

EVOLUTION OF AUDITOR LIABILITY TO NONCONTRACTUAL THIRD PARTIES: BALANCING THE EQUITIES AND WEIGHING THE CONSEQUENCES

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INTRODUCTION

Audits have been referred to as "admission tickets" for investors and creditors.¹ An enterprise seeking financing through loans, stock offerings, and other forms of credit enhancement looks to investors and creditors.² Creditors and investors, in turn, look to the enterprise's financial audit in making lending and investing decisions.³ Given this common scenario, an audit legitimizes the track record of a business by providing opinions⁴ on financial statements.⁵ If the auditor⁶ issues a clean audit,⁷ indicating a healthy enterprise, investors and creditors are often willing to provide credit and/or

1. Scott Vick, Note, *Bily v. Arthur Young & Co.: Is Limiting Auditor Liability to Third Parties Favoritism or Fair Play?*, 26 LOY. L.A. L. REV. 1335, 1336 (1993); see also *Bily v. Arthur Young & Co.*, 834 P.2d 745, 751 (Cal.) (noting businesses' frequent use of audits to establish financial credibility), modified, 3 Cal. 4th 1049a (1992).

2. See ROBERT W. HAMILTON, CASES AND MATERIALS ON CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED PARTNERSHIPS 297 (4th ed. 1990) (explaining corporate sources of capital).

3. See Vick, *supra* note 1, at 1336 (discussing importance of audits for entrance into venture capital markets); see also *infra* Part I.A. (discussing purposes of audits).

4. In this context, the term "opinions" is meant to convey the auditor's conclusions on the financial condition of the business as reflected in the financial statement.

5. See John A. Siliciano, *Negligent Accounting and the Limits of Instrumental Tort Reform*, 86 MICH. L. REV. 1929, 1932 (1988) (explaining how audits convince third parties to extend credit to, and invest in, particular business).

6. Throughout this Comment, the terms "accountant" and "auditor" are used interchangeably.

7. See Vick, *supra* note 1, at 1336 n.5, 1343-44 (defining clean audit as "an auditor's statement that the client's financial statements, taken as a whole, represent the entity's actual financial position"); see also Willis W. Hagen, II, *Certified Public Accountants' Liability for Malpractice: Effect of Compliance with GAAP and GAAS*, 13 J. CONTEMP. L. 65, 66 (1987) (defining audit as independent inquiry made by accountant into how fairly entity's financial statements reflect its actual financial position).

needed capital.⁸ In essence, investors and creditors are attracted to the enterprise based on its financial stability, which is certified by the audit.

A problem with extending loans and credit arises, however, when investors and creditors rely on an unqualified audit opinion⁹ prepared by an accountant, and are thereafter faced with an insolvent debtor who has defaulted on its payment obligations.¹⁰ Because a business fails, the question becomes whether the audit opinion was, in fact, not accurate, and if not accurate, whether the audit was negligently prepared by the accountant.¹¹ Investors and lenders tend to treat business failures as audit failures, and often look to the auditor when searching for a solvent party from whom losses may be recovered.¹² These business failures result in actions against the accountant for negligently preparing an audit that erroneously depicted a healthy business, which in fact was failing.

This Comment will focus on the degree to which an accountant's duty of care¹³ in preparing an audit extends beyond the entity in privity with the accountant.¹⁴ This issue has been hotly debated by

8. See Vick, *supra* note 1, at 1342-44 (explaining role of auditor and investor/creditor reliance on clean audits).

9. See Hagen, *supra* note 7, at 69-70 (defining unqualified audit opinion as one provided by accountant to indicate that financial statements accurately represent financial position "without any exceptions, reservations, or qualifications"). See generally *infra* text accompanying notes 25-30 (describing four types of audit reports utilized by accountants).

10. See Siliciano, *supra* note 5, at 1932-33 (describing fraudulent actions by clients that deceive auditors and are used by client to appear solvent and attractive to investors and creditors); Vick, *supra* note 1, at 1336-37 & n.7 (citing *Bily* and noting accountant's lack of control over clients); *infra* notes 184-93 and accompanying text (describing client-controlled environment in which accountants operate). One commentator explains why financial institutions have suffered such losses in the past several years, noting that "[d]uring the 1980s, many businesses and financial institutions failed [and t]hese failures, in turn, had an enormous impact on the nation's financial markets." Vick, *supra* note 1, at 1336 n.6 (citing Erica B. Baird, *Legal Liability Under the Expectation Gap Statements on Auditing Standards*, in ACCOUNTANTS' LIABILITY 1991, at 63, 65 (Dan L. Goldwasser ed., 1991)).

11. See Vick, *supra* note 1, at 1337 (noting that "when clients fail financially, the CPA auditor is a prime target" to blame).

12. See Nancy Chaffee, Note, *The Role and Responsibility of Accountants in Today's Society*, 13 J. CORP. L. 863, 882-83 (1988) (discussing "expectation gap" that leads public to "characterize business failures as audit failures") (citing Joseph E. Connor, *Enhancing Public Confidence in the Accounting Profession*, J. ACCT., July 1986, at 76-77). The court in *Bily v. Arthur Young & Co.* recognized that creditors and investors tend to treat business failures as audit failures. *Bily v. Arthur Young & Co.*, 834 P.2d 745, 763 (Cal.), *modified*, 3 Cal. 4th 1049a (1992). The court explained that the accountant becomes a prime target when a creditor claims economic loss because the accountant is the solvent party who had direct contact with the business enterprise. *Id.*

13. See generally Hagen, *supra* note 7, at 76-87 (discussing accountants' duty of care in both negligence and accounting contexts); Vick, *supra* note 1, at 1346-50 (defining "to whom an auditor owes a duty").

14. A party is in privity with the accountant if there is a contract between the parties to perform services. See Vick, *supra* note 1, at 1346-50 (discussing *Ultramares v. Touche*, 174 N.E. 441 (N.Y. 1931), and defining privity). A client, therefore, is in privity with the accountant

courts and commentators since Chief Judge Cardozo's 1931 seminal opinion in *Ultramares Corp. v. Touche Niven & Co.*¹⁵ Several varying schools of thought have emerged¹⁶ and have been adopted by legislatures and the judiciary.¹⁷

At the core of this debate are uncertainties surrounding both the role of accountants in performing audits as well as accountants' liability to third parties who rely on the audit. Part I of this Comment describes accounting and the role of the accountant in performing audit functions. In particular, Part I details the various audit reports

because the client has contracted for the services of the accountant. *Id.* (discussing privity and auditors' duty of care).

15. 174 N.E. 441 (N.Y. 1931).

16. Three of the four schools of thought are discussed and analyzed in this Comment. The first is privity, which permits recovery only where a contractual relationship exists between parties. *See infra* notes 57-107 and accompanying text; *see also* Vick, *supra* note 1, at 1346-48. The second school is the foreseeability approach, which allows any foreseeable third party to recover against an accountant for negligence, despite the absence of privity. *See infra* notes 108-35 and accompanying text; *see also* Vick, *supra* note 1, at 1348-49. The third school, the *Restatement (Second) of Torts* § 552 approach, strikes a balance between the privity doctrine and the foreseeability test by carving out limited exceptions to the privity bar. *See infra* notes 136-52 and accompanying text; *see also* Vick, *supra* note 1, at 1349-50. Finally, the federal securities laws have also dealt with the problem of accountant liability to third parties. *See generally* Aulana L. Peters, *Survey of Development of Accountants' Liability Law from the Demise of Privity to the Cry for Tort Reform*, C859 ALI-ABA 877 (June 21-25, 1993). The privity requirement was "summarily dispensed with" in federal securities statutes. *Id.* at 884-85. *See generally* Securities Act of 1933, § 11, 15 U.S.C. § 77(k) (1988) (stating that accountants are liable for preparing or certifying any report or valuation that is used in connection with registration statement). When financial statements prepared by an auditor are used in connection with public securities offerings, and are found to be erroneous, "a market impact can result, and investors may seek to recoup their losses by asserting securities claims, which are not necessarily subject to a privity requirement." Richard P. Swanson, *Theories of Liability*, C302 ALI-ABA 1, 37 (Feb. 4, 1993). In other words, when an accountant opines on "publicly disseminated financial statements to the investing public," liability may ensue. Peters, *supra*, at 885. The court in *Bily* outlined several limits to accountant liability under the federal securities laws. *Bily*, 834 P.2d at 760. The factors to be considered were whether:

(1) the accountant's liability is limited to situations in which he or she prepares or certifies the accuracy of a portion of a registration statement and thus is aware he or she is creating part of a communication to the public; (2) liability is limited to third parties who actually purchase securities; (3) damage exposure is limited to the out-of-pocket loss suffered by the purchaser and can be no greater than the amount of the offering.

Id. (citing 15 U.S.C. § 77k(a), (e), (g)). One commentator explained, "the plaintiff class, the proof of violation, and the measure of damages are statutorily defined in a manner that enhances the accountants' ability to gauge, *ex ante*, its liability exposure." Siliciano, *supra* note 5, at 1954 n.131.

17. *See, e.g.*, N.Y. EDUC. LAW § 7402 (McKinney 1985 & Supp. 1994) (imposing liability only where contractual relationship exists or where accountant is aware of particular parties who intend to rely on information supplied by accountant); UTAH CODE ANN. § 58-26-12 (1990) (requiring privity of contract except where (1) conduct constitutes fraud, or (2) professional knew of client's intent to influence particular person); *Koch Indus. v. Vosko*, 494 F.2d 713, 724-25 (10th Cir. 1974) (denying recovery where plaintiff was unknown to defendant); *Shofstall v. Allied Van Lines*, 455 F. Supp. 351, 360 (N.D. Ill. 1978) (denying recovery to reliant parties not in privity with auditor where no special relationship of any kind existed between plaintiff and accountants).

rendered by accountants and delineates the standard of care required of accountants as they perform audits. Part II traces the evolution of the privity bar and its application to accountant liability, focusing on the *Ultramares* Doctrine. Part III details the foreseeability approach to accountant liability, which allows all foreseeable plaintiffs to recover for the negligence of the accountant. Part IV evaluates the *Restatement* approach, recognizing the balance that it strikes between foreseeability and privity. Part V analyzes the three approaches by reviewing two recent court decisions that further shape and define accountant liability. Part VI recommends an approach that serves both the accounting profession and the public generally. Finally, this Comment concludes that the *Restatement* is the best approach because it promotes both responsible accounting and sophisticated lending.

I. ACCOUNTING FUNCTIONS AND PRINCIPLES

To lay a foundation for understanding accountant liability, the following section explains the auditing process, the types of opinions rendered by accountants, and the relevant standards of care to which accountants must adhere. These standards include compliance with industry principles and standards.

A. *The Auditing Function*

An accountant's primary function is to perform an audit of financial statements.¹⁸ Audits seek to verify the information contained in a company's financial statements.¹⁹ Auditing is a process of evaluating data and assertions made by an entity to determine whether they correspond.²⁰ Auditing procedures typically include, but are not limited to, examining tangible assets,²¹ confirming account balances,²² and observing business activities.²³ The entity, in turn, often disseminates the results of the audit to interested parties.²⁴

18. See WALTER G. KELL ET. AL., *MODERN AUDITING* 33 (4th ed. 1989).

19. See *id.* at 5.

20. See *id.* (describing financial statement audits).

21. See BLACK'S LAW DICTIONARY 1456 (6th ed. 1990) (defining tangible assets as assets that have physical existence, but are not held for resale). Examples of tangible assets include cash, real estate, and equipment. *Id.*

22. See Hagen, *supra* note 7, at 66-67 n.14 (defining "confirmation of account balances" as process of obtaining written verification from third party regarding accuracy of information that client claims is correct).

23. Hagen, *supra* note 7, at 67. Examples of business activities that are observed by the accountant may include reviewing business expenses and credit sales. *Id.* at 66-67.

24. See Kell, *supra* note 18, at 5 (noting that financial statement audits are distributed to stockholders, creditors, regulatory agencies, and general public).

B. *Types of Audit Reports*

There are four types of audit reports: (1) an unqualified opinion; (2) a qualified opinion; (3) an adverse opinion; and (4) a disclaimer opinion.²⁵ The first, the unqualified opinion,²⁶ is the most frequently issued audit report.²⁷ It expresses the opinion of a certified public accountant that, without exception, reservation, or qualification, the financial statements of the audited entity give a fair presentation of its financial position, the results of its operations, and changes in its financial position.²⁸ The next two types of audit reports, qualified and adverse opinions, both indicate that the financial statements do not comply with industry principles because they contain material misstatements.²⁹ Finally, the disclaimer opinion indicates that the financial statements fail to represent the true economic condition of the enterprise.³⁰

C. *The Accounting Standard of Care: GAAP and GAAS*

1. *GAAS and GAAP defined*

Generally Accepted Auditing Standards (GAAS)³¹ and Generally

25. See Hagen, *supra* note 7, at 69-72 (describing and defining four types of audit reports). In addition, unless issuing an unqualified opinion, the auditor makes certain assertions that explain the reasons for deviating from the unqualified opinion. *Id.* at 72-76 (describing and explaining audit report assertions).

26. See Hagen, *supra* note 7, at 69-70 (discussing unqualified opinions); see also Vick, *supra* note 1, at 1343-44 (discussing unqualified audit opinions). Vick explains that unqualified audit opinions are often referred to as "clean opinions." *Id.* In other words, the auditor reasonably believes that the entity's financial statements "fairly present its financial position." *Id.* It does not, however, guarantee that the client's financial position is stable, profitable, or an accurate reflection of the client's financial health. *Id.* The only implication of a clean audit opinion is that the auditor has performed the service in good faith and in accordance with GAAP and GAAS. *Id.* The unqualified opinion is the type of opinion most relevant to this Comment. When such an opinion is rendered by the accountant, it indicates a healthy company. When the unqualified opinion is erroneous, however, and the company is in fact operating at a loss, the bank relying on this opinion before extending a loan to the company who subsequently defaults, may look to the accountant as the solvent party from whom to recover its losses. See Siliciano, *supra* note 5, at 1932-33 (noting injured third party's reliance on solvent auditor for recovery against defaulted company).

27. Hagen, *supra* note 7, at 69.

28. See Hagen, *supra* note 7, at 69 (defining unqualified opinion).

29. See Hagen, *supra* note 7, at 70-71 (defining qualified and adverse opinions); *infra* Part I.C.1 (outlining industry standards and principles).

30. See Hagen, *supra* note 7, at 71-72 (defining disclaimer opinion).

31. See HOWARD F. STETTLER, AUDITING PRINCIPLES: A SYSTEMS-BASED APPROACH 9-10 (5th ed. 1982) (explaining generally accepted auditing standards (GAAS)). To comply with GAAS, the auditor must follow each of 10 basic standards:

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.

Accepted Auditing Principles (GAAP) are created by the American Institute of Certified Public Accountants (AICPA), a national professional accounting organization.³² GAAS establish the quality of performance and the objectives that accountants are to maintain when performing financial statement audits.³³ The GAAS provide criteria for evaluating financial statement audits and require that the accountant render an appropriate opinion based on the accountant's review of the financial statements.³⁴ GAAP, on the other hand, are the particular methods used, and acts performed, by the auditor during an audit.³⁵ Common auditing procedures include, but are not limited to, accounting for cash³⁶ and observing an inventory count.³⁷

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3. Due professional care is to be exercised in the performance of the examination and preparation of the report.

Standards of Field Work:

4. The work is to be adequately planned and assistants, if any, are to be properly supervised.
5. 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.
6. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

Standards of Reporting:

7. The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting.
8. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.
9. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
10. 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, reasons therefor should be stated. In all cases where the 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.

Id.

32. The American Institute of Certified Public Accountants (AICPA) has been developing accounting principles since 1917, in an effort to guide, strengthen, and improve the auditing practice. STETTLER, *supra* note 31, at 27-28.

33. KELL, *supra* note 18, at 13.

34. See KELL, *supra* note 18, at 13 (discussing three categories of GAAS procedures: general, field work, and reporting).

35. See KELL, *supra* note 18, at 13 (noting that GAAP relate to GAAS reporting standards).

36. See LEE J. SEIDLER & D.R. CARMICHAEL, ACCOUNTANTS' HANDBOOK 16.3-4 (6th ed. 1981) (stating that because each business sale "leads to a cash receipt and every expense to cash disbursement," cash accounting is crucial to how business functions); see also KELL, *supra* note 18, at 13-14 (noting types of auditing procedures).

37. See Kell, *supra* note 18, at 13-14 (discussing relationship between auditing standards and auditing procedures and explaining particular procedures, including observing inventory counts).

2. *Standards and principles guiding audits*

Both GAAS and GAAP include a series of statements that guide the auditor.³⁸ The accountant's duty of care is satisfied by performing the audit in accordance with GAAS and conforming to GAAP.³⁹ In fact, an accountant will generally satisfy the requisite duty of care and escape liability for negligence when complying in good faith with GAAP and GAAS.⁴⁰

D. Economic and Commercial Realities for the Accountant

Although an accountant needs to satisfy only a minimum standard of care under GAAS and GAAP in order to issue an unqualified opinion, commercial realities require accountants to perform additional roles in an audit. For example, clients generally retain an accountant to perform an audit and provide an unqualified opinion that indicates, without exception, that the financial statements of the clients fairly present their financial position.⁴¹ These opinions are often, if not exclusively, used by businesses to appear more attractive to lenders and investors.⁴² Accordingly, the AICPA has noted that

38. KELL, *supra* note 18, at 14. One such statement is that the audit must be performed and prepared with due professional care. *Id.*

39. See Hagen, *supra* note 7, at 78 (discussing accounting standard of care).

40. See Hagen, *supra* note 7, at 78-79 n.85 (reaching this conclusion by evaluating decisions in which CPA incurred criminal liability for willful violations of Securities Acts of 1933 or 1934: SEC v. Arthur Young & Co., 590 F.2d 785 (9th Cir. 1979); Rhode Island Hosp. Trust Nat'l Bank v. Swartz, Bresenoff, Yavner & Jacobs, 455 F.2d 847 (4th Cir. 1972); United States v. Simon, 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970)).

41. See *supra* note 26 and accompanying text (defining unqualified audit opinion).

42. See Bily v. Arthur Young & Co., 834 P.2d 745, 751 (Cal.) (describing unqualified audit report of CPA firm as "necessary condition precedent to attracting the kind and level of outside funds essential to the client's financial growth and survival"), *modified*, 3 Cal. 4th 1049a (1992); Siliciano, *supra* note 5, at 1932. Siliciano explains:

In the first instance, this unqualified opinion serves as an assurance to the client that its own perception of its financial health is valid and that its accounting systems are reliable. The audit, however, frequently plays a second major role: it assists the client in convincing third parties that it is safe to extend credit or invest in the client.

Id. Third parties may be creditors, investors, or suppliers, who either engage in frequent business relations with the auditor's client or have little prior association with the client. *Id.* If a client is in need of financial assistance and this assistance is vital to the continuation of its enterprise, the client may fraudulently alter its financial records "in an effort to obtain . . . funds from creditors and investors." *Id.* Accordingly, the financial statements that are audited "may present a materially inaccurate picture of the client's financial health." *Id.* If the auditor fails to detect the fraud, yet issues an unqualified opinion, third parties who rely on the representations made in the audit reports are liable to suffer economic loss and seek redress against the client. *Id.* The client, however, is likely insolvent, so "[t]he injured party's focus therefore naturally shifts to the accountant, whose unqualified opinion regarding the client's financial statements may have encouraged the third party's involvement with the client." *Id.* at 1932-33.

an auditor has a responsibility not only to clients, but also to investors, creditors, and the larger business and financial communities.⁴³

The U.S. Supreme Court has also recognized that the accountant serves a public function when acting as an auditor. In *United States v. Arthur Young & Co.*,⁴⁴ the Court denied work product protection to an auditor's work papers⁴⁵ requiring that the auditor disclose the papers to the Internal Revenue Service.⁴⁶ The Court held that when an auditor depicts a corporation's financial status, she "assumes a public responsibility transcending any employment relationship with the client."⁴⁷ The auditor "owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public."⁴⁸ In light of an auditor's universal duties, the Court in *Arthur Young* labeled the accountant a "public watchdog."⁴⁹ Consequently, an auditor's responsibilities extend well beyond mere adherence to GAAS and GAAP, which dictate only accounting methods and evaluation criteria. *Arthur Young* thus creates the commercial reality that an auditor has a duty to all entities associated with the client, regardless how tenuous that association may be.

II. HISTORICAL PERSPECTIVE: COMMON LAW LIABILITY—ULTRAMARES AND THE PRIVITY BAR

Based on the economic and commercial realities of the audit function and the role of the auditor, several schools of thought have emerged with respect to an accountant's liability as an auditor. Jurisdictions apply one of three rules⁵⁰ to determine whether nonclients can sue an auditor for negligently preparing financial

43. 2 AICPA Prof. Stds. (CCH) ET § 53.01 (1992).

44. 465 U.S. 805 (1984). In this case, Arthur Young & Co. was retained by Amerada Hess Corporation to review its financial statements in accordance with federal securities laws. *United States v. Arthur Young & Co.*, 465 U.S. 804, 808 (1984). In preparing the audit, the accountant verified the corporation's tax liabilities. *Id.* A routine IRS audit, however, revealed that the corporation had made some questionable payments. *Id.* Thus, pursuant to § 7602 of the Internal Revenue Code, the IRS issued an administrative summons requiring the accountant's work papers. *Id.* at 808-09. The corporation advised the accountant to deny the Government's request in the interest of preserving the confidentiality of the work papers. *Id.* at 809. In reversing the decision of the court of appeals, *United States v. Arthur Young & Co.*, 677 F.2d 211 (2d Cir. 1982), *rev'd*, 465 U.S. 804 (1984), the Supreme Court held that the accountant's work product was not protected because the accountant owed a public interest responsibility to the corporation's creditors and stockholders. *Arthur Young*, 465 U.S. at 818, 821.

45. *Id.* at 818, 821.

46. *Id.* at 821.

47. *Id.* at 817.

48. *Id.* at 818.

49. *Id.* (noting that "public watchdog" function requires accountant to remain wholly independent of client and maintain "complete fidelity to the public trust").

50. See *supra* note 16 and accompanying text (setting out theories of liability).

statements: (1) the privity rule, which generally allows only clients to recover;⁵¹ (2) the foreseeability approach, which allows any reasonably foreseeable party who relies on the audit to recover;⁵² and (3) the approach embodied in section 552 of the *Restatement (Second) of Torts*, allowing only intended beneficiaries to recover, provided that the auditor had knowledge of the intended beneficiaries.⁵³ While various jurisdictions have followed the privity rule,⁵⁴ relatively few jurisdictions follow the foreseeability approach.⁵⁵ The majority of jurisdictions, however, have adopted the *Restatement*, finding that it strikes an equitable balance between foreseeability and privity.⁵⁶

51. See *supra* note 16 and accompanying text (defining privity doctrine); *infra* notes 57-107 and accompanying text.

52. See *supra* note 16 and accompanying text (defining foreseeability approach); *infra* notes 108-35 and accompanying text.

53. See *supra* note 16 and accompanying text (outlining *Restatement (Second) of Torts* § 552 approach); *infra* notes 136-52 and accompanying text.

54. See, e.g., *McLean v. Alexander*, 599 F.2d 1190, 1202 (3d Cir. 1979) (agreeing that *Ultramares* rule should be applied under Delaware law); *Koch Indus. v. Vosko*, 494 F.2d 713, 724-25 (10th Cir. 1974) (endorsing trial court's use of *Ultramares* standard); *Stevens Indus. v. Haskins & Sells*, 438 F.2d 357, 359-60 (10th Cir. 1971) (affirming trial court's use of privity standard); *Toro Co. v. Krouse, Kern & Co.*, 644 F. Supp. 986, 994 (N.D. Ind. 1986) (declaring continued adherence to privity standards established in *Ultramares* and *Credit Alliance*, *aff'd*, 827 F.2d 155 (7th Cir. 1987); *Robertson v. White*, 633 F. Supp. 954, 970-71 (W.D. Ark. 1986) (declaring that Arkansas courts continue to use privity standard); *Hartford Accident & Indem. Co. v. Parente, Randolph, Orlando, Carey & Assocs.*, 642 F. Supp. 38, 41 (M.D. Pa. 1985) (holding that privity is required to maintain professional negligence action); *Idaho Bank & Trust Co. v. First Bancorp of Idaho*, 772 P.2d 720, 722 (Idaho 1989) (applying *Credit Alliance* criteria in determining whether accountant owed duty to noncontractual third parties); *Cashman v. Coopers & Lybrand*, 623 N.E.2d 907, 911 (Ill. App. Ct. 1993) (determining that no contractual duty existed between accountants and plaintiffs and affirming dismissal by trial court); *Citizens Nat'l Bank v. Kennedy & Coe*, 441 N.W.2d 180, 182 (Neb. 1989) (finding that accountants would not be liable to banks in negligence absent fraud or other facts establishing duty to banks); *Ward v. Ernst & Young*, 435 S.E.2d 628, 631 (Va. 1993) (declining to carve out exception to privity requirement). In four states, the privity rule has been enacted by statute. ARK. CODE ANN. § 16-114-302 (Michie Supp. 1993); ILL. ANN. STAT. ch. 225, § 450/30.1 (Smith-Hurd 1993); KAN. STAT. ANN. § 1-402 (1991); UTAH CODE ANN. § 58-26-12 (Supp. 1993).

55. See, e.g., *Touche Ross & Co. v. Commercial Union Ins. Co.*, 514 So. 2d 315, 322 (Miss. 1987) (finding auditors "liable to reasonably foreseeable users of the audit" who detrimentally rely on financial statements obtained for proper business purposes); *Rosenblum v. Adler*, 461 A.2d 138, 153 (N.J. 1983) (promulgating rule that independent auditors have duty to all reasonably foreseeable users of audits only if recipients of financial statements provided by audited company rely on such statements pursuant to proper business purposes); *Citizens State Bank v. Timm*, 335 N.W.2d 361, 366 (Wis. 1983) (concluding that mere lack of privity alone is insufficient to bar negligence actions by reliant third parties against accountants, and stating that liability extends to all reasonably foreseeable plaintiffs).

56. As of February 1994, *Restatement* § 552 had been adopted in 23 states: Alaska, *Selden v. Burnett*, 754 P.2d 256, 259 (Alaska 1988) (finding that where company offering investment is bankrupt and investors sue accountant, "accountant owes a duty of care to third parties only if the accountant specifically intends the third parties to invest relying on his advice, and only if he makes his intent known"); Alabama, *Boykin v. Arthur Andersen & Co.*, 639 So. 2d 504, 509-10 (Ala. 1994) (contending that Alabama must move forward and join the other jurisdictions in adopting *Restatement*); Florida, *First Fla. Bank v. Max Mitchell & Co.*, 558 So. 2d 9 (Fla. 1990); Georgia, *Badische Corp. v. Caylor*, 356 S.E.2d 198, 200 n.2 (Ga. 1987) (disallowing recovery by creditors where accountants, who prepared financial statements for debtor, failed to reveal that

A. Historical Background of Privity

The "privity" doctrine developed in England at common law as early as the 1840s when the Court of Exchequer presided over the case of *Winterbottom v. Wright*.⁵⁷ In that case, the defendant had violated a contract to keep a mail coach in repair.⁵⁸ The court held that the defendant was not liable to a third party who had suffered injuries caused by the mail coach's latent defects.⁵⁹ The court reasoned, "Unless we confine the operation 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 Because the plaintiff was not in privity of contract with the defendant, the court concluded that no liability existed.⁶¹ From this holding, the general rule of privity developed.⁶²

B. The Ultramares Doctrine

Ninety years after the English *Winterbottom* decision, the highest court of New York, in *Ultramares Corp. v. Touche Niven & Co.*,

various banks had secured interest in debtor's inventory); Hawaii, *In re Hawaii Corp.*, 567 F. Supp. 609, 617 (D. Haw. 1983) (applying § 552 in determining accountant's negligence); Iowa, *Pahre v. Auditor of State*, 422 N.W.2d 178 (Iowa 1988); Kentucky, *Ingram Indus. v. Nowicki*, 527 F. Supp. 683 (E.D. Ky. 1981); Louisiana, *First Nat'l Bank of Commerce v. Monco Agency*, 911 F.2d 1053 (5th Cir. 1990); Michigan, *Law Offices of Lawrence J. Stockler v. Rose*, 436 N.W.2d 70 (Mich. App. 1989); Minnesota, *Bonhiver v. Graff*, 248 N.W.2d 291 (Minn. 1976); Missouri, *MidAmerican Bank & Trust Co. v. Harrison*, 851 S.W.2d 563, 564 (Mo. Ct. App. 1993); Montana, *Thayer v. Hicks*, 793 P.2d 784 (Mont. 1990); Nebraska, *Seedkem Inc. v. Safranek*, 466 F. Supp. 340, 344 (D. Neb. 1979) (evaluating liability theories and preferring *Restatement* approach); New Hampshire, *Spherex, Inc. v. Alexander Grant & Co.*, 451 A.2d 1308 (N.H. 1982); North Carolina, *Raritan River Steel Co. v. Cherry, Bekaert & Holland*, 367 S.E.2d 609, 611 (N.C. 1988) (concluding that scope of liability is best measured by *Restatement* approach); North Dakota, *Bunge Corp. v. Eide*, 372 F. Supp. 1058 (D.N.D. 1974); Ohio, *Haddon View Inv. Co. v. Coopers & Lybrand*, 436 N.E.2d 212 (Ohio 1982); Oregon, *In re Melridge, Inc. Securities Litigation*, No. 88-1226-JV, 1989 U.S. Dist. LEXIS 15363 (D. Or. Dec. 14, 1989); Pennsylvania, *Sharp v. Coopers & Lybrand*, 457 F. Supp. 879, 886 (E.D. Pa. 1978) (refusing to endorse either foreseeability or privity approach), *aff'd*, 649 F.2d 175 (3d Cir. 1980), *cert. denied*, 455 U.S. 938 (1982); Rhode Island, *Rusch Factors, Inc. v. Levin*, 284 F. Supp. 85 (D.R.I. 1968); Tennessee, *Bethlehem Steel Corp. v. Ernst & Whinney*, 822 S.W.2d 592, 595 (Tenn. 1991) (modifying liability of national accounting firm using *Restatement* approach); Texas, *Blue Bell, Inc. v. Peat, Marwick, Mitchell & Co.*, 715 S.W.2d 408, 413 (Tex. Ct. App. 1986) (applying § 552); and West Virginia, *First Nat'l Bank of Bluefield v. Crawford*, 386 S.E.2d 310, 313 (W. Va. 1989) (finding that majority view provides middle ground and *Restatement* is most appropriate).

57. 152 Eng. Rep. 402 (1842).

58. *Winterbottom v. Wright*, 152 Eng. Rep. 402, 402-03 (1842).

59. *Id.* at 406.

60. *Id.* at 405.

61. *Id.*; see *Credit Alliance Corp. v. Arthur Andersen & Co.*, 483 N.E.2d 110, 115 (N.Y. 1985) (describing Lord Abinger's remarks in *Winterbottom*); *Winterbottom*, 152 Eng. Rep. at 405.

62. See *Credit Alliance*, 483 N.E.2d at 115 (noting that, after *Winterbottom*, privity doctrine developed into general rule that remained predominate well into 20th century); see also W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 93 (1984) (noting that privity rule developed from broad interpretation of dicta in *Winterbottom*).

considered whether an auditor was liable for negligence to unknown third parties with whom he had not contracted.⁶³ Chief Judge Cardozo, writing for the court, applied the privity doctrine to deny recovery to a nonclient who alleged that he had lost money as a result of his reliance on an auditor's negligent certifications.⁶⁴ The defendant, Touche, Niven & Company, a firm of public accountants, was employed by Fred Stern & Company to prepare and certify a balance sheet that was to reflect the condition of Stern's business.⁶⁵ Stern regularly obtained outside financing to maintain its operations, and needed the balance sheet certification to present to banks, creditors, and investors.⁶⁶ Knowing that Stern often obtained outside financing, the accountant provided Stern with thirty-two copies of the certification.⁶⁷ At no time, however, did Touche have knowledge of the specific parties to whom Stern would distribute the certification.⁶⁸ Although the certified balance sheet indicated that Stern was operating with capital and surplus intact, Stern was, in fact, insolvent.⁶⁹ Stern had fraudulently created fictitious assets and the audit did not uncover the discrepancies.⁷⁰ Relying on Touche's certification, the Ultramares Corporation extended loans to Stern that remained unpaid once Stern declared bankruptcy.⁷¹ When Ultramares was unable to recover its losses from Stern, it sued Touche for negligence and fraud.⁷²

Although the court found that the auditors were negligent in failing to uncover Stern's fictitious entries,⁷³ it did not find that fact sufficient to establish liability. Rather, Judge Cardozo focused on whether Touche owed the same duty of care to Ultramares as it did to Stern.⁷⁴ According to the court, Touche owed some duty to

63. *Ultramares Corp. v. Touche Niven & Co.*, 174 N.E. 441, 443 (N.Y. 1931).

64. *See id.* at 445-48.

65. *Id.* at 442.

66. *Id.*

67. *Id.*

68. *Id.*

69. *Id.*

70. *Id.* at 443.

71. *Id.*

72. *Id.* The court did not find that the defendants had committed fraud. According to the court, had the accountant committed fraud by knowingly intending to engage in deception, his duty of care would be expanded and liability would exist even absent a contractual relationship. *Id.* at 444; *see also* Siliciano, *supra* note 5, at 1934-35 (analyzing *Ultramares Doctrine*).

73. *Ultramares*, 174 N.E. at 444. According to the court, on closer examination, a cautious accountant could have discovered both discrepancies in Stern's financial ledgers amounting to a suspicious inflation of its inventory, and questionable invoices that should have served to "cast discredit upon the business and the books." *Id.*

74. *See id.* (noting that Touche owed Stern legal duty to make certification without fraud and in accordance with stated accounting principles).

creditors and investors who were given copies of the certification.⁷⁵ Although this duty clearly included liability for fraud, Chief Judge Cardozo reasoned that "[i]f liability for negligence exist[ed], a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, . . . would expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class."⁷⁶

In recognizing the potential for unlimited accountant liability, the court in *Ultramares* reexamined its prior holding in *MacPherson v. Buick Motor Co.*⁷⁷ In *MacPherson*, the court had adopted a foreseeability of harm test to determine tort liability, which assigned liability irrespective of the parties' contractual status.⁷⁸ The *MacPherson* standard was thus substantially more liberal than the privity doctrine in permitting findings of liability.⁷⁹ Although in *Ultramares*, Chief Judge Cardozo recognized the potential harm of a defective audit, he opted for a more restrictive alternative to the *MacPherson* rule,⁸⁰ noting the "indefinite and wide"⁸¹ number of possible parties to whom the accountant could be liable under the foreseeability test.⁸² The court in *Ultramares* reasoned that liability for negligence may arise from contract performance between the parties to the contract.⁸³ In short, when faced with a critical choice between expanding or

75. *Id.*

76. *Id.* The accountant is retained by the client to review prepared financial statements from which the accountant issues an opinion as to whether these statements are representative of the client's financial status. Siliciano, *supra* note 5, at 1931. This process is very client controlled. See *infra* notes 184-93 and accompanying text (discussing reasons why liability is disproportionate to fault). "Financial statements do not contain records of every financial transaction and are not meant to include all information investors and creditors may find pertinent." Vick, *supra* note 1, at 1340; *id.* at 1340 n.43 (citing *United States v. Weiner*, 578 F.2d 757 (9th Cir.) (stating that purpose of financial statement is to summarize financial position, not to provide all information third parties might want to know before making loan or investment decisions), *cert. denied*, 439 U.S. 981 (1978)).

77. 111 N.E. 1050 (N.Y. 1916). In *MacPherson*, the defendant was a car manufacturer who sold an automobile to a retailer, who in turn resold it to the plaintiff. *MacPherson v. Buick Motor Co.*, 111 N.E. 1050, 1051 (N.Y. 1916). The plaintiff was injured when one of the car's wheels collapsed. *Id.* The court was asked to determine "whether the defendant owed a duty of care and vigilance to any" person other than the immediate purchaser, here the retailer. *Id.* With one judge dissenting, the court held that, due to the dangerous nature of an automobile, the defendant owed a duty to appropriately inspect each car carefully, and that this duty extended to all foreseeable plaintiffs because the defendant was aware that the original buyer was a car dealer "who bought to resell." *Id.* at 1053, 1055.

78. *Id.* at 1053; see also Siliciano, *supra* note 5, at 1934.

79. See Siliciano, *supra* note 5, at 1935.

80. Siliciano, *supra* note 5, at 1935.

81. *Ultramares*, 174 N.E. at 442.

82. See *id.* ("The range of transactions on which a certificate of audit might be expected to play a part was as indefinite and wide as the possibilities of the business that was mirrored in summary.")

83. *Id.* at 448.

restricting liability, Cardozo chose to depart from the court's earlier holdings and limit liability.⁸⁴

The rule adopted in *Ultramares* has been widely applied. Today, many jurisdictions limit recovery to contractual parties.⁸⁵ More recently, however, and despite the privity requirement outlined in *Ultramares*, New York's highest court has not consistently required that plaintiffs in suits against accountants ground their claim in a contractual relationship. For instance, in *White v. Guarente*,⁸⁶ one of forty limited partners sued the auditor who prepared audit reports and tax returns for the partnership.⁸⁷ The plaintiff claimed that the auditor had committed professional negligence by failing to disclose that two general partners had withdrawn funds in violation of the partnership agreement.⁸⁸ The court held that the accountant had a duty to the plaintiff to exercise due care when preparing the partnership's tax returns because the limited partners relied on the returns to prepare their personal tax returns.⁸⁹

The court in *White* distinguished *Ultramares* on the ground that "the services of the accountant were not extended to a faceless or

84. Siliciano, *supra* note 5, at 1935. The New York court's ruling in *Ultramares* was not absolute and did not overrule its earlier decision in *Glanzer v. Shepard*, where relief was granted to a party not in privity with the defendant. *Glanzer v. Shepard*, 135 N.E. 275, 277 (N.Y. 1922). In *Glanzer*, the defendant, a public weigher who provided a seller of beans with an erroneous certification of weight, was found liable to the buyer of the certified goods for the excess amount paid as a result of the inflated weight certification. *Id.* at 275. The court found that, due to the close proximity of the defendant's purpose of public weighing, the defendant owed a duty to the buyer to weigh the goods carefully regardless of whether a contract existed between the weigher and buyer. *Id.* at 276.

In distinguishing *Glanzer* from *Ultramares*, Cardozo reasoned that because the bond between the defendant and the third-party plaintiff was so close in *Glanzer*, unlike in *Ultramares*, it approached privity and was an exception to the rule stated in *Ultramares*. *Ultramares*, 174 N.E. at 446. More specifically, *Glanzer* represented a situation in which the "transmission of the certificate to another was not merely one possibility among many, but the 'end and aim of the transaction.'" *Id.* at 445. On the contrary, in *Ultramares*, "the [auditor's] service was primarily for the benefit of the Stern Company, a convenient instrumentality for use in the development of the business, and only incidentally or collaterally for the use of those to whom Stern and his associates might exhibit it thereafter." *Id.* at 446.

85. See *supra* note 54 (providing examples of jurisdictions that adhere to privity doctrine).

86. 372 N.E.2d 315 (N.Y. 1977). In *White*, a partnership agreement stipulated that at the end of each fiscal year a certified public accountant would be designated by the general partners and retained to perform an audit of the partnership's books and records. *White v. Guarente*, 372 N.E.2d 315, 317 (N.Y. 1977). The plaintiff, a limited partner, sued the general partners and the accountant for, *inter alia*, inaccurate and misleading information contained in the audit reports and financial statements made in violation of the partnership agreement. *Id.* at 318. The New York Supreme Court, Special Term, dismissed the action against the auditor for failure to state a cause of action and the court of appeals affirmed, 388 N.Y.S.2d 1007 (1976) (mem.). Subsequently, the court of appeals reversed, holding that *Ultramares*' privity requirements would not bar liability because the plaintiff was a member of a known, fixed, and limited class for whom the audit was prepared. *White*, 372 N.E.2d at 318-19.

87. *White*, 372 N.E.2d at 317.

88. *Id.* at 317-18.

89. *Id.* at 319.

unresolved class of persons, but rather to a known group possessed of vested rights [the partners], marked by a definable limit and made up of certain components."⁹⁰ The court further noted that the audit and tax return information was only one part of the auditor's responsibility in the transaction and allegiance to the partners was equally important.⁹¹

C. *The New York Court of Appeals Follows Ultramares*

Although *White* represented a slight departure from the rule in *Ultramares*, it was a fact-specific variation not intended to modify the holding in *Ultramares*. In *Credit Alliance Corp. v. Arthur Andersen & Co.*,⁹² another case involving accountant liability to third parties, the New York court reframed the law in light of both *Ultramares* and *White*.⁹³ The plaintiff, Credit Alliance Corporation, as a condition to extending credit, insisted that L.B. Smith, Inc. provide audited financial statements before it would provide Smith with financing.⁹⁴ Accordingly, Smith employed defendant, Arthur Andersen, to perform the audit.⁹⁵ Credit Alliance extended credit to Smith in reliance on the audit, which depicted Smith as a healthy company.⁹⁶ Shortly thereafter, Smith defaulted on millions of dollars in obligations to the plaintiff and declared bankruptcy.⁹⁷ Credit Alliance sued Arthur Andersen for negligently overstating Smith's assets in the audit.⁹⁸

The court found that there was insufficient evidence of direct communications and personal meetings between Credit Alliance and Arthur Andersen to satisfy *Ultramares*' privity requirement.⁹⁹ The court in *Credit Alliance* also took the opportunity to set out three criteria for determining accountant liability to noncontractual third

90. *Id.* at 318.

91. *Id.* at 319.

92. 483 N.E.2d 110 (N.Y. 1985).

93. See *Credit Alliance Corp. v. Arthur Andersen & Co.*, 483 N.E.2d 110, 115 (N.Y. 1985) (restating and elaborating on continued adherence to strict privity requirement instituted in *Ultramares*). But see *White*, 372 N.E.2d at 318-19 (finding accountant liability in certain circumstances to identifiable group of limited partners).

94. *Credit Alliance*, 483 N.E.2d at 111.

95. *Id.*

96. *Id.* The initial audit, alleged to conform with GAAS, covered the years 1976 and 1977. *Id.* Based on these statements, Credit Alliance supplied Smith with substantial sums of money on various occasions. *Id.* It was only after the second audit, in 1979, that additional financing was provided. *Id.*

97. *Id.* at 111-12.

98. *Id.* at 111.

99. See *id.* at 119-20 (contrasting *European Am. Bank & Trust Co. v. Strauhs & Kaye*, 102 A.D.2d 776 (N.Y. App. Div. 1984), where "[t]he parties' direct communications and personal meetings resulted in a nexus between them sufficiently approaching privity under the principles of *Ultramares*").

parties who rely on erroneous financial reports. First, the accountants performing the financial reports must have been aware that such statements were to be used for a certain purpose or purposes.¹⁰⁰ For example, the accountant must have known the financial statements would be disseminated to attract third-party investors. Second, the accountant must have known that the third party intended to rely on the financial statements.¹⁰¹ Third, there must have been some conduct by the accountants that linked them to the third party and gave rise to at least an inference that the accountant understood that the third party was relying.¹⁰²

Applying the facts to the above criteria, the court in *Credit Alliance* held that the accountants were not liable because the plaintiff had failed to present evidence demonstrating that Arthur Andersen had knowledge that the audit would be distributed to it, and because it had failed to demonstrate that it had relied on the audit in extending credit to Smith.¹⁰³ In reiterating the requirement of a "contractual relationship or its equivalent,"¹⁰⁴ the court in *Credit Alliance* did not find that the "end and aim" of the audit was to satisfy the lender.¹⁰⁵ Accordingly, the auditor was not deemed to have been on notice for the purposes of the court's criteria.¹⁰⁶ Thus, the court in *Credit Alliance* maintained and reaffirmed New York's privity jurisprudence.¹⁰⁷

100. *Id.* at 118.

101. *Id.*

102. *Id.* Although these criteria permit a more flexible interpretation of the privity doctrine with respect to accountants' liability, "they do not represent a departure from the principles articulated in *Ultramares* [and] *Glanzer*. . . but, rather, they are intended to preserve the wisdom and policy set forth therein." *Id.*; see also *Bily v. Arthur Young & Co.*, 834 P.2d 745, 754 (Cal.) (discussing rule promulgated in *Credit Alliance*), modified, 3 Cal. 4th 1049a (1992); Swanson, *supra* note 16, at 14-15 (noting that court in *Credit Alliance* rejected opportunity to expand liability).

As recently as January 1993, a federal district court in New York followed the rules articulated in *Ultramares* and *Credit Alliance*. See *Ahmed v. Trupin*, 809 F. Supp. 1100 (S.D.N.Y. 1993). In *Ahmed*, investors who offered interests in commercial real estate sued the accounting firm that performed audits for the offering corporation for misrepresenting the soundness of the investment properties. *Id.* at 1103. The court found that the plaintiffs failed to allege "any nexus between them and the . . . Defendants from which the accountant's understanding of Plaintiff's reliance could be inferred." *Id.* at 1105. Therefore, the plaintiffs did not pass the third prong of the *Credit Alliance* test for the same reason that "the privity exception in *Ultramares* was limited to cases of direct, known reliance." *Id.*

103. *Credit Alliance*, 483 N.E.2d at 119.

104. *Id.* at 117 (quoting *State St. Trust Co. v. Ernst*, 15 N.E.2d 416, 418 (N.Y. 1938)).

105. *Id.*

106. *Id.* at 119-20; see also Swanson, *supra* note 16, at 14-15 (contrasting holdings in *Credit Alliance* and *European American Bank* in finding that no evidence of knowledge existed in former).

107. See *Credit Alliance*, 483 N.E.2d at 119.

III. THE FORESEEABILITY APPROACH

Some jurisdictions entirely disregard the privity approach of *Ultramares*¹⁰⁸ and allow any foreseeable plaintiff to recover.¹⁰⁹ This approach is far broader, and presently only New Jersey,¹¹⁰ Mississippi,¹¹¹ and Wisconsin¹¹² apply it in cases involving accountants.¹¹³

In *Rosenblum v. Adler*,¹¹⁴ the New Jersey Supreme Court applied the foreseeability approach in an action for negligent misrepresentation.¹¹⁵ In that case, stock purchasers argued that they had relied on audits of a corporation's financial statements.¹¹⁶ In the relevant transaction, the purchasers acquired common stock in conjunction with the sale of their business to the corporation.¹¹⁷ When the financial statements were found to be fraudulent, and the stock worthless, the purchasers sued the accountants.¹¹⁸ The New Jersey Supreme Court noted that liability would exist under both the *Ultramares* doctrine¹¹⁹ and the *Restatement* approach¹²⁰ only when there was a relationship between the auditor and the plaintiff third

108. Despite the absence of privity, recovery is allowed in several jurisdictions. See, e.g., *Larsen v. United Fed. Sav. & Loan Ass'n*, 300 N.W.2d 281, 286-87 (Iowa 1981) (expressly departing from strict rule of *Ultramares*); *Spherex, Inc. v. Alexander Grant & Co.*, 451 A.2d 1308, 1311 (N.H. 1982) (expressing disfavor with privity doctrine in personal injury cases and distinguishing privity requirement to recovering in financial loss actions); *Haddon View Inv. Co. v. Coopers & Lybrand*, 436 N.E.2d 212, 214 (Ohio 1982) (rejecting privity limitations in recovery).

109. This approach was proposed in 1983 by Justice Howard Wiener. See Howard Wiener, *Common Law Liability of the Certified Public Accountant for Negligent Misrepresentation*, 20 SAN DIEGO L. REV. 233, 236 (1983) (questioning rationale of *Ultramares* and suggesting that social, economic, and legal considerations now require accountants to be judged by same standards applied to other professionals); see also *Bily v. Arthur Young & Co.*, 834 P.2d 745, 755 (Cal.) (citing Justice Wiener's article and expanding on his conclusion that accountant liability based on foreseeable injury would serve dual functions of compensation for injury and deterring negligent conduct), *modified*, 3 Cal. 4th 1049a (1994).

110. See *Rosenblum v. Adler*, 461 A.2d 138, 145 (N.J. 1983) (stating that privity is not "salutary predicate" to prevent recovery and that reasonably foreseeable consequences of negligent act should be actionable).

111. See *Touche Ross & Co. v. Commercial Union Ins. Co.*, 514 So. 2d 315, 322 (Miss. 1987) (citing *Rosenblum* and holding that independent auditor is liable to reasonably foreseeable users of audit who detrimentally rely on financial statement).

112. See *Citizens State Bank v. Timm, Schmidt & Co.*, 335 N.W.2d 361, 366 (Wis. 1983) (concluding that liability will be imposed on accountants for foreseeable injuries resulting from their negligent acts, unless recovery is denied on public policy grounds).

113. Accord *Vick*, *supra* note 1, at 1348 (noting that three states apply foreseeability approach; and explaining that, generally, foreseeability permits recovery if plaintiff's harm was reasonably foreseeable result of defendant's conduct).

114. 461 A.2d 138 (N.J. 1983).

115. *Rosenblum v. Adler*, 461 A.2d 138, 143-45 (N.J. 1983).

116. *Id.* at 140.

117. *Id.* at 140-41.

118. *Id.* at 140.

119. See *supra* text accompanying notes 63-84 (discussing *Ultramares* doctrine).

120. See *infra* text accompanying notes 136-52 (discussing *Restatement* approach).

party.¹²¹ In addition, the court emphasized that, absent public policy considerations, privity should not be a prerequisite for recovery.¹²² Further, the court reasoned that the critical function accountants serve in society warranted expanded liability.¹²³

The court analogized damages for physical injury to damages for economic loss, questioning, "If recovery for defective products may include economic loss, why should such loss not be compensable if caused by negligent misrepresentation?"¹²⁴ The court asserted that assigning the auditor a duty to all foreseeable recipients of the audit was necessary to protect the public.¹²⁵ This policy emphasized the deterrent effect of imposing more expansive liability.¹²⁶ The court specifically noted that "[t]his might entail setting up stricter standards and applying closer supervision, which should tend to reduce the number of instances in which liability would ensue."¹²⁷ Addressing the dangers of broader liability, the court in *Rosenblum* argued that there was no reason that accountants could not purchase malpractice insurance.¹²⁸

Mississippi has similarly followed the foreseeability approach. In *Touche Ross & Co. v. Commercial Union Insurance Co.*,¹²⁹ the Mississippi Court applied a state statute that permits actions by parties not in privity.¹³⁰ Therefore, the court could not follow Cardozo's *Ultramares* decision. Nor, in the court's view, was the *Restatement* applicable, as the *Restatement* differed from privity only by the particular arbitrary limit it placed on the class of potential plaintiffs.¹³¹ Accordingly, the court found that the best rule was the

121. *Rosenblum*, 461 A.2d at 145.

122. *Id.*

123. *Id.*

124. *Id.* at 147.

125. *Id.* at 151.

126. The Wisconsin Supreme Court in *Citizens Bank v. Timm Schmidt & Co.*, similarly reasoned that if third parties who rely on the accuracy of financial statements could not recover, accountant's negligence would go undeterred and the general cost of credit would increase. *Citizens State Bank v. Timm, Schmidt & Co.*, 335 N.W.2d 361, 365 (Wis. 1983). The court stated that the cost of credit to the general public would increase because creditors would either have to "absorb the cost of bad loans made in reliance on faulty information or hire independent accountants to verify the information received." *Id.*

127. *Rosenblum*, 461 F.2d at 152.

128. *Id.* at 151.

129. 514 So. 2d 315 (Miss. 1987).

130. *Touche Ross & Co. v. Commercial Union Ins. Co.*, 514 So. 2d 315, 321 (Miss. 1987); see MISS. CODE ANN. § 11-7-20 (Supp. 1993) ("In all causes of action . . . for economic loss brought on account of negligence, . . . privity shall not be a requirement to maintain said action.").

131. See *Touche Ross & Co.*, 514 So. 2d at 321-22 (stating that audit's purpose solely defines auditor's liability to third parties).

foreseeability approach, which maximized protection for both parties.¹³²

Proponents of the foreseeability approach argue that accountant liability should be determined by the same principles as apply to other tortfeasors.¹³³ The theory behind holding accountants liable to all reasonably foreseeable injured parties is to compensate the injured plaintiff, while deterring negligence in auditing.¹³⁴ Further, the accountant, the financier, and the public-at-large will benefit when an auditor's liability is measured by the foreseeability standard because the auditor's incentive for accuracy is greatly heightened, thereby increasing reliability.¹³⁵

IV. THE RESTATEMENT APPROACH

Increasing dissatisfaction with both the broad implications of the foreseeability approach and the restrictive nature of the *Ultramares* doctrine have led courts and commentators to adopt an intermediate approach.¹³⁶ This approach is embodied in section 552 of the *Restatement (Second) of Torts*.¹³⁷ Section 552 imposes third-party liability on professionals who supply inaccurate information to their clients where the information is reasonably relied on by nonclients, such as creditors, banks, investors, and shareholders.¹³⁸ Liability is

132. *Id.* at 322-23. The court stated that a rule based on foreseeability "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." *Id.* at 322.

133. See generally Wiener, *supra* note 109.

134. Wiener, *supra* note 109, at 260.

135. Wiener, *supra* note 109, at 260.

136. See *Bily v. Arthur Young & Co.*, 834 P.2d 745, 759 (Cal.) (explaining that *Restatement* rule has been for many courts satisfactory compromise between traditional privity approach and "specter of unlimited liability"), *modified*, 3 Cal. 4th 1049a (1992).

137. RESTATEMENT (SECOND) OF TORTS § 552 (1976) [hereinafter RESTATEMENT]; see Swanson, *supra* note 16, at 25-26 (stating that *Restatement* approach is broader than New York approach, which requires knowledge by accountant of specific person who relies on financial report, but narrower than New Jersey approach, where accountant may be liable to all reasonably foreseeable users of financial report); Vick, *supra* note 1, at 1349 (explaining § 552 of *Restatement*).

There have been no proposals to change § 552 in the *Restatement (Third) of Torts*. The American Law Institute has embarked on revisions of the *Restatement (Second) of Torts*. Geoffrey C. Hazard, Jr., *Annual Report of the American Law Institute*, 21 A.L.I. 7 (May 17-20, 1994). The proposals address only two topics: products liability and apportionment of liability. *Id.* This Comment falls into neither category.

138. See RESTATEMENT, *supra* note 137, § 552(1). Section 552(1) provides:

One who, in the course of his business, profession or employment, or 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 information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.

Id.

limited, however, to those relying third-party recipients of the audit who are known to the auditor.¹³⁹

Under the *Restatement*, when an individual detrimentally relies on negligently prepared commercial information, and the information's supplier (or the entity that prepared that information) knew that the information would be provided to that individual, the supplier is liable.¹⁴⁰ Even more broadly, an auditor need not know that the audit will be disseminated to particular creditors, investors, and banks.¹⁴¹ The *Restatement* makes clear that it is enough that the auditor be aware that third parties exist who may "reasonably be expected sooner or later to have access to the information and foreseeably to take some action in reliance upon it."¹⁴²

The following illustration further demonstrates the intention of *Restatement* section 552:

Auditor is retained by Company to conduct an annual audit and to provide an opinion on Company's financial statements. Company does not inform Auditor of any intended use for the statements, but Auditor is aware that it is customary for financial statements and audits to be used in a wide variety of financial transactions involving creditors, investors, banks, and shareholders. In fact, Company uses the financial statements and accompanying audit certification to provide evidence of its stability to obtain a loan from Bank. Auditor, although acting in good faith, was negligent in preparing the audit and certified a healthy Company, when, in fact, Company was insolvent. In reliance upon the certification and financial statements, Bank made a \$10 million loan to Company on which Company subsequently defaulted. Company then declares bankruptcy. Auditor is not liable to Bank for pecuniary loss.¹⁴³

139. See *RESTATEMENT*, *supra* note 137, § 552(2)-(3). The *Restatement* provides that:

(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 he 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.

Id.; see also *Shatterproof Glass Corp. v. James*, 466 S.W.2d 873, 879 (Tex. Civ. App. 1971) (holding that under § 552, accountant may be held liable to third parties who rely on financial statements where accountant fails to exercise ordinary care and third party suffers financial loss or damage because of such reliance).

140. *RESTATEMENT*, *supra* note 137, § 552 cmt. a.

141. *RESTATEMENT*, *supra* note 137, § 552 cmt. h.

142. *RESTATEMENT*, *supra* note 137, § 552 cmt. h.

143. *RESTATEMENT*, *supra* note 137, § 552 cmt. h, illus. 10.

In the above example, Bank is unable to recover its losses from Auditor, who did not know that Company intended to disseminate the audit to third parties. Although section 552 does not require that Auditor have actual knowledge of the particular third parties,¹⁴⁴ third-party liability exists only if Company specified that it required the services of Auditor for the purpose of obtaining financing. Absent such a manifestation, Auditor is not liable to Bank, though Bank negligently conducted the audit and certification, and Bank justifiably relied on Auditor's representation.¹⁴⁵ Thus, the *Restatement* limits accountant liability to parties to whom the work product is intended and disseminated, provided the auditor knew the work product would be disseminated and to whom.¹⁴⁶

Section 552 of the *Restatement (Second) of Torts* is broader than both the *Ultramares* doctrine and the rule outlined in *Credit Alliance*, which require that the auditor possess actual knowledge that a specific third party will rely on the financial information supplied.¹⁴⁷ Yet, section 552 is narrower than the foreseeability approach, which extends liability to all reasonably foreseeable recipients of the accountant's work product.¹⁴⁸

In the above illustration, Auditor would be liable to Bank under the foreseeability approach because Auditor knew that the audit and certification of financial statements were customarily used by Company to receive financing. Therefore, it was reasonably foreseeable that Bank was an intended recipient of the information supplied by Auditor. On the other hand, applying the privity requirement, Auditor would escape liability because it lacked actual knowledge of the intended recipient.

Recognizing that section 552 achieves a middle ground with respect to auditors' liability to third parties, many jurisdictions have adopted

144. RESTATEMENT, *supra* note 137, § 552 cmt. h.

145. RESTATEMENT, *supra* note 137, § 552 cmt. h (stating that § 552 makes auditor liable only to those persons for whose benefit and guidance audit is supplied). This would be a different case if the Accountant had prepared the audit fraudulently. See *id.* § 531 (explaining that in case of fraudulent representation, liability extends to any person whom maker of representation has reason to expect will rely on it).

146. See Swanson, *supra* note 16, at 26 ("Section 552 of the Restatement limits liability to a small class of persons for whose intended use and benefit the accountant's information was supplied.").

147. See RESTATEMENT, *supra* note 137, § 552 cmt. h ("It is enough that maker of the representation intends [the information] to reach and influence either a particular person or persons . . . or class of persons, distinct from the much larger class who might reasonably be expected sooner or later to have the access to the information and foreseeably to take some action in reliance upon it.").

148. See *supra* notes 108-35 and accompanying text (outlining foreseeability approach).

the *Restatement* approach.¹⁴⁹ In fact, several state legislatures have enacted statutes that explicitly embrace the principles embodied in the *Restatement*.¹⁵⁰ Each statute makes clear that the accountant is not liable for negligence to any entity with which the accountant is not in privity, unless the accountant knew that the client intended for

149. See *supra* note 56 (listing 23 jurisdictions that have adopted *Restatement* approach); see also, e.g., *Badische Corp. v. Caylor*, 825 F.2d 339, 340-41 (11th Cir. 1987) (applying *Restatement* § 552, court held that professional liability for negligence extends to those individuals who (1) are actually known to professional, and (2) professional knows will rely on information prepared); *Toro Co. v. Krouse, Kern & Co.*, 827 F.2d 155, 155 (7th Cir. 1987) (deciding that under Indiana law, accounting firm and individual accountants were not liable to reliant creditor for negligence in absence of accountants' conduct linking them to creditor and demonstrating accountants' understanding of creditor's reliance); *Bancohio Nat'l Bank v. Schiesswohl*, 515 N.E.2d 997, 998 (Ohio Ct. App. 1986) (relying on *Restatement* § 552, trial court granted directed verdict for accountants where no evidence established knowledge on part of accountants that creditor would receive financial statements).

150. See, e.g., ARK. CODE ANN. § 16-114-302 (Supp. 1991). Section 16-114-302 specifies that:

No person, partnership, or corporation licensed or authorized to practice under the Public Accountancy Act of 1975, § 17-12-101 et seq., or any of its employees, partners, members, officers, or shareholders shall be liable to persons not in privity of contract with the person, partnership, or corporation for civil damages resulting from acts, omissions, decisions, or other conduct in connection with professional services performed by such person, partnership, or corporation, except for:

(1) Acts, omissions, decisions, or conduct that constitutes fraud or intentional misrepresentations; or

(2) Other acts, omissions, decisions, or conduct if the person, partnership, or corporation was aware that a primary intent of the client was for the professional services to benefit or influence the particular person bringing the action. For the purposes of this subdivision, if the person, partnership, or corporation:

(A) Identifies in writing to the client those persons who are intended to rely on the services; and

(B) Sends a copy of the writing or similar statement to those persons identified in the writing or statement, then the person, partnership, or corporation or any of its employees, partners, members, officers, or shareholders may be held liable only to the persons intended to so rely, in addition to those persons in privity of contract with such person, partnership, or corporation.

Id.; see also KAN. STAT. ANN. § 1-402 (1991). Section 1-402 provides that:

No person, proprietorship, partnership, professional corporation or association authorized to practice as a certified public accountant pursuant to article 3 of chapter 1 of the Kansas Statutes Annotated, or any employee, agent, partner, officer, shareholder or member thereof, shall be liable to any person or entity for civil damages resulting from acts, omissions, decisions or other conduct amounting to negligence in the rendition of professional accounting services unless:

(a) The plaintiff directly engaged such person, proprietorship, partnership, corporation or association to perform the professional accounting services; or

(b) (1) the defendant knew at the time of the engagement or the defendant and the client mutually agreed after the time of the engagement that the professional accounting services rendered the client would be made available to the plaintiff, who was identified in writing to the defendant; and (2) the defendant knew that the plaintiff intended to rely upon the professional accounting services rendered the client in connection with specified transactions described in writing.

Id.

the accountant's services to benefit or influence that particular entity.¹⁵¹ Knowledge would be established by a writing evidencing that the auditor knew that the plaintiff was an intended beneficiary of its services.¹⁵²

V. ANALYSIS

The highest courts of California and New York recently reviewed the extent of an auditor's third-party liability for negligence. Both cases, the California Supreme Court's decision in *Bily v. Arthur Young & Co.*¹⁵³ and the decision of the New York Court of Appeals in *Security Pacific Business Credit v. Peat Marwick Main & Co.*,¹⁵⁴ have squarely addressed the issue of limiting the class of persons to whom an auditor may be liable. These decisions are of vital importance because they set out rules that will guide other jurisdictions.

A. *Bily v. Arthur Young & Co.: Knowledge Required to Hold Accountants Liable*

In *Bily v. Arthur Young & Co.*, the California Supreme Court departed from its earlier determinations of whether an accountant's duty of care in auditing clients' financial statements extended to persons other than the client.¹⁵⁵ Addressing the facts before it, the court decided that the defendant accounting firm, Arthur Young & Company [Arthur Young], did not owe a duty of care to anyone other than its client.¹⁵⁶ In accordance with section 552 of the *Restatement (Second) of Torts*, however, the court held that the accountant would be liable to nonclients who (1) rely on the audit, and (2) the auditor intended to influence.¹⁵⁷ This decision was significant in that California courts had previously treated privity as a prerequisite to liability in negligence suits against auditors.¹⁵⁸

151. See *supra* note 150 (explaining that accountant shall not be liable resulting from rendition of professional accounting services unless accountant knows that plaintiff intends to rely on such services).

152. See *supra* note 150 (explaining that knowledge may be established if person, partnership, or corporation identifies in writing to client those persons who are intended to rely on professional accounting services).

153. 834 P.2d 745 (Cal.), *modified*, 3 Cal. 4th 1049a (1992).

154. 597 N.E.2d 1080 (N.Y. 1992).

155. *Bily v. Arthur Young & Co.*, 834 P.2d 745, 746 (Cal.), *modified*, 3 Cal. 4th 1049a (1992).

156. *Id.* at 747.

157. See *id.* (holding, additionally, that accountant would be liable to any reasonably foreseeable third party if accountant committed intentional fraud in preparing and disseminating audit report).

158. See Vick, *supra* note 1, at 1354 (noting court's shift in treatment of auditor's third-party liability from allowing unlimited recovery to requiring privity between parties).

The facts of *Bily* were as follows. In 1980, Adam Osborne formed Osborne Computer Corporation [Osborne], which manufactured the first portable personal computer.¹⁵⁹ Within two years, sales of Osborne's sole product, the Osborne I, had escalated so dramatically that the Osborne I became one of the fastest growing enterprises in American business history.¹⁶⁰ By 1983, Osborne began preparing for a public offering,¹⁶¹ which entailed commissioning three investment banking firms as underwriters.¹⁶² Due to various uncertainties surrounding the hiring of a new chief executive officer and Osborne's plan to introduce a replacement for the Osborne I, the underwriters suggested that the public offering be postponed.¹⁶³ Pending the public offering, however, Osborne required capital financing to maintain its operations.¹⁶⁴ To this end, the corporation sought to obtain "bridge" financing in the form of bank loans¹⁶⁵ and retained Arthur Young to audit the company's financial statements, which had been prepared by Osborne's in-house accounting department.¹⁶⁶

Following the audit, Arthur Young issued clean audit opinions.¹⁶⁷ In essence, the auditor certified that in 1981 Osborne operated at a loss of \$1 million on sales of \$6 million, and by 1982 the audit reported a modest net operating profit of \$69,000 on sales of more than \$68 million.¹⁶⁸ Relying on the soundness of the corporation as represented by the auditor's unqualified audit opinion, various investors, the plaintiffs in *Bily*, including pension funds and venture capital investment funds, purchased Osborne common stock.¹⁶⁹

Sales began to decline rapidly when, among other things, production of the "Executive," the Osborne I replacement, could not keep pace with the introduction of IBM personal computers.¹⁷⁰ The public offering never materialized and Osborne filed for bankruptcy

159. *Bily*, 834 P.2d at 747.

160. *Id.*

161. A public offering of stock occurs when a corporation makes an offering of shares "in a public manner or to numerous persons." ROBERT W. HAMILTON, CASES AND MATERIALS ON CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED PARTNERSHIPS 339 (4th ed. 1990). This requires compliance with federal securities laws. *Id.*

162. An underwriter is defined by the Securities Act of 1933 as "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security." See 15 U.S.C. § 77b(11) (1988).

163. *Bily*, 834 P.2d at 747.

164. *Id.*

165. *Id.*

166. *Id.*

167. *Id.*; see also *supra* note 26 (discussing clean audit opinions).

168. *Bily*, 834 P.2d at 748.

169. *Id.* at 747. One plaintiff, Robert Bily, a director of Osborne Computer Corporation, purchased 37,500 shares of stock from Adam Osborne for \$1.5 million. *Id.*

170. *Id.* at 748.

by September 1983.¹⁷¹ Consequently, the plaintiffs lost their investments and sued Arthur Young, alleging that: (1) the 1982 financial statements were not prepared in accordance with generally accepted accounting principles and standards;¹⁷² (2) Osborne's profits were grossly overstated;¹⁷³ and (3) Arthur Young had discovered material deficiencies in Osborne's accounting controls that it had failed to report.¹⁷⁴

At trial, the court instructed the jury in accordance with the foreseeability standard outlined in an earlier decision,¹⁷⁵ which held that "[a]n accountant owes a further duty of care to those third parties who reasonably and foreseeably rely on an audited financial statement prepared by the accountant. A failure to fulfill any such duty is negligence."¹⁷⁶ On appeal, however, the California Supreme

171. *Id.*

172. *Id.* The plaintiff's principal expert witness testified that, following a review of the audit, he discovered over 40 deficiencies in the performance of the audit, which, in his opinion, amounted to gross professional negligence on the part of Arthur Young. *Id.*

173. *Id.* Although the unqualified audit revealed a \$69,000 profit in 1982, Arthur Young understated the liabilities of the corporation by \$3 million. *Id.* Thus, the corporation's profit of \$69,000 was, in truth, a loss of approximately \$3 million. *Id.*

174. *Id.* During the course of the audit, a senior accountant at Arthur Young discovered \$1.3 million in unrecorded liabilities. *Id.* He recommended to his superiors that a letter be sent to the corporation outlining where their in-house accounting controls had failed. *Id.* The accountant's superiors did not share his concern and therefore made no disclosure. *Id.*

175. See *International Mortgage Co. v. John P. Butler Accountancy Corp.*, 223 Cal. Rptr. 218, 225 (1986) (finding that accountant was liable to all foreseeable third parties); see also Vick, *supra* note 1, at 1352 (discussing facts and procedures in *Bily*).

176. *Bily*, 834 P.2d at 749 (quoting *International Mortgage*, 223 Cal. Rptr. at 225). In *International Mortgage*, a company in the business of buying and selling loans on the secondary market, approached the accountant's client to buy and sell various government loans, and, in reliance on erroneous audited financial statements, lost its investment and filed suit against the auditor. *International Mortgage*, 223 Cal. Rptr. at 219-20. The court held that an "independent auditor owes a duty of care to reasonably foreseeable plaintiffs who rely on alleged negligently prepared and issued unqualified audited financial statements." *Id.* at 218.

The jury in *Bily* returned with a verdict in favor of Arthur Young, finding that Young did not perform the audit fraudulently, and that the audit did not contain negligent misrepresentations. *Bily*, 834 P.2d at 749. The jury did find, however, that Arthur Young had committed professional negligence and awarded the plaintiffs damages to compensate for the loss on their investment. See *id.* (awarding compensatory damages of approximately \$4.3 million). On appeal, the appellate court affirmed that judgment. *Id.* The Supreme Court of California then limited the holding of the appellate court by concluding that an auditor may be liable for negligent misrepresentation. See *id.* at 768 (defining separate tort of negligent misrepresentation, which exists where defendant makes "false statements, honestly believing that they are true, but without reasonable ground for such belief"). In California, this tort is similar to that of deceit or fraud. *Id.*

In analyzing the negligence theory and the legal duty owed by accountants in the absence of privity between parties, the court looked to factors it had previously outlined in *Biakanja v. Irving*, 320 P.2d 16 (Cal. Ct. App. 1958). *Bily*, 834 P.2d at 761. In *Biakanja*, the defendant, a notary public, prepared a will for the testator that was later invalidated because the defendant negligently failed to have the will properly attested. *Biakanja*, 320 P.2d at 17. As a result, the testator died without revoking a previous will, leaving the sole beneficiary of the invalid will with only one-eighth of the estate. *Id.* at 19.

Because there was no privity between the parties, the court, as a matter of public policy,

Court rejected that rule in favor of the *Restatement* approach, and held that because the plaintiffs were not clients of Arthur Young they were unable to recover on a general negligence theory.¹⁷⁷

In rejecting the foreseeability approach, the court in *Bily* reasoned that an auditor's potential liability to nonclients could be grossly disproportionate to its fault, given the secondary "watchdog" role of the auditor, the complexity of the auditing process, and the potentially tenuous relationship between the audit report and an investor's economic loss.¹⁷⁸ In addition, the court reasoned that cases involving generally more sophisticated plaintiffs in the area of accountant liability, such as banks and investors, are more effectively adjudicated using contract, rather than tort, liability.¹⁷⁹ Finally, the court abandoned the foreseeability rule because it concluded that the foreseeability approach does not lead to either more efficient loss spreading or more accurate accounting.¹⁸⁰

The court emphasized that every time an accountant prepares an audit, it is foreseeable that the audit report will be distributed to banks and investors.¹⁸¹ Therefore, to make foreseeability of injury the determinative factor would be tantamount to imposing liability on any accountant who performed an audit for a company that defaulted on loans, became insolvent, or filed for bankruptcy and was unable to pay its creditors.¹⁸² Accordingly, it was necessary to limit liability for

balanced various factors to determine whether the defendant owed a duty of care. *Id.* The factors were: (1) the extent to which the transaction was intended to affect the plaintiff; (2) the foreseeability of harm to plaintiff; (3) the degree of certainty that the plaintiff was injured; (4) the relationship between the defendant's conduct, and the injury suffered; (5) the moral blame attached to the defendant's conduct; and (6) the policy of preventing future harm. *Id.*

In *Biakanja*, the sole purpose of engaging the notary was to provide the plaintiff with the testator's estate. *Id.* The court was certain that the defendant must have known that faulty language would invalidate the will. *Id.* Further, it was indeed the defendant's poor draftsmanship that directly deprived plaintiff of the estate. *Id.*

The court found that the defendant had a duty to exercise due care to protect the beneficiary. *Id.* at 17. The plaintiff was awarded the difference between the amount that she would have received had the will been valid, and the amount actually distributed to her had the will been properly attested naming plaintiff the beneficiary of decedent's entire estate. *Id.*

Just as the court in *Biakanja* declined to limit recovery to privity, the court in *Bily* declined to extend accountant liability for negligence to all foreseeable third-party users of the audit report. *Bily*, 834 P.2d at 767. This case changed the standard established in *International Mortgage Co.*, in which the court of appeals had developed the most expansive standard for determining auditor's liability. *International Mortgage*, 223 Cal. Rptr. at 227. The court in *Bily*, however, limited this ruling significantly. See *Bily*, 834 P.2d at 767.

177. *Bily*, 834 P.2d at 774.

178. *Id.* at 761.

179. *Id.*

180. *Id.*

181. *Id.*

182. See *id.* at 761-62 (refusing to allow recovery where damage awards threatens to impose liability not proportional to fault).

intangible injury, such as economic loss. The court stated that "policy considerations may dictate a cause of action should not be sanctioned no matter how foreseeable the risk . . . in order to avoid an intolerable burden on society."¹⁸³

1. *Liability disproportionate to fault*

To demonstrate how potential liability for accountants to third parties is disproportionate to accountants' fault for negligently preparing audit reports, the court in *Bily* analogized accountants to "watchdog[s], not . . . bloodhound[s]."¹⁸⁴ This analogy suggests that bloodhounds are capable of discovering things that have been hidden, while a watchdog is limited to recognizing only visible objects that may seem out of the ordinary or suspicious. The court noted that, as a matter of commercial reality, an accountant operates in a "client-controlled environment" because it is the client, not the auditor, who prepares financial statements, controls what information is contained in them, and accordingly is responsible for their accuracy.¹⁸⁵ In the limited time that an accountant has to prepare the audit, the accountant cannot be expected to "become an expert in the client's business and record-keeping systems."¹⁸⁶ Instead, the auditor is forced to rely on the information furnished by the client.¹⁸⁷

The client is also in the position to disseminate the audit report to any entity it chooses,¹⁸⁸ and the auditor does not control who receives the work product.¹⁸⁹ In essence, despite a limited role in the process, the auditor potentially faces "massive" liability in a negligence suit by nonclients.¹⁹⁰ There is the added possibility that the client has liquidated or filed for bankruptcy and the auditor sits "center stage as the remaining solvent defendant and is faced with a claim for all sums of money ever loaned to or invested in the client. Yet the auditor may never have been aware of the existence . . . of the third party transaction that resulted in the claim."¹⁹¹ The auditor merely becomes a prime target as a solvent party who had direct

183. *Id.* at 762 (quoting *Eldon v. Sheldon*, 758 P.2d 582 (Cal. 1988)).

184. *Id.*

185. *Id.*

186. *Id.*

187. *Id.*

188. *See id.* (noting that report distribution and accompanying communications are exclusively controlled by client).

189. *Id.*

190. *Id.* at 763.

191. *Id.*

contact with the client's business transactions.¹⁹² In sum, the court reasoned that, given the considerations outlined above, public policy dictated that such unlimited liability, so disproportionate to fault, was unjustifiable and unfair.¹⁹³

2. *Theories of contract liability found more appropriate*

The foreseeability approach to auditor liability has been grounded in analogies to tort liability for manufacturers of consumer goods.¹⁹⁴ The court in *Bily* rejected that approach, distinguishing a maker of a consumer product, which exclusively controls what goes into that product, with an auditor, who is at its client's mercy with respect to what is contained in financial reports.¹⁹⁵ In addition, those who rely on audit reports, such as investors, banks, and creditors, are sophisticated as to the nuances of audits and financial reports, unlike consumers who generally lack knowledge of a product's makeup.¹⁹⁶

Third-party investors, creditors, and banks have the power to ensure that an audit is accurate, and to take appropriate steps to reduce the risks of poor investing and lending.¹⁹⁷ For example, a third party could hire its own accountant to verify the information contained in the audit report.¹⁹⁸ In doing so, privity is established between the third party and the auditor it hired.¹⁹⁹ Another option would be for the third party to establish direct communication with the initial auditor sufficient to render the auditor expressly aware that the third party intends to rely on the audit reports.²⁰⁰ The court in *Bily* summarized its contract liability argument by stating that "as a matter of economic and social policy, third parties should be encouraged to

192. See Siliciano, *supra* note 5, at 1932-33 (noting that because claims against client are usually precluded by client's insolvency, injured party's focus turns to auditor).

193. See *Bily*, 834 P.2d at 764 (suggesting that "disproportionate liability cannot fairly be justified on moral, ethical or economic grounds"); Siliciano, *supra* note 5, at 1944-45 (noting that disproportionate liability for negligence might deter socially beneficial activity and result in enormous administrative costs).

194. See *Bily*, 834 P.2d at 764 (noting that demise of privity as barrier to products liability actions implies that privity is irrelevant in accountant liability actions).

195. *Id.*

196. *Id.* at 765.

197. See *id.* (contrasting "presumptively powerless consumer" in product liability cases with third party in audit negligence cases, who has ability to protect himself through "other options"); *infra* notes 199-201 and accompanying text (discussing options for reducing risk).

198. See *Bily*, 834 P.2d at 765 (noting ways third party can limit risk).

199. *Id.*

200. *Id.*; see also Siliciano, *supra* note 5, at 1956-57 (noting that sophisticated creditor can protect itself against prospect that client will inaccurately portray financial conditions by expending resources to improve quality of financial information). Direct contact between the third party and the auditor was a key consideration in *Security Pacific Business Credit v. Peat Marwick Main & Co.*, 597 N.E.2d 1080 (N.Y. 1992). See *infra* notes 223-28 and accompanying text (discussing significance of telephone call between auditor and third party).

rely on their own prudence, diligence, and contracting power This kind of self-reliance promotes sound investment"²⁰¹

3. *Loss spreading and accurate accounting*

Proponents of the foreseeability approach argue that broad-based auditor liability promotes more diligent accounting and loss spreading.²⁰² The court in *Bily* disagreed, however, because "the stronger the probability that liability will be incurred when performance is adequate, the weaker is the deterrent effect of liability rules."²⁰³ In addition, allowing unlimited liability, a product of the foreseeability approach, would inevitably lead to an onslaught of litigation and require expending exorbitant financial resources while businesspeople seek to recover losses.²⁰⁴

For the reasons stated above, the court in *Bily* held that persons other than the accountant's client could not recover on a pure negligence theory,²⁰⁵ except where the nonclient was an intended beneficiary of the information, and this identity was made known to the auditor.²⁰⁶ The court opined that its findings were most consistent with section 552 of the *Restatement (Second) of Torts*.²⁰⁷ Like the *Restatement* approach, the court in *Bily* required that the provider of the information, the auditor, have notice that the third party would be receiving the information.²⁰⁸ In effect, by notifying the auditor of the scope of his liability to nonclients, the auditor could attempt to decrease the potential for liability.

For instance, the accountant could ensure that its insurance adequately covered the risk of litigation.²⁰⁹ In addition, the nonclient investor or creditor could establish direct communication

201. *Bily*, 834 P.2d at 765.

202. *See id.* (stating that proponents of foreseeability approach to liability predict that it will "deter auditor mistakes, promote more careful audits, and result in more efficient spreading of the risk"); *see also* H. Rosenblum, Inc. v. Adler, 461 A.2d 138, 152 (N.J. 1983) (suggesting that stricter standards would reduce number of instances where auditors would be held liable for negligence); Citizens State Bank v. Timm, Schmidt & Co., 335 N.W.2d 361, 366 (Wis. 1983) (rejecting *Restatement* and privity approaches, and imposing liability on accountants for foreseeable injuries resulting from their negligent acts).

203. *Bily*, 834 P.2d at 766.

204. *Id.* at 767.

205. *Id.* This did not mean that recovery for fraud was foreclosed. As Chief Judge Cardozo's opinion in *Ultramares* indicated, an exception exists where liability for fraud was found despite the lack of a contractual relationship. *See Ultramares Corp. v. Touche Niven & Co.*, 174 N.E. 441, 444 (N.Y. 1931).

206. *Bily*, 834 P.2d at 767.

207. *See id.* at 769.

208. *Id.*

209. *See id.* at 765.

with the auditor, thereby reducing its risk of bad investment.²¹⁰ Finally, by requiring specific knowledge of third-party beneficiaries' identities, a connection is established that more closely resembles privity.²¹¹

B. Security Pacific Business Credit v. Peat Marwick Main & Co.

Although courts have continued to chip away at or reject the doctrine of privity, New York courts have continued to act as guardian to Chief Judge Cardozo's *Ultramares* opinion.²¹² For example, the New York Court of Appeals, in *Security Pacific Business Credit v. Peat Marwick Main & Co.*, undertook to determine how much contact between a third party and auditor is sufficient to create liability.²¹³ In that case, Security Pacific, an institutional lender, relied on an auditor's unqualified audit opinion indicating that Top Brass was in a strong financial position, and loaned Top Brass approximately \$40 million.²¹⁴ Two years after the loan was made, Top Brass defaulted on its loans and filed for bankruptcy.²¹⁵ Thereafter, Security Pacific sued the auditor, Peat Marwick, for pecuniary losses, alleging that it had relied on Marwick's audit opinion, which negligently indicated that Top Brass' financial statements reflected its financial condition.²¹⁶ This reliance ostensibly stemmed from a telephone call from Security Pacific's vice president to an accounting partner at Peat Marwick.²¹⁷

The trial record indicated that Top Brass retained the auditor for the purpose of stating an opinion on its financial statements.²¹⁸ At no time did Top Brass mention either Security Pacific or a pending loan requiring an unqualified audit opinion.²¹⁹ Once Peat Marwick completed a draft opinion, Top Brass sent a copy to Security Pacific

210. See *id.* at 757 (suggesting that liability insurance may help accountants "spread the risk").

211. *Id.*

212. See *Security Pac. Business Credit v. Peat Marwick Main & Co.*, 597 N.E.2d 1080, 1087 (N.Y. 1992) (noting that court was following precedent and intended to preserve wisdom and policy set forth in *Ultramares*, *Glanzer*, and *White*).

213. See *id.* at 1081 (finding defendant not liable because relationship was not "sufficiently approaching privity") (quoting *Credit Alliance Corp. v. Arthur Andersen & Co.*, 483 N.E.2d 110, 119 (N.Y. 1985)).

214. *Id.* at 1082.

215. *Id.* at 1083.

216. *Id.* It was discovered, one year too late, that 30% of Top Brass' accounts receivable were uncollectible. *Id.* Instead of reflecting this substantial loss, the audit report indicated profits that did not in fact exist. *Id.*

217. *Id.* at 1081.

218. *Id.* at 1082.

219. *Id.*

for review.²²⁰ At the suggestion of Top Brass officers,²²¹ the vice president of Security Pacific then telephoned the audit partner at Peat Marwick to discuss the audit report. This contact was the "linchpin of plaintiff's claim."²²²

The court followed the rule established in *Credit Alliance*²²³ that requires a relationship, demonstrated by certain conduct, "sufficiently approaching privity."²²⁴ Security Pacific argued that the single telephone call was sufficient contact to create a bond of privity.²²⁵ The court in *Security Pacific*, however, found that this conduct fell short of the criteria required in *Credit Alliance*.²²⁶ The court in *Security Pacific* noted the stark contrast between one call and the multiple and direct communications and personal meetings with the third-party lender in *European American Bank*.²²⁷ To hold otherwise, the court further explained, would give recourse to a lender any time it made one simple phone call.²²⁸

220. *Id.*

221. *Id.*

222. *See id.* (suggesting that telephone call was only evidence of any affirmative conduct linking third party and auditor in way that auditor could reasonably know that third party intended to rely on information). Noting that the New York rule provided little guidance as to what "linking" conduct was sufficient to establish liability, the court in *Bily* had questioned the value of the New York rule in light of the following scenario:

From preengagement communications with its client, an auditor may acquire full knowledge of third party recipients of the audit report and a specific investment or credit transaction that constitutes the "end and aim" of the audit. As a consequence, the auditor is placed on notice of a specific risk of liability that accompanies the audit engagement. Yet, under the [New York] test, the auditor appears to have no liability in this situation in the absence of further, distinct conduct "linking" the auditor to the third party in a manner that "evinces [auditor] understanding" of third party reliance.

Bily v. Arthur Young & Co., 834 P.2d 745, 754 (Cal.), *modified*, 3 Cal. 4th 1049a (1992). The majority in *Bily* saw little necessity in maintaining a linking element when the auditor had actual knowledge of the identity of the third party as well as the fact that the auditor's work was meant to benefit that identifiable third party. *Id.*

223. *Credit Alliance Corp. v. Arthur Andersen & Co.*, 483 N.E.2d 110 (N.Y. 1985); *see supra* notes 97-99 and accompanying text (outlining *Credit Alliance* rule).

224. *Security Pac.*, 597 N.E.2d at 1083.

225. *Id.* at 1085.

226. *Id.* In his dissent, Judge Hancock protested that the majority failed to indicate what conduct *would* be sufficient to evince the auditor's understanding of the third party's reliance. *Id.* at 1091 (Hancock, J., dissenting). Indeed, Hancock went further in stating that, in his opinion, the phone call was clearly sufficient conduct to evince such understanding on the part of the auditor. *Id.* at 1092.

227. 483 N.E.2d 110 (N.Y. 1985). *European American Bank* was decided as a companion case to *Credit Alliance*. *Security Pac.*, 597 N.E.2d at 1084, 1085 (relying on evidence indicating that accountant was aware, prior to issuing unqualified audit opinion, that client was involved in negotiations for credit line to be secured by accounts receivable).

228. *See id.* (commenting that third party "cannot unilaterally create such an extraordinary obligation, imposing negligence liability of significant dimension and consequences, by merely interposing and announcing its reliance in this fashion"); *id.* at 1086 ("For the small price of a phone call, the bank would in effect acquire additional loan protection [by] placing the auditor in the role of an insurer or guarantee of loans extended to [its] clients.").

VI. RECOMMENDATIONS

Bily and *Security Pacific* are highly significant to the accounting profession in that they limit accountant liability in the absence of privity. Although *Bily* recognized the necessity of privity, the court allowed exceptions to the rule where evidence established that the accountant had reason to know the information supplied would be relied on by a specifically known beneficiary.²²⁹ *Security Pacific* goes further than *Bily* by addressing the degree of contact that establishes privity between noncontracting parties.²³⁰ *Security Pacific* falls short of effectively impacting the field of accountant liability, however, because the court failed to enumerate what is in fact a sufficient contact. Instead, it merely suggested that one telephone conversation will not be sufficient to hold an accountant liable.

A. *Foreseeability Is Too Expansive to Provide Incentive for Accountants to Improve Services*

Because the foreseeability test expands liability significantly, there is little incentive for auditors to improve the quality of their services. The more likely it is that liability will be imposed, the weaker the accountant's incentive to perform diligently.²³¹ Even if an accountant has exercised due care in performing the audit, the client still retains ultimate control by virtue of furnishing information supplied to the auditor, thereby controlling to whom the information is distributed.²³² Therefore, "there will always be a margin of error in audit opinions."²³³

In addition, under the foreseeability approach an accountant has little incentive to perform audits in the first place, considering the

229. See *Bily v. Arthur Young & Co.*, 834 P.2d 745, 747 (Cal.) (referring to tort of negligent misrepresentation), modified, 3 Cal. 4th 1049a (1992); Vick, *supra* note 1, at 1358-59 (describing application of negligent misrepresentation tort to auditor liability cases).

230. See *Security Pac.*, 597 N.E.2d at 1083 (holding that liability exists where: (1) accountants were aware reports were to be used for particular purpose; (2) in furtherance of which a known party was intended to rely that party would rely; and (3) there was "linking" conduct).

231. See *Bily*, 834 P.2d at 766 (discussing ineffectiveness of broad liability rules).

232. See *supra* notes 184-92 and accompanying text (discussing client control over audit information).

233. Vick, *supra* note 1, at 1360. Although Vick's article is cited frequently throughout this Comment, it should be noted that Vick's recommendations and conclusions differ from those proffered by this Author. For example, Vick's article was written prior to the decision in *Security Pacific* and therefore presents only part of the discussion in this Comment. In addition, Vick identified, in his legal analysis, a variety of questions that he felt remained unanswered. This Author, however, has been successful in developing responses to these and other questions through analysis and recent decisions. See also *supra* notes 184-93 and accompanying text (discussing how accountant liability disproportionate to fault results from conditions beyond accountant's control).

potential liability to a reliant third party. By the same token, the advantages gained by the third party may be significant, considering that "far-removed third parties can reap the full benefits of successful investments and enjoy some protection against bad investments at the auditor's expense."²³⁴

There is a further potential that as the number of parties to whom the auditor may be held liable increases, premiums charged by the auditor will rise as well.²³⁵ After all, there is little incentive for the auditor to keep its fees down in the face of great risks incurred simply by conducting an audit.²³⁶ These increased costs paid by clients will in turn be passed on to the consumer.²³⁷

As the number of lawsuits filed by third parties against negligent auditors continues to rise, many insurance carriers become hesitant to insure an auditor for professional liability,²³⁸ and insurance will become increasingly difficult for auditors to obtain.²³⁹ Even those carriers that are still willing to insure the auditor continue to increase their premiums.²⁴⁰

B. *The Strict Privity Approach Is Too Narrow*

Accountants have just as little incentive to perform quality audits under the privity doctrine as they do under the foreseeability approach. Although the court in *Ultramares* recognized that accountants could be exposed to limitless liability if the foreseeability approach were applied,²⁴¹ its adherence to a strict privity requirement was as limiting as the foreseeability approach is broad. Requiring privity of contract significantly reduces the number of parties to whom the accountant is liable; this theory allows only the client to recover. As discussed above, however, it is a common business practice for the client to share the information prepared by

234. Vick, *supra* note 1, at 1360.

235. Vick, *supra* note 1, at 1360.

236. Vick, *supra* note 1, at 1356.

237. Vick, *supra* note 1, at 1360.

238. Vick, *supra* note 1, at 1337-38.

239. Vick, *supra* note 1, at 1361.

240. See Vick, *supra* note 1, at 1337-38 (noting that "between 1985 and 1986 every major insurance carrier stopped writing liability insurance policies for California accountants. Premiums in California have skyrocketed, increasing approximately 1480% since 1984, despite the profession's efforts to keep premiums down by creating and running its own non-profit carrier"). The results are clear; fewer and fewer accountants are insured. *Id.* Estimates indicate that, as a consequence, "41% of accounting firms no longer perform audits and 76% will not do audits for . . . public offerings." *Id.* at 1338.

241. *Ultramares Corp. v. Touche Niven & Co.*, 174 N.E. 441, 444 (N.Y. 1931).

the accountant with other business entities.²⁴² Absent fraud by the auditor, privity provides little recourse for a third-party lender or investor who has relied on negligently prepared audits and financial statements. Consequently, the possibility exists that investors and lenders will be more hesitant in extending credit or capital.

C. *The Intermediate Approach Achieves the Best Results*

Adherence to the *Restatement* approach will clearly provide direction to auditors.²⁴³ The accountant will be cognizant of the risks involved in performing an audit and act accordingly.²⁴⁴ In addition, third parties will be aware that a relationship with the auditor must be established in order to sue the accountant for economic loss. This could be done by contract,²⁴⁵ or the third party could hire its own auditor.

To ensure understanding and compliance, however, state legislatures should codify the *Restatement* approach. This would be the most effective method of ameliorating the increasing problems associated with accountant liability to nonclients. Several jurisdictions have already done this.²⁴⁶ Statutes would achieve several objectives. First, the auditor will have a statutory basis to guide conduct if the accountant negligently prepares an audit for a client that is then relied upon by a third party. Second, clear statutory language would place third parties on notice that if they intend to invest in, or extend financing to, a business enterprise, they must take affirmative steps to ensure they are proceeding cautiously.

CONCLUSION

The foreseeability approach, which expands tort liability, provides little or no incentive for auditors to perform their audit with due care and diligence, or to curtail the premiums they charge. Limiting liability to instances where strict privity exists would be equally ineffective because it would leave many reliant third-party business entities without recourse. Even where the accountant knows that an

242. See *supra* note 42 and accompanying text (discussing tendency for audits to be used to attract lenders and investors).

243. See Vick, *supra* note 1, at 1361 (indicating that *Bily* makes liability more predictable and, consequently, parties can make more informed decisions).

244. See Vick, *supra* note 1, at 1361-62.

245. If a contract was executed between the third party and the accountant, privity would be created by law and the third party would be no longer just that. The third party would be a client who can bring an action for negligence against the accountant under any of the theories of contract liability.

246. See *supra* note 54 (applying statutory guidelines for privity doctrine).

intended beneficiary exists, the accountant would not be liable because a contractual relationship did not exist between the parties. Accordingly, the consequences for investors and creditors may be significant.

Unlike the foreseeability and privity approaches, the *Restatement* approach is the most equitable rule, evidenced by its adoption by a large number of jurisdictions.²⁴⁷ Section 552 is a compromise approach that clearly attains the goals of promoting fairness and deterring negligent conduct by the auditor. At the same time, it promotes responsible conduct on the part of sophisticated lenders and investors, while taking into account the commercial and economic realities of the marketplace.

247. See *supra* note 56 and accompanying text (noting that majority of jurisdictions have adopted *Restatement* approach).

