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COMMENTS

ADJUSTING ACCOUNTANTS' LIABILITY FOR NEGLIGENCE: RECOVERY FOR REASONABLY FORESEEABLE USERS OF FINANCIAL STATEMENTS

The privity requirement has traditionally served as a bar for many investors who have relied to their detriment on negligently prepared financial statements. This restriction of an accountant's liability has recently been broadened by some courts, which allow specifically and even reasonably foreseeable users of financial statements to bring negligence actions against the accountant. This comment examines the role of the financial statement in modern investment practice, discusses the recent expansion of the test, and advocates the adoption of a reasonably foreseeable standard.

I. INTRODUCTION

Today, "[t]he age-old axiom that physicians bury their mistakes, while . . . accountants file theirs away"[1] no longer rings true. The demise of this proposition is illustrated by the expansion of the auditor's[2] third party liability in negligence actions[3] to include "reasonably fore-

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1. Mess, *Accountants and the Common Law: Liability to Third Parties*, 52 NOTRE DAME LAW. 838, 838 n.1 (1977) (citing Eizenstat & Speer, *Accountants' Professional Liability: Expanding Exposure*, 22 FED. INS. COUNS. Q. 7 (1972)).
2. The terms "auditor" and "accountant" will be used interchangeably throughout this comment. Auditing, however, is encompassed within the discipline of accounting. More precisely, accounting is the "measuring and reporting [of] the effects of the economic activities of individual entities." THE COMMISSION ON AUDITORS' RESPONSIBILITIES, REPORTS, CONCLUSIONS AND RECOMMENDATIONS xiii (1978). Auditing, by contrast, "involves an independent examination to determine the propriety of accounting processes, measurements and communication." *Id.* This comment discusses the services performed by a certified public accountant (CPA). CPA candidates must meet the educational and any practical experience requirements set forth by the respective state boards of accounting. *See* D. CAUSEY, DUTIES AND LIABILITIES OF PUBLIC ACCOUNTANTS 37-40 (rev. ed. 1982) (synopsis of the education and experience requirements of each state). Candidates must then pass a national examination conducted by the American Institute of Certified Public Accountants (AICPA). Upon successful completion of these requirements, the state board of accountancy issues a certificate. *Id.*
3. The term "negligence actions" is used generally. The proper common law cause of action is for negligent misrepresentation. *See* W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 107 (4th ed. 1971); Weiner, *Common Law Liability of the Certified Public Accountant for Negligent Misrepresentation*, 20 SAN DIEGO L. REV. 233 (1983). Courts have also referred to the action as one for professional malpractice. *See* Haddon View Inv. Co. v. Coopers & Lybrand, 70 Ohio St. 2d 154, 436 N.E.2d 212 (1982).

   This comment is limited to the common law liability of accountants to third parties for negligence. Accountants may, however, be subjected to civil statutory liability, *see* Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, 540 F.2d 27

seeable" users of financial statements. Although decisional law has gradually increased the scope of accountants' liability to third parties by applying a specifically foreseeable standard, until recently no decision imposed liability based on a reasonably foreseeable standard.[4]

This comment begins with an overview of the audit function and its importance to the business community. Following this overview, the comment traces the evolution of accountants' third party liability in negligence from the antiquated concepts of privity to the two variations on the principle of "foreseeability." The analysis then examines the rationale underlying the various theories, focusing on the public policy considerations posited for and against the expansion of liability. This comment concludes that in light of the sophisticated nature of the accounting profession and the business community's reliance on the function of independent accountants, the reasonably foreseeable standard, applied in traditional tort analysis, represents a welcome expansion of liability to a once-shielded vocation.

II. BACKGROUND

A. Perspectives in Financial Reporting

The need for accurate, complete, and verified financial statements is imperative in today's marketplace.[5] Users of financial statements, be

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(2d Cir. 1976) (imposing liability under section 10(b) of the Securities Exchange Act of 1934), and criminal prosecutions, *see* United States v. Weiner, 578 F.2d 757 (9th Cir.) (former auditors of the Equity Funding Corporation of America were convicted of securities fraud and filing false statements with the Securities Exchange Commission; each was sentenced to three months of incarceration, four years of probation, and 2000 hours of charity service work), *cert. denied*, 439 U.S. 981 (1978); United States v. Natelli, 527 F.2d 311 (2d Cir. 1975) (partner of Peat, Marwick, Mitchell & Co., who was convicted for making false statements in the 1969 National Student Marketing proxy statement, was sentenced to one year in jail with all but 60 days suspended), *cert. denied*, 425 U.S. 34 (1976). For a thorough discussion of the forms of liability, see Gruenbaum & Steinberg, *Accountants' Liability and Responsibility: Securities, Criminal and Common Law*, 13 LOY. L.A.L. REV. 247 (1980).

4. *See* H. Rosenblum, Inc. v. Adler, 93 N.J. 324, 461 A.2d 138 (1983); Citizens State Bank v. Timm, Schmidt & Co., 113 Wis. 2d 376, 335 N.W.2d 361 (1983); *see also* Aluma Kraft Mfg. Co. v. Elmer Fox & Co., 493 S.W.2d 378, 382-83 (Mo. Ct. App. 1973) (establishing guidelines for the determination of liability even though precise issue confronting the court involved an actually foreseeable plaintiff); *cf.* Milliner v. Elmer Fox & Co., 529 P.2d 806, 808 (Utah 1974) (intimating the extension of liability to a reasonably foreseeable party).

5. "In the broadest sense the function of accounting and of the audit by an independent public accountant is to facilitate the operation of our economic system." D. CAUSEY, *supra* note 2, at 1. The need to check the stewardship function of management in the corporate setting underscores the importance of an independent audit. In addition, "accountants and auditors . . . play an important role in enabling our free market to allocate private property rights to their highest valued uses as measured by the dollar votes of demand. Perfect competition requires efficient markets supplied with complete information." *Id.* Furthermore, "accurate information is essential to the efficient use and exchange of property," which in turn "forms the basis of our economic freedom." *Id.* (footnote omitted).

they investors (present or prospective), creditors, or regulatory agencies, require economic and financial data to weigh alternatives and evaluate decisions.[6] Indeed, in most instances, financial statements are the user's primary tool in assessing his interaction with an entity.[7] The degree of reliance placed on any set of financial statements depends, however, upon the type of financial reporting assistance chosen by the reporting entity.[8]

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6. *See* FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 1 ("Objectives of Financial Reporting by Business Enterprises"), *codified in* AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, 3 PROFESSIONAL STANDARDS (CCH) AC § 1210.34 (1978) [hereinafter cited as ACCOUNTING CONCEPTS]. But "[f]inancial reporting is not an end in itself . . . [instead, it is] intended to provide information . . . for making reasoned choices among alternative uses of scarce resources in the conduct of business and economic activities." *Id.* § 1210.05.
7. The financial statements of an organization are "a principal means of communicating accounting information to those outside an enterprise." *Id.* § 1210.06. "[A]lthough investment and credit decisions reflect investors' and creditors' expectations about future enterprise performance, those expectations are commonly based at least partly on evaluations of past enterprise performance" as manifested by the financial statements. *Id.* § 1210.42. There is, however, an additional "need to combine information provided by financial reporting with pertinent information from other sources, for example, information about general economic conditions or expectations, political events and political climate, or industry outlook." *Id.* § 1210.22.
8. Although many publicly held corporations are required to have audited financial statements, *see* 15 U.S.C. §§ 77j, 77aa (1982) (required for prospectus offering); *id.* §§ 78l(l)(b)(1)(J), 78l(k) (required for annual report if corporation has assets of $1,000,000 or more and 500 or more equity holders), the same is not true for nonpublic entities, which are not required to register under federal securities laws. For many years, nonpublic companies had two alternatives when engaging a CPA's assistance for financial reporting: their financial statements could either be audited or unaudited. Today, a more defined range of financial reporting assistance is available for nonpublic companies. The three levels of service from which these entities can choose are (1) audited financial statements, (2) financial statement reviews, and (3) financial statement compilations.

   Audited financial statements provide an indication of the character of the auditor's examination, and the degree of responsibility that the auditor is assuming. D. CARMICHAEL, THE AUDITOR'S REPORTING OBLIGATIONS 2 (2d ed. 1978); *see* discussion *infra* notes 9-17 and accompanying text.

   A financial statement review is the performance of "inquiry and analytical procedures that provide that accountant with a reasonable basis for expressing limited assurance that there are no material modifications that should be made to the statements in order for them to be in conformity with generally accepted accounting principles." AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, STATEMENTS ON STANDARDS FOR ACCOUNTING AND REVIEW SERVICES NO. 1 (1979), *codified in* AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, 2 PROFESSIONAL STANDARDS (CCH) § 100.04 (1984).

   A financial statement compilation is the mere assistance by the CPA in preparing the financial statements "without undertaking to express any assurance on the statements." *Id.* For an excellent discussion concerning compilation and review engagements, see Note, *Accountants' Liability for Compilation and Review Engagements*, 60 TEX. L. REV. 759 (1982). This comment refers to unaudited statements because some of the cases discussed predate the advent of the review

The financial reporting assistance that provides the greatest degree of assurance to the user is the independent audit.[9] An independent audit involves a "systematic process of objectively obtaining and evaluating evidence"[10] concerning an entity's transactions "to determine the propriety of [management's] accounting processes, measurements and communication."[11] The objective of the audit process is to express an opinion on the "fairness" of management's presentation[12] of the entity's financial position, its results of operations, and its changes in financial position.[13] This presentation of the entity's financial status must be in accordance with generally accepted accounting principles (GAAP),[14] which have been applied consistently in preceding periods.[15] The expression of an opinion,[16] which forms the basis for any assertion of liability, requires that the auditor's examination comport

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and compilation standards. This comment, however, focuses on audited financial statements.

9. "CPAs do not guarantee audited financials, but rather represent that they have applied usual professional standards with respect to them." D. CAUSEY, *supra* note 2, at 93. Audited financial statements thus provide reasonable assurances, based upon the type of opinion expressed. In contrast, a financial statement review provides only "limited assurance," whereas a financial statement compilation provides no assurance. *See supra* note 8.
10. *See* R. HERMANSON, S. LOEB, J. SAADA & R. STRAUSER, AUDITING THEORY AND PRACTICE 3 (rev. ed. 1980) (quoting Committee on Basic Auditing Concepts, Report of the Committee on Basic Accounting Concepts, 47 ACCOUNTING REVIEW 15, 18 (Supp. 1972)) [hereinafter cited as AUDITING THEORY].
11. THE COMMISSION ON AUDITORS' RESPONSIBILITIES, REPORTS, CONCLUSIONS AND RECOMMENDATIONS xiii (1978).
12. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, STATEMENTS ON AUDITING STANDARDS (1972), *codified in* AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, 1 PROFESSIONAL STANDARDS (CCH) § 110.02 (1983) [hereinafter cited as AUDITING STANDARDS]. The auditor's "responsibility for the statements he has examined is confined to an opinion on them. The financial statements remain the representations of management." *Id.*
13. *Id.* § 110.01.
14. "The phrase 'generally accepted accounting principles' is a technical accounting term which encompasses the conventions, rules, and procedures necessary to define accepted accounting practices at a particular time. It includes not only broad guidelines of general application, but also detailed practices and procedures . . . ." *Id.* § 411.02. These principles are ever evolving and practitioners are cautioned to be alert to changes in accounting principles resulting from both pronouncements and common usage. *See id.* §§ 411.05 to -.09 (clarifying the order of authoritative sources to be relied upon).
15. *Id.* § 150.02 (the second standard of reporting); *see also id.* § 402.02 (stating the objective of consistency as providing comparability).
16. Generally, one of four types of opinions is issued pursuant to an audit engagement: (1) an unqualified opinion; (2) a qualified opinion; (3) an adverse opinion; or (4) a disclaimer of opinion.

    An unqualified opinion in the auditor's report states:

    > [T]he financial statements present fairly [the] financial position, results of operations and changes in financial position in conformity with generally accepted accounting principles (which include adequate disclosure) consistently applied . . . . This conclusion may be expressed only when the auditor has formed such an opinion on the basis of an examination made in accordance with generally accepted auditing standards.

with generally accepted auditing standards (GAAS).[17] The accounting

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Id. § 509.28.

A qualified opinion is usually issued when there is insufficient evidence to support an unqualified opinion or the auditor has limited the scope of his examination. In addition, if based on the examination an auditor believes there has been a material departure from GAAP, a material change between periods in the principles of accounting or method of application, or there exists uncertainties that might significantly affect the financial statements, he may choose to issue a qualified opinion. *Id.* § 509.29. "A qualified opinion states that, 'except for' or 'subject to' the effects of the matter to which the qualification relates," an unqualified opinion would have been issued. *Id.*

An adverse opinion expresses the auditor's judgment that "the financial statements taken as a whole are not presented fairly in conformity with generally accepted accounting principles." *Id.* § 509.41.

"A disclaimer of opinion states that the auditor does not express an opinion on the financial statements." *Id.* § 509.45. A disclaimer is proper when the scope of the auditor's examination was insufficient for him to form an opinion. *Id.* A disclaimer, however, is inappropriate when the auditor believes, based on his examination, "that there are material departures from generally accepted accounting principles . . . ." *Id.* In disclaiming an opinion, all substantive reasons for doing so should be set forth in the auditor's report. *Id.*

17. GAAS are formulated in three contexts: (1) general standards; (2) standards of field work; and (3) standards of reporting. Set forth below are these formulations:

General Standards

(1) The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.

(2) In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.

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

Standards of Field Work

(1) The work is to be adequately planned and assistants, if any, are to be properly supervised.

(2) There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.

(3) Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

Standards of Reporting

(1) The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.

(2) The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.

(3) Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

(4) The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefore should be stated. In all cases where an auditor's name is associated with the financial statements, the report should contain a clearcut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.

Id. § 150.02.

Moreover, Rule 202 of the American Institute of Certified Public Account-

profession, in its efforts to regulate the practitioner, has also set forth audit procedures.[18]

Each type of reporting assistance necessarily involves a cost/benefit analysis.[19] Since there are inherent limitations in any reporting assistance provided,[20] absolute fairness and accuracy cannot be expected. What can and should be expected is adherence to the principles and standards set forth by the accounting profession to inform users; these principles and standards incorporate the cost/benefit factor in a fair balance.[21] Accordingly, courts should use these principles and standards as guidelines in determining negligence.[22]

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ant's Code of Professional Ethics requires that members adhere to the GAAS proclaimed by the AICPA. This rule recognizes Statements on Auditing Standards as interpretations of GAAS and requires that members be prepared to justify departures from these statements. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, CODE OF PROFESSIONAL ETHICS Rule 202, *codified in* 2 AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, PROFESSIONAL STANDARDS (CCH) § 202.01 (1984).

18. "Auditing standards differ from auditing procedures in that 'procedures' relate to the acts to be performed, whereas 'standards' deal with measures of the quality of the performance of those acts and the objectives to be attained by the use of the procedures undertaken." AUDITING STANDARDS, *supra* note 12, § 150.01.

19. "An auditor typically works within economic limits; his opinion, to be economically useful, must be formed within a reasonable length of time and at a reasonable cost." *Id.* § 326.20. "As a guiding rule, there should be a rational relationship between the cost of obtaining evidence and the usefulness of the information obtained." *Id.* § 326.21. Moreover, in most cases "the auditor finds it necessary to rely on evidence that is persuasive rather than convincing." *Id.* § 326.19.

20. In an audit, the procedures used generally consist of tests of the accounting records after an evaluation of the system of internal accounting control. Because of the prohibitive costs that would be involved, there is no complete and detailed verification of every transaction. The basic premise underlying the use of sample testing is "that the demonstrated quality or amount of a properly selected sample is indicative of the probable quality or amount of the whole (population) from which the sample is selected." AUDITING THEORY, *supra* note 10, at 247.

    Despite these precautions, audit risks do exist. A recent pronouncement, Statement on Auditing Standards No. 47, which pertains to audit risks and the concept of materiality, discusses audit risk in a two part analysis. First, "the risk (consisting of inherent risks and [internal accounting] control risks) that the balance or class contains error that could be material to the financial statements when aggregated with error in other balances and classes." AUDITING STANDARDS, *supra* note 12, § 312.20. Second, there exists "the risk (detection risk) that the auditor will not detect such error." *Id.* Because of the nature of the auditing function there thus exists the possibility that auditors may not detect errors and irregularities.

21. By recognizing that CPAs are not guarantors of the financial statements they audit, *see* D. CAUSEY, *supra* note 2, at 93, the profession's standards incorporate both economic and inherent limitations of the audit function.

22. *But see* United States v. Simon, 425 F.2d 796, 805 (2d Cir. 1969) (upholding trial judge's charge to the jury that "[p]roof of compliance with generally accepted standards was 'evidence which may be very persuasive but not necessarily conclusive . . . .' "), *cert. denied*, 397 U.S. 1006 (1970).

B. Ultramares — *The "Primary Benefit" Hurdle*

Any discussion of negligence liability of auditors to third parties, in the absence of privity, must necessarily begin with *Ultramares Corp. v. Touche, Niven & Co.*[23] There, a public accounting firm was retained by Fred Stern & Co. (Stern) to prepare and certify a balance sheet presenting the financial position of the corporation as of December 31, 1923.[24] Thirty-two serial numbered copies of the certified balance sheet were supplied to Stern, with the recognition that they would be exhibited as the needs of the business dictated.[25] The audit report negligently overvalued the assets, thus creating a materially misleading report of the company's financial position. Plaintiff, who had lent money to Stern in reliance upon the balance sheet, alleged negligent misrepresentation and fraud on the part of the accountants in an action to recover for the resulting damages.[26]

The decision, written by Chief Judge Cardozo of the Court of Appeals of New York, held that in the absence of acts constituting fraud,[27] an accountant could not be held liable to third parties lacking the requisite privity of contract.[28] The *Ultramares* court stated that the audit

23. 255 N.Y. 170, 174 N.E. 441 (1931). Although *Ultramares* is generally regarded as the seminal case discussing accountants' liability to third parties, it was not the earliest. *See* Landell v. Lybrand, 264 Pa. 406, 107 A. 783 (1919) (accountant not liable to a third party for misstatements in the financial statements upon which the third party relied in purchasing the company's stock).

24. *Ultramares*, 255 N.Y. at 173, 174 N.E. at 442.

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

26. *Id.* at 176, 174 N.E. at 443. The jury awarded $187,576.32 to the plaintiff, Ultramares Corporation. The trial judge, however, granted the defendant's motion to set aside the verdict on the negligence action and dismissed the complaint. The Supreme Court, Appellate Division, First Department reinstated the verdict as to the negligence claim but affirmed as to the dismissal to the fraud claim. *Id.*; *see* Ultramares Corp. v. Touche, Niven & Co., 229 A.D. 581, 243 N.Y.S. 179 (1930), *rev'd*, 255 N.Y. 170, 174 N.E. 441 (1931).

27. The fraud aspect of *Ultramares*, though somewhat overshadowed by the negligence holding, is novel both in principle and in application. *See* discussion *infra* note 60. Chief Judge Cardozo wrote that "negligence or blindness, even when not equivalent to fraud, is none the less evidence to sustain an inference of fraud. At least this is so if the negligence is gross." *Ultramares*, 255 N.Y at 190-91, 174 N.E. at 449. It was on the fraud count that the court reversed and granted a new trial.

28. *Id.* at 189, 174 N.E. at 448. Courts have not uniformly interpreted *Ultramares* with respect to negligence. The first interpretation came in a 1937 Second Circuit decision. O'Connor v. Ludlam, 92 F.2d 50, 53 (2d Cir.) ("liability could be imposed only for fraud; a mistake in the balance sheet, even if it were the result of negligence, could not be the basis of a recovery") (strict interpretation), *cert. denied*, 302 U.S. 758 (1937); *see also* State St. Trust Co. v. Ernest, 278 N.Y. 104, 106, 15 N.E.2d 416, 418 (1938) (without the presence of a contractual relationship "accountants can not be held liable for ordinary negligence in preparing a certified balance sheet even though they are aware that the balance sheet will be used to obtain credit"). Later interpretations, however, emphasized the distinction between the *Ultramares* facts and those of Glanzer v. Shepard, 233 N.Y. 236, 135 N.E. 275 (1922). *See* Rusch Factors, Inc. v. Levin, 284 F. Supp. 85, 91 (D.R.I. 1968) (holding *Glanzer* was more analogous to the instant case); *see also* discus-

was "primarily for the benefit"[29] of the client company, and only by happenstance for the use of others. Further, the court reasoned that "[i]f liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or fraud beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class."[30] In sum, although the *Ultramares* court held that an action might lie in fraud, it was unwilling to impose liability upon accountants for mere negligence in the absence of privity.

C. *The Specifically Foreseeable Standard — The Intended Beneficiary Approach*

The specifically foreseeable standard, advocated by *Restatement (Second) of Torts*[31] and adopted by a number of jurisdictions,[32] expands accountants' third party liability beyond that imposed by the primary benefit rule espoused in *Ultramares*. The essence of the specifically foreseeable standard is set forth in section 552 of the *Restatement*.[33] The general rule of section 552 imposes liability for negligently supplying false information to others for use in their business affairs, if the information disseminated is justifiably relied upon by the recipient and occasioned by a pecuniary loss.[34] This liability, however, is circumscribed by two factors.

First, the loss must be sustained by a person or persons of a limited group "for whose benefit and guidance" the informer knew or intended to be supplied the information.[35] Second, the loss must be suffered as a result of reliance upon the information supplied in a transaction that the informer contemplated influencing or one "substantially similar" in nature.[36] Under the specifically foreseeable standard, the degree of "care and competence"[37] expected is determined by the circumstances

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sion *infra* notes 88-100 and accompanying text (discussing the significance of the *Glanzer* opinion).

29. *Ultramares*, 255 N.Y. at 183, 174 N.E. at 466.
30. *Id.* at 179, 174 N.E. at 444.
31. RESTATEMENT (SECOND) OF TORTS § 552 (1977).
32. 999 v. Cox & Co., 574 F. Supp. 1026 (E.D. Mo. 1983); Briggs v. Sterner, 529 F. Supp. 1165 (S.D. Iowa 1981); Ingram Indus. v. Nowicki, 527 F. Supp. 683 (E.D. Ky. 1981); Seedkem, Inc. v. Safranek, 466 F. Supp. 340 (D. Neb. 1979); Bonhiver v. Graff, 311 Minn. 111, 248 N.W.2d 291 (1976); Aluma Kraft Mfg. Co. v. Elmer Fox & Co., 493 S.W.2d 378 (Mo. Ct. App. 1973); Spherex, Inc. v. Alexander Grant & Co., 122 N.H. 898, 451 A.2d 1308 (1982); Haddon View Inv. Co. v. Coopers & Lybrand, 70 Ohio St. 2d 154, 436 N.E.2d 212 (1982); Shatterproof Glass Corp. v. James, 466 S.W.2d 873 (Tex. Civ. App. 1971).
33. RESTATEMENT (SECOND) OF TORTS § 552 (1977).
34. *Id.* § 552(1).
35. *Id.* § 552(2)(a).
36. *Id.* § 552(2)(b).
37. *Id.* § 552 comment e.

of each case and may change according to a number of factors.[38] In addition, the burden is upon the plaintiffs to show that they fall within the specifically foreseeable group.[39]

A recent decision applying section 552 in the context of auditing and other accounting services is *Haddon View Investment Co. v. Coopers & Lybrand*,[40] a 1982 decision by the Supreme Court of Ohio. In *Haddon View*, the individual plaintiffs were general partners in Haddon View Investment Company, through which they were limited partners in two business enterprises. Plaintiffs, in their capacity as limited partners, filed an action that included allegations of professional malpractice on the part of the defendant-accountant in the performance of accounting services for the two business enterprises.[41] In reversing a judgment in favor of the defendant, the Supreme Court of Ohio held that the plaintiffs "constitute[d] a limited class of investors whose reliance on the accountant's certified audits for purposes of investment strategy was specifically foreseen by [the] defendant."[42]

The application of the specifically foreseeable standard is not restricted to limited partners; courts have applied it in cases involving creditors,[43] investors,[44] and others.[45] Despite these applications, the

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38. *Id.* The *Restatement* notes factors such as the character of the information and the pretense of expertise.
39. *See* Ingram Indus. v. Nowicki, 527 F. Supp. 683, 684 (E.D. Ky. 1981) (describing the *Restatement*'s standard as imposing "a discreet and definite burden upon the plaintiffs").
40. 70 Ohio St. 2d 154, 436 N.E.2d 212 (1982).
41. *Id.* at 154, 436 N.E.2d at 213.
42. *Id.* at 157, 436 N.E.2d at 215.
43. *See* Rusch Factors, Inc. v. Levin, 284 F. Supp. 85 (D.R.I. 1968); Shatterproof Glass Corp. v. James, 466 S.W.2d 873 (Tex. Civ. App. 1971); *see also* Seedkem, Inc. v. Safranek, 466 F. Supp. 340 (D. Neb. 1979) (unaudited financial statements and a disclaimer); Spherex, Inc. v. Alexander Grant & Co., 122 N.H. 898, 451 A.2d 1308 (1982) (unaudited financial statements).
44. *See* Aluma Kraft Mfg. Co. v. Elmer Fox & Co., 493 S.W.2d 378 (Mo. Ct. App. 1973) (recovery allowed when opinion issued in contemplation that it would be used to assess book value in a stock purchase transaction); *cf.* Milliner v. Elmer Fox & Co., 529 P.2d 806 (Utah 1974) (no recovery allowed for future purchasers of stock belonging to an unlimited class of equity holders).
45. *See* Merit Ins. Co. v. Colao, 603 F.2d 654 (7th Cir. 1979) (casualty insurance company underwriting policies of the audited company); Tiffany Indus. v. Harbor Ins. Co., 536 F. Supp. 432 (W.D. Mo. 1982) (insurer of audited company); Bonhiver v. Graff, 311 Minn. 111, 248 N.W.2d 291 (1976) (insurance agent writing policies for audited companies).

Bonhiver, a 1976 decision by the Supreme Court of Minnesota, demonstrates how far courts can go in distorting the specifically foreseeable standard when imposing liability. The accountants did not certify the financial statements; instead, they prepared only working papers and made adjusting entries on the client's books. The client, an insurance company, was subject to examination by the state commissioner of insurance, who relied upon the accountants' work in maintaining a belief that the company was solvent. Based on the commissioner's assurance of the company's solvency, an insurance agent continued to write insurance with the company. The insolvency of the company was ultimately disclosed because the company's officers embezzled over $2,000,000. The *Bonhiver* court held the ac-

"specifically foreseeable" standard represents only a moderate expansion of liability.

D. Reasonably Foreseeable Standard — The Traditional Approach

The imposition of liability in tort law necessarily embraces the fundamental question of the extent to which "public policy justif[ies] [the] imposition of a duty."[46] In essence, the issue narrows to whether the plaintiff's interests qualify for legal protection against the conduct of the defendant.[47] Two recent state decisions from courts of last resort have held that a reasonably foreseeable user of financial statements, lacking privity, may be entitled to recover in a negligence action against accountants.[48]

In *H. Rosenblum, Inc. v. Adler*,[49] the Supreme Court of New Jersey analyzed whether a third party, lacking privity, may recover in a negligence action against accountants who were unaware that the third party would rely upon the audit at the time it was performed.[50] In *Adler*, Touche Ross & Co. (Touche) conducted an annual audit of the financial statements of Giant Stores Corporation (Giant) for the fiscal year ending January 30, 1971.[51] At the time, neither Giant nor Touche had met or were aware of the existence of the plaintiffs. In November 1971, Giant commenced negotiations to purchase the plaintiffs' business. Plaintiffs, allegedly relying on the unqualified opinion accompanying Giant's financial statements,[52] received common stock in Giant in exchange for their business. The stock later became worthless, after the financial statements were discovered to be materially misstated.[53]

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countants liable to the insurance agent under the rationale of section 552 of the *Restatement (Second) of Torts*. The court reasoned that the insurance agent was injured because the commissioner relied upon misrepresentations made by the accountants. Moreover, since the accountants were aware of the commissioner's reliance, the insurance agent fell within the class of persons whose "agent" is the commissioner and who should be protected by the reliance of the commissioner. *Id.* at 302-03.

46. H. Rosenblum, Inc. v. Adler, 93 N.J. 324, 329, 461 A.2d 138, 140 (1983). Dean Prosser indicated that duty "is a shorthand statement of a conclusion, rather than an aid to analysis in itself." W. PROSSER, *supra* note 3, § 53, at 325.
47. W. PROSSER, *supra* note 3, § 53.
48. H. Rosenblum, Inc. v. Adler, 93 N.J. 324, 461 A.2d 138 (1983); Citizens State Bank v. Timm, Schmidt & Co., 113 Wis. 2d 376, 335 N.W.2d 361 (1983).
49. 93 N.J. 324, 461 A.2d 138 (1983).
50. *Id.* at 329-30, 461 A.2d at 140-41. The Superior Court of New Jersey, Appellate Division, had adopted the specifically foreseeable rule enunciated in section 552 of the *Restatement (Second) of Torts*. H. Rosenblum, Inc. v. Adler, 183 N.J. Super. 417, 424, 444 A.2d 66, 70 (1982), *aff'd in part, rev'd in part*, 93 N.J. 324, 461 A.2d 138 (1983).
51. *Adler*, 93 N.J. at 330, 461 A.2d at 141.
52. *Id.* at 329-30, 461 A.2d at 140-41.
53. The SEC entered a consent order of censure against Touche for failing to meet the minimum standards of the accounting profession while auditing Giant's 1972 financial statements. *In re* Touche Ross & Co., [1937-1982 Transfer Binder] [Accounting Series Releases] FED. SEC. L. REP. ¶ 72,175A (1979).

The *Adler* court held that reasonably foreseeable users of the financial statements may recover if they establish the following: (1) the receipt of the financial statements from the company under a proper company purpose; (2) reliance upon the statements; (3) that misstatements were attributable to the auditor's negligence; and (4) that the misstatements were the proximate cause of the damages suffered.[54] Provided reasonably foreseeable users meet these criteria, they could recover the actual loss incurred as opposed to the loss of any benefit of the bargain.[55]

In *Citizens State Bank v. Timm, Schmidt & Co.*,[56] decided shortly after *Adler*, the Supreme Court of Wisconsin held that, unless public policy dictates otherwise, accountants may be liable to third parties, lacking privity, for reasonably foreseeable injuries resulting from the negligent preparation of an audit report.[57] In *Citizens*, the plaintiff bank allegedly had extended loans to the Clintonsville Fire Apparatus, Inc. (CFA) based upon the accountants' opinion letter that accompanied the financial statements.[58] Later, a number of material errors were discovered and, ultimately, CFA went into receivership.[59] The *Citizens* court reversed the trial court's grant of the accountants' motion for summary judgment and remanded for a full factual resolution.[60] In sum, both *Adler* and *Citizens* held traditional negligence standards applicable in formulating the rule of recovery for users of financial statements.

III. ANALYSIS

A. Ultramares — *Its Time Has Passed*

Although many commentators have questioned the wisdom of *Ultramares*,[61] a fairer treatment of the decision lies not in criticizing its jurisprudence, but in focusing on the dramatic changes in the accounting profession and the marketplace since the opinion's issuance in 1931.[62] Indeed, "[t]he [accounting] profession . . . was in its infancy,

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54. *Adler*, 93 N.J. at 350, 461 A.2d at 152.
55. *Id.* at 350 & n.13, 461 A.2d at 152 & n.13.
56. 113 Wis. 2d 376, 335 N.W.2d 361 (1983).
57. *Id.* at 386, 335 N.W.2d at 366.
58. *Id.* at 379-80, 335 N.W.2d at 362-63.
59. *Id.* at 378-79, 335 N.W.2d at 362.
60. *Id.* at 387-88, 335 N.W.2d at 367-68.
61. Levitin, *Accountants' Scope of Liability for Defective Financial Reports*, 15 HASTINGS L.J. 436, 445 (1964); Seavey, *Mr. Justice Cardozo and the Law of Torts*, 52 HARV. L. REV. 372, 399-401 (1939); Solomon, Ultramares *Revisited: A Modern Study of Accountants' Liability to the Public*, 18 DE PAUL L. REV. 56, 70 (1968); Weiner, *supra* note 3, at 243-44. *Contra* Comment, *Auditors' Third Party Liability: An Ill-Considered Extension of the Law*, 46 WASH. L. REV. 675, 679 (1971).
62. [O]wnership of stock is not conferred today to a few well-informed investors.

    . . . [W]ith the great increase in public ownership of stock, more and more investors, with little knowledge of the complexity of the business

professional standards were not rigorous and a typical audit entailed substantially less work than it would today."[63] Chief Judge Cardozo's concern for the accounting profession and his concomitant rationale as applied in *Ultramares* are unpersuasive in today's business world; accordingly, the standard enunciated in the opinion should no longer delineate the scope of auditor's liability to third parties in negligence actions.

By absolving accountants of liability in negligence actions brought by third parties, the *Ultramares* court evidenced a deep concern for what, at that time, was a fledgling profession.[64] The lack of training,[65] standards,[66] and an authoritative body to provide leadership[67] plagued the accounting profession during the 1920's and early 1930's. Moreover, prior to the crash of the stock market in 1929, the federal govern-

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> community, are relying on the accountant's report. This new performance [was] not present when *Ultramares* was decided.

Mess, *supra* note 1, at 855; *see also* D. CAUSEY, *supra* note 2, at 16 (noting that change in investment climate brought about a shift in objectives for financial reporting i.e., a move from providing information primarily for management and bankers to supplying information for stockholders and investors).

63. Volz, *Accountant's Liability to Third Persons: Resistance in Negligence*, 9 BARRISTER 31, 31 (Fall 1982).
64. "The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes [accountants] to these consequences." *Ultramares*, 255 N.Y. at 179-80, 174 N.E. at 446.
65. Directly preceding the Depression approximately 36% of the native born practitioners and 9% of the foreign born practitioners were college graduates. Moreover, the quality of training varied; indeed, the lack of uniform educational standards intimated that the instructional programs in many schools were simply inadequate. G. PREVITS & B. MERINO, A HISTORY OF ACCOUNTING IN AMERICA 215-16 (1979) [hereinafter cited as G. PREVITS & B. MERINO].

    Today, every state has educational or experience requirements, or both, to become a CPA. To become certified an individual must successfully pass a two-and-a-half-day uniform examination that tests a candidate's knowledge of accounting practice, accounting theory, auditing, and business law. *See* D. CAUSEY, *supra* note 2, at 37-40.
66. G. PREVITS & B. MERINO, *supra* note 65, at 237-39. For example, even in the late 1930's accepted practice in the profession "did not require the auditor to observe or test the taking of physical inventory or to confirm receivables." D. CAUSEY, *supra* note 2, at 17. The opportunity to fabricate figures was clearly present. This changed, as did many other practices in the field, after the SEC's investigation of the *McKesson & Robbins* fraud. *See In re* McKesson & Robbins, Inc., [1937-1982 Transfer Binder] [Accounting Series Releases] FED. SEC. L. REP. (CCH) ¶ 72,020 (1940). Indeed, the *McKesson & Robbins* investigation has been called "a major milestone in the development of American audit practice." *See* D. CAUSEY, *supra* note 2, at 19.
67. Two major organizations that existed during the 1920's and 1930's, the American Institute of Accountants (AIA) and the American Society of Certified Public Accountants (ASCPA), had different perceptions of accounting practices. To add further division, smaller organizations such as the National Association of Certified Public Accountants (NACPA) were accused of "selling" CPA certificates. G. PREVITS & B. MERINO, *supra* note 65, at 205-07. One writer deemed the dichotomy within the profession as "The Great Schism," see 1 J. CAREY, THE RISE OF THE ACCOUNTING PROFESSION 314 (1969), while another depicted the accounting

ment maintained a laissez-faire attitude towards business affairs, intimating little need for "corporate accountability" and resulting in no "external control."[68] The enactment of the 1933 and 1934 federal securities acts,[69] however, marked a new beginning for financial reporting in the United States.[70]

Although the state of the accounting profession and conditions in the business world may have justified the use of privity as a bar to recovery in *Ultramares*, the opinion nonetheless remains enigmatic in light of the factual situation that confronted the court and precedent authored by Chief Judge Cardozo. The *Ultramares* court reasoned that if liability for negligence absent privity existed, then the amount, time, and class of recovery would be "indeterminate."[71] To categorize the exposure to liability as "indeterminate" is especially puzzling in *Ultramares* since the auditors gave the client thirty-two serial numbered copies of the certified balance sheet[72] and were also aware of the extensive financing arrangements required by the business in its ordinary course of affairs.[73] Moreover, the errors committed by the accounting firm were numerous and substantial.[74]

Another plausible explanation in *Ultramares* for barring recovery

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profession from 1921 to 1931 as in a state of "chaos." G. PREVITS & B. MERINO, *supra* note 65, at 208.

Today, the AICPA provides leadership in the profession. With a membership of approximately 160,000, the AICPA through its boards and committees establishes standards and procedures pertaining to the audit function. The AICPA also provides publications, meetings, and other functions for the accounting profession. *See* R. BERGER, PRACTICAL ACCOUNTING FOR LAWYERS 6-7 (1981).

68. *See* G. PREVITS & B. MERINO, *supra* note 65, at 198.

69. Securities Act of 1933, ch. 38, 48 Stat. 74 (1933) (codified as amended at 15 U.S.C. §§ 77a-77aa (1982)); Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (1934) (codified as amended at 15 U.S.C. §§ 78a-78jj (1982)).

70. Until the securities enactments the demand for audits had decreased. G. PREVITS & B. MERINO, *supra* note 65, at 204. In addition, prior to the stock market crash there was a persistent refusal by the New York Stock Exchange to recognize the need for independent audits of companies listed on the Exchange. *Id.* at 205.

71. Ultramares Corp. v. Touche, Nevin & Co., 255 N.Y. 170, 179, 174 N.E. 441, 444 (1931).

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

73. *Id.*

74. The accountants, Touche, Niven & Co., started the audit of the 1923 Balance Sheet on January 24, 1924. The mistakes that followed read much like a comedy of errors. First, on February 23, 1924, after the auditors performed a preliminary check of the accounts receivable, an employee penciled a $706,843.07 fictitious entry in the general ledger. This fictitious ledger entry was never verified to the recording journal or to any supporting documents. Second, a suspicious $113,119.60 item appeared in the accounts payable. Third, the client initially reported an inflated inventory figure of $347,219.08. The auditors, however, uncovered errors in the client's figure that amounted to $303,863.20, and adjusted the balance sheet accordingly. Even after discovering this gross overstatement, the auditors failed to expand the scope of the examination. Fourth, certain accounts were simultaneously pledged two, three, and four times. Although this immediately creates doubt as to the solvency of an entity, the auditors merely accepted

in negligence may have been because of the court's novel reasoning that gross negligence may give rise to an inference of fraud.[75] Indeed, in reversing the fraud count,[76] the *Ultramares* court may have been quite confident that, on remand, recovery would be granted based on this theory.[77]

Aside from the particular factual setting presented by *Ultramares*, the decision appears incongruous when analyzed with prior opinions authored by Chief Judge Cardozo.[78] In a landmark negligence case, *Palsgraf v. Long Island Railroad Co.*,[79] decided three years before *Ultramares*, Cardozo defined duty in terms of "the risk reasonably to be perceived."[80] Reference to the *Palsgraf* opinion, however, is conspicuously missing from *Ultramares*.[81] It is difficult to discern from the court's opinion in *Ultramares* that the accountants did not reasonably perceive reliance by others on the certified balance sheets,[82] particularly lenders, given the precise number of copies supplied and the ac-

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the answer given by the client as sufficient without independent "investigation." *Id.* at 175-77, 174 N.E. at 443-44.

75. *See* discussion *supra* note 27 and accompanying text. It has been suggested that the extension of auditors' liability by allowing an inference of fraud drawn from gross negligence was perhaps unintentioned. G. PREVITS & B. MERINO, *supra* note 65, at 204. These authors, however, note that Chief Judge Cardozo thought the opinion was beneficial to the accounting profession because it clarified the profession's position. *Id.*

    In State St. Trust Co. v. Ernest, 278 N.Y. 104, 15 N.E.2d 416 (1938), the court extended the rationale of *Ultramares* with regard to the fraud count by holding that judgment errors, if sufficiently gross, can constitute fraud. A lower court later expanded the *State St. Trust* holding by allowing gross negligence to stand as a separate cause of action. Duro Sportswear, Inc. v. Cogen, 131 N.Y.S.2d 20 (N.Y. Sup. Ct. 1954), *aff'd*, 285 A.D. 867, 137 N.Y.S.2d 829 (1955). One federal district court recently recognized the tort of aiding and abetting a common law fraud. Aeronca v. Gorin, 561 F. Supp. 370 (S.D.N.Y. 1983); *cf.* Cenco, Inc. v. Seidman & Seidman, 686 F.2d 449, 452-53 (7th Cir.) (no tort law claim for aiding and abetting a common law fraud), *cert. denied*, 103 S. Ct. 177 (1982).

76. *Ultramares*, 255 N.Y. at 190-91, 174 N.E. at 449.

77. *See* Seavey, *supra* note 61, at 403-04. The *Ultramares* case, however, was never tried on remand. Instead, the case was settled out of court. *See* J. CAREY, *supra* note 67, at 257.

78. One commentator noted that *Ultramares* "appear[ed] somewhat of an abberation even when it was decided by the highest New York state court during its golden years." Weiner, *supra* note 3, at 242 (footnote omitted).

79. 248 N.Y. 339, 162 N.E. 99 (1928).

80. *Id.* at 344, 162 N.E. at 100.

81. It is ironic that the Supreme Court of New Jersey in H. Rosenblum, Inc. v. Adler, 93 N.J. 324, 461 A.2d 138 (1983), noted the *Palsgraf* definition of duty in holding that an auditor may be liable to "reasonably foreseeable" users of financial statements. *Id.* at 352, 461 A.2d at 153; *cf.* Spherex, Inc. v. Alexander Grant & Co., 122 N.H. 898, 451 A.2d 1308 (1982) (citing *Palsgraf* definition of duty but holding section 552 of the *Restatement (Second) of Torts* as the appropriate boundary of liability). The *Adler* court also recognized that *Ultramares* constituted an "unwarranted inroad" upon the principle. *Adler*, 93 N.J. at 352, 461 A.2d at 153 (quoting Rusch Factors, Inc. v. Levin, 284 F. Supp. 85, 91 (D.R.I. 1968)).

82. *See* Weiner, *supra* note 3, at 244 n.45.

countants' knowledge of the client's business.[83]

In another opinion by Chief Judge Cardozo, *MacPherson v. Buick Motor Co.*,[84] decided by the Court of Appeals of New York fifteen years prior to *Ultramares*, the court held that an automobile manufacturer may be liable in negligence to third parties when physical harm occurs to either the person or property of the third party.[85] Although the rationale of *MacPherson* emphasized physical harm, the court later abandoned this distinction.[86] Thus, in *MacPherson*, Chief Judge Cardozo attacked "the citadel of privity"[87] to expand liability of automobile manufacturers, yet in *Ultramares* retreated to the safe harbors of privity to bar recovery for auditors' negligence.

In devising the primary benefit test the *Ultramares* court stressed the distinction between the facts in that case and the situation in *Glanzer v. Shepard.*[88] In *Glanzer*, a public weigher, engaged by a vendor of beans, negligently certified the weight of the goods, thereby causing an overpayment by the buyers. In holding the weigher liable to the buyers for negligent misrepresentation, Chief Judge Cardozo noted that the use of the certificate for determining the payment due "was a consequence which . . . was *the end and aim* of the transaction"[89] and not merely one of many possibilities. In distinguishing *Glanzer*, the *Ultramares* decision emphasized the "end and aim" analysis[90] and concluded that unlike the certificate relied upon in *Glanzer*, the balance sheet certification was "primarily for the [client's] benefit."[91]

Although *Ultramares* was decided in 1931, to a large extent its

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83. *See supra* notes 72-73 and accompanying text.
84. 217 N.Y. 382, 111 N.E. 1050 (1916).
85. *Id.* at 389, 111 N.E. at 1053.
86. *See* Glanzer v. Shepard, 233 N.Y. 236, 135 N.E. 275 (1922) (involving a weigher's certificate and unrelated to any harm to person or property). Moreover, in *MacPherson*, Chief Judge Cardozo wrote:

> The contractor who builds the scaffold invites the owner's workmen to use it. The manufacturer who sells the automobile to the retail dealer invites the dealer's customers to use it. The invitation is addressed in one case to determinate persons and in the other to an *indeterminate* class, but in each case it is equally plain, and in each its consequences must be the same.
>
> There is nothing anomalous in a rule which imposes upon A, who has contracted with B, a duty to C and D and others according as he knows or does not know that the subject-matter of the contract is intended for their use.

MacPherson, 217 N.Y. at 393, 111 N.E. at 1054 (emphasis supplied).
87. *Ultramares*, 255 N.Y. at 180, 174 N.E. at 445.
88. 233 N.Y. 236, 135 N.E. 275 (1922).
89. *Id.* at 238-39, 135 N.E. at 275 (emphasis supplied).
90. *See Ultramares*, 255 N.Y. at 182-83, 174 N.E. at 445-46. In the discussion of *Glanzer*, the *Ultramares* court stated that "[t]he bond was so close as to approach that of privity, if not completely one with it." *Id.* at 182, 174 N.E. at 446. This distinction, however, has been called "highly artificial." Mess, *supra* note 1, at 843.
91. *Ultramares*, 255 N.Y. at 183, 174 N.E. at 446.

precedential value has endured.[92] In *White v. Guerante*,[93] the court that decided *Ultramares* declined to overrule it.[94] Instead, the *White* court reversed the trial court's dismissal of a negligence claim by limited partners against accountants performing auditing and tax services for the general partnership.[95] The *White* court noted that "the import of *Ultramares* is its holding that an accountant need *not* respond in negligence to those in the extensive and indeterminable investing public-at-large."[96] The court explained that since the plaintiffs were a settled and particularized group of limited partners, reliance upon the audit and tax services provided to the partnership, at least to prepare individual tax returns, was "*one* of the ends and aims of the transaction."[97] Since the claim upheld in *White* involved only "*one* of the ends and aims of the transaction"[98] as opposed to "*the* end and aim of the transaction,"[99] the *White* court essentially ignored the significance of *Glanzer* as distinguished in *Ultramares*.[100] Indeed, the *White* opinion appears to have discarded the primary benefit test of *Ultramares*, either by way of an exception,[101] or by overruling it *sub silentio*.

In sum, the advancement of the accounting profession as well as the incongruities of the *Ultramares* opinion demonstrate the need to reject the standard of accountants' liability enunciated by Chief Judge Cardozo and to move towards a standard that is viable for the 1980's.

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92. *See* Nortek, Inc. v. Alexander Grant & Co., 532 F.2d 1013 (5th Cir. 1976) (applying Florida law); Koch Indus. v. Vosko, 494 F.2d 713 (10th Cir. 1974) (interpreting Kansas law); Stephens Indus. v. Haskins & Sells, 438 F.2d 357 (10th Cir. 1971) (interpreting Colorado law); O'Connor v. Ludlam, 92 F.2d 50 (2d Cir. 1937) (applying New York law); Aeronca, Inc. v. Gorin, 561 F. Supp. 370 (S.D.N.Y. 1983) (applying New York law); Canaveral Capital Corp. v. Bruce, 214 So. 2d 505 (Fla. Dist. Ct. App. 1968); Investment Corp. of Fla. v. Buchman, 208 So. 2d 291 (Fla. Dist. Ct. App. 1968); MacNerland v. Barnes, 129 Ga. App. 367, 199 S.E.2d 564 (1973) (involving both a disclaimer and uncertified financial statements); Dworman v. Lee, 83 A.D.2d 507, 441 N.Y.S.2d 90 (1981), *aff'd*, 56 N.Y.2d 816, 438 N.E.2d 103, 452 N.Y.S.2d 570 (1982); *see also* Haddon View Inv. Co. v. Coopers & Lybrand, 70 Ohio St. 2d 154, 436 N.E.2d 212 (1982) (Krupansky, J., dissenting) (characterizing the abandonment of privity as an unneeded and unlimited expansion of liability).
93. 43 N.Y.2d 356, 372 N.E.2d 315, 401 N.Y.S.2d 474 (1977).
94. The gravamen of the plaintiff's cause of action revolved around the accountants' failure to notify all partners that the general partners' withdrawal of funds from the partnership capital account was in violation of the partnership agreement. The withdrawals amounted to about $2,000,000. *Id.* at 359-60, 372 N.E.2d at 317-18, 401 N.Y.S.2d at 476-77.
95. *Id.* at 363, 372 N.E.2d at 319, 401 N.Y.S.2d at 479.
96. *Id.* at 361, 372 N.E.2d at 318, 401 N.Y.S.2d at 477 (emphasis supplied).
97. *Id.* at 362, 372 N.E.2d at 319, 401 N.Y.S.2d at 478 (emphasis supplied).
98. *Id.* (emphasis supplied).
99. Glanzer v. Shepard, 233 N.Y. 236, 238-39, 135 N.E. 275, 275 (1922) (emphasis supplied).
100. *See supra* notes 88-91 and accompanying text.
101. *See* Aeronca, Inc. v. Gorin, 561 F. Supp. 370, 376 (S.D.N.Y. 1983); *cf.* Dworman v. Lee, 83 A.D.2d 507, 507, 441 N.Y.S.2d 90, 91 (1981) (stating that *Ultramares* was reaffirmed by the *White* court), *aff'd*, 56 N.Y.2d 816, 438 N.E.2d 103, 452 N.Y.S.2d 570 (1982).

Courts must thus recognize that the protection afforded accountants by Chief Judge Cardozo's opinion in the 1930's is neither necessary nor prudent.

B. Specifically Foreseeable Standard — Recovery for a Class of Intended Beneficiaries

Although the specifically foreseeable standard represents an improvement over the primary benefit requirement of *Ultramares*, it nonetheless remains limited in the imposition of liability. By extending a right to recovery only to a limited group of third parties who are expected to obtain the financial statement information in an anticipated transaction, the specifically foreseeable standard fails to promote the improvement of financial reporting. In addition, the smaller investor, the one who needs the greatest protection, is left unprotected. Thus, when compared to the reasonably foreseeable standard,[102] the rationale of the specifically foreseeable test is unpersuasive.

The *Restatement* advances three reasons in support of the specifically foreseeable standard. First, a user of commercial information cannot expect a duty to extend to him when the supplier is unaware of the terms of the third party obligation.[103] Second, the limitations are imposed to promote "the important social policy of encouraging the flow of commercial information upon which the operation of the economy rests."[104] Finally, since only monetary damages are suffered as opposed to damage to person or property, the scope of liability is limited because of the extent to which the erroneous information may be propagated and the magnitude of the losses that may ensue from reliance.[105]

The rationale underlying the specifically foreseeable test, however, ignores reality. Auditors know that individuals throughout the business world will rely upon financial statements.[106] Indeed, one of the specific purposes of an independent attestation is to provide a degree of assurance to economic and financial data that are used in weighing business alternatives and evaluating decisions.[107] Since this degree of

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102. *See* discussion *infra* notes 110-23 and accompanying text.
103. RESTATEMENT (SECOND) OF TORTS § 552 comment a (1977).
104. *Id.*
105. *Id.*
106. In H. Rosenblum, Inc. v. Adler, 93 N.J. 324, 461 A.2d 138 (1983), the court stated that the auditors "could reasonably expect that their client would distribute the [audited] statements in furtherance of matters relating to business. Having inserted the audit in that economic stream, the defendants should be responsible for their careless misrepresentations to parties who justifiably relied upon their expert opinions." *Id.* at 356, 461 A.2d at 155; *see also In re* Touche, Niven, Bailey & Smart, [1937-1982] [Accounting Series Releases] FED. SEC. L. REP. (CCH) ¶ 72,100, at 62,220 (public accountant is responsible "not only to the client who pays his fee, but also to investors, creditors and others who may rely on the financial statements which he certifies").
107. *See* discussion *supra* notes 5-11 and accompanying text.

assurance will not inure to the reasonably foreseeable user of the financial statements, there exists little incentive for the accounting profession to improve the standards relating to accounting principles and the conduct of an audit engagement.[108] Given the specifically foreseeable standard, a potential investor may be unwilling to invest because of the inability to place any legal reliance upon the auditor's report. Further, the free flow of commercial information will not be impeded by allowing recovery to reasonably foreseeable users of the financial statements. Instead, because of risk spreading,[109] the commercial information being disseminated will be more reliable and will be continually upgraded to avoid any potential liability.

The specifically foreseeable test represents a moderate increase in auditors' liability but it surely is more pragmatic in today's business world than the standard enunciated over fifty years ago in *Ultramares*. Still, because of the intrinsic limitations of the specifically foreseeable test, the standard fails to promote the improvement of and reliance on financial reporting. Consequently, a more expansive standard is needed.

C. *Reasonably Foreseeable Standard — A Traditional Standard for a Modern Profession*

"Why the development of the common law of accountant's liability has proceeded so cautiously, in what is almost universally perceived to be an activist judicial world, is inexplicable."[110] The justification for the imposition of a duty to third parties reasonably relying on financial statements lies not only in the change of circumstances that have occa-

108. The profession has on its own initiative and with the guidance of the SEC made vast strides in improving the audit function. Despite these improvements, the imposition of sanctions or liability has always prompted changes and standards to be followed. The profession's response to *In re* McKesson & Robbins, Inc., [1937-1982 Transfer Binder] [Accounting Series Releases] FED. SEC. L. REP. (CCH) ¶ 72,020 (1940), demonstrates this point. The release emphasized the need for independence of auditors and the need for physical inspection and verification of assets. The SEC also suggested that the profession distinguish auditing standards from auditing procedures. This provided the impetus for formulating GAAS and issuing auditing procedures. *See* D. CAUSEY, *supra* note 2, at 18-19.

Most recently, the profession has come under increased congressional scrutiny. The call for federal regulation of the accounting profession has intensified with failures such as that of the United American Bank of Knoxville, which touched off the "largest commercial banking collapse in American history." *Auditing the Auditors: Why Congress May Tighten Up*, BUS. WK., Dec. 12, 1983, at 130. Only three weeks before its collapse, the bank had received an unqualified opinion as to its financial statements by Ernst & Whinney, a prominent public accounting firm. *Id.* The Government Operations Subcommittee of the House of Representatives and the General Accounting Office are reportedly investigating the accounting profession and its efforts in self-regulation. *Id.*

109. *See* discussion *infra* notes 115-17 and accompanying text.

110. Weiner, *supra* note 3, at 249.

sioned the accounting profession and the marketplace,[111] but also in traditional tort law concerns. The policy considerations inherent in the reasonably foreseeable analysis will surely absolve auditors' liability in circumstances where the imposition would be improvident. The analytical framework provided by the reasonably foreseeable standard will allow compensation through risk spreading, encourage a continued improvement in standards and procedures used in the profession, and elevate auditors' liability to a position comparable to their status in the marketplace.

A basic tort doctrine provides that, as between an innocent party and a negligent party, the latter should bear the expense of damages flowing from his negligence unless compelling public policy considerations dictate otherwise.[112] This general rule demonstrates societal concern for the compensation of innocent victims.[113] The primary argument against increasing liability for accountants' negligence is that the costs to the accounting profession would outweigh any benefit that would accrue to the public. This argument rests on the premise that increased liability would mark the demise of the profession.[114] This argument is specious since the profession is well able to distribute the risk of negligence through the use of liability insurance and, in the long run, the profession will benefit.[115]

The use of liability insurance can effectively shift the risk of ac-

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111. *See* discussion *supra* notes 62-70 and accompanying text. The accountants in *Adler* argued:

> The holding of *Ultramares* has even more applicability to current conditions than to conditions in 1933. Suffice it to say that a flood of lawsuits have been brought against accountants by persons who invested in failing businesses during recent recessionary periods and now seek a deep pocket from which to recover their losses. The liability claims made against auditors in connection with each business failure often exceed $100 million. Thus, exposing accountants to liability to all foreseeable plaintiffs based upon negligent misrepresentations would have the effect of making them insurers of the financial viability of their client's businesses and would result in the potential for staggering amounts of liability to the profession.

Brief and Appendix for Defendants-Respondents at 21, H. Rosenblum, Inc. v. Adler, 183 N.J. Super. 417, 444 A.2d 66 (1982), *aff'd in part, rev'd in part*, 93 N.J. 324, 461 A.2d 138 (1983).

112. *See* Rusch Factors, Inc. v. Levin, 284 F. Supp. 85, 90-91 (D.R.I. 1968); F. HARPER & F. JAMES, THE LAW OF TORTS § 18.1 (1956 & Supp. 1968).

113. W. PROSSER, *supra* note 3, § 5.

114. *See* Mess, *supra* note 1, at 856.

115.

> Litigation and enforcement proceedings do more than merely assess penalties for substandard performance or misconduct. The legal environment affects the profession as a whole as well as the practices of individual auditors and firms.
>
> . . . Legal penalties and public disclosure of them have clearly spurred the profession and firms to reexamine and strengthen technical standards and compliance with them.

THE COMMISSION ON AUDITORS' RESPONSIBILITIES, REPORTS, CONCLUSIONS AND RECOMMENDATIONS 152 (1978).

countants' negligence throughout the marketplace.[116] Those opposing reliance upon liability insurance as a justification for expanding liability point to the prohibitive costs involved.[117] In addition, treating insurance as an escape will eventually lead to premiums exceeding awards that might have been received had the issues been contested in court.[118] These arguments, however, neglect the effect of risk distribution to the client and the incentive to improve financial reporting that would accompany the broadening of liability.

Both *Adler* and *Citizens* recognized as a primary justification the deterrent or financial disincentive effect that liability to reasonably foreseeable users of financial statements would accomplish.[119] Although any audit or other accounting services necessarily involves a cost/benefit analysis,[120] the increased costs for a more effective performance could be passed to the client who would then distribute the costs throughout the marketplace. The accountants' status in the marketplace is quite unique[121] given the need for financial information. By providing a financial deterrent, the imposition of liability based on a reasonably foreseeable standard will encourage the improvement of financial reporting and allow for legal reliance on the information disseminated.

Most importantly, the reasonably foreseeable analysis will also encompass policy considerations that will limit auditors' liability where an expansion would be imprudent. The requirements established by the *Adler* court in allowing third parties to sustain an action against accountants places a fair burden upon the party claiming negligence.[122]

116. *See* Rusch Factors, Inc. v. Levin, 284 F. Supp. 85, 90-91 (D.R.I. 1968); H. Rosenblum, Inc. v. Adler, 93 N.J. 324, 348 & n.11, 461 A.2d 138, 151-52 & n.11 (1983); Citizens State Bank v. Timm, Schmidt & Co., 113 Wis. 2d 376, 384, 335 N.W.2d 361, 365 (1983); Mess, *supra* note 1, at 856.
117. The average deductible for legal insurance carried by the major firms has been cited at over $1 million per lawsuit. *See Liability Lawsuits: The Profession Fights Back*, J. ACCOUNTANCY, May 1983, at 131; *see also* H. Rosenblum, Inc. v. Adler, 93 N.J. 324, 349-50 n.11, 461 A.2d 138, 151-52 n.11 (1983) (noting defendant's contention that insurance coverage would be "catastrophic," but stating that the assertion was unsupported by empirical data).
118. *See* Woolf, *Auditing and Staying Out of Court*, J. ACCOUNTANCY, Feb. 1983, at 65.
119. H. Rosenblum v. Adler, 93 N.J. 324, 352, 461 A.2d 138, 153 (1983) (citing Weiner, *supra* note 3, at 260); Citizens State Bank v. Timm, Schmidt & Co., 113 Wis. 2d 376, 384, 335 N.W.2d 361, 366 (1983).
120. *See supra* notes 19-20 and accompanying text.
121. "The legal duties of the auditor ought to be co-extensive with his professional pretensions. He aspires to be more than a rubber stamp for management, so his legal duties ought to go beyond that status . . . ." Bradley, *Liability to Third Parties for Negligent Audits*, 1966 J. BUS. L. 190, 196.
122. The *Adler* court has set reasonable limitations by requiring the party claiming negligence to establish the following: (1) receipt of the financial information under a proper company purpose; (2) reliance thereon; (3) that misstatements were the result of the auditor's negligence; and (4) that the misstatements proximately caused the damages claimed. *See* H. Rosenblum, Inc. v. Adler, 93 N.J. 324, 350, 461 A.2d 138, 152 (1983). The *Adler* court's emphasis is on reasonable reliance by a third party. For the proposition that a nexus must exist between the injury and

Factors such as remoteness, degree of culpability in relation to damages suffered, and likelihood that recovery would lead to fraudulent claims must weigh in a court's determination of liability.[123] In addition, a number of defenses,[124] such as contributory negligence, may be available for auditors to assert against the plaintiffs.

In sum, the reasonably foreseeable standard protects the innocent user of financial statements and will help deter unprofessional workmanship of accountants by providing financial disincentive.

IV. CONCLUSION

The evolution of accountants' liability has come to the point where the reasonably foreseeable standard is now judicious. The rationale underlying *Ultramares* and its progeny is no longer persuasive in today's business world. Likewise, the specifically foreseeable test does not adequately extend liability for negligent conduct.

The accounting profession has enjoyed the unprecedented position of playing a central role in the decisions engaged in by the business community without the corresponding legal responsibility. This situation has led courts to reexamine this disparity. Those courts that have held accountants liable to reasonably foreseeable users of financial statements have recognized not only the change in circumstances and the status of the accountant within the business world, but also the need to protect third parties, the financial deterrent available, and the profession's ability to spread the risk through the use of liability insurance. The imposition of liability based on a reasonably foreseeable standard will therefore benefit both the accounting profession and the public's interest in business.

Brian Jeffrey Frank

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the negligent conduct, the court cited Toromont Indus. Holdings Ltd. v. Thorne, Gunn, Helliwell & Christenson, 62 D.L.R.3d 225 (1976), 73 D.L.R.3d 122 (1976) (High Court of Ontario found that plaintiffs would have proceeded with a takeover bid despite a negligent audit. The Court of Appeals of Ontario, however, held that the plaintiffs suffered damages to the extent that a new audit had to be prepared). *See also* JEB Fasteners Ltd. v. Marks, Bloom & Co. [1981] 3 All E.R. 289 (takeover would have proceeded in any event because of the desire to acquire the services of directors).

123. *See* H. Rosenblum, Inc. v. Adler, 93 N.J. 324, 342, 461 A.2d 138, 147 (1983); Citizens State Bank v. Timm, Schmidt & Co., 113 Wis. 2d 376, 387, 335 N.W.2d 361, 366 (1983); *see also* Scott Group Ltd. v. McFarlane, [1981] 1 N.Z.L.R. 553.

124. *See* K. ST. PIERRE, AUDITOR RISK AND LEGAL LIABILITY 16-18 (1983) (setting forth the primary common law defenses available including attempts to prove there existed no negligence, that the negligence did not cause the loss, that the plaintiff was contributorily negligent, and that plaintiff's loss was recovered from another source); *see also* D. CAUSEY, *supra* note 2, at 93-104 (discussing the above defenses plus the tolling of the statute of limitations).