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LIABILITY OF ACCOUNTANTS FOR NEGLIGENT AUDITING: DOCTRINE, POLICY, AND IDEOLOGY

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The collapse of the Enron Corporation was spectacular for its scale and its suddenness—$70 billion of shareholder value, held by Enron employees in their 401(k) plans and by other working people through their pension plans and mutual funds, as well as by other individual and institutional investors, wiped out in less than a year. After the collapse came the inevitable accusations, many leveled at Enron's accounting firm, Arthur Andersen L.L.P.,[1] for scheming with Enron executives to set up the rococo structure of off-the-books partnerships and other accounting gimmicks that concealed Enron's implausible and ultimately untenable financial condition, and for reporting nothing amiss in its annual audits of Enron's financial statements. When Enron restated its earnings for the past five years to recognize $600 million in losses, the irony of Andersen's prescribed assurance that the Enron financial statements it audited "present fairly, in all material respects" the company's financial condition[2] was only surpassed by the near self-parody of the firm's maxim taught to firm founder Arthur Andersen by his Norwegian mother:

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1. For its role in the Enron scandal, Arthur Andersen was convicted of obstruction of justice in June 2002 and officially ended its public auditing business on August 31, 2002. Karen Robinson-Jacobs, *Andersen Says Goodbye to Accounting*, L.A. TIMES, Aug. 31, 2002, at C1.

2. Richard W. Stevenson & Jeff Gerth, *Web of Safeguards Failed as Enron Fell; Inside and Out, Signals Went Unheeded*, N.Y. TIMES, Jan. 20, 2002, at 1.

"Think straight, talk straight."[3]

After the collapse came the accusations, and after the accusations came the lawsuits.[4] In this respect, neither Enron nor Arthur Andersen are unique. In March 2002, Andersen agreed to pay $217 million to settle suits arising from its role as auditor of the Baptist Foundation of Arizona, investors in which were bilked by sham transactions that hid massive losses.[5] Also, Andersen paid $110 million to settle suits arising from its audit of Sunbeam during the reign of CEO "Chainsaw Al" Dunlap, and $75 million to settle a suit brought by Waste Management, Inc., in 1998.[6] Ernst & Young paid more than $335 million for its role in the Cendant Corporation debacle.[7]

Even more recently, AOL Time Warner, Inc., has made a downward adjustment of $190 million for the past two years of revenues,[8] Tyco International has admitted that "aggressive accounting" exaggerated its 2002 earnings by almost $400 million,[9] Xerox Corporation has restated revenues since 1997 by $6.4 billion,[10] WorldCom, Inc., has repeatedly restated earnings to recognize false profits currently totaling $7.2 billion, with the potential to exceed $9 billion,[11] and Rite Aid Corp. executives have been charged with overstating earnings in the 1990s by $1.6 billion.[12] Between 1998 and March 2002, 233 public companies restated earnings, correcting statements which had been attested to by their accountants.[13] And so on.

The potential liability of accountants to investors, lenders, and others who rely on their audit reports is not only restricted to Big Five accounting firms and their huge corporate clients. In the more

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3. BARBARA LEY TOFFLER, FINAL ACCOUNTING: AMBITION, GREED, AND THE FALL OF ARTHUR ANDERSEN 9, 12-13 (2003).

4. Several class actions have already been filed against Andersen. Greg Farrell, *Enron Troubles Could Extend to Arthur Andersen*, USA TODAY, Dec. 7, 2001, at B7; Kevin Moran, *Firm Alleges Andersen Conspiracy: American National Says Enron Auditor Lied*, HOUS. CHRON., Jan. 3, 2002, at Business 1.

5. Jonathan D. Glater, *Auditor to Pay $217 Million to Settle Suits*, N.Y. TIMES, Mar. 2, 2002, at C1.

6. Carolyn Aldred, *Auditors' E&O Costs Add Up*, BUS. INS., Feb. 4, 2002, at 3; William Greider, *Crime in the Suites*, THE NATION, Feb. 4, 2002, at 11, 12.

7. Aldred, *supra* note 6, at 32.

8. Martin Peers & Julia Angwin, *AOL to Restate Two Years of Results: Questionable Transactions in Advertising Continue to Plague Media Company*, WALL ST. J., Oct. 24, 2002, at A3.

9. Kevin McCoy, *Tyco Acknowledges More Accounting Tricks*, USA TODAY, Dec. 31, 2002, at B3.

10. Kathleen Day, *Xerox Restates 5 Years of Revenue: '97-'01 Figures Were Off by $6.4 Billion*, WASH. POST, June 29, 2002, at A1.

11. Deborah Solomon & Jared Sandberg, *Worldcom's False Profits Climb: Telecom Firm's Latest Tally May Exceed $9 Billion; SEC Files More Charges*, WALL ST. J., Nov. 6, 2002, at A3.

12. Scott Kilman, *Rite Aid Ex-Officials Charged in Accounting-Fraud Probe*, WALL ST. J., June 24, 2002, at A2.

13. Joseph Nocera, *Who's to Blame?*, MONEY, Mar. 2002, at 79, 80.

prosaic *Walpert, Smullian & Blumenthal, P.A. v. Katz*, for example, the tragically familiar failure of Magnetics, Inc., a family printing supplies and press repair business, sparked a suit by George Katz, the retired owner who had passed the business to his wife and sons, against the Baltimore accounting firm that allegedly had negligently audited the business's financial statements, failing to discover inflated inventory and accounts receivable.[14] There are scores, if not hundreds, of reported cases where the consequences of economic cycles and business failures lead to a search for a solvent party on which to attach a claim; often an accountant is left holding the bag.[15]

This Article first presents a comprehensive description of the law of auditor liability.[16] It begins by summarizing the audit process and the history of auditor liability.[17] An early Cardozo opinion, *Ultramares Corp. v. Touche*,[18] sets out an argument and a standard for limited liability that is still important.[19] The influence of that decision contributed to a bar on liability until the 1960s, when liability expanded under the influence of more general developments in tort law.[20]

The Article then describes the state of the law in every jurisdic-

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14. 762 A.2d 582 (Md. 2000).

15. Nor is the problem limited to the United States. For a review of the law throughout the common law countries, see Carl Pacini et al., *The International Legal Environment for Information Systems Reliability Assurance Services: The CPA/CA Systrust*, 105 COM. L.J. 351, 361-80 (2000).

16. The Article focuses on the liability of accountants in their role as auditors. "Accountant" and "auditor" are used interchangeably throughout. For information on the liability of accountants in non-audit situations, see JAY M. FEINMAN, PROFESSIONAL LIABILITY TO THIRD PARTIES 138-39 (2000) [hereinafter FEINMAN, THIRD PARTIES]. The literature on auditor liability is expansive. *See, e.g.*, ALI-ABA, COURSE OF STUDY MATERIALS, ACCOUNTANTS' LIABILITY (2001); JAY M. FEINMAN, ECONOMIC NEGLIGENCE: LIABILITY OF PROFESSIONALS AND BUSINESSES TO THIRD PARTIES FOR ECONOMIC LOSS 211-74 (1995) [hereinafter FEINMAN, ECONOMIC NEGLIGENCE]; FEINMAN, THIRD PARTIES, *supra*, at 115-46; Christopher Allegaert & Daniel Tinkelman, *Reconsidering the "Lack of Duty" Defense to State Auditor Negligence Claims*, 25 J. CORP. L. 489 (2000); Victor P. Goldberg, *Accountable Accountants: Is Third-Party Liability Necessary?*, 17 J. LEGAL STUD. 295 (1988); Willis W. Hagen II, *Accountants' Common Law Negligence Liability to Third Parties*, 1988 COLUM. BUS. L. REV. 181; Gary Lawson & Tamara Mattison, *A Tale of Two Professions: The Third-Party Liability of Accountants and Attorneys for Negligent Misrepresentation*, 52 OHIO ST. L.J. 1309 (1991); Jodie B. Scherl, *Evolution of Auditor Liability to Noncontractual Third Parties: Balancing the Equities and Weighing the Consequences*, 44 AM. U. L. REV. 255 (1994); John A. Siliciano, *Negligent Accounting and the Limits of Instrumental Tort Reform*, 86 MICH. L. REV. 1929 (1988); Roger J. Buffington, Note, *A Proposed Standard of Common Law Liability for the Public Accounting Profession*, 5 S. CAL. INTERDISC. L.J. 485 (1997).

17. For more discussion of these topics, see FEINMAN, ECONOMIC NEGLIGENCE, *supra* note 16; FEINMAN, THIRD PARTIES, *supra* note 16.

18. 174 N.E. 441 (N.Y. 1931).

19. FEINMAN, THIRD PARTIES, *supra* note 16, at 115.

20. *See id.* at 118.

tion.[21] Auditor liability is a particularly interesting doctrinal problem because of the diversity of approaches to liability. A few states still require that a third party be in privity or a similarly close relationship with the auditor to recover. Several others allow any foreseeably injured party to recover. Most states have taken a middle ground by adopting the negligent misrepresentation standard of the *Restatement (Second) of Torts*, section 552. That standard, however, is notably diffuse, so courts applying it still range from a near privity requirement to a foreseeability test.

The diversity of approaches among the jurisdictions inevitably seeks resolution—a resolution that would provide the "correct answer" or the "better rule." This Article provides neither of those. It does, however, frame the issue in several ways that make the process of selecting an answer or rule more accessible. The Article lays out the policy analysis of auditor liability. The analysis begins with consensus treatment of a paradigm case of liability, but then splits into two approaches that reach different results in situations beyond the paradigm case. The Article surveys empirical research on auditor liability, but finds no resolution of the policy conflict there. Finally, the Article relates the auditor liability issue to broader questions in modern private law.

I. THE CONTEXT: AUDITING AND THE HISTORY OF AUDITOR LIABILITY

A. Auditing

Accountants perform a variety of functions for their clients,[22] but only a narrow range of situations give rise to actions by third parties. The great majority of reported cases concern accountants in the performance of their auditing function, with a few cases arising from compilation or review engagements, or the provision of tax-planning

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21. The Article's focus is on the liability of auditors at common law, or under statutory substitutes for the common law. Other liability may rest on the federal or state securities laws. For a review of liability under the securities laws, see Richard P. Swanson, *Theories of Liability*, *in* ALI-ABA, COURSE OF STUDY MATERIALS, ACCOUNTANTS' LIABILITY 37 (2000).

22. A useful introduction to accounting from the lawyer's perspective is provided by the annual symposia of the Practicing Law Institute. *E.g.*, PRACTISING LAW INST., BASICS OF ACCOUNTING AND FINANCE: WHAT EVERY PRACTICING LAWYER NEEDS TO KNOW (1998).

The expansion of accountants into consulting and other areas raises questions of their independence as auditors and has been controversial. *See* Tamar Frankel, *Accountants' Independence: The Recent Dilemma*, 2000 COLUM. BUS. L. REV. 261. In 2000, Arthur Andersen spun off its consulting business, now known as Accenture, although that action was more a product of financial conflicts between the two halves of the firm than of concern over auditor independence. The other Big Five accounting firms have stated their intention to do the same. Jeremy Kahn, *Deloitte Restates Its Case*, FORTUNE, Apr. 29, 2002, at 64, 65.

services.[23]

An audit is a systematic, objective examination of a company's financial statements.[24] As accountants frequently point out in debates about liability, the company, not the accountant, prepares the financial statements.[25] The purpose of an audit is to determine if the statements fairly present the financial condition of the company by determining that they have been prepared in accordance with Generally Accepted Accounting Principles (GAAP), applied on a consistent basis. The Auditing Standards Board of the American Institute of Certified Public Accountants (AICPA) promulgates Generally Accepted Auditing Standards (GAAS) and the interpretive Statements on Auditing Standards (SAS) that govern the conduct of audits.[26]

After concluding the audit, the auditor issues its report. The report expresses the auditor's independent, professional opinion about the fairness of the financial statements and, depending on the results of the audit, may be one of several kinds:

> An unqualified opinion states that the accountant followed GAAS and that the financial statements fairly present the financial condition of the company in accordance with GAAP. An unqualified opinion may sometimes contain explanatory language, as when the company has changed its accounting practice or when there is an unresolved uncertainty, such as significant pending litigation. As a practical matter, an unqualified opinion is almost a necessary result of an audit of large, publicly-held companies, and of smaller companies when the audit is needed to satisfy lenders or investors. If the auditor discovers discrepancies that may require a qualified report, the auditor and the client often will discuss, negotiate, and attempt to remedy the difficulties.
>
> A qualified opinion states exceptions to the observance of GAAS, where the scope of the audit is limited or the auditor is unable to obtain necessary information, or to the fairness of the statements in accordance with GAAP, when the principles have not been observed or when not all necessary disclosures have been made.

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23. Two specially-defined non-audit services are compilation and review. A compilation is an unaudited presentation by the accountant of financial statements, based on information provided by the client, which represents no assurances by the accountant. In a review, the accountant provides only limited assurance that the financial statements do not deviate materially from generally accepted accounting principles—a much lower level of assurance than is provided in an audit report. Accountants also provide tax and estate planning and prepare tax returns. For a discussion of the law concerning non-audit services, see FEINMAN, THIRD PARTIES, *supra* note 16, at 138-39.

24. *See* LARRY P. BAILEY, MILLER GAAS Guide 3-6 (Aspen Law & Bus. 2002); HANDBOOK OF ACCOUNTING AND AUDITING § B1.01 (Frank C. Minter et al. eds., 2000).

25. In some cases, however, as with Enron, the accountant previously retained to assist in the design of the company's internal accounting procedures will produce the financial statements. Stevenson & Gerth, *supra* note 2.

26. *See* BAILEY, *supra* note 24, at 4. The AICPA owes no duty to third parties in the promulgation of its auditing standards. Waters v. Autuori, 676 A.2d 357, 362 (Conn. 1996).

> An adverse opinion states that the financial statements are not fairly stated in conformity with GAAP.
>
> A disclaimer of opinion is not an opinion at all; rather, the accountant states that the scope of the audit was not sufficient to enable it to render an opinion.[27]

Auditing is a mix of judgment and technique which may result in certain pitfalls. Auditors can make seemingly reasonable judgments, but third parties who later rely on the audit may come to question these judgments. Auditors also may misinterpret either GAAS or GAAP, carry out the audit improperly, or fail to detect fraud by the client in preparing the financial statements or in the underlying transactions. Finally, auditors can make errors in failing to discover or explain that the financial statements do not fairly represent the client's position.[28]

B. The History of Auditor Liability

The history of accountant liability is made up of two or two-and-one-half stages. In the first stage, which began in the late nineteenth century and extended through the 1950s, restrictive liability rules made it virtually impossible for a third party to recover for harm caused by a negligent audit. In the second stage, which began in the 1950s and has continued to the present, the traditional doctrines came under attack and liability increased, particularly through the expansion of the law of negligence and negligent misrepresentation. The increase of liability has not been uniform, however, and has been contested, in some jurisdictions, on some facts, and, particularly in the past fifteen years, by increasingly-conservative courts.[29]

The foundation for the application of the narrow doctrine of privity in economic loss cases generally was the United States Supreme Court's 1879 decision in *Savings Bank v. Ward*.[30] The case involved an action by a bank which lent money for the purchase of real estate in reliance on a title report prepared by the defendant lawyer.[31] The court cited the classic English case of *Winterbottom v. Wright*[32] for the fear of the "absurd consequences" of indeterminate liability that would ensue if a third party action was allowed.[33] Accordingly, the court established the rule that a third party not in privity was barred from recovering for economic loss.[34]

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27. *See* BAILEY, *supra* note 24, at 346-80.
28. KENT E. ST. PIERRE, AUDITOR RISK AND LEGAL LIABILITY 8-10, 25-41 (1983).
29. *See, e.g.*, Bily v. Arthur Young & Co., 834 P.2d 745 (Cal. 1992); *infra* note 89.
30. 100 U.S. 195 (1879).
31. *Id.* at 195-98.
32. 152 Eng. Rep. 402 (Ex. 1842).
33. *Savings Bank*, 100 U.S. at 203.
34. *Id.*

Savings Bank v. Ward quickly established the privity bar. Some sixteen years after *Savings Bank*, the California Supreme Court asserted that the "overwhelming weight of authority" supported the doctrine.[35] The Pennsylvania Supreme Court, in the early accountant liability case of *Landell v. Lybrand*, applied the same rule developed in *Savings Bank* to bar an action by the purchaser of stock in a company against the accountant that had prepared its financial statements.[36]

Over time, courts eroded the requirement of privity in personal injury cases, particularly those involving manufactured products. The decisive case was *MacPherson v. Buick Motor Co.*, in which Cardozo's opinion substituted a rule of foreseeability for the privity bar.[37] In a pair of important cases, the New York Court of Appeals first raised the possibility of extending that analysis to economic loss cases and then foreclosed that possibility, leaving the privity rule substantially intact.[38]

In the first of these two cases, *Glanzer v. Shepard*, the court imposed liability for economic loss caused to a purchaser of beans when the bean weigher, under contract to the seller, certified an erroneous weight for the beans.[39] Because the "end and aim" of the transaction was to provide a service to the buyer, the buyer had an action against the weigher either for the negligent performance of its service or as the third party beneficiary of the weigher's contract with the seller.[40]

In *Ultramares Corp. v. Touche*, the court recognized that "[t]he assault upon the citadel of privity is proceeding in these days apace" in tort cases involving personal injury and in contract law through the widening of third party beneficiary liability.[41] The court refused, however, to extend the foreseeability principle of *MacPherson* to economic losses caused by an auditor's neglect, and it limited *Glanzer's* "end and aim" concept to cases in which there was a connection between the plaintiff and the defendant that was the equivalent of priv-

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35. Buckley v. Gray, 42 P. 900, 900 (Cal. 1895), *overruled by* Biakanja v. Irving, 320 P.2d 16 (Cal. 1958).

36. *Landell v. Lybrand*, 107 A. 783, 783 (Pa. 1919):

> There were no contractual relations between the plaintiff and defendants, and, if there is any liability from them to him, it must arise out of some breach of duty, for there is no averment that they made the report with intent to deceive him. The averment in the statement of claim is that the defendants were careless and negligent in making their report; but the plaintiff was a stranger to them and to it, and, as no duty rested upon them to him, they cannot be guilty of any negligence of which he can complain.

37. 111 N.E. 1050, 1053 (N.Y. 1916).

38. Glanzer v. Shepard, 135 N.E. 275 (N.Y. 1922); Ultramares Corp. v. Touche, 174 N.E. 441 (N.Y. 1931).

39. 135 N.E. at 275.

40. *Id.* at 275-76.

41. 174 N.E. at 445.

ity.[42]

In *Ultramares*, the defendants, Touche, Niven & Co., had prepared and certified a balance sheet for Fred Stern & Co., an importer and seller of rubber, as it had for several years before.[43] On this occasion, Touche supplied Stern with thirty-two copies of the certified balance sheet knowing that Stern would provide them to banks, creditors, and others in the ordinary course of its business.[44] Ultramares, a factor, provided financing to Stern in reliance on the balance sheet prepared by Touche.[45] Because the principals of Stern had falsified the company's accounts receivable, the business collapsed, resulting in a loss to Ultramares.[46]

The court interpreted *Glanzer* to be a case in which "[t]he bond [between the bean weigher and the third-party buyer] was so close as to approach that of privity, if not completely one with it."[47] Indeed, the same result would have been reached in *Glanzer* through the application of third party beneficiary law as through the law of negligence. In *Ultramares*, however, there was no such bond because the service rendered by the defendant was primarily for the benefit of Stern, its contracting partner, not Ultramares.[48]

The court characterized *Ultramares*, unlike *Glanzer*, as a case involving a misrepresentation rather than a service.[49] Accordingly, the issue was what "liability attaches to the circulation of a thought or a release of the explosive power resident in words."[50] The implications of imposing such liability would have been catastrophic. Liability would extend to other professions and businesses, such as attorneys and title abstracters, and the liability would be immense and uncertain.[51] In Cardozo's cogent aphorism: "If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class."[52]

The policies stated in *Ultramares* set the standard for accountant liability for the next third of a century. Until the late 1950s, there were only occasional criticisms of and exceptions to the approach, and these were never generalized or widely adopted. Eventually,

42. *Id.* at 445-47.
43. *Id.* at 442.
44. *Id.*
45. *Id.* at 443.
46. *Id.* at 442-43.
47. *Id.* at 446.
48. *Id.*
49. *Id.* at 446-48.
50. *Id.* at 445.
51. *Id.* at 448.
52. *Id.* at 444.

however, courts and commentators mounted a series of challenges that resulted in many jurisdictions moving away from the traditional approach in significant respects.

The most noteworthy development was the rise of a general concept of negligence. A central development in modern tort law was "a veritable ground swell in the law of negligence that pushed liability for physical injuries toward the full extent of what was foreseeable and shattered ancient barriers to recovery based on limitations associated with privity of contract and similar restrictive concepts."[53] In third-party liability cases, this development was initially driven by the implementation of a new standard for determining whether a duty to exercise reasonable care exists on a particular set of facts, often referred to as the "balance of factors test."[54]

The balance of factors test was formulated in *Biakanja v. Irving*, in which the would-be beneficiary of a will failed to receive the property which had been devised to her because of improper attestation of the testator's will under the supervision of the defendant notary public.[55] The central issue in the case was whether the defendant notary public owed a duty to the plaintiff, with whom it was not in privity.[56] The court formulated a new standard to answer this question:

> The determination whether in a specific case the defendant will be held liable to a third person not in privity is a matter of policy and involves the balancing of various factors, among which are the extent to which the transaction was intended to affect the plaintiff, the foreseeability of harm to him, the degree of certainty that the plaintiff suffered injury, the closeness of the connection between the defendant's conduct and the injury suffered, the moral blame attached to the defendant's conduct, and the policy of preventing future harm.[57]

In applying these factors, the court found that the purpose of the

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53. Fleming James, Jr., *Limitations on Liability for Economic Loss Caused by Negligence: A Pragmatic Appraisal*, 25 VAND. L. REV. 43, 47 (1972).

54. The standard was originally developed in the context of economic loss cases, but it has been applied as a fundamental duty analysis to abolish the traditional categories for analyzing the duties a landowner owes to entrants, Rowland v. Christian, 443 P.2d 561, 564 (Cal. 1968), *superceded in part by statute as stated in* Mastro v. Petrick, 112 Cal. Rptr. 2d 185, 189 (Cal. Ct. App. 2001), to recognize a claim for emotional distress by a witness to an accident, Dillon v. Legg, 441 P.2d 912 (Cal. 1968), *modified*, Thing v. La Chusa, 771 P.2d 814 (Cal. 1989), to extend to therapists the duty to warn of the dangerous propensity of patients, Tarasoff v. Regents of the Univ. of Cal., 551 P.2d 334 (Cal. 1976), and to recognize an action for loss of spousal consortium, Rodriguez v. Bethlehem Steel Corp., 525 P.2d 669 (Cal. 1974).

55. 320 P.2d 16 (Cal. 1958).

56. *Id.* at 18.

57. *Id.* at 19. Courts sometimes vary the elements of the test. *See, e.g.*, Nally v. Grace Cmty. Church of the Valley, 763 P.2d 948, 956 (Cal. 1988); Lucas v. Hamm, 364 P.2d 685 (Cal. 1961).

transaction was to benefit the plaintiff, the defendant must have been aware of the consequence of its negligence, the plaintiff suffered its loss because of the negligence, the conduct was blameworthy in that it was the unauthorized practice of law, and such conduct should be discouraged by providing the plaintiff with a right of action.[58] Accordingly, the court held that the defendant owed a duty to the plaintiff.[59]

The second development in the law of torts that led to a significant expansion of liability was the growth of the law of negligent misrepresentation. In *Ultramares*, recovery for economic loss caused by a negligent misrepresentation was held to be unavailable to a party not in privity.[60] In the early 1960s, a growing body of scholarship challenged the *Ultramares* rule, *Restatement (Second) of Torts*, section 552 was drafted, and several important court decisions allowed actions for negligent misrepresentation in various situations.

As adopted in the *Restatement (Second) of Torts*, section 552 extended liability to professionals who negligently supplied information to known or intended recipients of the information.[61] The Reporter's Note states that the rewording of the section was intended "to clarify [its] meaning,"[62] but the debate in the American Law Institute suggests it was intended to expand liability beyond the *Ultramares* rule.[63]

Coinciding with the drafting of the revised section 552, the first accountant liability case to depart from the *Ultramares* doctrine was *Rusch Factors, Inc. v. Levin*.[64] In this case, a Rhode Island corporation sought financing from the plaintiff. The plaintiff requested certified financial statements to assess the financial stability of the corporation.[65] The defendant accountant prepared the statements, which incorrectly represented that the corporation was solvent.[66] The corporation went into receivership, and the plaintiff was unable to recover

58. *Biakanja*, 320 P.2d at 19.

59. *Id.* Although the balance of factors test was broadly stated and turned out to be revolutionary, the opinion in *Biakanja* was not out of line with earlier authorities. The court reconciled *Glanzer* and *Ultramares* by characterizing *Glanzer* as a case in which the end and aim of the transaction was to benefit the plaintiff, *id.* at 18, and *Ultramares* as a case in which the benefit to the plaintiff was only a collateral consideration of the transaction and the plaintiff's injury was unforeseeable. *Id.* at 19. Following that reasoning, on the facts in *Biakanja*, the notary owed the beneficiary a duty because the "end and aim" of the transaction between the testator and the defendant was to provide for the passing of the estate to the plaintiff. *Id.*

60. 174 N.E. 441, 448 (N.Y. 1931).

61. RESTATEMENT (SECOND) OF TORTS § 552 (1977).

62. *Id.* § 552 reporter's note (1981).

63. 42 ALI PROC. 383-93 (1965).

64. 284 F. Supp. 85 (D.R.I. 1968).

65. *Id.* at 86.

66. *Id.*

the full amount it had loaned.[67]

The court noted that no appellate court had ever held an accountant liable in negligence to a relying party not in privity, but rejected that position.[68] Instead, the court asked:

> Why should an innocent reliant party be forced to carry the weighty burden of an accountant's professional malpractice? Isn't the risk of loss more easily distributed and fairly spread by imposing it on the accounting profession, which can pass the cost of insuring against the risk onto its customers, who can in turn pass the cost onto the entire consuming public? Finally, wouldn't a rule of foreseeability elevate the cautionary techniques of the accounting profession? For these reasons it appears to this Court that the decision in *Ultramares* constitutes an unwarranted inroad upon the principle that "[t]he risk reasonably to be perceived defines the duty to be obeyed."[69]

While the *Rusch Factors* court embraced a rule of foreseeability, it also concluded that on the facts of the case it need not go that far. The facts more closely resembled those of *Glanzer* than those of *Ultramares* because the plaintiff was a single party whose reliance was actually foreseen by the accountant.[70] Therefore, the plaintiff fell within the *Glanzer* principle as redacted in the draft of section 552 of the *Restatement (Second) of Torts*. The court held that "an accountant should be liable in negligence for careless financial misrepresentations relied upon by actually foreseen and limited classes of persons."[71]

Following *Rusch Factors* and the publication of the *Restatement*, a majority of courts rejected the *Ultramares* rule and allowed recovery by third parties against accountants. Many of these courts followed section 552 of the *Restatement* in allowing an action for negligent misrepresentation.[72] The most dramatic departure came in two cases in 1983 that continued the generalization of negligence begun in *Biakanja*: the New Jersey case of *H. Rosenblum, Inc. v. Adler*[73] and the Wisconsin case of *Citizens State Bank v. Timm, Schmidt & Co.*[74]

In *Rosenblum*, the court applied the recently-developed general negligence principle, stating:

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67. *Id.* at 87.
68. *Id.* at 90.
69. *Id.* at 91 (quoting Cardozo's opinion in Palsgraf v. Long Island R.R., 162 N.E. 99, 100 (N.Y. 1928)).
70. *Id.*
71. *Id.* at 93.
72. *See infra* note 165.
73. 461 A.2d 138 (N.J. 1983), *superceded by statute as stated in* Finderne Mgmt. Co. v. Barrett, 809 A.2d 857 (N.J. Super. Ct. App. Div. 2002). The New Jersey legislature subsequently adopted a different law. N.J. STAT. ANN. § 2A:53A-25 (West 2003).
74. 335 N.W.2d 361 (Wis. 1983).

> Unless some policy considerations warrant otherwise, privity should not be, and is not, a salutary predicate to prevent recovery. Generally, within the outer limits fixed by the court as a matter of law, the reasonably foreseeable consequences of the negligent act define the duty and should be actionable.[75]

In the case of accountants, policy considerations do not warrant limiting liability; indeed, in the court's view, they favor liability. First, the role of the accountant is one of public responsibility, in which the accountant serves as "an independent check upon management's accounting of its stewardship."[76] Second, accountants already are subject to similar duties, as under the federal securities laws.[77] Third, the imposition of a duty would require accountants to exercise greater care and to insure against losses caused by their neglect.[78] Finally, the duty was not an unlimited one, as demonstrated in the rule formulated by the court:

> When the independent auditor furnishes an opinion with no limitation in the certificate as to whom the company may disseminate the financial statements, he has a duty to all those whom that auditor should reasonably foresee as recipients from the company of the statements for its proper business purposes, provided that the recipients rely on the statements pursuant to those business purposes.[79]

One month later, the Wisconsin Supreme Court also applied general negligence principles in *Citizens State Bank*.[80] Rejecting the *Ultramares* rule and *Restatement (Second) of Torts*, section 552 as too restrictive, the court held that liability would attach unless the court, after a determination of the facts, found that public policy dictated otherwise.[81] Some of the public policy factors to be considered include the remoteness or fortuity of the injury in relation to the harm, the proportionality of the injury to the defendant's culpability, the reasonableness of the burden placed on the defendant, and the administrability of the rule because of fraudulent claims or the absence of a logical stopping point.[82]

The expansion of liability advocated in *Rosenblum* and *Citizens State Bank* was not widely followed. As noted, the majority of states have opted for the *Restatement* position, and several states, including New Jersey, have adopted legislation limiting liability.[83] Two devel-

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75. 461 A.2d at 145.
76. *Id.* at 149 (quoting *In re* Kerlin, SEC Accounting Release 105 (1966)).
77. *Id.* at 151.
78. *Id.* at 152.
79. *Id.* at 153.
80. 335 N.W.2d 361, 365-66 (Wis. 1983).
81. *Id.* at 366.
82. *Id.*
83. *See infra* notes 133-37, 165.

opments, in New York and California, have been particularly important. Although the *Ultramares* principle was substantially eroded by the generalization of negligence and the expansion of negligent misrepresentation, in New York, its jurisdictional home, it was revitalized by the Court of Appeals' 1985 decision in *Credit Alliance Corp. v. Arthur Andersen & Co.*[84] In that case, the court rejected the expansive possibilities of earlier decisions and reaffirmed the policies of *Ultramares* and *Glanzer*.[85] The court formulated a three-part test that would be more precise in application than the "end and aim" language of *Glanzer*, or the "bond approaching privity" standard of *Ultramares*. Under this test, the defendant owes a duty to the third party who relies on its representations only if the following conditions are met:

> (1) [T]he accountants must have been aware that the financial reports were to be used for a particular purpose or purposes;
> (2) in the furtherance of which a known party or parties was intended to rely; and
> (3) there must have been some conduct on the part of the accountants linking them to that party or parties, which evinces the accountants' understanding of that party or parties' reliance.[86]

The third element of the test was particularly important. The court emphasized that, in cases such as *Glanzer*, there was an intimate nexus between the bean weigher and the relying third party that was the equivalent of a third-party beneficiary relationship.[87] In cases such as *Ultramares*, the intimate nexus was missing, so that the third party's use of the information was merely one potential use among many others.[88] The requirement of some linking conduct or nexus between the plaintiff and defendant became the factor that most distinguished the New York near privity test from other, more expansive standards.

Because of New York's prominence, the *Credit Alliance* doctrine represented an important limitation on the expansion of liability for economic negligence. In addition to its application in New York, it was adopted by the courts of a few other states,[89] and was widely discussed as a position that had to be considered in formulating a doc-

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84. 483 N.E.2d 110, 118-19 (N.Y. 1985).
85. *Id.*
86. *Id.* at 118.
87. *Id.* at 117.
88. *Id.*
89. *See, e.g.*, Colonial Bank of Ala. v. Ridley & Schweigert, 551 So. 2d 390, 395 (Ala. 1989); Idaho Bank & Trust Co. v. First Bancorp of Idaho, 772 P.2d 720, 722 (Idaho 1989); Thayer v. Hicks, 793 P.2d 784, 789 (Mont. 1990). Subsequently the Alabama Supreme Court rejected the privity rule of *Colonial Bank of Alabama* in favor of the negligence standard of the *Restatement (Second) of Torts*, section 552. Boykin v. Arthur Andersen & Co., 639 So. 2d 504, 509 (Ala. 1994).

trine of liability. By giving credence to the narrow end of the liability spectrum, the doctrine had some influence in moderating the courts' move to a general negligence standard. The doctrine also was adopted by legislation in a number of states to limit the liability of accountants to non-clients.[90]

Of equal importance was the 1992 decision of the California Supreme Court in *Bily v. Arthur Young & Co.*[91] As part of a retreat from its historic posture of extending liability,[92] the court held that a negligence cause of action was restricted to those parties in privity with the accountant, and that a negligent misrepresentation action would be available only to those who met the standards of section 552 of the *Restatement*.[93] In doing so, the court took two steps to restrict liability. First, on the issue of negligence, it effectively supplanted the balance of factors test with a narrower test, rejecting the foreseeability doctrine which had prevailed in California since the Court of Appeals' much cited decision in *International Mortgage Co. v. John P. Butler Accountancy Corp.*,[94] following *Rosenblum* and *Citizens State Bank*.[95] Resurrecting the privity rule, the court held that a third party could not sue for an auditor's negligence.[96] Second, on the issue of negligent misrepresentation, it applied an extremely narrow interpretation of section 552, practically equating the knowledge requirement of section 552 with the intended beneficiary requirement of contract law.[97]

> The "intent to benefit" language of the Restatement Second of Torts thus creates *an objective standard* that looks to the specific circumstances (e.g., supplier-client engagement and the supplier's communications with the third party) to ascertain whether a supplier has undertaken to inform and guide a third party with respect to *an identified transaction or type of transaction*.[98]

II. A SURVEY OF AUDITOR LIABILITY

A. *Characterizing the Action: Negligence or Negligent Misrepresentation*

The plaintiff in an auditor liability case necessarily makes two

90. *E.g.*, UTAH CODE ANN. § 58-26-12 (repealed 2000).
91. 834 P.2d 745 (Cal. 1992).
92. *See* Ralph James Mooney, *The New Conceptualism in Contract Law*, 74 OR. L. REV. 1131 (1995); Stephen D. Sugarman, *Judges as Tort Law Un-Makers: Recent California Experience with "New" Torts*, 49 DEPAUL L. REV. 455 (1999).
93. *Bily*, 834 P.2d at 768-69.
94. 223 Cal. Rptr. 218 (Cal. Ct. App. 1986), *overruled by Bily*, 834 P.2d at 774.
95. *Bily*, 834 P.2d at 771-72.
96. *Id.* at 772.
97. *See id.* at 767, 775 (Kennard, J., dissenting).
98. *Id.* at 769-70.

claims: that the accountant negligently performed the audit and that the audit report communicated to the plaintiff was misleading because the audit was negligently performed. As a conceptual matter, the plaintiff may bring its action either for negligence (for the improper performance of the audit) or for negligent misrepresentation (for negligently communicating false information in the report).[99]

The great similarities between negligence and misrepresentation make it possible for a court to shift easily from elements or policies of one doctrine to the other. In *H. Rosenblum, Inc. v. Adler*, the leading case for the use of a general negligence standard in accountant liability cases, the New Jersey Supreme Court noted that negligence and negligent misrepresentation were virtually identical where a false or misleading communication results.[100] Although the plaintiffs' claim with respect to carelessness in performing an audit was brought in negligence, the court noted that the claim could be viewed as grounded in negligent misrepresentation for presenting the results of the audit.[101] Throughout the opinion, the court treats the claim doctrinally as one of misrepresentation, but it employs much of the logic of the ordinary negligence action—such as foreseeability and public policy—in determining whether the action lies.[102]

In contrast to *Rosenblum*, other courts have distinguished the negligence and negligent misrepresentation actions where the characterization of the action may have significant liability consequences.[103] In *Raritan River Steel Co. v. Cherry, Bekaert & Holland* (Raritan I),[104] the North Carolina Supreme Court emphasized the dif-

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99. A third party beneficiary action also is possible but seldom is brought because the requirements are stricter than those of negligence or negligent misrepresentation. *See* Riley v. Ameritech Corp., 147 F. Supp. 2d 762 (E.D. Mich. 2001); Yadlosky v. Grant Thornton, L.L.P., 120 F. Supp. 2d 622 (E.D. Mich. 2000); Mariani v. Price Waterhouse, 82 Cal. Rptr. 2d 671 (Cal. Ct. App. 1999); Raritan River Steel Co. v. Cherry, Bekaert & Holland (Raritan II), 407 S.E.2d 178 (N.C. 1991). *But see* Seaboard Sur. Co. v. Garrison, Webb & Stanaland, P.A., 823 F.2d 434 (11th Cir. 1987); Williams Controls, Inc. v. Parente, Randolph, Orlando, Carey & Assocs., 39 F. Supp. 2d 517 (M.D. Pa. 1999); Ward v. Ernst & Young, 435 S.E.2d 628 (Va. 1993).

100. 461 A.2d 138, 146 (N.J. 1983), *superceded by statute as stated in* Finderne Mgmt. Co. v. Barrett, 809 A.2d 857 (N.J. Super. Ct. App. Div. 2002).

101. *Id.* at 142.

102. In *Greycas, Inc. v. Proud*, an attorney liability case, Judge Richard Posner echoed this sentiment, stating: "[W]e have great difficulty both in holding [negligence and negligent misrepresentation] apart in our minds and in understanding why the parties are quarreling over the exact characterization." 826 F.2d 1560, 1563 (7th Cir. 1987); *see also* Barrie v. V.P. Exterminators, Inc., 625 So. 2d 1007, 1015 (La. 1993) (applying duty/risk analysis to determine duty in misrepresentation cases); Walpert, Smullian & Blumenthal, P.A. v. Katz, 762 A.2d 582, 587 (Md. 2000) (stating that negligent misrepresentation is a variety of negligence).

103. *See* Tri-Professional Realty, Inc. v. Hillenburg, 669 N.E.2d 1064, 1068-69 (Ind. Ct. App. 1996) (Indiana courts have not generally recognized negligent misrepresentation, but an action for misrepresentation may be brought under a claim of negligence.).

104. 367 S.E.2d 609 (N.C. 1988).

ference between the foreseeability standard, which defines the scope of duty in negligence, and the more limited class of plaintiffs permitted under section 552 of the *Restatement*:

> [Section 552] prevents extension of liability in situations where the accountant "merely knows of the ever-present possibility of . . . action in reliance upon [the audited financial statements], on the part of anyone to whom it may be repeated." *Restatement (Second) of Torts* § 552, Comment h. As such it balances, more so than the other standards, the need to hold accountants to a standard that accounts for their contemporary role in the financial world with the need to protect them from liability that unreasonably exceeds the bounds of their real undertaking.[105]

The California Supreme Court in *Bily* stressed even more the practical desirability of distinguishing the two actions.[106] Under negligence, the court held, only the client (or perhaps a third party beneficiary) can recover.[107] For the negligent misrepresentation action, however, the court adopted section 552 of the *Restatement*.[108] The court made this distinction because of the different statutory bases of the two actions in the *California Civil Code*, and because of the practical implications of those differences. Chief among these implications is the effect of the instructions on the jury in each case; the negligent misrepresentation instructions emphasize, in a way the negligence instructions do not, the necessity of reliance by the plaintiff on the auditor's report.[109]

> By allowing recovery for negligent misrepresentation (as opposed to mere negligence), we emphasize the indispensability of justifiable reliance on the statements contained in the report. As the jury instructions in this case illustrate, a general negligence charge directs attention to defendant's level of care and compliance with professional standards established by expert testimony, as opposed to plaintiff's reliance on a materially false statement made by defendant. The reliance element in such an instruction is only implicit—it must be argued and considered by the jury as part of its evaluation of the causal relationship between defendant's con-

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105. *Id.* at 617; *see also* Standard Chartered P.L.C. v. Price Waterhouse, 945 P.2d 317, 340-42 (Ariz. Ct. App. 1996).

106. 834 P.2d 745, 768 (Cal. 1992).

107. *Id.* at 767.

108. *Id.* at 769.

109. *Id.* at 772. Other implications concern the statute of limitations. *Compare* Ventura County Nat'l Bank v. Macker, 57 Cal. Rptr. 2d 418, 419-20 (Cal. Ct. App. 1996) (professional malpractice statute of limitations), *with* Barger v. McCoy Hillard & Parks, 488 S.E.2d 215, 223-24 (N.C. 1997) (negligent misrepresentation statute of limitations); *compare* Hendricks v. Thornton, 973 S.W.2d 348, 365 (Tex. App. 1998), *superceded by statute as stated in* Prostok v. Browning, No. 05-99-00826-CV, 2003 Tex. App. LEXIS 2723 (Tex. App. Mar. 28, 2003) (discovery rule applies to accounting malpractice claims), *with* Brown v. KPMG Peat Marwick, 856 S.W.2d 742, 746-48 (Tex. App. 1993) (discovery rule does not apply to accounting malpractice claims).

> duct and plaintiff's injury. In contrast, an instruction based on the elements of negligent misrepresentation necessarily and properly focuses the jury's attention on the truth or falsity of the audit report's representations and plaintiff's actual and justifiable reliance on them. Because the audit report, not the audit itself, is the foundation of the third person's claim, negligent misrepresentation more precisely captures the gravamen of the cause of action and more clearly conveys the elements essential to a recovery.[110]

There are, therefore, two doctrinal differences between the actions of negligence and negligent misrepresentation.[111] First, a misrepresentation action specifically requires that the third party rely on the defendant's misrepresentation,[112] while a negligence action does not contain that specific requirement. Second, a misrepresentation action, as stated in *Restatement (Second) of Torts*, section 552(2), contains specific limitations on the third parties to whom a duty is owed and the types of transactions for which harm suffered is legally cognizable. The concern raised by the North Carolina and California courts is whether these limiting factors, especially reliance, are adequately spelled out in the statement of the rules of negligence. These concerns are particularly acute when considering the differences in jury instructions (although the occasional inattentive court also may miss the distinctions).

In practice, however, the differences often turn out to be insignificant because the specific requirements of the misrepresentation action are reflected in the way the general requirements of the negligence action are applied. As a practical matter, the reliance requirement for misrepresentation often is subsumed within the negligence action's requirement of a causal link between the breach of duty and the harm; only by relying on the information can the third party suffer harm as a result of the defendant's communication. Under either doctrine, reliance can be interpreted to require a demonstrable act of specific reliance, or it can be more attenuated. Likewise, the limitations on duty in a misrepresentation claim are found within the scope of issues considered under the duty analysis in negligence. In applying either a foreseeability standard or a balance of factors test, courts often use the same methods of limiting the scope of duty as those embodied in *Restatement* section 552(2).

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110. *Bily*, 834 P.2d at 772 (footnote omitted).

111. Texas courts articulate a third difference because of their adoption of a rule of privity for negligence cases with an exception for misrepresentation cases. This difference is purely formal; liability in a negligence case arises from a breach of professional duty owed to a client, but liability in a misrepresentation case is based on a duty to a non-client arising from the awareness of the non-client's reliance. Sec. Investors Prot. Corp. v. Cheshier & Fuller, L.L.P., 262 B.R. 384, 400 (Bankr. E.D. Tex. 2001); McCamish, Martin, Brown & Loeffler v. F.E. Appling Interests, 991 S.W.2d 787, 792 (Tex. 1999).

112. RESTATEMENT (SECOND) OF TORTS § 552 (1977).

B. The Doctrines

Whether approaching the accountant liability issue through the lens of negligence or negligent misrepresentation, jurisdictions vary on the scope of liability. There are three general doctrinal positions on the liability rule: the requirement of privity or near privity, the foreseeability test, and the group and transaction test of *Restatement (Second) of Torts*, section 552.

1. Privity and Near Privity

In *Ultramares Corp. v. Touche*, the New York Court of Appeals established near privity as a prerequisite of liability for the negligent performance of an audit.[113] Although the court recognized that its own decisions had removed the privity barrier in the case of physical harm to third parties, it retained the barrier with respect to purely economic loss arising from misrepresentation.[114] The threat of indeterminate liability led the court to conclude that liability should be limited to those in privity with the defendant or those for whose benefit the information is provided.[115] In other words, if the third party is not in a contractual relationship with the defendant accountant, the "end and aim" of the transaction must have been to provide the audit for the third party's benefit so that, as in *Glanzer v. Shepard*, "[t]he bond was so close as to approach that of privity, if not completely one with it."[116] The *Ultramares* court's interpretation of *Glanzer* effectively established a rule that only if the third party could enforce the defendant's contract as a third-party beneficiary would it be able to bring the action in negligence.

State[117] and federal courts[118] in a number of jurisdictions adhere to

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113. 174 N.E. 441, 446-48 (N.Y. 1931).

114. *Id.* at 445-48.

115. *Id.* at 446-47.

116. *Id.* at 445-46.

117. Idaho Bank & Trust Co. v. First Bancorp of Idaho, 772 P.2d 720, 722 (Idaho 1989); Thayer v. Hicks, 793 P.2d 784, 789 (Mont. 1990); Sec. Pac. Bus. Credit, Inc. v. Peat Marwick Main & Co., 597 N.E.2d 1080, 1087 (N.Y. 1992); Ward v. Ernst & Young, 435 S.E.2d 628, 634 (Va. 1993).

118. Ackerman v. Schwartz, 947 F.2d 841, 846 (7th Cir. 1991) (applying Indiana law); Toro Co. v. Krouse, Kern & Co., 827 F.2d 155, 160-61 (7th Cir. 1987) (also applying Indiana law); McLean v. Alexander, 599 F.2d 1190, 1202 (3d Cir. 1979) (applying Delaware law); Stephens Indus., Inc. v. Haskins & Sells, 438 F.2d 357, 360 (10th Cir. 1971) (applying Colorado law); Robertson v. White, 633 F. Supp. 954, 970 (W.D. Ark. 1986) (applying Arkansas law). *But see* Giant Eagle of Del., Inc. v. Coopers & Lybrand, 892 F. Supp. 676, 690 (W.D. Pa. 1995) (applying Pennsylvania law, citing conflicting authority); Seedkem, Inc. v. Safranek, 466 F. Supp. 340, 343-44 (D. Neb. 1979) (applying Indiana law). Of these cases, *Toro* is the most often cited and the strongest authority. Some of the other cases are of limited precedential value. *McLean* is primarily a securities action, but suggests that Delaware courts would follow the *Ultramares* rule, relying on an old Delaware Chancery decision, *Eastern States Petroleum Co. v. Universal Oil Products Co.*, 3 A.2d 768 (Del. Ch.

the rule that privity or near privity is required between a third party and an accountant. New York has remained the leading jurisdiction to espouse the view of liability limited to privity or a similar relationship. In a series of cases, the New York Court of Appeals has explained and modified the *Ultramares* doctrine in ways that have been influential in other jurisdictions.

In its leading contemporary opinion, *Credit Alliance Corp. v. Arthur Andersen & Co.*, the New York Court of Appeals formulated a three-part test that requires near privity.[119] This requirement defines a relationship sufficiently narrow for the accountant to avoid indeterminate liability and predict the scope of its exposure to liability. At the same time, the test aims to provide criteria that are easier to apply than the more general formulations in *Glanzer* and *Ultramares*.[120]

The *Credit Alliance* case illustrates the application of this rule. In *Credit Alliance*, an accountant was found not liable to a non-privity plaintiff which had loaned money to the accountant's client in reliance on the accountant's erroneous audit, a report of which had been provided to it by the client.[121] Even though the accountant was alleged to have actual or constructive knowledge that the client showed the report to the lender to induce the loan, there was no allegation that the audit was prepared for that particular purpose or that the accountant had any direct dealings with the plaintiff.[122] Thus, the linking conduct required by the third element of the *Credit Alliance* test was lacking.[123]

In the companion case of *European American Bank and Trust Co. v. Strauhs & Kaye*, by contrast, the plaintiff alleged that the accountant was aware that the lender was relying on the accountant's audit in valuing the collateral of its loans and otherwise assessing

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1939). In *Stephens* and *Robertson*, the courts declined to depart from the *Ultramares* rule in the absence of strong signals to do so from the state courts.

In *Williams Controls, Inc. v. Parente, Randolph, Orlando, Carey & Associates*, the court held that Pennsylvania law requires privity for a negligence action, but allows an action for negligent misrepresentation under *Restatement (Second) of Torts*, section 552. 39 F. Supp. 2d 517, 526, 533 (M.D. Pa. 1999). Texas courts take the same position. McCamish, Martin, Brown & Loeffler v. F.E. Appling Interests, 991 S.W.2d 787, 792 (Tex. 1999).

119. 483 N.E.2d 110, 118 (N.Y. 1985). *See supra* p. 29 (containing three part test); *see also* Westpac Banking Corp. v. Deschamps, 484 N.E.2d 1351, 1352 (N.Y. 1985) (requiring a third party claiming harm to demonstrate a relationship or bond with the accountants "sufficiently approaching privity" based on "some conduct on the part of the accountants").

120. The Maryland Court of Appeals aptly noted that the requirement of a linking conduct furthers the policy of avoiding indeterminate liability by requiring proof that the accountant knew of the plaintiff's reliance, and therefore knew its liability to exposure. Walpert, Smullian & Blumenthal, P.A. v. Katz, 762 A.2d 582, 608 (Md. 2000). This policy was expressed in *Ultramares* as well. 174 N.E. at 447.

121. 483 N.E.2d at 111-12, 119-20.

122. *Id.* at 119.

123. *Id.* Arguably, all three required elements were lacking.

the financial status of the accountant's client, the borrower.[124] Further, the accountant and the lender were in contact with respect to the borrower's affairs over a substantial period of time. They met for the purpose of discussing the borrower's financial condition and the lender's reliance on the accountant's evaluation. The accountant made repeated in-person representations during these meetings about the value of the borrower's assets.[125] On these facts, the court held that the relationship between the parties was the practical equivalent of privity under the three *Credit Alliance* criteria.[126]

New York courts have applied the criteria rigidly, requiring proof that the accountant was retained to further a particular purpose in which the third party was involved,[127] and that there was an adequate nexus or linking conduct between the accountant and the third party.[128] In *Security Pacific Business Credit, Inc. v. Peat Marwick Main & Co.*, for example, during a telephone call from an officer of the third party who was lending money to the accountant's client to the accountant's audit partner, the partner confirmed that the audit was correct, that the income figures in the draft audit would be the same as in the final report, and that the opinion would be unqualified.[129] The court found that even though the accountant may then have known of the lender's reliance, the conduct failed to meet the nexus requirement of the third element of the test.[130] Moreover, because the primary aim of obtaining the audit was to meet the normal reporting requirements of a public company, there was no claim that the accountant was retained to prepare the audit report to enable the client to obtain credit, or that the accountant ever specifically agreed to prepare the report for the lender's use.[131]

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124. 477 N.Y.S.2d 146, 147 (N.Y. App. Div. 1984), *aff'd by* Credit Alliance, Inc. v. Arthur Andersen & Co., 483 N.E.2d 110 (N.Y. 1985).

125. *Id.*

126. *Id.* at 148.

127. *See* Parrott v. Coopers & Lybrand, L.L.P., 741 N.E.2d 506, 509 (N.Y. 2000). *But see* AUSA Life Ins. Co. v. Ernst and Young, 206 F.3d 202, 223 (2d Cir. 2000) (holding that no-default letters accompanying an audit sufficient to prove accountant's awareness of investors' reliance).

128. Sec. Investor Prot. Corp. v. BDO Seidman, L.L.P., 746 N.E.2d 1042, 1048 (N.Y. 2001); *Parrott*, 741 N.E.2d at 509; LaSalle Nat'l Bank v. Ernst & Young, L.L.P., 729 N.Y.S.2d 671, 675 (N.Y. App. Div. 2001); *see* Lampert v. Mahoney, Cohen & Co., 630 N.Y.S.2d 733, 735 (N.Y. App. Div. 1995).

129. 597 N.E.2d 1080, 1082 (N.Y. 1992).

130. *Id.* at 1082, 1087.

131. *Id.* at 1086. The conflict between the majority and Judge Hancock's dissent in this case further illustrates the limitations imposed by the *Credit Alliance* test. Judge Hancock emphasized that there had been prior discussions between the accountant and the lender, that the accountant knew of negotiations between the lender and client for a new line of credit at the time it conducted the audit, that the draft audit report indicated that the client was negotiating for a line of credit, and that the lender's officer telephoned the audit partner to confirm certain facts in the audit. *Id.* at 1092 (Hancock, J., dissenting). In light

Of the jurisdictions that have adopted the requirement that there be a relationship approaching privity, nearly all have done so by using the *Credit Alliance* test as an appropriate standard.[132]

A few states have adopted the rule of privity or a near substitute by statute.[133] The American Institute of Certified Public Accountants has promoted legislation of this type in a model statute that closely resembles the *Credit Alliance* test.[134] Four states have adopted ver-

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of this background, the telephone conversation provided clear evidence of the linking conduct required. *Id.*

The *Credit Alliance* court had not explained what precisely was meant by "some conduct by the [accountants] linking them to the party or parties and evincing [the accountants'] understanding of [that party or parties'] reliance." *Id.* at 1091 (quoting Credit Alliance Corp. v. Arthur Andersen & Co., 483 N.E.2d 110, 118 (N.Y. 1985)). Other courts have interpreted this language to require a "showing of some communication or contacts demonstrating the accountant's awareness of the third party's reliance." *Id.* In Judge Hancock's view, the *Security Pacific* majority narrowed the *Credit Alliance* test by requiring contact equivalent to that in *European American Bank* and by reimposing a requirement equivalent to the third party beneficiary rationale underlying *Glanzer*. *Id.* (Hancock, J., dissenting) (citing First Nat'l Bank of Commerce v. Monco Agency, 911 F.2d 1053, 1059 (5th Cir. 1990)); Huang v. Sentinel Gov't Sec., 709 F. Supp. 1290, 1298 (S.D.N.Y. 1989). *See* Ahmed v. Trupin, 809 F. Supp. 1100, 1104-05 (S.D.N.Y. 1993); CMNY Capital, L.P. v. Deloitte & Touche, 821 F. Supp. 152 (S.D.N.Y. 1993); Hamond v. Marks Shron & Co., 671 N.Y.S.2d 106 (N.Y. App. Div. 1998) (finding that a limited partner was not in near privity with accountant retained by the company through a general partner). *But see* AUSA Life Ins. Co. v. Dwyer, 928 F. Supp. 1239, 1253-54 (S.D.N.Y. 1996) (concluding that the absence of direct communication between an accountant and a third party is not fatal to plaintiff's claim where a no-default certificate issued by accountant states it is for the use of a third party).

132. Twin Mfg. Co. v. Blum, Shapiro & Co., 602 A.2d 1079 (Conn. Super. Ct. 1991); Idaho Bank & Trust Co. v. First Bancorp of Idaho, 772 P.2d 720, 722 (Idaho 1989); Walpert, Smullian & Blumenthal, P.A. v. Katz, 762 A.2d 582, 608 (Md. 2000); Thayer v. Hicks, 793 P.2d 784, 789 (Mont. 1990). In *Thayer*, the court adopted a stricter version of the *Credit Alliance* test, noting that the facts of the case would meet even the strictest formulation of the accountant's duty of care and finding no need to adopt a more liberal standard "at this time." *Id.*

133. *See* ARK. CODE ANN. § 16-114-302 (Michie 2003); 225 ILL. COMP. STAT. ANN. 450/30.1 (West 2003); KAN. STAT. ANN. § 1-402 (Supp. 2002); UTAH CODE ANN. § 58-26a-602 (Supp. 2002). In addition to these specific statutes, Georgia has a general statutory requirement of privity in actions for economic loss. However, the statute has been interpreted not to apply to actions for negligent misrepresentation. *See* Wood Bros. Constr. Co. v. Simons-Eastern Co., 389 S.E.2d 382, 383-84 (Ga. Ct. App. 1989).

134. The relevant portion of the model statute prohibits actions by parties not in privity unless:

> The defendant licensee or firm: (1) was aware at the time the engagement was undertaken that the financial statements or other information were to be made available for use in connection with a specified transaction by the plaintiff who was specifically identified to the defendant accountant, (2) was aware that the plaintiff intended to rely upon such financial statements or other information in connection with the specified transaction, and (3) had direct contact and communication with the plaintiff and expressed by words or conduct the defendant accountant's understanding of the reliance on such financial statements or other information.

AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, UNIFORM ACCOUNTANCY ACT AND UNIFORM ACCOUNTANCY ACT RULES § 20(c)(2) (2002).

sions of this statute.[135] Four others have adopted statutes of similar effect which provide that an accountant is liable in negligence to a party in the absence of privity only if the accountant was aware that the benefit to a third party was a primary purpose of the client, or if the accountant identifies the third party who is intended to rely on its work by sending a writing to that effect to both the client and the third party.[136] Because these latter statutes require that the accountant issue a writing identifying the third party who may rely on its work when the primary purpose of the work is other than to benefit the third party, they give the accountant an effective veto over the possibility of third party reliance.[137]

2. Negligence

Privity and near privity essentially take accountant liability and other third-party liability cases out of the realm of tort law and place them within the sphere of contract law, allowing recovery only where there is privity or a third-party beneficiary relationship, and under the *Credit Alliance* linking conduct element,[138] sometimes not even then. An alternative to privity or near privity is to treat these cases the same as ordinary negligence cases and apply a rule of liability for foreseeable harm. For a moment in the mid-1980s, the foreseeability approach appeared promising to courts and scholars, but it has not attracted much support since then.

The major case on foreseeability in accountant liability cases is

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135. KAN. STAT. ANN. § 1-402 (Supp. 2002); LA. REV. STAT. ANN. § 37.91 (West 2003); N.J. STAT. ANN. § 2A:53A-25 (West 2003); WYO. STAT. ANN. § 33-3-201 (Michie 2001); *see* Monarch Normandy Square Partners v. Normandy Square Assocs. Ltd. P'ship, 817 F. Supp. 896 (D. Kan. 1993); *see also* Gillespie v. Seymour, 796 P.2d 1060 (Kan. Ct. App. 1990) (upholding the Kansas statute under the state constitution).

136. ARK. CODE ANN. § 16-114-302 (Michie 2003); 225 ILL. COMP. STAT. ANN. 450/30.1 (2003); MICH. COMP. LAWS § 600.2962 (West 2003); UTAH CODE ANN. § 58-26a-602 (Supp. 2002).

137. *See* Riley v. Ameritech Corp., 147 F. Supp. 2d 762, 773-74 (E.D. Mich. 2001) (citing Ohio Farmers Ins. Co. v. Shamie, 597 N.W.2d 553 (Mich. Ct. App. 1999)) (holding that Act requires that accountant and client give written notice regarding identified third parties and intended use); Yadlosky v. Grant Thornton, L.L.P., 120 F. Supp. 2d 622, 634 (E.D. Mich. 2000); Dougherty v. Zimbler, 922 F. Supp. 110 (N.D. Ill. 1996) (finding that the statute bars an action for negligent misrepresentation, but not actions for fraud); Endo v. Albertine, 812 F. Supp. 1479 (N.D. Ill. 1993); Robin v. Falbo, 1992 WL 188429, at *8-9 (N.D. Ill. 1992) (stating that intent of legislature was to require privity or written notification by accountant); Swink v. Ernst & Young, 908 S.W.2d 660, 662-63 (Ark. 1995); Chestnut Corp. v. Pestine, Brinati, Gamer, Ltd., 667 N.E.2d 543, 547 (Ill. App. Ct. 1996) (concluding that, under the statute, an accountant owes a duty to a third party only where the accountant is aware that a primary intent of client is to benefit a third party and that the accountant's failure to identify the third party in a writing does not preclude that duty); Gillespie v. Seymour, 796 P.2d 1060, 1062-63 (Kan. Ct. App. 1990). *But see* Battenfeld of Am. Holding Co. v. Baird, Kurtz & Dobson, 60 F. Supp. 2d 1189, 1198 (D. Kan. 1999) (finding that purchaser of corporation met requirements of Kansas statute).

138. 483 N.E.2d 110, 118 (N.Y. 1985).

the 1983 New Jersey Supreme Court opinion in *H. Rosenblum, Inc. v. Adler*.[139] *Rosenblum* has been widely commented on, but it is no longer honored even in its own home, as the New Jersey Legislature in 1994 adopted a statute that substituted a near privity test for its foreseeability standard.[140]

The *Rosenblum* court began its analysis with a basic principle of tort law: the historical movement away from privity.[141] For physical and economic injuries from defective products, the New Jersey court had discarded privity as a requirement for duty: "Unless some policy considerations warrant otherwise, privity should not be, and is not, a salutary predicate to prevent recovery. Generally, within the outer limits fixed by the court as a matter of law, the reasonably foreseeable consequences of the negligent act define the duty and should be actionable."[142]

The issue, therefore, is one of policy, and the central policy in this area is the important position that the accountant's report plays in networks of accountability. The *Rosenblum* court looked to accounting literature, legal commentary, and federal and state law regulating accountants, and concluded that the accountant is "a kind of arbiter, interpreter, and umpire" among the competing interests of its client, third parties who may rely on its work, and its own professional responsibility.[143] Within this context, liability to third parties provides an incentive for accountants to exercise due care. Contrary to the view expressed in *Ultramares*,[144] imposition of liability through negligent misrepresentation will not have deleterious consequences. Accountants are already subject to similar liability under the federal securities laws, the risks are insurable, and under the liability rule the court formulates, the risks have built-in limits.[145] Accordingly, the *Rosenblum* court formulated a liability rule based on the extent of reliance that the accountant should foresee:

> When the independent auditor furnishes an opinion with no limitation in the certificate as to whom the company may disseminate the financial statements, he has a duty to all those whom that auditor should reasonably foresee as recipients from the company of the statements for its proper business purposes, provided that

139. 461 A.2d 138 (N.J. 1983), *superceded by statute as stated in* Finderne Mgmt. Co. v. Barrett, 809 A.2d 857 (N.J. Super. Ct. App. Div. 2002).
140. N.J. STAT. ANN. § 2A:53A-25 (West 2003).
141. 461 A.2d at 142-45.
142. *Id.* at 145.
143. *Id.* at 150.
144. 174 N.E. 441 (N.Y. 1931).
145. *Rosenblum*, 461 A.2d at 151-52.

> the recipients rely on the statements pursuant to those business purposes.[146]

Foreseeability is certainly a much broader standard than near privity, and the application of the court's rule to the facts of the case illustrates the breadth of the holding. Touche Ross & Company had audited the financial statements of Giant Stores Corporation during the fiscal years ending 1969 through 1972.[147] In November 1971, Giant commenced negotiations with Rosenblum for the acquisition of Rosenblum's businesses in New Jersey.[148] The negotiations concluded in an agreement in which Rosenblum received Giant stock, with a closing in May 1972.[149] During the negotiations and merger process, Giant made a public offering of common stock in December 1971, the prospectus for which included the audits for the four years ending January 30, 1971.[150] Also, Touche audited Giant's financial statements for fiscal year 1972, issuing the report in April 1972.[151] During 1973 it was discovered that Giant had manipulated its books; Touche withdrew its audit opinion for 1972 and Giant went bankrupt, rendering Rosenblum's stock worthless.[152]

The court held that Touche knew or should have known that Giant would use its report for various business purposes, such as securities offerings and corporate acquisitions.[153] Because such uses were foreseeable, Touche was liable for its negligence.[154] In this case, Touche became aware of the merger negotiations, but the court found that specific knowledge was not necessary to impose liability.[155] All that was necessary for imposition of liabilty was that the client, Giant Stores Corporation, used the report for a proper business purpose in the course of which a third party justifiably and foreseeably relied on the report.[156]

The Wisconsin Supreme Court followed *Rosenblum* almost immediately with its decision in *Citizens State Bank v. Timm, Schmidt & Co.*[157] Like the New Jersey court, the Wisconsin court concluded that accountant liability cases ought to be decided under ordinary principles of negligence law.[158] Under those principles, "a tortfeasor is fully

146. *Id.* at 153.
147. *Id.* at 140.
148. *Id.*
149. *Id.* at 141.
150. *Id.*
151. *Id.*
152. *Id.*
153. *Id.* at 154.
154. *Id.* at 155.
155. *Id.*
156. *Id.*
157. 335 N.W.2d 361 (Wis. 1983).
158. *Id.* at 366.

liable for all foreseeable consequences of his act except as those consequences are limited by policy factors."[159] The court recognized public policy factors that might limit the accountant's duty, including remoteness of the harm, disproportion between the culpability of the accountant and the injury, and the floodgates problem. However, the court concluded that the application of these factors can only be done after a full factual resolution of the case, making it unlikely that an accountant can achieve dismissal or summary judgment.[160]

In *Touche Ross & Co. v. Commercial Union Insurance Co.*, the Mississippi Supreme Court also adopted a foreseeability rule.[161] The court was precluded from adopting a privity rule by statute,[162] and it rejected the narrower rule of *Restatement (Second) of Torts*, section 552 as arbitrarily preferring foreseen to foreseeable relying parties when neither paid for the audit and neither was owed a greater duty of care. The *Touche* court preferred the *Rosenblum* position because of the foreseeable reliance of third parties, the accountant's capacity to distribute the loss, the deterrent effect of imposing liability on the accountant, and the fairness of imposing liability on the accountant for failing to detect fraud when that is one of the specific functions for which the accountant is employed.[163] Like the New Jersey and Wisconsin courts, the *Touche* court stated a traditional negligence rule as the basis of liability: "[A]n independent auditor is liable to reasonably foreseeable users of the audit, who request and receive a financial statement from the audited entity for a proper business purpose, and who then detrimentally rely on the financial statement, suffering a loss, proximately caused by the auditor's negligence."[164]

3. Negligent Misrepresentation

Privity, near privity, and foreseeability have pockets of adherents among the states, but the overwhelming majority of courts have adopted the *Restatement (Second) of Torts*, section 552 as the standard for accountant liability.[165] The relevant portion of section 552

159. *Id.*
160. *Id.*
161. 514 So. 2d 315, 322-23 (Miss. 1987).
162. MISS. CODE ANN. § 11-7-20 (Supp. 1986).
163. *Touche*, 514 So. 2d at 322.
164. *Id*. at 322.
165. First Nat'l Bank of Commerce v. Monco Agency, Inc., 911 F.2d 1053, 1060 (5th Cir. 1990) (applying Louisiana law); Williams Controls, Inc. v. Parente, Randolph, Orlando, Carey & Assocs., 39 F. Supp. 2d 517, 529-30 (M.D. Pa. 1999) (applying Pennsylvania law); Forcier v. Cardello, 173 B.R. 973, 982-83 (D.R.I. 1994) (applying Rhode Island law); Bowers v. Allied Inv. Corp., 822 F. Supp. 835, 839 (D. Me. 1993); Ingram Indus., Inc. v. Nowicki, 527 F. Supp. 683, 684 (E.D. Ky. 1981) (applying Kentucky law); Bunge Corp. v. Eide, 372 F. Supp. 1058, 1062-63 (D.N.D. 1974) (applying North Dakota law in dictum); Rusch Factors, Inc. v. Levin, 284 F. Supp. 85, 91-93 (D.R.I. 1968) (applying Rhode Island law); Colonial Bank of Ala. v. Ridley & Schweigert, 551 So. 2d 390, 394 (Ala. 1989); Stan-

provides:

> Information Negligently Supplied for the Guidance of Others
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> (1) One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.
>
> (2) Except as stated in Subsection (3), the liability stated in Subsection (1) is limited to loss suffered
>
> (a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it; and
>
> (b) through reliance upon it in a transaction that he intends the information to influence or knows that the recipient so intends or in a substantially similar transaction.

Courts that have adopted the *Restatement* rule regard it as prescribing an intermediate standard for liability between privity or

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dard Chartered P.L.C. v. Price Waterhouse, 945 P.2d 317 (Ariz. Ct. App. 1996); Bily v. Arthur Young & Co., 834 P.2d 745, 757-59 (Cal. 1992); First Fla. Bank v. Max Mitchell & Co., 558 So. 2d 9, 14-16 (Fla. 1990); Badische Corp. v. Caylor, 356 S.E.2d 198, 200 (Ga. 1987); Kohala Agric. v. Deloitte & Touche, 949 P.2d 141, 162 (Haw. Ct. App. 1997); Pahre v. Auditor of State, 422 N.W.2d 178, 180 (Iowa 1988) (citing Ryan v. Kanne, 170 N.W.2d 395, 403 (Iowa 1969)); Nycal Corp. v. KPMG Peat Marwick, L.L.P., 688 N.E.2d 1368, 1372 (Mass. 1998); Law Offices of Lawrence J. Stockler, P.C. v. Rose, 436 N.W.2d 70, 82 (Mich. 1989); Bonhiver v. Graff, 248 N.W.2d 291, 298-99 (Minn. 1976); Spherex, Inc. v. Alexander Grant & Co., 451 A.2d 1308, 1312 (N.H. 1982); Raritan River Steel Co. v. Cherry, Bekaert & Holland (Raritan I), 367 S.E.2d 609, 617 (N.C. 1988); Haddon View Inv. Co. v. Coopers & Lybrand, 436 N.E.2d 212, 214-15 (Ohio 1982); Bethlehem Steel Corp. v. Ernst & Whinney, 822 S.W.2d 592, 595 (Tenn. 1991); Blue Bell, Inc. v. Peat, Marwick, Mitchell & Co., 715 S.W.2d 408, 411-12 (Tex. App. 1986) (citing Shatterproof Glass Corp. v. James, 466 S.W.2d 873, 880 (Tex. App. 1971)); Milliner v. Elmer Fox & Co., 529 P.2d 806, 808 (Utah 1974) (adopting a test equivalent to section 552 of the *Restatement*); Haberman v. Wash. Pub. Power Supply Sys., 744 P.2d 1032 (Wash. 1987) *modified by* 750 P.2d 254 (Wash. 1988), *and overruled in part by* Scott Fetzer Co. v. Weeks, 786 P.2d 265 (Wash. 1990); First Nat'l Bank of Bluefield v. Crawford, 386 S.E.2d 310, 313 (W. Va. 1989).

The Missouri courts have used their own four-factor version of the California six-factor test, *Biakanja v. Irving*, 320 P.2d 16, 19 (Cal. 1958), to adopt a standard similar to section 552 of the *Restatement*. Lindner Fund v. Abney, 770 S.W.2d 437, 438 (Mo. Ct. App. 1989); Aluma Kraft Mfg. Co. v. Elmer Fox & Co., 493 S.W.2d 378, 383 (Mo. Ct. App. 1973). Because of its use of the four-factor test, *Aluma Kraft* is sometimes cited as representing a fourth approach to accountant liability, distinguishable from the near-privity test, section 552 of the *Restatement*, and the foreseeability standard. *See Raritan I*, 367 S.E.2d at 615. Even though the court's methodology is distinctive, the liability rule it adopts by using that methodology is akin to the *Restatement* rule. Midamerican Bank & Trust Co. v. Harrison, 851 S.W.2d 563, 565 (Mo. Ct. App. 1993). The Missouri Supreme Court has modified the application of this test in an attorney liability case. Donahue v. Shughart, Thomson & Kilroy, P.C., 900 S.W.2d 624, 629 (Mo. 1995) (en banc).

The situation in Nebraska is unclear. The Nebraska Supreme Court cited *First Fla. Bank v. Max Mitchell & Co.*, 558 So. 2d 9, 14 (Fla. 1990) (adopting section 552 of the Restatement), but stated that expansion of liability would occur on "a case-by-case basis." St. Paul Fire & Marine Ins. Co. v. Touche Ross & Co., 507 N.W.2d 275, 280-81 (Neb. 1993).

near privity and foreseeability. As the North Carolina Supreme Court stated in its much-cited opinion in *Raritan I*:

> [Section 552] recognizes that liability should extend not only to those with whom the accountant is in privity or near privity, but also to those persons, or classes of persons, whom he knows and intends will rely on his opinion, or whom he knows his client intends will so rely. On the other hand, as the commentary makes clear, it prevents extension of liability in situations where the accountant "merely knows of the ever-present possibility of repetition to anyone, and the possibility of action in reliance upon [the audited financial statements], on the part of anyone to whom it may be repeated." *Restatement (Second) of Torts* § 552, Comment h. As such it balances, more so than the other standards, the need to hold accountants to a standard that accounts for their contemporary role in the financial world with the need to protect them from liability that unreasonably exceeds the bounds of their real undertaking.[166]

Section 552 is best understood as prescribing seven elements of a cause of action for negligent misrepresentation:

> (1) The defendant supplies information in the course of its business or in a transaction in which it has a pecuniary interest.
> (2) The information is false.
> (3) The defendant failed to exercise reasonable care in obtaining or communicating the information.
> (4) The plaintiff justifiably relies on the information, and the reliance causes harm.
> (5) The plaintiff is the person or is within the group for whom the defendant intends to supply the information or knows that the recipient of the information intends to supply it.
> (6) The plaintiff relies on the information in a transaction that the defendant intends to influence or knows that the recipient of the information intends to influence, or in a substantially similar transaction.
> (7) The plaintiff suffers pecuniary loss.

In accountant liability cases, the requirements that the information be supplied in the course of the defendant's business (element 1) and that the plaintiff have suffered pecuniary loss (element 7) are easily met. Whether the information supplied in the audit report is false (element 2) and whether the accountant exercised reasonable care (element 3) are doctrinally simple, though they can present difficult factual issues.[167]

Issues of causation and reliance (element 4) include whether the

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166. 367 S.E.2d at 617. *See also Kohala*, 949 P.2d at 160.

167. *See* Willis W. Hagen II, *Certified Public Accountants' Liability for Malpractice: Effect of Compliance with GAAP and GAAS*, 13 J. CONTEMP. L. 65, 76-89 (1987) (discussing factors courts take into account when determining what reasonable care for accountants entails).

plaintiff has looked to the audit to the exclusion of other sources of information.[168] Courts generally hold that reliance is sufficient if the accountant's representations contributed to the decision concerning the accountant's client.[169] Also, when the relying party has been negligent itself, that negligence may bar or reduce recovery under contributory or comparative negligence principles.[170]

In some cases, courts merge the causation and reliance requirement (element 4) with the knowledge and intent requirements (elements 5 & 6 respectively). The relationship can be seen when examining the issue of whether the third party must be injured by direct reliance on the auditor's report itself.[171] If the third party receives the information originally reported in the financial statements from a source other than the statements themselves, some courts have held that the reliance is too attenuated,[172] while others have allowed the cause of action.[173] This issue can be framed as whether the plaintiff justifiably relied on the audit report (element 4), or whether the plaintiff is within the known or intended group (element 5) and transaction (element 6). Similarly, whether a qualification or disclaimer can limit liability can be seen as a reliance (element 4) or an intent (element 5) issue.[174]

The key to section 552 of the *Restatement* is the double intent and knowledge requirement (elements 5 & 6 respectively). The principle

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168. Cordial v. Ernst & Young, 483 S.E.2d 248, 261-62 (W. Va. 1996).

169. *Id.*

170. *See* ESCA Corp. v. KPMG Peat Marwick, 939 P.2d 1228, 1232 (Wash. Ct. App. 1997) (comparative negligence), *aff'd*, 959 P.2d 651 (Wash. 1998).

171. *See* Eugene R. Erbstoesser, Bily's *Distinction Between Negligence and Negligent Misrepresentation*, *in* PRACTISING LAW INST., ACCOUNTANTS' LIABILITY 319, 322-24 (1993).

172. KPMG Peat Marwick v. Asher, 689 N.E.2d 1283, 1288 (Ind. Ct. App. 1997) (applying Missouri law); Eldred v. McGladrey, Hendrickson & Pullen, 468 N.W.2d 218, 219-20 (Iowa 1991); Raritan River Steel Co. v. Cherry, Bekaert & Holland (Raritan II), 407 S.E.2d 178, 183 (N.C. 1991); Hendricks v. Thornton, 973 S.W.2d 348, 362-63 (Tex. App. 1998), *superceded by statute as stated in* Prostok v. Browning, No. 05-99-00826-CV, 2003 Tex. App. LEXIS 2723 (Tex. App. Mar. 28, 2003); *see also* Erbstoesser, *supra* note 171.

173. Alten v. Atlantic Fin. Fed., 805 F. Supp. 5, 7 (E.D. Pa. 1992) (applying Pennsylvania law) (imputing direct reliance when third party relied on the advice of its accountant, acting as the third party's representative, who in turn relied on the report of the defendant accountant); Bonhiver v. Graff, 248 N.W.2d 291, 299 (Minn. 1976) (holding that an accountant who supplied work papers to the insurance commissioner was liable to the insurance agent).

174. A disclaimer of opinion does not provide the basis for reliance that an unqualified opinion does. MacNerland v. Barnes, 199 S.E.2d 564, 566-67 (Ga. Ct. App. 1973) (finding no persuasive authority for upholding liability when there is "both [a] lack of privity and an uncertified statement or more particularly an express disclaimer"). When a qualification is vague, however, courts might still hold accountants liable. *See, e.g.*, R.I. Hosp. Trust Nat'l Bank v. Swartz, Bresenoff, Yavner & Jacobs, 455 F.2d 847, 851-52 (4th Cir. 1972). When a disclaimer is inconsistent with the nature of the engagement, it is not given the same effect. *See* Kline v. First W. Gov't Sec., 794 F. Supp. 542, 556 (E.D. Pa. 1992), *aff'd in part, rev'd in part*, 24 F.3d 480 (3d Cir. 1994); First Nat'l Bank of Bluefield v. Crawford, 386 S.E.2d 310, 314 (W. Va. 1989).

underlying section 552 is that liability for negligent misrepresentation is more restricted than liability for either intentional misrepresentation (fraud) or for negligence that causes physical injury.[175] Accordingly, the plaintiff must bring itself and its actions within the limiting requirements of section 552(2)(a) (the person for whose benefit the information is supplied), and section 552(b) (the transaction for which it is supplied).

In the comments to section 552, the *Restatement* authors suggest that the limitations in the section rest on a balancing principle. The section embodies "a relative standard, which may be defined only in terms of the use to which the information will be put, weighed against the magnitude and probability of loss that might attend that use if the information proves to be incorrect."[176] Liability is only reasonable when and to the extent that the accountant is aware of the potential risk, can engage in balancing, and can take due care in conducting the audit.[177]

The application of the double intent and knowledge requirement depends on how the courts interpret "intends" and "knows," and the interpretations vary widely. The narrowest interpretation equates the knowledge requirement of section 552 with the intended beneficiary requirement of contract law and the intent requirement of intentional torts. The leading case articulating this position is the California Supreme Court's adoption of section 552 in *Bily v. Arthur Young & Co.*, requiring that the accountant "has undertaken to inform and guide a third party with respect to *an identified transaction or type of transaction*."[178]

> The representation must have been made with the intent to induce plaintiff, or a particular class of persons to which plaintiff belongs, to act in reliance upon the representation in a specific transaction, or a specific type of transaction, that defendant intended to influence. Defendant is deemed to have intended to influence [its client's] transaction with plaintiff whenever defendant knows with substantial certainty that plaintiff, or the particular class of persons to which plaintiff belongs, will rely on the representation in the course of the transaction. If others become aware of the representation and act upon it, there is no liability even though defendant should reasonably have foreseen such a possibility.[179]

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175. RESTATEMENT (SECOND) OF TORTS § 552 cmt. a (1977).
176. *Id.*
177. *See id.* § 552.
178. 834 P.2d 745, 769-70 (Cal. 1992).
179. *Id.* at 772-73; *see also* RESTATEMENT (SECOND) OF TORTS § 8(A) (1965).

For interpretations of *Bily*, see *Nutmeg Sec., Ltd. v. McGladrey & Pullen*, 112 Cal. Rptr. 2d 657 (Cal. Ct. App. 2002), *review denied* No. S102583, 2002 Cal. LEXIS 336 (Cal. Jan. 16, 2002); *Mariani v. Price Waterhouse*, 82 Cal. Rptr. 2d 671, 675-77 (Cal. Ct. App. 1999); *Ar-*

The *Bily* court limited the scope of the doctrine even further by holding that the question of the accountant's intent is not necessarily to be determined as a question of fact; in the absence of "competent evidence" that permits a "reasonable inference that the auditor supplied its report with knowledge of the existence of a specific transaction or a well-defined type of transaction which the report was intended to influence," summary judgment is appropriate.[180]

Several courts require that the accountant have actual knowledge of the prospect of reliance without placing so much emphasis on intent and direct undertaking of responsibility. As the court notes in *Bank of New Orleans & Trust Co. v. Monco Agency Inc.*, the *Restatement* distinguishes among the concepts "know," "reason to know," and "should know."[181] By using the specific term *know* in section 552, the *Restatement* drafters intended to convey a narrower standard than the types of constructive knowledge expressed in the other phrases and required actual knowledge on the part of the accountant.[182] Even though an accountant knows that its audit report will be provided to a firm's current lender, for example, it is not liable to a subsequent lender who is shown the report.[183] Other courts apply this same standard,[184] often finding that the accountant possessed sufficient knowledge to impose liability.[185]

The scope of the intent or knowledge requirement is most at issue when the plaintiff is not identified individually in advance, but is a member of a group of persons who potentially may rely on the accountant's work. Limited partners of a limited partnership[186] or shareholders of a corporation which is the accountant's client,[187] a

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thur Andersen, L.L.P. v. Superior Court, 79 Cal. Rptr. 2d 879, 881-83 (Cal. Ct. App. 1998); *Industrial Indem. Co. v. Touche Ross & Co.*, 17 Cal. Rptr. 2d 29, 32-33 (Cal. Ct. App. 1993).

180. 834 P.2d at 773. *Bily* itself involved such summary adjudication.

181. 719 F. Supp. 1328, 1331-32 (E.D. La. 1989), *aff'd by* First Nat'l Bank of Commerce v. Monco Agency, Inc., 911 F.2d 1053 (5th Cir. 1990).

182. *Id.* at 1331-32 n.4.

183. *Id.* at 1334-36.

184. *E.g.*, N. Am. Specialty Ins. Co. v. LaPalme, 258 F.3d 35, 40 (1st Cir. 2001) (applying Massachusetts law); Kohala Agric. v. Deloitte & Touche, 949 P.2d 141, 163 (Haw. Ct. App. 1997); Nycal Corp. v. KPMG Peat Marwick, L.L.P., 688 N.E.2d 1368, 1372 (Mass. 1998).

185. *E.g.*, TCF Banking & Sav. v. Arthur Young & Co., 706 F. Supp. 1408, 1419 (D. Minn. 1988); First Fla. Bank v. Max Mitchell & Co., 558 So. 2d 9, 15-16 (Fla. 1990); Bonhiver v. Graff, 248 N.W.2d 291, 298-99 (Minn. 1976). When the client designates several groups of relying third parties, the accountant owes a duty to every member of all of those groups. Amwest Sur. Ins. Co. v. Ernst & Young, 677 So. 2d 409, 412 (Fla. 5th DCA 1996).

186. Alten v. Atlantic Fin. Fed., 805 F. Supp. 5, 7 (E.D. Pa. 1992); Abbott v. Herzfeld & Rubin, P.C., 609 N.Y.S.2d 230, 232 (N.Y. App. Div. 1994); Haddon View Inv. Co. v. Coopers & Lybrand, 436 N.E.2d 212, 215 (Ohio 1982).

187. *Compare* Simpson v. Specialty Retail Concepts, Inc., 908 F. Supp. 323, 331 (M.D.N.C. 1995) (holding "public-market investors" can be foreseeable class of persons to whom an accountant's duty extends), *and* Boykin v. Arthur Andersen & Co., 639 So. 2d 504, 509 (Ala. 1994), *and* Murphy v. Campbell, 964 S.W.2d 265, 268 (Tex. 1997) (holding

specific lender,[188] the corporation purchasing the accountant's client corporation,[189] existing trade creditors reflected on a firm's financial statements,[190] and customers of a securities broker[191] have all been found to be within a known relying group. Courts have divided on whether prospective purchasers of the shares of a corporation[192] and future lenders[193] are too indeterminate a class to meet the requirements of section 552(2)(a) of the *Restatement*.

Under the second half of the *Restatement's* intent or knowledge requirement, the accountant must know the type of transaction in which the reliance may occur. In most cases, this issue is closely related to the question of whether a third party is within the group of persons whom the accountant knows may rely on its report. If a com-

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stockholders can have individual cause of action against accountant they relied on if they were harmed), *with* Mariani v. Price Waterhouse, 82 Cal. Rptr. 2d 671, 681 (Cal. Ct. App. 1999) (holding "there are no 'express third party beneficiaries' of an ordinary, white-bread audit engagement contract. . . . only incidental beneficiaries who have no legal rights arising from the contract"), *and* Barger v. McCoy Hillard & Parks, 488 S.E.2d 215, 220 (N.C. 1997) (holding shareholders could not bring suit against accountant because there were not individual claims distinct from claims against the corporation).

188. *Cf.* Badische Corp. v. Caylor, 356 S.E.2d 198 (Ga. 1987) (holding an auditor is only liable to a creditor if the auditor is actually aware the creditor will rely on the information).

189. Mindis Acquisition Corp. v. BDO Seidman, L.L.P., 559 S.E.2d 111, 115 (Ga. Ct. App. 2002), *rev'd*, 578 S.E.2d 400 (Ga. 2003).

190. Marcus Bros. Textiles, Inc. v. Price Waterhouse, L.L.P., 513 S.E.2d 320, 328 (N.C. 1999) (holding there was sufficient evidence of knowledge and reliance to get past summary judgment); Blue Bell, Inc. v. Peat, Marwick, Mitchell & Co., 715 S.W.2d 408, 413 (Tex. App. 1986).

191. Sec. Investor Prot. Corp. v. Cheshier & Fuller, L.L.P., 262 B.R. 384, 400-01 (Bankr. E.D. Tex. 2001).

192. *Compare* Oppenheimer-Palmieri Fund, L.P. v. Peat Marwick Main & Co., 812 F. Supp. 338, 357-60 (E.D.N.Y. 1993) (deciding that there is no duty to potential purchasers of company known to be "in play"), *and* White v. BDO Seidman, L.L.P., 549 S.E.2d 490, 493 (Ga. Ct. App. 2001), *cert. denied*, No. S01C1349, 2001 Ga. LEXIS 813 (Ga. Oct. 1, 2001) (rejecting "fraud on the market" theory), *and* Noram Inv. Servs., Inc. v. Stirtz Bernards Boyden Surdel & Larter, P.A., 611 N.W.2d 372, 375 (Minn. Ct. App. 2000) (broker who extended credit is not in the foreseeable class protected by the SEC's reliance), *and* Lindner Fund v. Abney, 770 S.W.2d 437, 438 (Mo. Ct. App. 1989) (holding accountants are not liable to mutual fund advisors), *and* Milliner v. Elmer Fox & Co., 529 P.2d 806, 808 (Utah 1974), *with* Scottish Heritable Trust, P.L.C. v. Peat Marwick Main & Co., 81 F.3d 606, 612-14 (5th Cir. 1996) (applying Texas law), *and In re* Checkers Sec. Litig., 858 F. Supp. 1168, 1180 (M.D. Fla. 1994), *and* Simpson v. Specialty Retail Concepts, Inc., 908 F. Supp. 323, 331 (M.D.N.C. 1995), *and* Boykin v. Arthur Andersen & Co., 639 So. 2d 504, 509 (Ala. 1994) (holding accountant liable to investors who used annual report to make investment decisions). For a case finding that the defendant accountant had different knowledge with respect to two different groups of plaintiffs, see *In re SmarTalk Teleservice, Inc. Securities Litigation*, 124 F. Supp. 2d 505 (S.D. Ohio 2000) (applying Massachusetts law).

193. *Compare* Bank of New Orleans and Trust Co. v. Monco Agency, Inc., 719 F. Supp. 1328, 1333-36 (E.D. La. 1989), *aff'd*, First Nat'l Bank of Commerce v. Monco Agency, Inc., 911 F.2d 1053, 1063 (5th Cir. 1990) (holding accountant not liable to future lenders where accountant did not know the report would be used by the future lender), *with* Haberman v. Wash. Pub. Power Supply Sys., 744 P.2d 1032, 1068 (Wash. 1987) (noting that the firm may have told the accountant that the report would be used to induce investors to purchase bonds).

pany's auditor is not liable to a prospective purchaser of stock who relies on the audit, usually the conclusion can be framed either as one involving a remote third party or a remote transaction. When a wholly different transaction occurs, the accountant will not be liable. When a transaction similar to that originally contemplated occurs, the analysis is likely to turn on the court's perception of the knowledge of the accountant vis-à-vis the particular party and transaction.[194]

The most favorable interpretation of section 552 for plaintiffs shifts from requiring that the accountant actually know of the intended reliance to allowing recovery where the accountant had reason to know of the reliance. Using this interpretation, the rule approaches one of foreseeability. This approach is particularly relevant where the accountant's knowledge need not arise from a specific contact provided by its client or a third party, but may arise instead from the knowledge the accountant should have acquired from the audit itself.

> To allow liability to turn on the fortuitous occurrence that the accountant's client specifically mentions a person or class of persons who are to receive the reports, when the accountant may have that same knowledge as a matter of business practice, is too tenuous a distinction for us to adopt as a rule of law. Instead, we hold that if, under current business practices and the circumstances of that case, an accountant preparing audited financial statements knows *or should know* that such statements will be relied upon by a limited class of persons, the accountant may be liable for injuries to members of that class relying on his certification of the audited reports.[195]

III. POLICY ANALYSIS OF AUDITOR LIABILITY

The history and present array of doctrines, and interpretations of these doctrines available to courts, suggest the twin problems that a court presented with an auditor liability case must face. First, which of the many available doctrines should the court apply? Courts which particularly disfavor liability generally adopt a privity or near privity requirement. Courts that favor expansive liability adopt negligence.

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194. *See* ML-Lee Acquisition Fund v. Deloitte & Touche, 463 S.E.2d 618 (S.C. Ct. App. 1995), *aff'd in part and rev'd in part*, 489 S.E.2d 470 (S.C. 1997). *Compare Bank of New Orleans*, 719 F. Supp. at 1333 (noting there was no knowledge of second lender although accountant knew of first lender), *with* Raritan River Steel Co. v. Cherry, Bekaert, & Holland (Raritan I), 367 S.E.2d 609, 618 (N.C. 1988) (accountant knew the report would be used by prospective lenders).

195. Blue Bell, Inc. v. Peat, Marwick, Mitchell & Co., 715 S.W.2d 408, 412 (Tex. App. 1986), *cited with approval in Raritan I*, 367 S.E.2d at 614, *and* Bethlehem Steel Corp. v. Ernst & Whinney, 822 S.W.2d 592, 596 (Tenn. 1991).

Courts whose tendencies lie somewhere in between or are not clearly defined adopt negligent misrepresentation, typically as expressed in the *Restatement (Second) of Torts*, section 552.[196] Second, how should the court apply the doctrine it has selected? This process involves more than the simple or even complex application of law to facts. Except for the particularly parsimonious *Credit Alliance* version of the near privity doctrine,[197] none of the available doctrines are so clearly defined that they can be applied without considerably more thought by the courts. The variations in application of the *Restatement* test make this point most clearly. The same doctrinal formulation that is applied to require the functional equivalent of a third-party beneficiary relationship by the California court in *Bily*[198] approaches a broad negligence standard grounded in foreseeability when applied by the North Carolina court in *Raritan I*.[199]

These twin problems comprise a quite common situation in the law, when doctrine breaks down, and a case, or a class of cases, cannot be decided within the usual mode of doctrinal analysis. Doctrine presupposes an authoritative legal rule—such as section 552, made law by judicial adoption—that can be applied through a relatively logical, analytic process to decide a case.[200] As is evident in the auditor liability cases, doctrine does not dictate which rule (near privity, negligence, or misrepresentation) or which interpretation of an adopted rule (strict, broad, or in-between readings of the intent and knowledge requirement of section 552, for example) is authoritative. Instead, the controlling doctrine is, in the first instance, prescribed by and then interpreted through policy analysis. Policy analysis, as it is usually practiced in legal milieus from the first-year classroom, to law review articles, to courts of last resort (without much distinction among the settings, as it happens), is argument about the desirability of a rule or outcome in terms of the social values of utility, right, morality, or legal institutional values such as judicial competence and administrability.[201]

The most common mode of policy analysis in auditor liability cases focuses on the particular type of situation presented by the cases (the reliance on a negligently prepared audit report by a lender, investor, or other third party), rather than including this type of case within a broader category or relating it to broader choices. From this perspec-

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196. Few courts have even considered third-party beneficiary actions, which are widely used in other types of third-party liability cases. *See* FEINMAN, THIRD PARTIES, *supra* note 16, at 31-44.

197. 483 N.E.2d 110 (N.Y. 1985).

198. 834 P.2d 745 (Cal. 1992).

199. 367 S.E.2d at 609.

200. *See* DUNCAN KENNEDY, A CRITIQUE OF ADJUDICATION (FIN DE SIECLE) 97-105 (1997).

201. *Id.* at 99.

tive, the principal focus of the analysis is the factual setting in which audits arise. More abstract principles or policies are relevant only to the extent that they are manifested in this setting.

A. Empirical Analysis

One possibility is that the policy analysis is essentially an empirical question. The choice between a broad and narrow liability rule, from this perspective, ultimately rests on determining the desirability of one or the other as a matter of fact. Indeterminate liability, for example, either would impose such intolerable burdens on accountants that they would be forced to leave the market for auditing services by the costs of insurance or liability judgments, or it would simply raise the cost of auditing services to an appropriate and bearable level, given the risks of liability to third parties.

The cases and commentary are filled with empirical statements of this sort, in the first instance probably culled from advocates' briefs, but the paucity of citation to any serious investigations of the issue suggests that these statements are the products of typical legal empiricism—a "vivid imagination," unencumbered by systematic inquiry.[202] A substantial body of research does exist, but it is inconclusive, providing modest support for each position, perhaps marginally more for the expansive position on liability.

As with other areas of the law in which the tort reform agenda has been advanced, the first empirical claim used by advocates of limited liability is that a flood of litigation and the prospect of large and particularly indeterminate litigation is increasing liability costs and insurance premiums at a rate that threatens the viability of accounting firms. Claims certainly have been increasing.[203] Claims by third parties for negligent auditing are not the most numerous type of claim, but they are the most expensive.[204] The greater proportion of claims arise from accountants' tax practice and other non-audit services, not from the conduct of audits;[205] among audit claims, about one-half come from the client and one-half from third parties.[206] However, audit claims are threatening because of their size. For example, for one insurer, yearly tax claims in 2000 averaged $105,000, while audit claims averaged $341,000.[207]

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202. Stewart Macaulay, *The Reliance Interest and the World Outside the Law Schools' Doors*, 1991 WIS. L. REV. 247, 285.

203. Sherry Anderson & Joseph Wolfe, *Accountants' Liability: Where are Claims Coming From?*, OHIO CPA J., Oct.-Dec. 2001, at 21.

204. *Id.* at 23.

205. *Id.*

206. *Id.*

207. John F. Raspante & Ric Rosario, *Understanding and Minimizing CPA Liability*, CPA J., May 2001, at 19, 20-21.

The size of liability costs and the insurance premiums that are a proxy for them is not the central issue. Rather, the issues are whether the liability costs are sufficiently predictable such that accounting firms can price audits to account for them, and whether the liability costs assessed are an appropriate reflection of auditor error. The research suggests there is some reason to believe that even auditors operating under the relative uncertainty of a negligence regime properly price audit services consistent with the risk of possible losses, although litigation risk is less of a factor in audit pricing than are other factors, such as the size of the client and its operating complexity.[208] Much of the increase in cost in riskier engagements may be attributable to auditors' tendencies to respond to higher risks by devoting more personnel, time, and effort to the audit.[209] This response reduces the expected litigation cost, both by decreasing the probability of error and by reducing the probability of an adverse judgment in the event of litigation.[210] The resulting higher fees are ordinarily sufficient to cover any eventual litigation costs.[211]

The relative predictability of litigation costs provides a basis for questioning the indeterminacy of liability. There is further evidence that the imposition of liability is not simply the allocation of responsibility to the deepest pocket. It is true that there is an "expectations gap"[212] between the public, at least as reflected in potential jurors, and the technical limitations on the audit.[213] In one study, sixty-four percent of those asked agreed that "[t]he purpose of an audit is to uncover any type of fraud or wrongdoing," and sixty-three percent believed that "[a]ccountants have the responsibility to police the financial reporting a company makes to investors."[214] Yet, there are no conclusive findings about the role or the merits of litigation in determining the incidence of suits against accountants and the outcomes of such suits.[215] At least in securities litigation, plaintiffs appear to be selective in including auditors as defendants; dismissals and defendant victories account for an expected forty to fifty percent of the cases, and auditors are generally only secondary contributors to the amounts actually paid to plaintiffs.[216]

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208. *See* Dan A. Simunic & Michael T. Stein, *The Impact of Litigation Risk on Audit Pricing: A Review of the Economics and the Evidence*, 15 AUDITING: A J. OF PRAC. & THEORY 119 (Supp. 1996).

209. *Id.* at 130.

210. *Id.* at 132.

211. *Id.*

212. *See* Pacini et al., *supra* note 15, at 355.

213. Raspante & Rosario, *supra* note 207, at 21.

214. *Id.*

215. Zoe-Vonna Palmrose, *Audit Litigation Research: Do the Merits Matter? An Assessment and Directions for Future Research*, 16 J. ACCT. & PUB. POL'Y 355, 369 (1997).

216. *Id.* at 363-64.

The effect of these factors may be reflected in liability insurance premium rates. According to the Insurance Information Institute, malpractice premiums for some accounting firms increased as much as thirty to one hundred percent in 2000-2001.[217] But premium rates may be more connected to the business cycle than to the prospect of liability. Insurers typically set rates low to attract business and premiums when their expected return on investment is high, with less regard for the underwriting loss that may occur. As recently as the late 1990s, insurance was freely available at falling rates because the projected return on investment in the bull-market was high.[218] To the extent that premium rates are related to risk, they reward those firms which exercise care; even at the downturn of the business cycle, premium rates hold steady and even fall for firms with little or no experience of malpractice.[219]

The empirical evidence relevant to auditor liability is far from conclusive, but even if it was it would hardly resolve the question. The empirical evidence requires interpretation. For example, several studies have demonstrated, not surprisingly, a significant positive correlation between the financial distress of a company, measured by the probability of bankruptcy, and the incidence of litigation against auditors.[220] Some researchers suggest that this correlation demonstrates that much litigation against auditors is meritorious because managers' incentives to mislead increase and reporting problems are more likely when a firm is in distress.[221] Other researchers believe that the correlation indicates a lack of merit in auditor litigation since the lack of financial resources by the firm leaves the auditor as the prominent potential defendant with deep pockets.[222]

B. The Paradigm Case of Auditor Liability

The dispute about the proper scope of liability for auditors, then, is a normative question, not an empirical question. Auditors have a dual responsibility to management and to third-party users of the audit, but which of these roles is primary? Most fundamentally, how is the conflict to be resolved between the values of private ordering and the values of public ordering?

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217. John M. Covaleski & Roger Russell, *Special Services Prove to Be a "Premium" Malpractice Concern*, ACCT. TODAY, July 23, 2001, at 1, 44.

218. Kristin L. Nelson, *Malpractice Insurors Battle for Accounting Firm Dollars*, ACCT. TODAY, July 27-Aug. 9, 1998, at 5, 39.

219. Covaleski & Russell, *supra* note 217, at 44.

220. *See* Palmrose, *supra* note 215, at 367-68.

221. Thomas Lys & Ross L. Watts, *Lawsuits Against Auditors*, 32 J. ACCT. RES. 65, 68 (1994).

222. James D. Stice, *Using Financial and Market Information to Identify Pre-engagement Factors Associated with Lawsuits Against Auditors*, 66 ACCT. REV. 516, 521 (1991).

In the paradigm case of accountant liability,[223] the client retains the accountant specifically to prepare an audit report to be furnished to an investor or lender who requires audited financial statements as a condition of making an investment or loan. The accountant conducts the audit for that specific, identified purpose, knowing that the audit report will be relied on by a particular third party, and furnishes a copy of the audit report to the third party.

A consensus exists among the jurisdictions on the proper treatment of the paradigm case. When an accountant conducts an audit for a specific, identified purpose and furnishes the audit report to a particular third party who is expected to rely on it, the accountant owes the third party a duty of reasonable care in performing the audit and reporting its results. The consensus imposition of liability in the paradigm case results from two factors which are central to the policy analysis.

First, in performing the audit, the accountant has a dual role: to provide information to the third party as well as to its client.[224] An audit has two purposes: to provide information to the management of a company about the effectiveness of its internal accounting system and the accuracy of the information the system produces, and to provide to third persons an independent evaluation of the company's financial statements and the process that produced them.[225] The company's management needs to know, for its own purposes in running the firm, what its financial condition is and whether the systems in place to produce accurate financial information are suitable.[226] Third persons, such as present or potential lenders, investors, creditors, or regulators, also need to know the firm's financial condition, and they need the assurance that the financial statements reliably mean what they say.[227] In the paradigm case, the dual elements of the auditor's role do not generate inconsistent duties because the client intends that the audit will serve the third party's interest.

Second, the scope of liability that would result from the accountant's negligence is relatively predictable. The accountant knows both the identity of the third party who will rely on the audit and the extent of the third party's reliance. When the audit is prepared for a

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223. On the concept of paradigms in law, see Jay M. Feinman, *The Jurisprudence of Classification*, 41 STAN. L. REV. 661, 696-717 (1989).

224. Courts at different ends of the liability spectrum have often recognized that a primary benefit of the audit is to third parties. *E.g.*, Bily v. Arthur Young & Co., 834 P.2d 745, 751 (Cal. 1992); H. Rosenblum, Inc. v. Adler, 461 A.2d 138, 149 (N.J. 1983), *superceded by statute as stated in* Finderne Mgmt. Co. v. Barrett, 809 A.2d 857 (N.J. Super. Ct. App. Div. 2002).

225. *See* DONALD H. TAYLOR & G. WILLIAM GLEZEN, AUDITING: INTEGRATED CONCEPTS AND PROCEDURES 10-12 (1979).

226. *Rosenblum*, 461 A.2d at 149.

227. *Id.*

potential lender to the audited company, for example, the accountant knows the size of the loan and therefore can predict the loss that the lender will incur if the audit negligently fails to reveal that the company is not credit-worthy. Accordingly, the accountant can take appropriate precautions to prevent the loss or to insure against it.

C. Divergent Approaches

Beyond the paradigm case, the agreement on the policy analysis of auditors' liability breaks down. The analysis splits into two distinct approaches, one disfavoring and one favoring liability.

1. Limited Liability

The argument for limited liability begins with defining the limits of the auditor's role.[228] Lenders and investors may take an audit report as indicating that nothing is amiss in the financial affairs of a company.[229] "[T]here sometimes seems to be the expectation that an audit should disclose all misuse of corporate assets, fraud, and any illegal acts or irregularities, and that a clean opinion means that the audit client is and will continue to be a successful and profitable operation."[230] Even an unqualified audit report, however, does not guarantee that the financial statements are entirely accurate, that the client has not committed fraud in their preparation, or that the company's financial past is a reliable predictor of its future. The client prepares its own financial statements and assumes primary responsibility for their contents, while the accountant's responsibility is secondary.[231] Moreover, auditing is not a mechanical process,[232] and an audit report is not an objective statement of fact. Rather, "an audit report is a professional opinion based on numerous and complex factors."[233] In its opinion, therefore, the accountant only states that it has exercised competence, due care, and independence in the conduct of the audit to determine that the financial statements fairly present the condition of the company.[234] As the California court colorfully summarized in *Bily*:

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228. The best expressions of this view may be found in Siliciano, *supra* note 16, and *Bily*, 834 P.2d at 749, which relies on Siliciano's analysis.

229. Joseph A. Clark III, *Accountants and the Law: Facing the Challenge*, *in* DEPAUL U. SCH. OF ACCT. RES. SYMP., A PROFESSION IN TRANSITION: THE ETHICAL AND LEGAL RESPONSIBILITIES OF ACCOUNTANTS 163, 166-67 (Belverd E. Needles, Jr. ed., 1988).

230. *Id.* at 167.

231. *Bily*, 834 P.2d at 763.

232. *See id.*

233. *Id.*

234. AM. INST. OF CERTIFIED PUB. ACCTS., RULES OF PROF'L CONDUCT §§ 101, 102, 201 (1988).

> An auditor is a watchdog, not a bloodhound. As a matter of commercial reality, audits are performed in a client-controlled environment. . . .
>
> . . . .
>
> Moreover, an audit report is not a simple statement of verifiable fact that, like the weight of the load of beans in *Glanzer v. Shepard*, can be easily checked against uniform standards of indisputable accuracy. . . . [T]he report is based on the auditor's interpretation and application of hundreds of professional standards, many of which are broadly phrased and readily subject to different constructions. Although ultimately expressed in shorthand form, the report is the final product of a complex process involving discretion and judgment on the part of the auditor at every stage.[235]

While a lender or investor must rely on the client and the accountant for financial statements, a sophisticated third party can deal with the risk of financial irregularities in ways other than pure reliance on the audited financial statements.[236] The third party may be as expert in evaluating the client's affairs as is the accountant, although it uses different means to do so. The third party can obtain other data about the client, its principals, and its prospects; inquiries of financial reporting services and financial entities which deal with the client are common. A large commercial bank contemplating a loan, for example, will demand to see audited financial statements, but the bank has numerous other methods that it regularly uses to ascertain the credit risk of a potential borrower.[237] If it has concerns, the bank can obtain more information from the borrower or from third parties. It can also bargain to reduce its risks by receiving an increased rate of interest, additional security, personal guarantees, or other advantageous contract terms.[238] To the extent that every transaction entails some risk, and some transactions more than others, the lender calculates the risk as one of the ordinary costs of engaging in its line of business. Audit failure is one of the risks of banking as much as of accountancy.[239]

Because of the multiple sources of information available to the third party, difficulties can arise in determining the actual extent of the third party's reliance on the report.[240] Sometimes the report will clearly be a crucial factor inducing the reliance, but more often it will only be one among many factors that provides the third party with

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235. *Bily*, 834 P.2d at 762-63 (citations omitted).
236. *Id.* at 763.
237. *See id.* at 765.
238. *Id.*
239. *Id.*
240. "Investment and credit decisions are by their nature complex and multifaceted . . . . And, particularly in financially large transactions, the ultimate decision to lend or invest is often based on numerous business factors that have little to do with the audit report." *Id.* at 763.

the assurance that it needs to proceed.[241] When the third party suffers a loss, it faces a moral hazard. There is a significant temptation for an injured party to attempt to attach liability to the accountant because it may be the only solvent potential defendant available.[242] These cases present particularly challenging proof problems because the plaintiff's claim of reliance on the accountant's opinion often may rest on no more than the plaintiff's testimony to that effect.[243]

Beyond the auditor's limited role in relation to third parties, the indeterminacy of liability in situations other than the paradigm case makes it undesirable to expand liability. The threat of imposing open-ended liability on a defendant has been one of the central concerns of courts in accountant liability cases since the beginning, receiving its authoritative expression in *Ultramares*.[244] In that case, Cardozo argued that liability for negligence "may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class."[245]

The concept is appropriately named because the key problem of indeterminate liability is one of indeterminacy or uncertainty. It is not simply a problem of the large size of the damages the accountant may have to pay. Instead, the problem of indeterminacy is a problem of the spreading out or rippling down of harm caused by the defendant's negligence.[246] First, liability expands to an uncertain number of parties as the class of potential plaintiffs expands from those specifically known to the accountant, to those known only as members of a class, to those who are only foreseeable.[247] Second, the extent of liability is uncertain because the losses of each plaintiff depend on individual facts not within the knowledge or control of the accountant.[248]

The threat of indeterminate liability is particularly acute in accountant liability cases because the consequences of a negligent audit report can extend very far, unlike the consequences of a negligent act causing physical injury.[249] The consequences of a physical accident can be catastrophic, but they tend to be limited in space and time to the immediate victims.[250] The economic consequences of a negligent

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241. *See id.*
242. *Id.*
243. Siliciano, *supra* note 16, at 1947.
244. 174 N.E. 441, 444 (N.Y. 1931).
245. *Id.*
246. Siliciano, *supra* note 16, at 1943.
247. *See id.* at 1933-44.
248. *Id.* at 1949.
249. *Id.* at 1943.
250. Economic loss which flows to persons other than the immediate victim of the accident, such as the emotional harm suffered by members of the victim's family, do raise inde-

audit, on the other hand, can extend along chains of causation to many persons far removed in time and contact from the accountant.[251] Once an audit report is issued, it can be disseminated widely and relied on by members of the general public. The rippling of consequences is particularly likely to occur today since information can be passed quickly and costlessly from person to person (and often to many persons at once) in ways over which the accountant has no control.

In this way, indeterminate liability imposes an unfair burden on the accountant. The expanded liability of the accountant may be totally out of proportion to its fault in bringing about the harm of which the third party complains.[252] In many cases, the company which is the accountant's client is insolvent, so the search for potential defendants will focus on the accountant's deep pockets.[253]

> Although the auditor's role in the financial reporting process is secondary and the subject of complex professional judgment, the liability it faces in a negligence suit by a third party is primary and personal and can be massive. The client, its promoters, and its managers have generally left the scene, headed in most cases for government-supervised liquidation or the bankruptcy court. The auditor has now assumed 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, let alone the nature or scope, of the third party transaction that resulted in the claim.[254]

In theory, the accountant is compensated in its professional fee, not only for the cost of providing its services, but also for the risk that it will have to compensate third parties if the services are negligently performed.[255] However, because the information the accountant purveys is potentially useful to many third parties who deal with the client in many different situations, it may be difficult for the accountant to assess properly the extent of its potential responsibility to all of those third parties,[256] and then either conform its conduct to the potential scope of the loss, or capture the value of the information in its price by including a premium for the risk of liability.[257]

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terminacy problems and are usually dealt with under special duty rules. *See, e.g.*, 3 FOWLER V. HARPER ET AL., THE LAW OF TORTS § 18.4 (2d ed. 1986).

251. *See id.*

252. Bily v. Arthur Young & Co., 834 P.2d 761, 765 (Cal. 1992).

253. *Id.* at 763.

254. *Id.*

255. H. Rosenblum, Inc. v. Adler, 461 A.2d 138, 152 (N.J. 1983), *superceded by statute as stated in* Finderne Mgmt. Co. v. Barrett, 809 A.2d 857 (N.J. Super. Ct. App. Div. 2002).

256. Siliciano, *supra* note 16, at 1965.

257. *Cf.* Greycas, Inc. v. Proud, 826 F.2d 1560, 1564-65 (7th Cir. 1987) (noting the importance of protecting those who produce socially valuable information from tort liability).

On the other hand, just as some sophisticated third parties have readily available means of obtaining information about the client and controlling the risk of their interactions with it, so too, many third parties are in as good or better a position than the accountant to bear the risk of losses posed by problem clients.[258] For a lender or investor who regularly engages in transactions of the kind at issue, the risk of default can be viewed as the risk of the accountant's failure to discover the difficulty and reveal it to the third party, or it can be viewed as the risk of client fraud or failure due to unforeseen circumstances. If the latter, the risk of default by the client can be figured into the cost of the financing it provides as easily as it can be figured into the accountant's fee.

Expanded liability produces little more incentive for accountants to exercise care because they already have sufficient incentives to audit with due care.[259] These incentives include malpractice liability to the client, sanctions by regulators in securities cases or other regulated matters, concern for reputation, and the threat of professional disciplinary proceedings.[260] Even when liability imposes an additional incentive, an accountant may have limited ability to increase the quality of its auditing practices. Because auditing is a labor-intensive activity, the only means of improving quality—by adding personnel-time—is likely to have minimal returns once a reasonable level has been achieved.[261]

Stated most generally, indeterminate liability and liability out of proportion to fault undermine what would otherwise be an efficient process of private ordering.[262] The private-ordering principle assumes that individuals are the best judges of their own interests. Accordingly, parties are better able to prospectively determine the desirable level of care and the appropriate means of distributing losses in the event of audit failure than a court can do retrospectively. A third party can choose to rely on the accountant's audit, and therefore take the risk that the audit has been negligently performed, or it can moderate that risk by commissioning its own audit, looking to other sources of financial information, bargaining for better security or more favorable terms with the client, or requiring the client to have the accountant give specific assurances to the third party, thereby bringing itself within a narrow rule of liability.[263] Therefore, liability should be limited to cases in which the third party fits within the paradigm case, and principles that are grounded in contract law, not

258. Siliciano, *supra* note 16, at 1956-57.
259. *Id.* at 1953.
260. *Id.*
261. *Id.* at 1962.
262. Bily v. Arthur Young & Co., 834 P.2d 745, 761, 765 (Cal. 1992).
263. Siliciano, *supra* note 16, at 1956.

tort law, provide the appropriate basis of liability.[264]

2. Expanded Liability

The argument for expanded liability also begins with the auditor's dual role, but it emphasizes the accountant's public responsibility in that role.[265] The audit has long had dual purposes, but its use by persons other than the company's management has become increasingly important.[266] In *Ultramares*, consistent with the prevailing view of auditing at the time, Cardozo regarded the auditor's report as "primarily for the benefit of the [auditor's client], a convenient instrumentality for use in the development of the business, and only incidentally or collaterally for the use of those to whom [the company] might exhibit it thereafter."[267] As the reaction to Arthur Andersen's participation in the Enron debacle has made clear, today that view is regarded as outmoded.[268] For those who deal with companies large and small, the audit report provides assurance that things are what they appear to be. As Comptroller General David M. Walker stated after Enron, making special reference to the auditor's role in the financial markets:

> The audit is a critical element of the financial reporting structure because it subjects information in the financial statements to independent and objective scrutiny, increasing the reliability and assurance that can be placed on those financial statements for efficient allocation of resources in a capital market where investors are dependent on timely and reliable information . . . . The audi-

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264. *See id.* at 1975-80.

265. The leading exemplars of this approach are *H. Rosenblum, Inc. v. Adler*, 461 A.2d 138 (N.J. 1983), *superceded by statute as stated in* Finderne Mgmt. Co. v. Barrett, 809 A.2d 857 (N.J. Super. App. Div. 2002), and Howard B. Wiener, *Common Law Liability of the Certified Public Accountant for Negligent Misrepresentation*, 20 SAN DIEGO L. REV. 233 (1983).

266. *Rosenblum*, 461 A.2d at 149-50.

267. 174 N.E. 441, 446 (N.Y. 1931).

268. *See, e.g.*, *Rosenblum*, 461 A.2d at 149 (citations omitted):

> At one time the audit was made primarily to inform management of irregularities and inefficiencies in the business. That function remains one of the principal reasons for the audit. Gradually a need for independent audits was generated by public ownership of business enterprises and by requirements of the stock exchanges and the Securities and Exchange Commission (SEC). Institutional investors, investment specialists, stockholders, and lenders demanded more and reliable information. It is now well recognized that the audited statements are made for the use of third parties who have no contractual relationship with the auditor.

For citations to older and to contemporary accounting treatises illustrating this change, see Allegaert & Tinkelman, *supra* note 16, at 502-03.

> tor's opinion on the financial statements is like an expert's stamp of approval to the public and the capital markets.[269]

The accountant fulfills its public responsibility in its role as an independent professional. As a professional, the accountant must be competent and must perform the audit with due care. As an independent professional, the accountant must be impartial in fact and in appearance to the interests of the client and to the interests of those persons who will rely on the financial statements.[270] Auditors must be "independent expert professionals who have neither mutual [interests] nor conflicts of interests in connection with the entities they are auditing" and must "bring to the financial reporting process integrity, independence, objectivity, and technical competence."[271]

The requirements of competence, due care, and independence are primary among the Generally Accepted Auditing Standards[272] and Code of Professional Conduct,[273] standards that the accounting profession has defined for itself. The federal securities laws and related regulatory requirements are important sources of accountant obligations in transactions involving large, public companies. In many other settings, from large commercial loans to much smaller investments, the requirement of an audit report has become ubiquitous. As such, it is part of the customary practice in the financial arena, and is specifically planned into transactions by the parties.

Other sources such as these are important in defining the accountant's responsibility, but they are less effective than tort liability in enforcing that responsibility. Although the Securities and Exchange Commission, the American Institute of Certified Public Accountants, and state licensing authorities have the formal authority to discipline accountants, that authority is rarely exercised.[274] Limited resources and professional protectionism combine to minimize the risk of regulatory action against accountants who have been negligent, or worse, in the conduct of audits.[275]

The public dimension of the auditor's role, therefore, induces third parties to rely on the audit. Reliance is particularly likely where the third party has no access to the company's financial information, other than through management, no check on their accuracy, other

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269. DAVID M. WALKER, U.S. GEN. ACCOUNTING OFFICE, PROTECTING THE PUBLIC INTEREST: SELECTED GOVERNANCE, REGULATORY OVERSIGHT, AUDITING, ACCOUNTING, AND FINANCIAL REPORTING ISSUES (GAO-02-483T) 4 (Mar. 5, 2002) (statement before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate).

270. BAILEY, *supra* note 24, at 16-19.

271. WALKER, *supra* note 269, at 13.

272. BAILEY, *supra* note 24, at 14-21.

273. RULES OF PROF'L CONDUCT, *supra* note 234, §§ 101, 102, 201.

274. David S. Hilzenrath, *Auditors Face Scant Discipline*, WASH. POST., Dec. 6, 2001, at A1.

275. *Id.*

than the auditor's report, or has limited access to other sources of information about the financial position of the auditor's client.

As this point suggests, third parties are differently situated to anticipate and deal with the risk of audit failure and with the more fundamental risk of error or fraud by the client in supplying financial information to the third party. From the perspective of liability-limiting courts from *Ultramares* onward, the third party in the paradigm case who is able to extract from the client the concession that the audit is expressly conducted, in part, for the third party's benefit, so that the accountant focuses on the third party's prospective reliance, is most worthy of protection.[276] But from the perspective of the liability-expanding approach, this is exactly backwards. The party who has less leverage, or is somewhat removed from the audit, is most in need of being able to rely on the accuracy of the audit because that party is unable to demand a specially-prepared audit, rather than relying on a preexisting routine audit, or to have access to other sources of information. The typical investor or creditor, for example, cannot acquire information other than through the audited financial statements or obtain adequate security to ameliorate the risk of a negligent audit.[277]

In some of these cases, the auditor will not have specific knowledge of the potential for reliance by individual third parties. This lack of knowledge presents the prospect of indeterminate liability. It is this prospect that causes courts adopting the liability-limiting view to deny liability.[278] But indeterminacy is not a significant problem in most accountant liability cases. With respect to the number of potential plaintiffs, even the foreseeability test, the broadest doctrine used in such cases, limits liability to plaintiffs who were known or who reasonably could have been predicted to potentially rely on the accountant's report.[279] Accordingly, the reasonable accountant will be able to predict the kinds of parties to whom it may be liable, even though it may not know their identity. The accountant is only liable to third parties who should have been reasonably foreseen at the time of the audit, the usual standard in the law of negligence.[280] As long as the accountant is only liable for foreseeable uses of its report, the accountant will be able to predict the scope of potential loss because it will know, or should know, the potential scope of the transactions involved.

In most cases, there is a natural limit on the potential scope of li-

276. 174 N.E. 441, 444-45 (N.Y. 1931).
277. *See* Wiener, *supra* note 265, at 253.
278. *Id.* at 444.
279. *See* Touche Ross & Co. v. Commercial Union Ins. Co., 514 So. 2d 315, 322-23 (Miss. 1987).
280. *Id.*

ability that arises from the size of the firm being audited and the nature of its activities.[281] Nearly all cases arise from the extension of credit to the firm or equity investments in the firm. The capacity of a firm to absorb additional debt or equity is generally predictable within a range based on its current size and the scope of its current business, which are, of course, known to the accountant.

The responsibility of the accountant to such parties is a matter of fairness as well as risk. The accountant is not solely responsible for the harm to the third party—fraud or mismanagement by the client is the underlying cause—but the third party is probably not responsible for the harm at all. Ordinarily, when one party is totally innocent and one party is partially blameworthy, the law favors shifting the loss away from the innocent party.[282] However, if the third party is partly responsible for the loss because it acted negligently, then comparative negligence may be appropriate.[283] If the third party is not responsible but other parties are—such as lawyers and underwriters–then comparative negligence ensures that the accountant bears no more than its proportional share of the third party's loss.[284]

At its most general level, the argument for expanded liability emphasizes the accountant's responsibility to third parties more than it values the process of private ordering.[285] This responsibility arises from third parties' reliance on the audit and the risks that the negligent conduct of the audit creates for them. The focus on private ordering is deficient because it does not take adequate account of these kinds of reliance and risks, nor does it recognize that some third parties are not in a position to take advantage of private ordering. The result is that tort principles are needed to supplement contract principles in these cases.[286]

IV. UNDERSTANDING THE DIVERGENT POLICY APPROACHES

Thus, there are two alternative policy analyses of the scope of auditor liability: one narrowing liability only to those in privity or an equivalent relationship with the auditor; the other extending liability to parties not specifically identified and, perhaps, only foreseen. The situation thereby presented to courts is as common as it is peculiar because the alternative analyses are, to a considerable extent, irreconcilable. Either the public half of the auditor's dual role is secon-

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281. *See* Siliciano, *supra* note 16, at 1946 n.95.

282. *See* H. Rosenblum, Inc. v. Adler, 461 A.2d 138, 152 (N.J. 1983), *superceded by statute as stated in* Finderne Mgmt. Co. v. Barrett, 809 A.2d 857 (N.J. Super. Ct. App. Div. 2002).

283. *Id.*

284. *See id.*

285. *See* Siliciano, *supra* note 16, at 1959.

286. *See* Wiener, *supra* note 265, at 259-60.

dary, so that only identified third parties should rely on it, or the public half is sufficiently prominent, so that foreseeable third parties should be able to rely on it. Either such deleterious consequences flow from indeterminate liability that only identified third parties can recover,[287] or liability to foreseeable third parties is not so indeterminate that it imposes unfair and socially suboptimal burdens on accountants.[288] Most fundamentally, accountant liability should proceed on a private-ordering principle that leads to limited liability or on a public-ordering principle that leads to expanded liability.

As this survey of the law demonstrates, courts and scholars who seriously consider the issue reach opposite conclusions on the normative questions and the resulting desirable rule of law. Many of the opinions described in this Article review the history and authorities, weigh the policies, and then firmly conclude that one solution or the other is the only sound one. And they do so with a degree of certainty that is strange, given the contested nature of the issue.

One could characterize the dispute embodied in the auditor liability issue as a conflict between a "conservative" liability-limiting view and a "liberal" liability-expanding view. "Liberal" and "conservative" are not strictly defined terms, and the elements of a liberal or conservative position are not logically entailed, but there is a familiar coherence among the elements of each position based on history, politics, and culture. This coherence makes it possible, and even appropriate, to characterize the liability-limiting position as conservative, and the liability-expanding position as liberal.

It is interesting to characterize the competing positions in this way, if for no other reason than to avoid losing sight of the fact that the choice being made is not purely "legal," and is, in some sense, "political." However, it may be more useful to connect the policy choice of auditor liability to a central issue in modern private law: the conflict between contractarian and relational approaches.

The contractarian approach embodies the private-ordering principle.[289] It emphasizes the contractual origins of the relationships that give rise to the cases and asserts that liability should ordinarily be imposed only when the narrow standards of contract law are met, including, in the case of claims by a third party, the standards of third-party beneficiary law.

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287. Siliciano, *supra* note 16.

288. Wiener, *supra* note 265, at 255-57.

289. On the contractarian approach, see, for example, RICHARD A. EPSTEIN, SIMPLE RULES FOR A COMPLEX WORLD 71-90 (1995); PETER W. HUBER, LIABILITY: THE LEGAL REVOLUTION AND ITS CONSEQUENCES 5 (1988); Jean Braucher, *The Afterlife of Contract*, 90 NW. U. L. REV. 49 (1995); Jean Braucher, *Contract Versus Contractarianism: The Regulatory Role of Contract Law*, 47 WASH. & LEE L. REV. 697 (1990); William Powers, Jr., *Border Wars*, 72 TEX. L. REV. 1209 (1994).

Every case arises from a contractual setting. The parties allocate the costs, benefits, and risks of their interaction through this contracting process, sometimes explicitly and sometimes implicitly. The law's role in this process is to support the parties' private ordering by using contract law, including third-party beneficiary law, to fulfill the parties' expectations by enforcing the contracts as the parties have made them. When the courts impose liability beyond the contract, it upsets the parties' own allocation of rights and duties, diminishes their ability to regulate their own affairs, introduces inefficiencies into the process, and raises the threat of indeterminate liability.

Liability should only be imposed beyond that prescribed by contract law when the private-ordering process is inadequate. The principal instance of inadequacy is accidental physical harm, when contracting *ex ante* is unavailable. Even then, to protect individual autonomy, liability should be imposed only on the basis of fault, and not to achieve broader policy objectives. In economic loss cases, contract law is better suited than tort law for the redress of harm,[290] except in the event of fraud, which is a subversion of contracting principles.[291]

The relational approach, on the other hand, builds on extra-contractual elements of the parties' relationships and employs a public-ordering principle to stress the responsibility that arises from causing harm to another.[292] From this expanded perspective, the law's role is not limited to enforcement of the express terms of the parties' contracts. The express terms must be supplemented by factors from the context and by concern for policies not adequately captured in the concept of enforcing the parties' contracts. In the relational approach, the law has values to serve in addition to effectuating the parties' explicit planning—particularly the values of responsibility for reliance induced or harm caused that are expressed in tort policies. Accordingly, tort liability is an appropriate supplement to liability based on contract law, and tort and contract law do not occupy entirely separate realms.

The choice of a position on auditor liability is in this way tied into choices on other private law issues. In this context, the choice between the liability-limiting and liability-expanding positions on audi-

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290. Siliciano, *supra* note 16.

291. EPSTEIN, *supra* note 289, at 80-81.

292. On the relational approach, see, for example, FEINMAN, ECONOMIC NEGLIGENCE, *supra* note 16, § 7.3; IAN R. MACNEIL, THE NEW SOCIAL CONTRACT: AN INQUIRY INTO MODERN CONTRACTUAL RELATIONS 71-117 (1980); Jay M. Feinman, *Relational Contract Theory in Context*, 94 NW. U. L. REV. 737 (2000); Jay M. Feinman, *The Significance of Contract Theory*, 58 U. CINC. L. REV. 1283, 1299-1304 (1990); Gidon Gottlieb, *Relationism: Legal Theory for a Relational Society*, 50 U. CHI. L. REV. 567 (1983); Ian R. Macneil, *Values in Contract: Internal and External*, 78 NW. U. L. REV. 340 (1983).

tor liability can be seen as ideological.[293] The issues at stake extend far beyond the question of auditor liability. The contractarian and relational approaches are applied across a range of situations, and the decision in one type of case, such as accountant liability, resonates with decisions made in many others.

V. CONCLUSION

There is a formulaic structure to law review articles that deal with doctrinal issues (rather than articles that are primarily historical, jurisprudential, or otherwise theoretical). A law review article identifies a problem in doctrine that arises from a new situation, a gap in the rule system, or an arguably unsatisfactory result in a case or line of cases. It surveys the background and current state of affairs in the area of law relevant to the problem. It concludes by resolving the problem. The resolution may be achieved by a clever manipulation of the doctrine (a form that was particularly prevalent through the middle of the twentieth century), by the use of policy analysis, or by the application of some other approach, such as economic analysis. This survey of the conflicting positions arrived at by the many courts and scholars that have addressed the issue of auditor liability renders adherence to that formula an act of hubris. Instead, the aim of this Article has been to describe the controversy, to explore its ramifications, and to situate it within the context of modern private law.

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293. KENNEDY, *supra* note 200, at 41.