCOUNTING AND AUDITING* chs. 9-2 through 9-4 (J. Burton, R. Palmer & R. Kay, eds. 1981) [hereinafter *HANDBOOK*]; B. NEEDLES, *Fi-*

accuracy with which the statements present the company's actual financial position and operations in accordance with generally accepted accounting principles (GAAP).²¹ The company itself uses this information in business planning and outsiders with an interest in the company need it to scrutinize the profitability of their investment.²²

The audit process involves three general stages: the investigation and collection of data; the drawing of inferences from the findings; and the presentation of conclusions.²³ As a preliminary task, the auditor must become familiar with the nature, operation, and organization of the client's business. He reviews annual reports, tax returns, organizational charts, and accounting manuals; investigates the client's manufacturing, marketing, and budgeting techniques; collects information on major customers; and inspects plant facilities.²⁴ After the auditor studies the client's prior financial statements and basic accounting procedures she makes a preliminary evaluation of the client's internal control system and develops an "audit program". The audit program serves as the detailed guide to the audit, describing the specific procedures to be followed so as to ascertain the reliability and integrity of the client's recordkeeping system.²⁵ The auditor will trace sample transactions throughout the system to determine, for example, whether a purchase order was properly authorized before an item was ordered.²⁶ He will also match the reports of goods retained in the receiving department with vendors' invoices or perhaps contact customers to confirm accounts receivable or banks to verify balances.²⁷ The better the results of these "compliance tests," the less need there is for the auditor to use "substitute tests" (such as observing the taking of inventory) to evaluate the

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21. *American Institute of Certified Public Accountants, Professional Standards*, AU § 110.01 (1980) [hereinafter *AICPA Standards*]; see also H. Rosenblum, Inc. v. Adler, 93 N.J. 324, 332, 461 A.2d 138, 142 (1983); Bilek, *Accountant's Liability to the Third Party and Public Policy: A Calabresi Approach*, 39 Sw. L.J. 689, 691-92 (1985); Fifiis, *supra* note 3, at 35-42; Weiner, *supra* note 1, at 237; *Accountant's Liability*, *supra* note 7, at 564; Note, Rosenblum, Inc. v. Adler: *CPAs Liable at Common Law to Certain Reasonably Foreseeable Third Parties Who Detrimentally Rely on Negligently Audited Financial Statements*, 70 CORNELL L. REV. 335, 339 (1985) [hereinafter *CPAs Liability*].

22. Mesh, *A Basic Approach to Accountants' Liability*, 4 AM. J. TRIAL ADVOC. 299, 301 (1980); see Wyatt, *Auditor's Responsibilities*, 12 ST. LOUIS U.L.J. 331 (1968).

23. See Hawkins, *Professional Negligence Liability of Public Accountants*, 12 VAND. L. REV. 797, 803 (1959); *Contemporary Approach*, *supra* note 7, at 402. For a comprehensive examination of the stages of an audit, see Fifiis, *supra* note 3, at 37-42.

24. Fifiis, *supra* note 3, at 37; Hagen, *supra* note 19, at 67; *Contemporary Approach*, *supra* note 7, at 402. For a discussion of the various procedures that an auditor uses to gather evidence, see A. ARENS & J. LOEBBECKE, *supra* note 19, at 170-74; J. ROBERTSON & F. DAVIS, *AUDITING* 19 (4th ed. 1985).

25. *Id.* at 207, 213-14, 304-08; Fifiis, *supra* note 3, at 37; Hagen, *supra* note 19, at 68.

26. Hagen, *supra* note 19, at 68.

27. Fifiis, *supra* note 3, at 38; *Contemporary Approach*, *supra* note 7, at 401.

proficiency of the internal control system.²⁸ The auditor must always be aware of the possibility of deliberate misrepresentation by management and should probe any suspicious circumstances.²⁹

At the completion of the audit program, the auditor will have working papers³⁰ covering each item listed in the audit procedure. This information will form the basis for the integration of the audit findings with the financial statements of the business.³¹ The most significant items in the financial statement require strong supporting evidence.³² Management will then give the auditor a

28. *AICPA Standards*, *supra* note 21, § 350.19, at 463-66; Fifiis, *supra* note 3, at 38; Hagen, *supra* note 9, at 68. *See generally* A. ARENS & J. LOEBBECKE, *supra* note 19, at 150-52; J. ROBERTSON & F. DAVIS, *supra* note 24, at 19; HANDBOOK, *supra* note 20, ch. 7-20.

29. *See* Fifiis, *supra* note 3, at 97:

The auditor's duty does not permit him to wait for an alarm bell to arouse him to investigation. He has a duty in the first instance to focus a skeptical eye on the accounts. That is the purpose of an audit — it is not merely an arithmetical check and a determination of compliance with form. One of the things GAAS specifically includes is a duty to look for the suspicious circumstances that in turn will raise the auditor's duty to probe to the bottom.

See also Bilek, *supra* note 21, at 692, where the author concludes that "[a]n accountant is expected to . . . [play] the role of [a] watchdog, thus enabling each interested person to detect whether his interest is in jeopardy." *Id.* Although a thorough examination cannot assure that illegal acts will be detected, "[n]onetheless, the independent auditor should be expected to detect illegal or improper acts that would be uncovered in the exercise of normal professional skill and care." *H. Rosenblum, Inc. v. Adler*, 93 N.J. 324, 344, 461 A.2d 138, 148 (1983). For a further discussion, see Ebke, *In Search of Alternatives: Comparative Reflections of Corporate Governance and the Independent Auditor's Responsibilities*, 79 Nw. U.L. Rev. 663 (1984), Minow, *supra* note 1, at 78; Romney, Albrecht & Cherrington, *Auditors and the Detection of Fraud*, 149 J. Accr. 63 (1980); Comment, *Auditor's Third Party Liability: An Ill Conceived Extension of the Law*, 46 WASH. L. REV. 675, 691-92 (1971).

30. Working papers serve mainly to: 1) Aid the auditor in the conduct of his work, 2) Provide an important support for the auditor's opinion, including his representation as to compliance with the generally accepted auditing standards. *AICPA Standards*, *supra* note 21, § 328.02, at 441. Working papers are the records kept by the independent auditor of the procedures he followed, the tests he performed, the information he obtained, and the conclusions he reached pertinent to his examination. Working papers, accordingly, may include work programs, analyses, memoranda, letters of confirmation and representation, abstracts of company documents, and schedules or commentaries prepared or obtained by the auditor. *Id.* § 338.03, at 441.

Working papers should fit the circumstances and the auditor's needs on the engagement to which they apply. The factors affecting the independent auditor's judgment as to the quantity, type, and content of the working papers desirable for a particular engagement include (a) the nature of the auditor's report, (b) the nature of the financial statements, schedules, or other information upon which the auditor is reporting, (c) the nature and condition of the client's records and internal controls, and (d) the needs in particular circumstances for supervision and review of the work performed by any assistants. *Id.* § 338.04, at 441-42. *See also* Fifiis, *supra* note 3, at 39-40.

31. Fifiis, *supra* note 3, at 40.

32. "It is fundamental that there should be stronger grounds to sustain the audi-

letter of representation that the financial statements are accurate and that disclosure has been complete.³³

The final stage of the audit is the audit report or opinion which evaluates the information obtained to determine if the client's financial statements accurately reflect the financial condition of the business.³⁴

In an "unqualified report," the accountant indicates that, on the basis of an examination made in accordance with generally accepted auditing standards (GAAS), an opinion has been formed without exception, reservation, or qualification that the financial statements of the audited entity present fairly its financial position.³⁵

In a "qualified report," the accountant states that an improper accounting technique has been applied to one or more items in the report which would have a material, but not a pervasive effect upon the statements.³⁶ "Except for" or "subject to" this particular matter, the financial statements present fairly the financial position of the business.³⁷ This sort of opinion will be given when

tor's opinion of relatively important items in the financial statements and those with possibilities of relatively material error than are required to sustain his opinion of items without these characteristics." Fiflis, *supra* note 3, at 39. "Financial insecurity of the business also has a significant influence on how far the auditor's procedure must go." *Id.*

33. *AICPA Standards*, *supra* note 21, § 333.04; *see also* Fiflis, *supra* note 3, at 39-40.

34. *AICPA Standards*, *supra* note 21, § 110.01, at 61; *see also* Fiflis, *supra* note 3, at 40; Weiner, *supra* note 1, at 237 (the auditor's report "normally forms the basis for any assertion of liability against [the CPA]," because the report usually contains representations that he has conducted the audit in accordance with GAAS and that the financial statements are presented in accordance with the GAAP).

35. The standard unqualified opinion is as follows:
(Scope paragraph)

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 made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we consider necessary in the circumstances.

(Opinion paragraph)

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 ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

AICPA Standards, *supra* note 21, § 509.07, at 632. *See also* Fiflis, *supra* note 3, at 41-42.

36. *HANDBOOK*, *supra* note 20, ch. 16, at 5-6.

37. *AICPA Standards*, *supra* note 21, § 509.29, at 638. An example of a qualified opinion (due to departures from GAAP) is as follows:

(Scope paragraph)

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

there are restrictions on the scope of the auditor's examination, a lack of competent evidential matter, changes in accounting principles applied, or significant uncertainties that affect the financial statements.³⁸

An "adverse opinion" states "that the financial statements do not present fairly the financial position, results of operations or changes in financial position in conformity with generally accepted accounting principles."³⁹ This

in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we consider necessary in the circumstances.

The Company has excluded from property and debt in the accompanying balance sheet certain lease obligations, which, in our opinion, should be capitalized in order to conform with generally accepted accounting principles. If these lease obligations were capitalized, property would be increased by \$, long term debt by \$, and retained earnings by \$, as of December 31, 19XX, and net income and earnings per share would be increased (decreased) by \$ and \$ respectively for the year then ended.

(Opinion paragraph)

In our opinion, except for the effects of not capitalizing lease obligations, as discussed in the preceding paragraph, the financial statements present fairly. .

Id. § 509.36, at 640.

38. *Id.* § 509.29, at 638.

39. *Id.* § 509.41, at 642. An example of an adverse opinion is as follows:

(Scope paragraph)

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 made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we consider necessary in the circumstances.

As discussed in Note X to the financial statements, the Company carries its property, plant and equipment accounts at appraisal values, and provides depreciation on the basis of such values. Further, the Company does not provide for income and taxable income arising because of the use, for income tax purposes, of the installment method of reporting gross profit from certain type of sales. Generally accepted accounting principles, in our opinion, require that property, plant and equipment be stated at an amount not in excess of cost, reduced by depreciation based on such amount, and that deferred income taxes be provided. Because of the departures from generally accepted accounting principles identified above, as of December 31, 19XX, inventories have been increased \$ by inclusion in manufacturing overhead of depreciation in excess of that add on cost; property, plant and equipment, less accumulated depreciation, is carried at \$ in excess of an amount based on the cost to the Company; and allocated income tax of \$ has not been recorded; resulting in an increase of \$ for the year ended December 31, 19XX, cost of goods sold has been increased \$ have not been provided, resulting in an increase in net income and earnings per share of \$ and \$ respectively.

(Opinion paragraph)

In our opinion, because of the effects of the matters discussed in the preceding paragraph, the financial statements referred to above do not present fairly, in

occurs if any items have a material and pervasive effect on the financial statement that destroys the credibility of the statement.⁴⁰

A "disclaimer opinion" is a statement by the accountant that it is not objectively possible to ascertain whether the financial statements conform to GAAP.⁴¹ The accountant renders this opinion only when she cannot form an opinion because of serious limitations on the scope of the examination.⁴² She must issue an adverse opinion if she has enough information to conclude that the statements are an unfair representation.⁴³

ELEMENTS OF A CAUSE OF ACTION:
WHAT THE THIRD PARTY PLAINTIFF MUST PROVE

The accountant has a responsibility to the client to perform the contractual services in a skillful manner. Failure to render services competently may

conformity with generally accepted accounting principles, the financial position of X Company as of December 31, 19XX, or the results of its operations and changes in its financial position for the year then ended.

Id. § 509.43, at 642-43. See also Weiner, *supra* note 1, at 238.

40. HANDBOOK, *supra* note 20, at 16-5 through 16-6.

41. AICPA Standards, *supra* note 21, § 509.45, at 643. An example of a disclaimer of opinion (due to the inability to obtain sufficient evidential matter) is as follows:

(Scope paragraph)

Except as set forth in the following paragraph, our examination was made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other audition procedures as we considered necessary.

The Company did not take a physical inventory of merchandise, stated at \$. . . . in the accompanying financial statements as of December 31, 19XX and at \$. . . . as of December 31, 19XX. Further, evidence supporting the cost of property and equipment acquired prior to December 31, 19XX is no longer available. The Company's records do not permit the application of adequate alternative procedures regarding the inventories or the cost of property and equipment.

(Disclaimer paragraph)

Since the Company did not take physical inventories and we were unable to apply adequate alternative procedures regarding inventories and the cost of property and equipment, as noted in the preceding paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the financial statements referred to above.

Id. § 509.47, at 644. See also Hagen, *supra* note 19, at 72.

42. A. ARENS & J. LOEBBECKE, *supra* note 19, at 43-45. For a discussion of the rare situations warranting a disclaimer opinion by the CPA, see AICPA Standards, *supra* note 21, at 649-50. See also Fiffis, *supra* note 3, at 42; Weiner, *supra* note 1, at 238-39 n.18.

43. A. ARENS & J. LOEBBECKE, *supra* note 19, at 39; HANDBOOK, *supra* note 20, at 16-6. See Rhode Island Hosp. Trust Nat'l Bank v. Swartz, Bresenoff, Yavner & Jacobs, 455 F.2d 847 (4th Cir. 1972) for the position that a disclaimer of opinion cannot be issued by the CPA to avoid liability for negligence. See also F. WINDAL & R. CORLEY, THE ACCOUNTING PROFESSIONAL: ETHICS, RESPONSIBILITY, AND LIABILITY 204-09 (1980).

result in an action by the client for breach of contract, reformation or rescission of the agreement, or perhaps even a tort suit by the client for negligent misrepresentation.⁴⁴ Unless the accountant's acts are intentional, however, a third party is limited to only one action. He must bring a suit under tort law for negligent misrepresentation. This requires proof of: a legal duty owed to the plaintiff, breach of that duty, justifiable reliance on the plaintiff's behalf, damage, and a causal connection between breach and damage.⁴⁵

Accountants and auditors have the duty to exercise the reasonable care, judgment, honesty, and independence of a competent member of the profession in obtaining and communicating information.⁴⁶ The difficulty lies in the determination of what conduct is, in fact, reasonable. The profession's⁴⁷ own guidelines are helpful. The GAAP governs the manner in which the information regarding a business entity is presented, and the GAAS deals with the auditor's professional qualities and the judgment he exercises in the performance of his examination and report.⁴⁸ While proof that the auditor complied with

44. See Besser, *supra* note 7, at 509 n.10; Fiflis, *supra* note 3, at 103; see also Hawkins, *supra* note 23, at 797-812; Levitin, *Accountants' Scope of Liability for Defective Financial Reports*, 15 HASTINGS L.J. 436, 437-39 (1964).

45. See McDowell, *Foreseeability in Contract and Tort: The Problems of Responsibility and Remoteness*, 36 CASE W.L. REV. 286, 299-301 (1985) for a discussion of these elements; see also W. PROSSER & P. KEETON, PROSSER AND KEETON ON THE LAW OF TORTS § 107, at 745-48 (W. Keeton 5th ed. 1984) [hereinafter PROSSER & KEETON]; Besser, *supra* note 7, at 537-41; AICPA Standards, *supra* note 21, at 430.

46. RESTATEMENT (SECOND) OF TORTS, *supra* note 1, § 552. See also SEC v. Arthur Young & Co., 590 F.2d 785, 788 (9th Cir. 1979) (citing SEC v. Republic Nat'l Life Ins., 378 F. Supp. 430, 440 (S.D.N.Y. 1974)); Franklin Supply Co. v. Tolman, 454 F.2d 1059, 1065 (9th Cir. 1972); Hawaii Corp. v. Crossley, 567 F. Supp. 609, 617 (D. Hawaii 1983). See Fiflis, *supra* note 3, at 45-49 for a discussion of the importance of the independence of the auditor.

47. The American Institute of Certified Public Accountants is the national professional organization of CPAs whose membership is comprised of those who are in possession of valid and unrevoked certified public accountant certificates issued by the state boards of accountancy. The AICPA consists of more than 156,000 members, most of whom are in public practice (86,000) and industry (60,000). See HANDBOOK, *supra* note 20, at 39-9; Hagen, *supra* note 19, at 73 n.47.

48. Fiflis, *supra* note 3, at 40-41 discusses the distinction between accounting principles on the one hand, and auditing standards on the other:

"Auditing standards" address the objectives to be attained by the audit and fix the standard of quality of performance of the audit procedures. GAAS, as established by the AICPA, require the auditor to exercise skill, independence and care, compel adequate planning and supervision of the audit including evaluation of the client's internal controls and independent confirmations, and require the report of compliance with GAAP.

"Accounting principles," distinguishable from both auditing standards and auditing procedures, generally deal with such facts or conclusion as the existence of a deposit in the sum of \$1,000 to the First National Bank which is still outstanding, and provide for certain accounting treatment of that fact; e.g., that the bank deposit will be designated "cash" in the accounts, instead of, for example, "Accounts Receivable — First National Bank."

See also Donaldson, *Accountants' Liability*, TRIAL, Feb. 1987, at 38; Arthur Young & Co., *supra* note 46, at 788.

these guidelines⁴⁹ is evidence that may be very persuasive in demonstrating that he was not negligent, it is not conclusive.⁵⁰ However, an accountant will not be able to hide behind esoteric accounting norms if the circumstances clearly demonstrate that something more is required to disclose the true

Co., 590 F.2d at 789 n.4.

49. The "generally accepted auditing standards" as established by the AICPA have been briefly stated:

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 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 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 disclosure 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 therefore 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.

Fiflis, *supra* note 3, at 40 n.24.

50. See *United States v. Simon*, 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970), where the court held that an accountant's compliance with the generally accepted accounting standards was not conclusive evidence that he acted in good faith. This was the first time that such compliance did not provide an accountant complete protection from liability. See also *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, 378 F. Supp. 112, 122 (S.D.N.Y. 1974), *aff'd in part and rev'd in part*, 540 F.2d 27 (2d Cir. 1976). For excellent discussions of the issue, see Adams, *Lessening the Legal Liability of Auditors*, 32 BUS. LAW 1037 (1977); Lantry, *Thor Power Tool Co. v. C.I.R. Further Erodes CPA's Defense of Observing Professional Standards*, 19 AM. BUS. L. J. 87 (1981); Solomon, *Who Judges the Auditor, and How?*, J. ACCT. 67 (Aug. 1976); Volz, *Accountants' Liability to Third Persons: Resistance in Negligence*, 9 BARRISTER 31 (Fall 1982). See generally Fiflis, *supra* note 3, at 62-87; Solomon, *Ultramares Revisited: A Modern Study of Accountants Liability to the Public*, 18 DE PAUL L. REV. 56, 58 (1968); Weiner, *supra* note 1, at 239 n.19.

picture of the firm.⁵¹ In determining whether the accountant performed carefully, the trier of fact must consider his actual behavior in relationship to a number of factors, including the customs and practices of the profession and the standards of the particular firm. Expert testimony or journal articles on the particular issue are also helpful.⁵²

The plaintiff must also demonstrate that the representations by the accountant played a material and substantial role in leading him to decide as he did. This requirement is often difficult to substantiate since the typical investor relies on a number of factors in making a decision.⁵³ Further, such reliance must also have been justifiable. In this regard, the plaintiff's conduct will be judged against that of a reasonable person or entity under similar circumstances.⁵⁴

The very nature of accounting services leaves open the possibility that mistakes will not cause financial loss. In fact, third parties' suits only arise when they have lost money because of the inability of the accountant's client to honor his financial commitment. Most courts hold the accountant liable for the actual loss suffered by the plaintiff as a result of his negligence.⁵⁵ All jurisdictions require that financial loss be established with reasonable certainty.

The final hurdle for the plaintiff is demonstrating that the accountant's negligence caused the financial loss. This requires proof of cause in fact, i.e., that "but for" the accountant's negligence there would have been no financial loss. Additionally, the plaintiff must demonstrate proximate cause,⁵⁶ that is,

51. See *McLean v. Alexander*, 420 F. Supp. 1057 (D. Del. 1976); *Herzfeld*, 378 F. Supp. at 121.

52. See *Fiffis*, *supra* note 3, at 65-66.

53. PROSSER & KEETON, *supra* note 1, § 108, at 749-54; see also *Besser*, *supra* note 7, at 538.

54. For a discussion of the role that the plaintiff's conduct has in a suit against the accountant, see *Menzel, The Defense of Contributory Negligence in Accountant's Malpractice Actions*, 13 SETON HALL 292 (1983). See generally *supra* note 17.

55. See *Bonhiver v. Graff*, 311 Minn. 111, 248 N.W.2d 291 (1976); see also *Mesh, A Basic Approach to Accountants' Liability*, 4 J. TRIAL ADVOC. 297, 307-08 (1980). See generally *Comment, Third Party Liability for Negligence - The Accountant's Price for Producing a Reliable Commodity*, 14 U. TOL. L. REV. 1371, 1394-96 (1983) [hereinafter *Comment, Accountant's Price*; *Mesh, A Basic Approach to Accountants' Liability*, 4 J. TRIAL ADVOC. 297, 307-08 (1980)].

56. See *McDowell*, *supra* note 45, at 300 n.53, where the author notes:

Some of the most difficult legal problems in tort occur in the element of causation. If the conduct of the defendant was tortious and there was damage suffered by the plaintiff, was that damage proximately caused by the wrongful act? Although the precise meaning of proximate cause is the subject of some dispute, see *Dellwo v. Pearson*, 259 Minn. 452, 453-54, 107 N.W.2d 859, 860 (1961) ("There is no subject in the field of law upon which more has been written with less elucidation than that of proximate cause."), the determination of proximate cause turns on a combination of cause-in-fact, foreseeability of ensuing events, and the existence of independent intervening causes occurring between defendant's breach of a tort duty and plaintiff's damage. See *Texas & Pacific Ry. v. McCleery*, 418 S.W.2d 494, 497 (Tex. 1967) (using

that the defendant could foresee the plaintiff's loss.

Such foreseeability is not only involved in proof causation. It also is utilized in determining whether the accountant owed a legal duty to the plaintiff. If the defendant could not have foreseen the likelihood of injury to a particular individual as a result of his negligent conduct, then he owes no legal duty to that individual.⁵⁷ Which particular third parties are, in fact, foreseeable users of the accountant's work product is a policy decision that determines the extent of the accountant's liability. This issue is the focus of the current debate surrounding accountant's liability to third parties.

THE EVOLUTION OF ACCOUNTANTS' LIABILITY IN THIRD PARTY TRANSACTIONS: FROM "PRIVITY" TO "REASONABLE FORESIGHT"

Historically, courts have been reluctant to allow a third party to recover in a negligence action without a direct contractual relationship between the third party and the defendant.⁵⁸ This doctrine was established in the 1842 English case *Winterbottom v. Wainwright*,⁵⁹ in which the hired driver of a stage-coach was injured when the coach overturned because of a defectively manufactured part. The court decided that the manufacturer owed a duty to only the owner of the coach to keep it maintained and in good repair:

If the plaintiff can sue, every passenger, or even any person passing along the road, who was injured by the upsetting of the coach, might bring a similar action. Unless we confine the operations of such contracts as this to the parties who entered into them, the most absurd and outrageous consequences, to which I can see no limit, would ensue.⁶⁰

'but-for' test to determine whether or not a train's excessive speed was proximate cause of collision).

Id. The very nature of the accounting profession causes problems in determining proximate cause, especially when the accountant/client relationship has existed over an extended period of time. Determining the specific occurrence which gives rise to a pecuniary loss is often important in regard to insurance coverage. See Comment, *Accountant's Price*, *supra* note 55, at 1395-96.

57. Foreseeability is a dominant aspect of tort analysis. McDowell, *supra* note 45, at 301-02, proposes the following definition of foreseeability:

Foreseeability is such awareness of the serious possibility that harmful consequences would ensue from a projected action that a reasonable and decent person would either choose to act in a way that avoids such harm or else could not voluntarily accept responsibility for the consequences of such harm.

....

A foresighted person sees into the future and takes necessary precautions to protect himself and others while taking advantage of opportunities.

Id. at 290. See *Palsgraf v. Long Island R.R.*, 248 N.Y. 339, 344, 162 N.E. 99, 100 (1928) for Cardozo's classic statement, "The risk reasonably to be perceived defines the duty to be obeyed. . . ." See also PROSSER & KEETON, *supra* note 1, § 92, at 665.

58. For a discussion of the development of the privity doctrine, see Besser, *supra* note 7, at 510-12 n.15.

59. 10 M & W. 109, 152 Eng. Rep. 402 (Ex. 1842).

60. *Id.* at _____, 152 Eng. Rep. at 405.

The practical effect of liability commensurate with specific contractual acceptance of risk was to protect emerging industrial and commercial enterprises. The possibility that a manufacturer could be forced into bankruptcy by liability suits outweighed the desire to compensate injured consumers.⁶¹ Only in an exceptional circumstance (for instance, in *Thomas v. Winchester*,⁶² where a vendor was held liable to a third party for the mislabeling of a toxic drug) was the limitation of privity not followed.⁶³

This precedent stood until 1916, when the New York court of appeals decided *MacPherson v. Buick Motors*,⁶⁴ the first of a number of landmark decisions by that court involving the law of torts. The court disposed of the privity doctrine by allowing the plaintiff, the purchaser of an automobile, to go beyond his contract with the dealer and sue the manufacturer for injuries he received as a result of a negligently manufactured wheel.⁶⁵ The new view, as stated by Judge Cardozo, was that a duty of reasonable care was created by the foreseeability of injury rather than by a contractual relationship.⁶⁶ Practical concerns for human life and public safety became paramount.

If there is knowledge that the thing will be used by persons other than the purchaser, and used without new tests, then, irrespective of contract, the manufacturer of this thing of danger is under a duty to make it carefully. If [a manufacturer] is negligent, where danger is to be foreseen, a liability will follow.⁶⁷

The same court, six years later, expanded the rationale of *MacPherson* in

61. Note, *Contemporary Approach*, *supra* note 7, at 412; see Note, *Accountants Liability*, *supra* note 7, at 569; PROSSER & KEETON, *supra* note 1, § 96, at 642.

62. 6 N.Y. 397 (1852).

63. See, e.g., *Davidson v. Nichols*, 93 Mass. (11 Allen) 514, 516, 518 (1866) (buyer may not recover from wholesaler who mislabeled chemical when mixture of such harmless chemical with another caused explosion and physical injury); *Losee v. Clute*, 51 N.Y. 494, 496-97 (1873) (vendor not liable for damages to neighbors' homes when defective boiler exploded in purchaser's basement); *Curtin v. Somerset*, 140 Pa. 70, 80, 21 A. 244, 245 (1891) (building contractor not liable to anyone but purchaser when defective construction of house caused injuries). One court reviewed three exceptions to the general privity rule: where the negligent act is imminently dangerous to life or limb and done in the preparation of a life-saving product; where the owner's negligence injures one invited to use a defective product; or where the vendor knows that the product is imminently dangerous yet conceals the defect or fails to give notice of it. *Huset v. J. I. Case Threshing Mach. Co.*, 120 F. 865, 870-72 (8th Cir. 1903) (concealment of known defect by manufacturer which makes product imminently dangerous results in liability for injuries despite lack of privity); *Devlin v. Smith*, 89 N.Y. 470, 478 (1882) (contractor liable to painter's employees for injuries resulting from negligently constructed scaffolding).

64. 217 N.Y. 382, 111 N.E. 1050 (1916).

65. *Id.* at 389, 111 N.E. at 1053.

66. *Id.* This case was a major turning point in products liability law. Mess, *supra* note 1, at 840. See, e.g., *Greenman v. Yuba Power Prods., Inc.*, 59 Cal. 2d 57, 377 P.2d 897, 27 Cal. Rptr. 697 (1963).

67. *MacPherson*, 217 N.Y. at 389-90, 111 N.E. at 1053.

Glanzer v. Shepard.⁶⁸ *Glanzer* was the first case to allow a third party plaintiff to recover in negligence when the only damage was financial loss.⁶⁹ In that case, the defendant was a public weigher who had been hired by a bean merchant to certify the weight of the beans the merchant was selling to the plaintiff buyer. The buyer, who overpaid when the weights were negligently overstated, sued the weigher. Judge Cardozo, speaking for the court, concluded

The plaintiff's use of the certificates was not an indirect or collateral consequence of the action of the weighers. It was a consequence which, to the weighers' knowledge, was the end and aim of the transaction. The defendants held themselves out to the public as skilled and careful in their calling. They knew that beans had been old, and that on the faith of their certificate payment would be made. They sent a copy to the plaintiffs for the very purpose of inducing action. In such circumstances, assumption of the task of weighing was the assumption of the duty to weigh carefully for benefit of all whose conduct was to be governed. We do not need to state the duty in terms of contract or of privity. Growing out of a contract, it has nonetheless an origin not exclusively contractual. Given the contract and the relation, the duty is imposed by law.⁷⁰

Again in 1928, the New York court of appeals decided an important case to the developing concept of duty in tort, *Palsgraf v. Long Island Railroad*.⁷¹ The issue before the court was the scope of a negligent defendant's liability; that is, the specific class of plaintiffs that the defendant was obligated to compensate. In *Palsgraf*, the defendant's coachman acted negligently by helping a passenger board a moving train. When the passenger inadvertently dropped his parcel, which contained fireworks, an explosion resulted. The plaintiff, standing on the platform about twenty-five feet away, was injured, but the defendant was not legally responsible.⁷² The case concluded that a defendant's

68. 233 N.Y. 236, 135 N.E. 275 (1922).

69. See Mess, *supra* note 1, at 841; Besser, *supra* note 7, at 513. Courts have historically afforded less protection to pecuniary loss than to loss for physical injury. See James, *Limitations on Liability for Economic Loss Caused by Negligence: A Pragmatic Appraisal*, 25 VAN. L. REV. 43, 50-51 (1972) explaining that this reluctance to compensate for financial loss is based on crude and unreliable "pragmatic" objections, *i.e.*, courts' fear. The effect of finding the defendant liable — rather than any of "the physical consequences of negligence usually have been limited, but not the indirect economic repercussions of negligence may far be wider, indeed virtually open-ended." *Id.* at 45. See also Comment, *Foreseeability of Third Party Economic Injuries - A Problem in Analysis*, 20 U. CHI. L. REV. 283 (1953); Comment, *Union Oil Co. v. Oppen: Recovery of a Purely Economic Loss in Negligence*, 60 IOWA L. REV. 315 (1974). See James & Gray, *Misrepresentation - Part 1*, 37 MD. L. REV. 286, 307 n.6 (1977) for a discussion of the reluctance of English courts to compensate for pecuniary loss. See Hawkins, *supra* note 23, at 814 n.77 for a discussion of the abrogation of the privity rule in early cases of pecuniary loss.

70. 233 N.Y. at 238-39, 135 N.E. at 275-76.

71. 248 N.Y. 339, 162 N.E. 99 (1928).

72. *Id.* at 340-41, 162 N.E. at 99.

liability extends only to foreseeable plaintiffs.⁷³

This triad of cases marked a significant shift in the law: the restrictive contract theory of privity was being phased out as a requirement to recover for either physical or pecuniary loss. It was being replaced by a liability-expanding tort theory of negligence.⁷⁴ Individual responsibility was no longer determined by the bounds of an agreement, but expanded to include third parties whom the defendant could foresee would be affected by the negligent operation of his or her services. Based on the logic inherent in these precedents, it seemed that the responsibility of public accountants would run beyond their direct clients to certain third parties who relied on the accountants' audited statements.⁷⁵

THE *Ultramares* STANDARD: CONFLICTING PRECEDENT?

Nevertheless, in *Ultramares Corp. v. Touche Ross & Co.*,⁷⁶ the New York court of appeals disallowed a negligence suit against an accounting firm by a plaintiff who had neither contractual privity nor a relationship "so close as to approach that of privity."⁷⁷

In *Ultramares*, Fred Stern and Company hired the defendant certified public accountants to perform an audit of its financial condition.⁷⁸ The accountants' balance sheet reported that the company had assets exceeding one million dollars when, in fact, the company was insolvent.⁷⁹ This discrepancy was due to the overvaluation of assets through the use of fictitious and non-existent accounts receivable which the accountants negligently failed to substantiate.⁸⁰ Plaintiff *Ultramares*, relying on the balance sheet, lent Stern money and suffered a loss when the company declared bankruptcy.⁸¹ *Touche* was aware of the fact that Stern & Co., as part of their ongoing business activity, would be soliciting loans based on the audit that *Touche* performed.⁸² The defendant supplied its client with thirty-two copies for dispersal.⁸³ *Touche*, however, did not know that *Ultramares* specifically would see the balance sheets.⁸⁴ When *Ultramares* sued the accounting firm for negligence, the court faced the task of either exposing the accounting profession to the

73. *Id.* at 345, 162 N.E. at 101. See *supra* note 57.

74. Besser, *supra* note 2, at 514; see also Note, *Contemporary Approach*, *supra* note 7, at 410.

75. Besser, *supra* note 2, at 514; Weiner, *supra* note 1, at 243; Note, *Contemporary Approach*, *supra* note 7, at 410.

76. 255 N.Y. 170, 174 N.E. 441 (1931).

77. *Id.* at 182-83, 174 N.E. at 446. See generally *supra* note 11.

78. 255 N.Y. at 173, 174 N.E. at 442.

79. *Id.* at 174-75, 174 N.E. at 442.

80. *Id.* at 175, 174 N.E. at 442-43.

81. *Id.* at 175-76, 174 N.E. at 443.

82. *Id.* at 173-74, 174 N.E. at 442.

83. *Id.* at 174, 174 N.E. at 442.

84. *Id.*

possibility of extensive liability or of distinguishing the line of precedent established in *Glanzer* and *MacPherson*.⁸⁵

Cardozo distinguished the cases,⁸⁶ noting that in *Glanzer*:

[There] was something more than the rendition of a service in the expectation that the one who ordered the certificate would use it thereafter in the operations of his business as occasion might require. Here was a case where the transmission of the certificate to another was not merely one possibility among many, but the "end and aim of the transaction." In a word, the service rendered by defendant in *Glanzer v. Shepard* was primarily for the information of a third person, in effect, if not in name, a party to the contract, and only incidentally for that of the formal promisee. In the case at hand, the service was primarily for the benefit of the Stern Company and only incidentally or collaterally for the use of those to whom Stern and his associates might exhibit it thereafter.⁸⁷

Glanzer and *Ultramares* "best exemplify the conflicting precedent for extending liability for breach of contract to third parties."⁸⁸ Cardozo felt that the relationship between the weigher and the buyer in *Glanzer* created a bond "so close as to approach that of privity although not identical to it."⁸⁹ In *Ultramares*, on the other hand, the beneficiaries of the accountant-client contract were more remotely removed.⁹⁰ Although Touche could have foreseen the possible reliance of a number of parties, neither the "who" nor the "when" was certain. This distinction leaves open an accountant's liability to a third party if, for example, the accountant knew that the audit, although paid for by the client, would be given to a specific third party who would rely on it. In such a case, the "end aim" of the transaction would be the third party's acquisition of the accounting statements.⁹¹

85. See Note, *Contemporary Approach*, *supra* note 7, at 410 where the author comments:

After *MacPherson* and *Glanzer*, the defense of privity to an action in negligence appeared to be all but dead. Cardozo's language in those opinions was not only unequivocal, but devoid of any limitation imposed by the law of contract. The duty of the defendant to the injured plaintiff was enlarged beyond the "bounds" of his contractual obligations by his "knowledge of a prospective use."

According to the author, the *Ultramares* court recognized that "the assault upon the citadel of privity is proceeding in these days apace," yet went on to distinguish the acts of accountants as merely "the circulation of a thought or a release of the explosive power resident in words." *Id.* (quoting *Ultramares*, 255 N.Y. at 180-81, 174 N.E. at 445).

86. For a further discussion of the distinction drawn by Justice Cardozo, see *Besser*, *supra* note 7, at 514; *Mess*, *supra* note 1, at 843-44; *Weiner*, *supra* note 1, at 242-44.

87. 255 N.Y. at 182-83, 174 N.E. at 445-46.

88. *Bilek*, *supra* note 21, at 692.

89. 255 N.Y. at 182-83, 174 N.E. at 446.

90. *Id.* at 183, 174 N.E. at 446; see also *Besser*, *supra* note 7, at 515; *Weiner*, *supra* note 1, at 243.

91. Although this is a logical conclusion from Cardozo's opinion, courts inter-

Legal scholars have criticized Cardozo's *Ultramares* position as artificial and inconsistent with his prior decisions.⁹² Certainly, *Ultramares*' use of an audit was foreseeable since the audit was intended to be used by third party creditors. Hence, a duty was owed to each of the thirty-two recipients of the Stern audit despite the fact that each had not been identified. The accountant could have foreseen that his negligent act could injure the plaintiff in some way.⁹³

When subtle distinctions are used to substantiate a decision that counters a distinct trend in the case law, policy considerations often play an important role. *Ultramares* reflects a very different view of the accounting profession and its relationship to the business community. At the time of the decision in 1931, the accounting profession was not the powerful, prestigious entity that it is today. The public accountant was little known and little recognized because "the matters which were referred to him at that time were relatively unimportant, and this unimportance tended to reduce him to the level of a clerk."⁹⁴

The accountant's product was intended for the benefit of his client — to inform managers of any inefficiencies or irregularities in the business while any use beyond this by third parties was merely incidental.⁹⁵ This perspective is reflected in Cardozo's statement that "public accountants are public only in the sense that their services are offered to anyone who chooses to employ

preted *Ultramares* as barring all negligence suits against accountants where a privity relationship did not exist. See *infra* notes 109-15 and accompanying text.

92. See, e.g., Besser, *supra* note 7, at 516-17 (accountants' duty should expand to correspond to their expanded functions); Fiflis, *supra* note 3, at 107 (*Ultramares* obsolete because of "current public service status" of accountants); Mess, *supra* note 1, at 843; see also Solomon, *supra* note 50, at 74-75 (arguing that Cardozo was imprecise when he asserted that services rendered by public accountants are primarily for benefit of client and that they are "public" only in the sense that they offer their services to anyone who chooses to employ them); Weiner, *supra* note 1, at 249-53 (privity requirement does not account for important function CPAs fulfill in economy); Note, *Contemporary Approach*, *supra* note 7, at 401 (privity shield is inapplicable to the modern, sophisticated business world); Note, *Public Accountants and Attorneys: Negligence and the Third Party*, 47 NOTRE DAME L. 588, 602-07 (1972) (discussing policy reasons for extension of liability).

93. See Mess, *supra* note 1, at 843 where the author concludes that "the harm which befell the plaintiff was a reasonably foreseeable risk, which the accounting firm could be expected to have foreseen would be the result of a negligently prepared report." See also Besser, *supra* note 7, at 515 n.33. See generally *supra* note 57.

94. CAREY, *supra* note 7, at 34; see also Mess, *supra* note 1, at 839. "Accountants performed substantially less work per audit than they do today," and the profession, as a whole, was much less sophisticated. *Id.* See Note, *Contemporary Approach*, *supra* note 7, at 405-06. See generally Fiflis, *supra* note 3, at 105.

95. Comment, *Auditors Responsibility for Misrepresentation: Inadequate Protection for Users of Financial Statements*, 44 WASH. L. REV. 139, 178 (1968) ("as ownership and management of business separated, it became necessary for corporate owners to review the performance of corporate managers"); see also Besser, *supra* note 7, at 531-32; Bilek, *supra* note 21, at 692; Fiflis, *supra* note 3, at 105-06; Note, *Accountant's Liability*, *supra* note 7, at 564-65.

them."⁹⁶ Since during this era the standards governing corporate financial reports were relatively primitive, an "auditor was more likely to miss discrepancies in a client's records,"⁹⁷ and third parties who received the accountant's audit were aware that such discrepancies might exist.⁹⁸ In fact, as late as 1938, the New York Society of Certified Public Accountants permitted an auditor to rely on statements by management regarding the cost and accuracy of inventory items.⁹⁹ Also, during this time, third-party investors were a smaller, generally more well-informed group than they are today. For these reasons, Cardozo did not view the accounting profession as owing a responsibility to the public to perform its work with due care. Such a duty flowed only to those who paid for the service.¹⁰⁰

Perhaps the most crucial factor in Cardozo's position was his fear that the accounting profession, at the time a fledgling industry, could be destroyed by

96. 255 N.Y. at 188, 174 N.E. at 448.

97. Note, *Contemporary Approach*, *supra* note 7, at 405.

98. Cardozo suggested in *Ultramares*, "[w]e doubt whether the average business man receiving a certificate without paying for it and receiving it merely as one among a multitude of possible investors, would look for anything more" than that the ensuing liability for negligence is bounded by the contract, and in the absence of fraud, is to be enforced between the parties by whom the contract has been made. 255 N.Y. at 189, 174 N.E. at 448. This view of the role of the public accountant, perhaps accurate in 1931, is no longer valid today. In the words of Justice Weiner, an accountant has become a "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 . . ." Weiner, *supra* note 1, at 235. See generally *supra* note 7.

99. Note, *Contemporary Approach*, *supra* note 7, at 405. The author notes that: The mandated auditing standards and procedures were not improved until 1940, when the SEC issued an accounting release concerning the McKesson & Robbins case. The SEC criticized the accountants for inaccuracies in the corporation's audited financial statements and set forth several findings. First, the accounting firm "failed to employ that degree of vigilance, inquisitiveness, and analysis of the evidence available that is necessary in a professional undertaking and is recommended in all well-known and authoritative works on auditing.

Id. (citations omitted). Second, although the accounting profession claims that the auditor is not a guarantor and should not be liable for fraud, the SEC ruled that "the discovery of gross overstatements in the accounts is a major purpose of such an audit even though it be conceded that [the audit] might not disclose every minor defalcation." *Id.* Third, the SEC advised the accounting profession to take physical inventories and to require confirmations of accounts and notes receivable. Finally, it recommended that the board of directors nominate the auditors and that the activities of management be included in the audit. The SEC also made recommendations to the American Institute of Certified Public Accountants (AICPA). It suggested that the AICPA distinguish auditing "standards" from auditing "procedures," and that the auditor's certificate should state whether "the audit was made in accordance with generally accepted auditing standards applicable in the circumstances." Subsequently, the AICPA adopted these procedures and eventually codified them in the Statement on Auditing Standards. Note, *Contemporary Approach*, *supra* note 7, at 405-06.

100. 255 N.Y. at 189, 174 N.E. at 448.

the economic impact of extensive liability. This, in turn, would hinder the capital markets that relied on audited financial statements.¹⁰¹ Hence, restricting the scope of an auditor's liability within a narrowly prescribed framework was preferable to exposing accountants to "liability in an indeterminate amount for an indeterminate time to an indeterminate class."¹⁰² In retrospect, the decision far exceeded its objective of protecting the industry until it became sufficiently strong to pay for the consequences of its mistakes.¹⁰³

Another of Cardozo's concerns was that a decision for the plaintiff could set a precedent for imposing liability on lawyers, title companies, and others in the business of transferring information.¹⁰⁴ At the time of the *Ultramares* decision, these groups were not liable to third parties. Thus, although a decision to expand accountant's liability beyond that contained in a contract would have been a logical legal step, Cardozo felt that the economic and social consequences warranted the deferral of the decision to the legislature.¹⁰⁵

101. Comment, *Rosenblum v. Adler: Auditors' Liability for Negligent Misrepresentation - "The Explosive Power Resident in Words,"* 38 U. MIAMI L. REV. 939, 940-41 (1984) [hereinafter Comment, *Rosenblum v. Adler*]. In support of his position, Cardozo cited *Moch Co. v. Rensselaer Water Co.*, 247 N.Y. 160, 164, 159 N.E. 896, 897 (1928). *Moch Co.* also involved an important fledgling industry, public waterworks, that could have been greatly hampered by expansive liability. See Seavey, *supra* note 92, at 392; see also Besser, *supra* note 1, at 534; Katsoris, *Accountants' Third Party Liability - How Far Do We Go?*, 36 FORDHAM L. REV. 191, 204-05 (1967); Meek, *Liability of the Accountant to Parties Other Than His Employer*, 1942 WIS. L. REV. 371, 389; Comment, *Auditors' Responsibility*, *supra* note 7, at 180.

102. 255 N.Y. at 179, 174 N.E. at 444.

103. The accounting industry is now very powerful and prosperous. See generally *supra* notes 7-8, and *infra* note 158.

104. Cardozo reflected in *Ultramares*:

Liability for negligence if adjudged in this case will extend to many callings other than an auditor's. Lawyers who certify their opinion as to the validity of municipal or corporate bonds, with knowledge that the opinion will be brought to the notice of the public, will become liable to the investors, if they have overlooked a statute or a decision, to the same extent as if the controversy were one between client and advisor. Title companies insuring titles to a tract of land, with knowledge that at an approaching auction the fact that they have insured will be stated to the bidders, will become liable to purchasers who may wish the benefit of a policy without payment of a premium. These illustrations may seem to be extreme, but they go little, if any, farther than we are invited to go now.

255 N.Y. at 188, 174 N.E. at 448.

105. *Id.* at 187, 174 N.E. at 447. "A change so revolutionary, if expedient, must be wrought by legislation." *Id.* Although Cardozo left the decision as to whether or not to allow liability for accountants without privity to the legislature, "no state legislature has done so." Weiner, *supra* note 1, at 236 n.10. Nevertheless, "in the light of the economic maturation of the independent accounting profession, . . . dependence on . . . judicial solitude seems ill-advised." Bradley, *supra* note 8, at 921; see also Filfis, *supra* note 3, at 105.

APPLYING THE *Ultramares* DOCTRINE

Although Cardozo, in distinguishing *Ultramares* from *Glanzer*, left room for third-party recovery if the service was rendered for the primary benefit of the plaintiff (when the plaintiff's acquisition of the information was the "end and aim" of the transaction), later decisions ignored this distinction.¹⁰⁶ The first case to interpret *Ultramares*, *O'Conner v. Ludlum*,¹⁰⁷ concluded, "[s]ince there was no contractual relationship between the plaintiffs and the defendants, liability could be imposed only for fraud . . . a mistake in the balance sheet, even if it were the result of negligence, could not be the basis of a recovery."¹⁰⁸ The New York court of appeals reached a similar result in *State Street Trust Co. v. Ernst*,¹⁰⁹ decided seven years after *Ultramares*. In this case, despite the fact that the accountant knew that the third-party plaintiff intended to rely on his audit in deciding whether to make a loan to the client, the court decided that the accountant could not be liable "in the absence of a contractual relationship or its equivalent."¹¹⁰ Consequently, *Ultramares* came to represent the rule that without contractual privity there could be no recovery by plaintiffs against accountants for their negligence. This perspective prevailed for over thirty years in every jurisdiction in which the issue arose, and today remains the law in a number of states.¹¹¹

Recently, the New York court of appeals in *Credit Alliance Corp. v. Arthur Andersen & Co.*¹¹² reexamined the issue of an auditor's liability to a third party lender. The court reaffirmed its reliance on the *Ultramares* standard, finding that the facts failed "to demonstrate the existence of a relationship between the parties sufficiently approaching privity."¹¹³ The court developed a three-prong test for holding an accountant may be liable in negligence to a noncontractual party who had detrimentally relied on inaccurate financial statements. These three requirements are: (1) the accountant must have been aware that the financial reports were to be used for a particular purpose or purposes; (2) the accountant must have known that a party or parties would rely on the financial reports; and (3) there must have been some conduct on the part of the accountant linking him to the party or parties which evinces the accountant's understanding of their reliance.¹¹⁴

106. In addition to the cases cited in the text and *supra* note 11, see, e.g., *Nortex, Inc. v. Alexander Grant & Co.*, 532 F.2d 1013, 1015 (5th Cir. 1976); *MacNerland v. Barnes*, 129 Ga. App. 367, 370-71, 199 S.E.2d 564, 566 (1973). For other cases with similar holdings, see Annotation, *Liability of Public Accountant to Third Parties*, 46 A.L.R.3d 979, 991-94 (1972).

107. 92 F.2d 50 (2d Cir. 1937).

108. *Id.* at 53.

109. 278 N.Y. 104, 15 N.E.2d 416 (1938).

110. *Id.* at 111, 15 N.E.2d 419.

111. See *supra* note 11 for a list of the states and prevailing cases.

112. 65 N.Y.2d 536, 483 N.E.2d 110, 493 N.Y.S.2d 435 (1985).

113. *Id.* at 553, 483 N.E.2d at 119, 493 N.Y.S.2d at 444.

114. *Id.* at 551, 483 N.E.2d at 118, 493 N.Y.S.2d at 443. For an analysis of the

This modern interpretation of *Ultramares* seems to represent Cardozo's intentions when he wrote the opinion 5 years ago. Third-party recovery for an accountant's negligence is possible, but only in the narrow and specific circumstances in which the accountant has acted upon knowledge that the third party bringing the suit will rely on the audit in making a business decision involving the client.

Toro Co. v. Krouse, Kern & Co.,¹¹⁵ decided according to Indiana case law, is the most recent case to apply the *Ultramares* doctrine. The facts are similar to the cases above. Krouse prepared yearly audit reports for Summit Power Equipment Distributors, Inc. (Summit).¹¹⁶ Summit bought equipment from the Toro Company and received credit from Toro Credit Company, Toro's wholly owned subsidiary.¹¹⁷ When Toro required audited reports from Summit in order to evaluate its financial condition, Summit supplied those prepared by auditor Krouse.¹¹⁸ These statements, negligently prepared, overstated Summit's assets.¹¹⁹ Relying on the inaccurate reports, Toro extended credit to Summit.¹²⁰ When Summit was unable to repay, Toro brought suit against Krouse. The district court, in denying recovery to Toro, concluded that there was no evidence that Krouse had the necessary contact with Toro which demonstrated Krouse's understanding of Toro's actual reliance on the reports Krouse furnished to Summit.¹²¹ The Court of Appeals for the Seventh Circuit upheld the lower court's decision:

[I]n those areas where privity still applies, there exists an "actual knowledge" exception. However, this "actual knowledge" exception is a very narrow and specific one. It requires proof that the defendant had *actual* knowledge that the *particular person or entity bringing the law suit* "would rely on the information given." In short, the Indiana courts have made a "distinction between *knowledge* that a third party will rely on the opinion given and an *expectation* that unidentified others might rely on it." We further believe that the district court was correct when it held that this "actual knowledge" exception to the privity rule was the functional equivalent of the *Ultramares* test's insistence on "near privity."¹²²

discussion, see Note, *New York Upholds Ultramares*, *supra* note 3, at 1034-40. See also *White v. Guarente*, 43 N.Y.2d 356, 361-62, 372 N.E.2d 315, 318-19, 401 N.Y.S.2d 474, 477-78 (1977).

115. 827 F.2d 155 (7th Cir. 1987).

116. *Id.* at 156.

117. *Id.*

118. *Id.*

119. *Id.*

120. *Id.*

121. 644 F. Supp. 986, 994 (N.D. Ind. 1986).

122. 827 F.2d at 161.

DEPARTURE FROM *Ultramares*: THE *Restatement* STANDARD OF THE
FORESEEN

The first case to depart from *Ultramares* and allow a non-privy plaintiff to recover against an accountant for negligence was *Rusch Factors, Inc. v. Levin*,¹²³ decided by the United States District Court for Rhode Island in 1968. In response to a request by the plaintiff (a prospective creditor), a Rhode Island corporation hired an auditor to evaluate its financial stability. The defendant accountant knew that the plaintiff would base its credit decision on the accountant's financial statement.¹²⁴ Relying on the validity of the prepared statements, plaintiff lent over \$330,000 to the corporation. When the corporation subsequently went into receivership, plaintiff brought a tort action against the accountant.¹²⁵ Applying Rhode Island law, the court held that lack of privity should not prevent recovery when the third party was part of a "limited class" of potential financiers of the corporation whose reliance was "actually foreseen" by defendant.¹²⁶ The court concluded that "the case at bar is qualitatively distinguishable from *Ultramares*"¹²⁷ and governed instead by *Glanzer* since "the defendant knew that his certification was to be used for, and had as its very aim and purpose, the reliance of potential financiers of the corporation."¹²⁸

To support its argument the court used the position of the then recently completed draft of the Restatement of Torts, which permits recovery to those who can be actually foreseen as parties who will and do rely upon the financial statements.¹²⁹ The objective of the Restatement, a product of legal practitioners working under the auspices of the American Law Institute, is to synthesize judicial viewpoints on particular issues. It limits the liability of a professional who has made a negligent misrepresentation to loss suffered:

(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.¹³⁰

123. 284 F. Supp. 85 (D.R.I. 1968).

124. *Id.* at 91.

125. *Id.* at 86-87.

126. *Id.* at 92-93.

127. *Id.* at 91. The court criticized *Ultramares*, concluding that it constituted an unreasonable inroad upon the rule that the risk perceived defines the duty owed. *Id.*

128. *Id.* at 93.

129. *Id.* at 90-92.

130. RESTATEMENT (SECOND) OF TORTS § 552(2)(a), (b) (1977). The full text of § 552 is as follows:

(1) One who, in the course of his business, profession or employment, or in any other transaction 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 Restatement, then, allows for a wider range of possible plaintiffs. Whereas *Ultramares* requires that the auditor know specifically the third party who acts in reliance, the Restatement allows unidentified parties to recover if they are members of a class that the auditor knows his client intends to supply with information. The key element in this view is the accountant's knowledge that his information would be communicated to a specifically identified individual or limited class of persons.¹³¹

Shortly after *Rusch*, the Iowa Supreme Court found an accountant liable when a specifically foreseen party relied on a negligently prepared financial statement.¹³² These cases were a departure from *Ultramares* and signified the beginning of an expansion of the accountant's liability. Now the Restatement view is the most commonly applied alternative to the privity doctrine.¹³³

The *Rusch* court left the question of whether an accountant's liability for negligent misrepresentations should extend to the full limits of foreseeabil-

the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.

(2) Except as stated in Subsection (3), the liability stated in Subsection (1) is limited to loss suffered

(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.

(3) The liability of one who is under a public duty to give the information extends to loss suffered by any of the class of persons for whose benefit the duty is created, in any of the transactions in which it is intended to protect them.

131. Comment (h) of the explanatory notes pertaining to § 552 provides that an accountant's liability to non-privity parties is not limited to a specifically foreseen plaintiff:

Under this Section, . . . it is not necessary that the maker should have any particular person in mind as the intended, or even the probable, recipient of the information. . . . It is sufficient, in other words, insofar as the plaintiff's identity is concerned, that the maker knows that the maker supplies the information for repetition to a certain group or class of persons and that the plaintiff proves to be one of them, even though the maker never had heard of him by name when the information was given.

RESTATEMENT (SECOND) OF TORTS § 552 comment h (1977). Compare § 552 comment h with *Glanzer v. Shepard*, 233 N.Y. 236, 238-39, 135 N.E. 275, 275 (1922) (bean weigher liable because he actually knew the identity of relying buyer). The Restatement position would allow recovery to an unidentified third party as long as that third party was a member of an identified class of persons whose reliance the accountant could foresee. See *Besser*, *supra* note 7, at 524-25 (Restatement extends liability to class actually foreseen by accountant as opposed to person specifically foreseen).

132. *Ryan v. Kanne*, 170 N.W.2d 395 (Iowa 1969).

133. See *supra* notes 10 & 13 and accompanying text; see also Note, H. Rosenblum, Inc. v. Adler: *A Foreseeably Unreasonable Extension of an Auditor's Legal*

ity.¹³⁴ For years courts interpreted the case narrowly, dismissing negligence suits against accountants in which the plaintiff's reliance was foreseeable rather than specifically foreseen.¹³⁵

THE REASONABLY FORESEEABLE: FROM *Rosenblum v. Adler* TO
Touche Ross v. Commercial Union

In 1983, in *Rosenblum v. Adler*,¹³⁶ the New Jersey Supreme Court set new precedent, expanding the liability of accountants to third parties whose reliance on audited financial statements was reasonably foreseeable.

In *Rosenblum*, a Massachusetts corporation which operated discount department stores, hired the defendant accounting firm of Touche Ross & Company to prepare an audit of the corporation's financial situation.¹³⁷ Plaintiff Rosenblum, which operated retail catalogue showrooms, was interested in merging with Giant and relied on Touche's unqualified opinion in making its decision.¹³⁸ The two companies reached an agreement in which Rosenblum sold its operations to Giant in exchange for Giant common stock.¹³⁹ When Giant subsequently filed for bankruptcy, Rosenblum's stock became worthless.¹⁴⁰ Rosenblum sued, alleging that Touche was negligent in failing to detect a large-scale management fraud when it audited Giant's books.¹⁴¹ After considering the various public policy concerns and the legal environment in which the auditor operated, the court rejected the limitations on accountant's third-party liability imposed by *Ultramares* and the Restatement. Instead, the court held that when an independent auditor furnished an opinion without any limitation as to whom the audited company may disseminate the financial statements, he has a duty to all reasonably foreseeable third parties who rely on the statements reviewed from the company for a "proper business purpose."¹⁴² "Stockholders, potential investors, creditors, and potential creditors" were considered by the court to be reasonably foreseeable third parties.¹⁴³

134. 284 F. Supp. 93; see also Gormeley, *supra* note 10, at 548-49.

135. Besser, *supra* note 7, at 520. "[N]one of the courts which stepped away from the pre-1960 mechanical application of *Ultramares* was compelled to forge new law. In each case, the injured party was specifically known by the accountant to be the intended user of the audit. The party was, in short, the 'primary beneficiary' contemplated by *Glanzer*." *Id.* See also Gormeley, *supra* note 10, at 549.

136. 93 N.J. 324, 461 A.2d 138 (1983).

137. *Id.* at 330, 461 A.2d at 140-41.

138. *Id.* at 330, 461 A.2d at 141. The opinion stated that "the financial statements 'presented fairly' Grant's financial position." *Id.*

139. *Id.* at 331, 461 A.2d at 141.

140. *Id.*

141. *Id.* at 331-32, 461 A.2d at 141.

142. *Id.* at 352, 461 A.2d at 153.

143. See Note, *CPA's Liability*, *supra* note 21, at 335-36 n.4 where the author notes:

The scope of this class will differ somewhat depending on the nature of the audited client's business. For example, the reasonably foreseeable users of a manufacturing company's financial statements may include suppliers of inven-

Shortly after the New Jersey Supreme Court decision was handed down, the Supreme Court of Wisconsin in *Citizens State Bank v. Trim, Schmidt & Co.*¹⁴⁴ followed the *Rosenblum* precedent. In this case, the plaintiff bank extended a loan to a company based on the negligently prepared financial statement by the defendant's accountants.¹⁴⁵ When the borrowing company fell into receivership, the bank sued the accountants for negligence. The court held that accountants, like any other tortfeasors, are fully liable for all the foreseeable consequences of their negligent acts.¹⁴⁶

In 1986, the California court of appeals also adopted this position when it permitted recovery by a real estate developer who relied on negligently prepared financial statements in entering into an agreement to purchase and sell government loans.¹⁴⁷ In its decision, the court rejected *Ultramares* as being inconsistent with the fundamental principles of California negligence law and also referred to the changing role of the independent auditor in today's society.¹⁴⁸

The most recent decision on the issue was handed down by the Mississippi Supreme Court which, in *Touche Ross & Co. v. Commercial Union*,¹⁴⁹ continued the trend begun by *Rosenblum*. Touche Ross, as an independent auditor for Fidelity Bank, a state-chartered financial institution, knew that Fidelity was insured against employee fraud with a "Banker's Blanket Bond" issued by its carrier, United States Fidelity and Guaranty (USFG).¹⁵⁰ Touche also knew that USFG could cancel its coverage with thirty days' notice. Four months after completion of the audit, USFG did, in fact, terminate the agreement.¹⁵¹ In seeking out other insurers, Fidelity showed these insurers the financial statements audited by Touche Ross.¹⁵² Commercial Union relied on these statements, which were negligently prepared, in making its decision to extend coverage.¹⁵³ Commercial Union asserted that it would never have extended

tory who sell inventory to the company on credit, or others who factor the company's accounts receivable. Those types of third party users of financial statements, however, would probably not be reasonably foreseeable in the case of a bank or financial institution.

144. 113 Wis. 2d 376, 335 N.W.2d 361 (1983).

145. *Id.* at 378, 335 N.W.2d at 362.

146. *Id.* at 386-88, 335 N.W.2d at 366-67. For an analysis of the decision, see Note, *Recent Decisions: Citizens State Bank v. Timm, Schmidt & Co.*, 22 DUQ. L. REV. 1185 (1984).

147. *International Mortgage Co. v. John P. Butler Accountancy Corp.*, 177 Cal. App. 3d 806, 820-21, 223 Cal. Rptr. 218, 227 (1986).

148. 25 DUQ. L. REV. 287 n.29. For a more detailed discussion, see Note, *International Mortgage Co. v. John P. Butler Accountancy Corp.: Third Party Liability - Accountants Beware*, 18 PAC. L.J. 1055 (1986) [hereinafter Note, *Accountants Beware*].

149. 514 So. 2d 315 (Miss. 1987).

150. *Id.* at 321.

151. *Id.*

152. *Id.* at 323.

153. *Id.* at 316.

coverage to Fidelity if the financial statements had disclosed, as they should have, Fidelity's activities in violation of the GAAP.¹⁵⁴

Touche Ross would not have been liable under *Ultramares* since they did not know of Commercial Union's reliance nor under the Restatement position since they did not supply Fidelity with information for Commercial Union's benefit and guidance. But the court followed *Rosenblum*, upholding the lower court's finding that Touche Ross, under these circumstances, should have "reasonably foreseen that an entity such as Commercial Union Insurance Company" might rely on the audit.¹⁵⁵

Investors, creditors, vendors, and insurers regularly rely on audits conducted by independent examiners for a variety of purposes. Though reasonably foreseeable users of the audit, they are too often excluded from any recovery, despite losses, because of the negligent auditor's limited immunity from a third party's suit The court finds that an independent auditor is liable to reasonably foreseeable users of the audit, who request and receive a financial statement from the audited entity for a proper business purpose, and who then detrimentally rely on the financial statement, suffering loss, proximately caused by the auditor's negligence. Such a rule protects third parties, who request, receive and rely on a financial statement, while it also protects the auditor from an unlimited number of potential users, who may otherwise read the financial statement, once published.¹⁵⁶

Clearly, the reasonably foreseeable standard represents a significant departure from the restrictive view of *Ultramares* and the middle ground of the Restatement. It effectively expands the class of persons to whom accountants owe a legal responsibility. *Touche*, like *Rosenblum*, represent a trend toward making the accountant's duties commensurate with their central roles in today's business environment.¹⁵⁷ Cardozo's policy considerations to protect accountants from liability to third parties for negligence are now obsolete. While once viewed as a clerk, the accountant today plays a vital role in maintaining the integrity of sophisticated business transactions. Accounting is no longer a profession in its infancy but one that flourishes financially and enjoys the status and prestige often associated with the legal and medical fields.¹⁵⁸

154. *Id.*

155. *Id.* at 323.

156. *Id.* at 322-23.

157. "[I]t becomes a highly questionable practice to allow a profession to be employed and gain the benefits of a position of trust, without insisting it assume the responsibilities which accompany that position." Besser, *supra* note 7, at 533. *See generally supra* note 7.

158. *See* Mess, *supra* note 1, at 855. The author notes:

[A] reexamination of the assumptions and basis for *Ultramares* reveals that the decision is no longer valid, and its result is that accountants today generally do not have legal responsibility for their professional conduct to match their significant role in the modern business community. The accounting profession is not a new and developing profession in need of judicial protection, nor are the standards of the profession in their formative years. . . . Finally, the use of financial reports by third parties who are expected to rely on them

THE ACCOUNTING PROFESSION TODAY: EXPANDED LEGAL RESPONSIBILITY

The accountant's role in the operation of the American financial system has expanded tremendously since the beginning of the twentieth century.¹⁵⁹ Initially, when businesses were customarily owned and managed by an individual or a limited number of partners, the role of the accountant was merely to provide information to the owner(s) regarding the financial status of the business.¹⁶⁰ However, as prosperity increased and the modern corporation emerged, companies became dependent on outside investors to provide capital beyond that which the owner could supply.¹⁶¹ At the time of *Ultramares*, the audit was still viewed primarily as a tool for management to entice investors and obtain credit.¹⁶²

The stock market crash in 1929 was responsible for a number of changes in the regulation of the securities industry. Most notably, Congress intended in the passage of federal securities law, in 1933 and 1934,¹⁶³ to implement a policy of full disclosure to the public of relevant information regarding corporate securities so that a buyer of stock would, in theory, have access to the same information as the seller.¹⁶⁴ This legislation served as a tremendous benefit to the accounting profession, especially in a business environment where the amount of publicly offered stock was increasing. The demand for audits and other accounting procedures increased sharply, as did the number of individuals and institutions who received and relied on the information which the accountant provided as an accurate and independent evaluation of a

is no longer a collateral matter to the preparation of the report for the client. See also Note, *Contemporary Approach*, *supra* note 7, at 413 n.75. "[T]he accounting profession today needs little sympathy and should be treated as any other business." *Id.* Weiner, *supra* note 1, at 250. "The fees charged by firms have risen commensurate with the accountants' increased sophistication, and the complexity and the risk associated with their endeavors." *Id.* See generally *supra* notes 7-8.

159. Besser, *supra* note 7, at 541-42. As the author asserts, The demands of a consumer oriented economy, governmental regulation, constantly shifting and more complicated taxes and tax regulations, enforcement of federal and state securities statutes aimed at fully informing the potential investor, intricate corporate mergers and acquisitions, all have thrust duties upon the accountant, expanded his engagement and complicated his work far beyond what might have been regarded as mere bookkeeping duties 45 years ago.

Id. See Causey, *Duties and Liabilities of the CPA*, in *EVOLUTION OF AUDIT RESPONSIBILITY* 27 (1973) for an analysis of the development of the professional responsibility of accountants. See also Mess, *supra* note 1, at 839-40.

160. Mess, *supra* note 1, at 839. See generally *supra* note 95.

161. Mess, *supra* note 1, at 839; Weiner, *supra* note 1, at 240, 250.

162. See Fiffis, *supra* note 3, at 106-07; Mess, *supra* note 1, at 839.

163. Securities Act of 1933, 48 Stat. 74 (1933); Securities Act of 1934, 48 Stat. 881 (1934). The Securities and Exchange Commission (SEC) was enacted in 1934 to maintain and enforce compliance with these regulations.

164. Marinelli, *The Expanding Scope of Accountants' Liability to Third Parties*, 23 CASE W. RES. 113 (1971).

company's financial status.¹⁶⁵ The principal user of the audit became third parties (often unknown to the accountant) who the client was attempting to influence.¹⁶⁶ The audit was the only means available for these third parties to determine their potential risk in relation to the current financial posture of the accountant's client. The accounting profession,¹⁶⁷ as well as the legal system, has acknowledged that accountants have assumed a role of responsibility and public trust that extends beyond the relationship with the client. The Supreme Court has described the role of the independent auditor as follows:

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.¹⁶⁸

In return, the accountant is well-compensated for the complex, sophisti-

165. "Auditors now had a consumer for their reports beyond their direct client. Further, the new consumer was likely not to be so well informed nor so sophisticated on the financial matters being reported as was the direct client." Wyatt, *Auditors' Responsibilities*, 12 St. Louis U.L.J. 331, 333 (1968). See Weiner, *supra* note 1, at 259 ("accounting services as the major if not only way to efficiently compile and communicate relevant financial information which serves as the basis for investment decisions"); Bilek, *supra* note 21, at 692 ("The accountant must also convey this information in an understandable and nondeceptive manner. Accountants, therefore, must make their language understandable to the frequent nonaccountant users of such information.").

166. See Solomon, *supra* note 50, at 74, where the author states, "[T]o say that the primary utility derived from the independent accountant's report and statements rests with third parties, such as suppliers, credit lenders, potential and present investors, and financial analysts is certainly no great overstatement." See also Note, *Contemporary Approach*, *supra* note 7, at 407 ("The accountant may have no contract with these persons, but their decisions and conduct are influenced by his findings."); Rosenblum, 93 N.J. at 345, 461 A.2d at 149 ("It is now well recognized that the audited statements are made for the use of third parties who have no contractual relationship with the auditor. Moreover, it is common knowledge that companies use audits for many proper business purposes [involving third parties]."). See generally *supra* note 7.

167. The first page of the AICPA's Code of Ethics is concerned with the accountant's relationship to the public: "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." American Institute of Certified Public Accountants, *Professional Standards, Code of Professional Ethics* (CCH) ET § 51.04 (1978) [hereinafter AICPA].

168. *United States v. Arthur Young & Co.*, 465 U.S. 805, 817-18 (1984).
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cated services that he alone can provide.¹⁶⁹ The accountant's legal responsibility should be commensurate with the benefits derived from his expanding function in the business community. This responsibility should place him on an equal footing with other types of professional liability. Like other professionals, the accountant should be liable for the foreseeable consequences of performing a service in a negligent fashion. The law has slowly changed to reflect his viewpoint. The focus of the current debate is on how far to expand the accountant's liability.

The modern interpretation of *Ultramares*, (*Credit Alliance Corp. v. Arthur Andersen & Co.*) limits recovery to those specifically known to the accountant as parties who would rely on his audit.¹⁷⁰ The lending institution's ability to recover from an accountant is determined by whether the accountant's client, the borrowing party, disclosed the identity of the institution to the accountant. For example, assume that the client informed the accountant that it would use the audit to demonstrate the strength of its financial position in seeking a loan from Bank A. If the audit were negligently performed, Bank A could bring a negligence suit. But if Bank A denied the application and the client then borrowed from Bank B, Bank B would be unable to sue since it was not a specifically known third party. The Restatement position would allow recovery in this situation. Bank B, although unidentified, is a member of "an actually foreseen" limited class. However, if a potential purchaser of stock relied on this same audit, he would be denied recovery since he would not be a member of a class foreseen by the accountant. He is a potential investor, not a potential creditor.¹⁷¹

Clearly, the Restatement standard reflects the accountant's responsibility to those beyond the direct client, but does not protect the general public from the accountant's negligence. While large, known investors are protected; smaller, unknown investors who foreseeably and reasonably rely on the accountant are forced to bear the risk of such reliance.¹⁷² Therein lies the flaw of the Restatement approach; the relying public, not the flourishing accounting profession, needs protection.

Rosenblum and, most recently, *Touche Ross*, have shifted the loss away from the innocent creditor or investor who relies on the audit to the easiest cost-avoider, the auditor himself.¹⁷³ In the example above, under the doctrine

169. *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984).

170. *See supra* text accompanying notes 68-73.

171. *See Note, Accountants' Liability, supra* note 7, at 584-85 n.108.

172. Besser, *supra* note 7, at 527 has concluded that "This is illogical, considering that the same standards of care must be observed regardless of the identity of the actual recipient." Note, *Accountant's Negligence, supra* note 7, at 446-47. "[T]he Restatement approach . . . draws an arbitrary limit on the class of potential plaintiffs . . . creat(ing) an undesirable inflexibility which denies injured third parties recovery simply because they do not fall within a specific class of persons." *Id.*

173. *See G. CALABRESI, THE COSTS OF ACCIDENTS* 312 (1970). A central theme in tort literature is that tort liability should be imposed on the party who can most easily avoid the occurrence of negligent conduct. *See also Rosenblum*, 93 N.J. at 347,

established by these cases, the potential investor could recover. He is a third party whose reliance on the audited financial statements is reasonably foreseeable to the accountant.

Extending accountant's liability to foreseeable users' audited financial statements will not cripple the now financially strong accounting industry. The expansion of the accountant's liability does not make him an insurer of the accuracy of his work.¹⁷⁴ He certifies only that the financial statements fairly present the financial position of the firm in accordance with the GAAP as codified by the AICPA. Liability is possible only in the circumstances in which the accountant fails to conform to accepted professional practices by performing his duties in a careless, irresponsible fashion. Even when mistakes do slip through the sophisticated modern audit procedures, the potential for unlimited liability is diminished by the difficult burden of proof placed on the plaintiff in a negligent misrepresentation suit. The plaintiff must show that he received the accountant's audit from a company for a proper business purpose, that he reasonably relied on the accountant's negligence, and that these particular misstatements were the proximate cause of the plaintiff's specific financial

461 A.2d at 150 (accountants "can eliminate the necessity for costly separate investigations by each party of interest"). Were CPA's to "engage in more thorough reviews" they could "reduce the number of instances" of negligence. *Id.* at 350, 461 A.2d at 152. For a discussion of enterprise liability supporting the contention that the accountant is the "superior risk bearer," see Comment, *Extensions of Accountants' Liability for Negligence: One Step Closer to a New Implied Warranty of Results*, 56 U. COLO. L. REV. 265, 276-80 (1985); see also Calabresi & Hirschoff, *Toward a Test for Strict Liability in Torts*, 81 YALE L.J. 1055 (1972); Calabresi, *Some Thoughts on Risk Distribution and the Law of Torts*, 70 YALE L.J. 499 (1961); Klemme, *The Enterprise Liability Theory of Torts*, 47 U. COLO. L. REV. 153 (1976). See generally Weiner, *supra* note 1, at 253.

174. It is not practical for the CPA to examine and test every transaction that a company makes. Due to this inherent limitation in the auditing process, "the auditor is not an insurer or a guarantor of the fairness of [financial statements] . . ." A. ARENS & J. LOEBBECKE, *supra* note 19, at 18. See also *Rosenblum*, 93 N.J. at 344, 461 A.2d at 148, where the court notes that an auditor's review is subject to constraints because he is not required to investigate every supporting document nor deemed to have the training of a criminal investigator. Solomon, *supra* note 50, at 89, also concludes that "It is clear that the CPA should not be made a guarantor of the absolute accuracy of the financial statements he certifies." But see Comment, *supra* note 173, at 280-86 where the author argues for an implied warranty of accurate results, the theoretical basis of which is product liability cases. For an argument that implied warranty doctrine can and should be applied to consumer service transactions, see Greenfield, *Consumer Protection in Service Transactions — Implied Warranties and Strict Liability in Tort*, 1974 UTAH. L. REV. 661; Norman, *Consumer Service Transactions, Implied Warranty and a Mandate for Realistic Reform*, 11 LOY. U. CHI. L.J. 405 (1980); Singal, *Extending Implied Warranties Beyond Goods Equal Protection for Consumers of Services*, 12 NEW ENG. 859 (1977); Comment, *Guidelines for Extending Implied Warranties to Service Markets*, 125 U. PA. L. REV. 365 (1976); Note, *The Application of Implied Warranties to Predominantly "Service" Transactions*, 31 OHIO ST. L.J. 580 (1970).

loss.¹⁷⁵ Proving reliance and causation can be extremely difficult. Creditors and investors, in making a decision, often rely on a variety of factors other than the accountant's financial statements.¹⁷⁶ Further, if the plaintiff could have prevented his loss by the exercise of reasonable care and failed to do so, his recovery will be limited or perhaps even barred under the doctrines of comparative or contributory negligence.¹⁷⁷ This would occur in a situation when, for example, the plaintiff had done his own investigation of a company and had reason to believe the financial statements prepared by the accountant did not accurately reflect the company's financial position, but nonetheless continued to rely on the statements.

The accounting industry has several options through which to pay the cost of negligence suits. It can raise the price of accounting services, thereby distributing the cost of negligent behavior to the general public.¹⁷⁸ It can utilize malpractice insurance and charge the cost to the client. The client, in turn, can allocate that cost to the public as a part of doing business.¹⁷⁹ Finally, the

175. *Rosenblum*, 93 N.J. at 350, 461 A.2d at 152; Note, *Public Accountants and Attorneys: Negligence and the Third Party*, 47 NOTRE DAME L. 588, 605 (1971) ("If the courts adhere to strict rules of proof of causation, foreseeability, and reliance, the profession will not face ruin."); see also Besser, *supra* note 7, at 537-41. See generally *supra* notes 44-59 and accompanying text.

176. Comment, *Accountant's Liability*, *supra* note 7, at 581-82; see *Professional Liability — A New Development*, 99 N.J.L.R. 356, 356 (1976).

In the typical commercial transaction, the creditor or investor parting with his money often relies on many factors other than a financial statement or legal opinion proffered by the other side. Many investors do not bother with an audit at all, but accept contractual representations and warranties. Others bring in their own accountants and lawyers (with whom, of course, they are in direct privity) to conduct the necessary investigations on which they rely.

Id.

177. Comparative negligence statutes, which now exist in over 40 jurisdictions, reduce the plaintiff's recovery based on the proportion that his own fault contributed to the injury. In states that still use the doctrine of contributory negligence, negligence on the part of the plaintiff, will completely bar any recovery of damages. See K. CLARKSON, E. MILLER, & JENTZ, WEST'S BUSINESS LAW 69-70 (1986); see also Note, *Accountants' Liability*, *supra* note 7, at 358-59. For a discussion of the role of contributory negligence in actions against accountants, see Menzel, *supra* note 54. See generally PROSSER & KEETON, *supra* note 1, § 65, at 451-62; Note, *Contemporary Approach*, *supra* note 7, at 413-14.

178. The *Rosenblum* court acknowledged that accountants are the most efficient cost distributors. The court stated: "Isn't the risk of loss more easily distributed and fairly spread by imposing it on the accounting profession, which can pass the cost of insuring against the risk onto its customers, who can in turn pass the cost onto the entire consuming public?" 93 N.J. at 351, 461 A.2d at 153 (quoting from *Rusch Factors, Inc. v. Levin*, 284 F. Supp. 85, 91 (D.R.I. 1968)); see also *International Mortgage v. John P. Butler Accountancy Corp.*, 177 Cal. App. 3d 806, 820, 223 Cal. Rptr. 218, 227 (1986) (the "enterprise liability" approach suggests that the burden would be funneled down until it reached the consuming public); Marinelli, *supra* note 164, at 127-28; Griffin, *The Beleaguered Accountant: A Defendant's Viewpoint*, 62 A.B.A.J. 759, 762 (1976).

179. The expansion of the liability of CPAs to foreseeable plaintiffs will increase

auditor can limit the dissemination of his or her opinion through a separate

both the cost of insurance for auditors and the cost of an audit, as CPAs make a more expansive examination in order to avoid negligence. Comment, *CPA's Liability, supra*, note 21, discusses how the cost of insurance will be spread throughout society:

The degree to which CPAs can pass these increased costs on to their clients depends on the elasticity of demand for and supply of CPAs' auditing services. To the extent that such demand and supply are relatively inelastic, much of the increased costs of insurance and additional auditing can be passed on. To the extent that such demand and supply are relatively elastic, however, CPAs will have to bear much of the increased costs of insurance and additional auditing themselves.

Among large publicly held companies, the demand for CPA audit services is inelastic because those companies are required by law to have annual independent audits of their financial statements. The supply of CPA firms with the expertise and resources to perform audits of that size and complexity is also relatively inelastic. Therefore, most, if not all, of the initial increase in CPA malpractice insurance premiums and the cost of augmented auditing will be passed from the CPA to the client through higher audit fees.

....

Once the CPA passes on his increased insurance and auditing costs to the client via higher fees, the extent to which a client company can in turn pass the increased audit fee on to its customers or stockholders depends on the elasticity of demand for and supply of its goods or services. . . .

. . . Ultimately, the initial increase in CPA malpractice insurance premiums and the cost of augmented auditing procedures, resulting from an expanded law of accountants' liability, will be spread over a large group of people. . . . Such a result is socially beneficial because it prevents the financial demise of the accounting profession and the concomitant loss of the valuable independent auditing function from the public markets.

Id. at 350-353. Another result is that diligent accounting firms that make sound audits will benefit from low insurance premiums, since the difficulty in obtaining insurance and the size of premiums increase with the frequency and size of an insured's loss. Negligent accounting firms, in order to pay for the increased insurance will have to absorb the cost, thus lowering their profit. Passing the cost to the client will not be possible because the client will in turn hire the non-negligent accountant, whose fees will be lower. The result is that the negligent accounting firm may be forced out of business. *Id.* at 353-54. This is beneficial however, because "[t]here is no sound reason to protect professional firms that act negligently, and accountants' liability can be another means to make the accounting profession more reliable by weeding out the bad firms." Note, *Contemporary Approach, supra* note 7, at 415. For a discussion of CPA malpractice insurance, see Comment, *Auditors' Third Party Liability: An Ill-Considered Extension of the Law*, 46 WASH. L. REV. 675, 682-85 (1971) [hereinafter as Comment, *Auditors' Third Party Liability*]. For a discussion of the concepts of supply, demand, and market elasticity, see R. LIPSEY & P. STEINER, MICROECONOMICS 53-68 (5th ed. 1979); R. POSNER, ECONOMIC ANALYSIS OF LAW 196-97 (2d ed. 1977); P. SAMUELSON, ECONOMICS 380-81 (9th ed. 1973). The above analysis, however, is inapplicable to the smaller CPA firms. Since the number of firms capable of auditing smaller companies is larger than the number of firms capable of auditing the large, publicly-owned corporations, the supply of CPA's in this market is not inelastic.

In light of this relative elasticity of the demand for and the supply of audit services among small privately held corporations, the result of the *Rosenblum* decision for these small corporations and the CPA firms that audit them is two-fold. First, for some small clients, CPA audits are a business necessity.

Because of the inelasticity of this demand, CPAs will be able to pass on some of their initial increases in insurance costs and auditing costs to these small companies. They will not, however, be able to pass on these costs to the same extent large firms will be able to pass on costs to their publicly held clients because the supply of small CPA firms is not as inelastic as the supply of large CPA firms. Second, clients that do not require audits but have them performed for management purposes nonetheless may decide to cancel these voluntary audits if CPAs increase their fees. In the alternative, these companies may substitute audits with "reviews" or "compilations" of their financial statements. These two special CPA services require less work and therefore cost less than a complete audit, but provide less assurance that the financial statements are accurate. Therefore, it appears that, in practice, the *Rosenblum* rule will have more of an adverse financial impact on small and medium sized CPA firms than on large firms.

Note, *CPA's Liability*, *supra* Note 21, at 351 n.19 (citations omitted). See Note, *Accountants Beware*, *supra* note 148, at 1067, where the author discusses the effects of expanded liability on smaller firms:

The smaller accounting firms are being hit the hardest, since litigation will usually be limited to cases involving commercial transactions that do not fall under the securities laws. Those cases generally involve smaller businesses dealing with smaller accounting firms. Of the nearly one dozen insurance companies which formerly offered liability insurance for smaller accounting firms, only three companies still offer coverage.

Another commentator reports that:

Of those firms offering liability insurance to small companies, one has stopped writing policies for individual accountants and anticipates ending its group policy plan for the California Society of CPAs. For those companies still offering liability insurance to smaller firms, premiums and deductibles have skyrocketed while maximum coverage has plummeted. Larger firms have also indicated that similar insurance problems are affecting them; [j]udgements and settlements of lawsuits involving accountants have been huge, . . . \$180,000,000 for the 8 larger CPA firms since 1980, and insurance for all firms has become limited and prohibitively expensive.

Collins, *Minimizing Risk for CPAs is Focus of AICPA Conference*, 161 J. ACCT., July 1986, at 52. These authors fear that due to the increased cost of insurance, many smaller accounting firms may simply withdraw from the audit market altogether. See also Comment, *Auditors' Third Party Liability*, *supra* note 179, where the author argues that expanded liability will result in injury to both the auditing profession and the general public since only larger firms will remain solvent because only they could distribute the losses. In turn, an oligopoly consisting of the "Big Eight" accounting firms could, through price-fixing powers, extract a large profit from society. See Gormeley, *supra* note 10, at 570-73; Comment, *Accountant's Liability to the Third Party and Public Policy: A Calabresi Approach*, 39 Sw. L.J. 689 (1985); Note, H. Rosenblum, Inc. v. Adler: *A Foreseeably Unreasonable Extension of an Auditor's Legal Duty*, 48 ALB. L. REV. 876 (1984) for a conclusion that the imposition of accountants' liability to all foreseeable persons for negligence is not justifiable economically. *But see* Weiner, *supra* note 1, at 252 who argues that the economic consequences as such have been given minimal consideration by the courts in other areas and that the accounting profession should not be singled out for protection. See generally Collins, *supra* note 3, at 57. For a brief discussion of reviews and compilations, see A. ARENS & J. LOEBBECKE, *AUDITING: AN INTEGRATED APPROACH* 742-50 (2d ed. 1980); Comment, *Accountants' Liability for Compilation and Review Engagements*, 60 TEX. L. REV. 759 (1982).

agreement with his client.¹⁸⁰

The uniform expansion of accountant's liability for negligence to the foreseeable users of their financial statements will serve an important public benefit: higher quality accounting services. Negligent auditing will be deterred as accountants, realizing that their mistake will involve potentially greater financial consequences, will use even greater care to avoid them. Diligent accounting firms will reap the benefits of low insurance premiums while negligent firms may eventually be forced out of business.¹⁸¹ Expanding liability will also lessen the likelihood that an accountant will use "creative methods" in order to preserve a relationship with a major client. In this regard, the independent role of the auditor will be preserved, in turn, ensuring a more accurate report for the investing public.¹⁸² On the whole, greater legal responsibility will increase the public trust in and enhance the credibility of the public accountant.

180. See *Rosenblum*, 93 N.J. at 351, 461 A.2d at 152 (quoting Stanton & Dugdale, *Recent Developments in Professional Negligence II: Accountants Liability to Third Parties*, 132 NEW L.J. 5 (1982)). Practically, however, the audited company might be reluctant about such an idea because it would cast doubt on the financial statements, while firms might be reluctant to attempt such an approach because they would fear losing business to those who would not disclaim responsibility. Hence, this policy is unlikely to work unless it is done on a uniform basis. See Comment, *Rosenblum v. Adler*, *supra* note 101, at 958 n.93. See also Rosenfield & Lorenson, *Auditors' Responsibilities and the Audit Report*, J. ACCT., Sept. 1974, at 82-83. See Collins, *supra* note 3, at 64 for suggestions for accountants on how to limit liability.

181. See generally *supra* note 180.

182. See Fishel, *The Regulation of Accounting: Some Economic Issues*, 52 BROOKLYN L. REV. 1051, 1052-55 (1987). See generally Fiflis, *supra* note 2, at 45-49; Mess, *supra* note 1, at 857.

