

Washington University Law Review

Volume 67

Issue 3 *Symposium on the State Action Doctrine of Shelley v. Kraemer*

1989

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Recommended Citation

Eric R. Fencl, *Rebuilding the Citadel: State Legislative Responses to Accountant Non-Privity Suits*, 67 WASH. U. L. Q. 863 (1989).

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NOTES

REBUILDING THE CITADEL: STATE LEGISLATIVE RESPONSES TO ACCOUNTANT NON-PRIVITY SUITS

Nearly sixty years ago, in *Ultramares Corp. v. Touche, Niven & Co.*,¹ Chief Judge Cardozo distinguished a negligent audit from a defective product and held that privity of contract was required to hold an accountant² liable for negligence.³ Recently, several jurisdictions have eroded the privity doctrine by applying the expanded liability principles of product liability law⁴ to negligent accountants.⁵ Conversely, other states have expressly reaffirmed the accountant privity doctrine.⁶ In many states where the courts have not recently taken a stand, accountants, clients, and third party users of financial statements are in the uncomfortable position of not knowing which standard the courts will apply in future cases.⁷

1. 255 N.Y. 170, 174 N.E. 441 (1931).

2. In general usage, "accountant" typically refers to anyone who figures and records financial data. Accountants can be either internal, meaning the organization for whom they keep records employs them, or external, meaning the organization hires them to inspect the work of the organization's internal accountants. As used in this Note, the term "accountant" refers to an external auditor hired by the organization to express an opinion regarding the propriety of the organization's financial records.

3. Fifteen years prior to *Ultramares*, Cardozo helped initiate the abolition of the privity requirement for product liability, in *MacPherson v. Buick Motor Co.*, 217 N.Y. 382, 111 N.E. 1050 (1916). See *infra* notes 21-26 and accompanying text.

4. See *infra* notes 43-44 and accompanying text. See generally Priest, *The Invention of Enterprise Liability: A Critical History of the Intellectual Foundations of Modern Tort Law*, 14 J. LEGAL STUD. 461 (1985); Stewart, *Crisis in Tort Law? The Institutional Perspective*, 54 U. CHI. L. REV. 184 (1987).

5. States that have rejected the privity requirement for accountant negligence have adopted either the Restatement (Second) of Torts standard, see *infra* notes 50-57 and accompanying text, or the foreseeability rule, see *infra* notes 58-83 and accompanying text.

6. See *infra* note 42 and accompanying text.

7. The issue becomes more important as investors and creditors increasingly look to the accountant after a business failure. "In the past 15 years, more suits have been filed against accountants than in the entire previous history of the profession." Miller, *Avoiding Lawsuits*, J. ACCT., Sept. 1988, at 57. Recent examples of accountants forced into the role of defendant upon business failure are the Federal Home Loan Bank Board suits filed against three of the nation's largest accounting firms in connection with financial irregularities at troubled savings and loan institutions. Although no accountant criminal activity is alleged, the Bank Board is seeking several million dollars in damages from the accountants. N.Y. Times, Jan. 27, 1989, at 1, col. 1. Troubles in the savings and loan industry and the resulting federal bailouts have "produced a search for someone to blame." *Id.*

In an effort to provide certainty to all parties concerned, three state legislatures have passed accountant privity statutes⁸ that define the scope of an accountant's duty of care to third parties.⁹ This Note examines the need for accountant-privity statutes. Part I examines the roots of the traditional privity requirement, and its application in the context of accountant negligence. Part II evaluates the arguments on both sides of the recent judicial erosion of the accountant privity requirement. Part III identifies and analyzes state legislative responses to the expansion by some courts of the accountant's duty of care.

I. PRIVACY REQUIREMENT FOR ACCOUNTANT LIABILITY

A. Accountant Liability

Of the wide range of accountant services, legal liability most frequently arises in the context of an audit engagement.¹⁰ Financial statements are not prepared during an audit. Rather, the accountant merely reviews the accuracy of the client's statements,¹¹ while client management remains primarily responsible for financial statement accuracy.¹² The financial statement certification states that the accountant has conducted the audit "in accordance with generally accepted auditing standards"¹³ to obtain

Because the client is often insolvent, the accountant is frequently the only party from whom recovery is possible.

8. See *infra* notes 137-162 and accompanying text.

9. Third parties include any user of the financial statements other than the client who contracts with the accountant. Typically, third parties use financial statements to assess the financial strength of the client. Suppliers, creditors, and investors are examples of third parties who use a client's financial statements.

10. Other services accountants frequently provide include tax advice, tax return preparation, management consulting, and litigation support. However, the vast majority of cases that test the privity requirement involve an audit. See *infra* notes 54 and 59.

11. In order to improve the public understanding of the auditor's role in an audit engagement, the American Institute of Certified Public Accountants (AICPA), the self-governing body for accountants, recently issued Statement on Auditing Standards No. 58, *Reports on Audited Financial Statements*. The first paragraph of the new audit opinion, now accompanying every accountant certification, explicitly defines the roles of client and auditor: "These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits." Roussey, Ten Eyck & Blanco-Best, *Three New SASs: Closing the Communications Gap*, J. ACCT., Dec. 1988, at 44, 45-46.

12. *In re Interstate Hosiery Mills, Inc.*, 4 S.E.C. 706, 721 (1939). "Management does not discharge its [responsibility for the accuracy of financial statements] . . . by the employment of independent public accountants, however reputable." *Id.*

13. Roussey, Ten Eyck & Blanco-Best, *supra* note 11, at 45. Generally accepted auditing standards (GAAS) are professional standards promulgated by the AICPA. These standards establish the objectives of an audit and the expected quality of performance. The AICPA periodically issues

“reasonable assurance [that] the statements are free of material misstatement . . . [and are] in conformity with generally accepted accounting principles.”¹⁴

Accountant liability can arise when an accountant performs an audit negligently. Although the audit certification does not purport to guarantee financial solvency,¹⁵ the accountant must perform with the skill and knowledge normally possessed by other accountants.¹⁶ An audit is negligent if the accountant fails to apply generally accepted auditing standards and consequently certifies a financial statement that does not conform with generally accepted accounting principles.

Accountant negligence does not necessarily render the accountant liable to all who have read the certification. Review by an accountant does not relieve clients of their duty to produce accurate financial statements.¹⁷ Consequently, injured third parties usually have a fraud or negligent misrepresentation claim against the client.¹⁸ However, because significant recovery from an insolvent client is unlikely, third party financial statement users frequently attempt to recover from the accountant. Liability to all third parties would place an enormous burden on the accounting profession because an unknown number of readers may use the financial statements for an indeterminate number of transactions, thereby creating an inestimable amount of accountant exposure.¹⁹ Recognition

Statements on Auditing Standards (SASs) which interpret GAAS. W. KELL & R. ZIEGLER, MODERN AUDITING 4 (2d ed. 1983). The AICPA sanctions accountants who do not apply GAAS when conducting an audit. GAAS is “used by peers, courts, and regulatory agencies in evaluating the auditor’s performance.” *Id.* Thus, departure from GAAS subjects the accountant to legal liability as well as professional sanctions.

14. Roussey, Ten Eyck & Blanco-Best, *supra* note 11, at 45. Generally accepted accounting principles (GAAP) are established by the Financial Accounting Standards Board (FASB). The FASB periodically issues *Statements of Financial Accounting Concepts* which “set forth fundamental concepts on which financial accounting and reporting standards will be based.” G. WELSCH, C. ZLATKOVICH & W. HARRISON, INTERMEDIATE ACCOUNTING 4 (6th ed. 1982). The FASB also issues interpretations of pre-existing GAAP. Thus, the FASB adapts GAAP to meet the changing accounting requirements of the dynamic business environment. As with GAAS, an accountant who fails to apply GAAP during an audit is subject to both legal liability and professional sanctions by the AICPA.

15. The phrase “reasonable assurance” in the financial statement certification is meant to acknowledge the accountant’s responsibility to provide reasonable, as opposed to absolute, assurance that the statements are free of material misstatements.

16. RESTATEMENT (SECOND) OF TORTS § 299A (1979).

17. *See supra* notes 11-12 and accompanying text.

18. Siliciano, *Negligent Accounting and the Limits of Instrumental Tort Reform*, 86 MICH. L. REV. 1929, 1932 (1988).

19. Mednick, *Accountants Liability: Coping With the Stampede to the Courtroom*, J. ACCT.,

of this hardship is the traditional justification for the privity requirement in accountant negligence suits.²⁰

B. Privity Requirement

The privity doctrine has its roots in the English case of *Winterbottom v. Wright*.²¹ Under the *Winterbottom* privity rule, an injured third party had no cause of action against a defendant performing under a contract unless the contract was made for the benefit of that third party.²² Early American courts widely accepted the privity requirement as a means to prevent limitless liability.²³ However, Judge Cardozo's landmark opinion in *MacPherson v. Buick Motor Co.*²⁴ effectively rejected the privity defense for negligence claims involving defective products.²⁵ The *MacPherson* rule is now a settled principle.²⁶ A negligent manufacturer is liable for any personal injuries proximately caused by his negligence.

The privity defense, however, is still available in several jurisdictions when the plaintiff suffers only economic harm.²⁷ Courts and commentators have expressed concern that allowing recovery for economic damages without requiring privity may result in excessive levels of liability, exaggerated assessment of damages, and an increase in fraudulent

Sept. 1987, at 121 ("The number of third parties who might use the results of the accountant's work is exponentially greater than the number of actual clients.").

20. See *infra* notes 29-42 and accompanying text for a discussion of the traditional justifications for the privity requirement. But see *infra* notes 50-83 and accompanying text for contrary arguments.

21. 152 Eng. Rep. 402 (Ex. 1842).

22. In *Winterbottom*, the court noted that "[u]nless we confine the operation of . . . contracts . . . to the parties who entered into them, the most absurd and outrageous consequences, to which I can see no limit, would ensue." 152 Eng. Rep. at 405.

23. See J. HENDERSON & R. PEARSON, *THE TORTS PROCESS* 652-53 (2d ed. 1981).

24. 217 N.Y. 382, 111 N.E. 1050 (1916).

25. The erosion of the privity requirement in product liability cases actually began before *MacPherson*. See, e.g., *Statler v. Ray Mfg. Co.*, 195 N.Y. 478 (1909); *Devlin v. Smith*, 89 N.Y. 470 (1882); *Loop v. Litchfield*, 42 N.Y. 351 (1870); *Thomas v. Winchester*, 6 N.Y. 397 (1852). See generally, R. EPSTEIN, C. GREGORY & H. KALVEN, *CASES AND MATERIALS ON TORTS* 413-35 (1984).

26. See RESTATEMENT (SECOND) OF TORTS § 395 (1977).

27. Thus, privity remains a defense where injuries are of a purely economic nature, even in product liability law, where the privity requirement has been universally rejected for personal injuries. See Edmeades, *The Citadel Stands: The Recovery of Economic Loss in American Products Liability*, 27 CASE W. RES. 647 (1977); Rabin, *Tort Recovery for Negligently Inflicted Economic Loss: A Reassessment*, 37 STAN. L. REV. 1513 (1985); Schwartz, *Economic Loss in American Tort Law: The Examples of J'Aire and of Products Liability*, 23 SAN DIEGO L. REV. 37 (1986).

claims.²⁸ This concern may explain the retention of the privity requirement for accountant negligence when reliant third parties seek damages for purely economic injuries.

Fifteen years after *MacPherson*, Judge Cardozo, writing in *Ultramares Corp. v. Touche, Niven & Co.*,²⁹ acknowledged that harm from a defective audit was foreseeable,³⁰ but declined to abandon the privity requirement in the context of accountant negligence. In *Ultramares*, a third party who relied on a certified balance sheet was denied recovery from a negligent accountant. The accountant knew the client used the balance sheet in the usual course of business but did not know the extent to which third parties would rely on the accountant's certification. Cardozo distinguished accountant liability from product liability in *MacPherson* and expressed apprehension about uncertainties that result from allowing recovery for purely economic harm without privity of contract:

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. The hazards . . . are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences.³¹

The *Ultramares* holding, however, does not preclude all third party recovery for negligently inflicted economic losses. *Ultramares* specifically reaffirmed *Glanzer v. Shepard*,³² an earlier Cardozo opinion that extended the duty of care to reliant third parties when "the end and aim of the transaction" was to provide information to that party.³³ In

28. See Siliciano, *supra* note 18, at 1943-45. See generally Rabin, *supra* note 27. The Supreme Court has refused to allow recovery for economic damages absent privity in the securities context. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 734-35 (1975) ("a putative plaintiff, who neither purchases nor sells securities but sues instead for intangible economic injury . . . is more likely to be seeking a largely conjectural and speculative recovery").

29. 255 N.Y. 170, 174 N.E. 441 (1931).

30. Cardozo noted that the accountants "knew . . . that in the usual course of business the balance sheet when certified would be exhibited by the . . . [client] to banks, creditors, stockholders, purchasers, or sellers, according to the needs of the occasion, as the basis of financial dealings." *Id.* at 173-74, 174 N.E. at 442.

31. *Id.* at 179-80, 174 N.E. at 444. The Supreme Court has also questioned the wisdom of extending indeterminate liability for economic loss in the securities context: "[w]e are not the first court to express concern that the inexorable broadening of the class of plaintiff [sic] who may sue in this area of the law will ultimately result in more harm than good." (citing *Ultramares*). *Blue Chip Stamps*, 421 U.S. at 747-48.

32. 233 N.Y. 236, 135 N.E. 275 (1922).

33. *Ultramares*, 255 N.Y. at 182-83, 174 N.E. at 445-46.

Glanzer, a bean purchaser recovered for the negligence of a public weigher hired by the seller to weigh beans and provide a report to the purchaser. The court in *Ultramares* distinguished the duty to third parties in the “end and aim” situation of *Glanzer* from the relationship that existed between the accountant and the indeterminate class of persons who might rely on the audit.³⁴ Thus, read together, *Ultramares* and *Glanzer* acknowledge a duty to third parties only if the statements were intended to benefit that third party.³⁵

Under *Ultramares*, the privity defense extended only to third-party claims for negligence. The accountant owes a duty to both the client and third parties to perform his services without fraud³⁶ or gross negligence.³⁷ Although third parties can expect that an accountant’s statement is neither fraudulent nor recklessly prepared, the court in *Ultramares* stated that liability for mere negligence requires a contract; specifically, it expressed “doubt whether the average business man [sic] receiving a certificate without paying for it, and receiving it merely as one of a multitude of possible investors, would look for anything more.”³⁸

Other state courts³⁹ uniformly followed *Ultramares* for more than thirty years⁴⁰ before some courts began eroding the accountant-privity

34. *Ultramares*, 255 N.Y. at 183, 174 N.E. at 446. “[W]hile actual foresight of reliance by a specific third party might displace privity as a trigger for liability, the mere objective foreseeability of such reliance would not suffice to establish an accountant’s liability in negligence for economic losses suffered by reliant third parties.” Siliciano, *supra* note 18, at 1936.

35. *H. Rosenblum, Inc. v. Adler*, 93 N.J. 324, 337-38, 461 A.2d 138, 145 (1983).

36. *Ultramares*, 255 N.Y. at 179, 174 N.E. at 444. Cardozo noted that “[f]raud includes the pretense of knowledge when knowledge there is none.” *Id.*

37. *Id.* at 189, 174 N.E. at 448. The *Ultramares* holding does not relieve accountants from liability for negligence so gross “as to justify a finding that [the accountant] had no genuine belief in [the statement’s] adequacy.” *Id.*

38. *Id.* at 189, 174 N.E. at 448. For a discussion of third-party expectations, see *infra* notes 115-23 and accompanying text.

39. The issue of accountant privity arises only in state law cases because privity is not an element in suits against accountants under the federal securities laws. For example, under the Securities Act of 1933, § 11, 15 U.S.C. § 77k (1981), only direct purchasers of the securities initially issued under the registration statement may sue “experts” such as accountants.

The Securities Act of 1934, § 18, 15 U.S.C. § 78r (1981), establishes civil liability for any person who makes a false or misleading statement of a material fact on an SEC filing. Similarly, an implied cause of action exists against accountants under § 10(b) of the 1934 Act, 15 U.S.C. § 78j(b) (1981). *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

For a brief overview of accountant liability under federal law, see Note, *Accountant Liability to Third Parties: To What Extent is Comparative Negligence a Defense?*, 55 UMKC L. REV. 608, 621-24 (1987).

40. Siliciano, *supra* note 18, at 1936.

doctrine.⁴¹ The ensuing abandonment of *Ultramares*, however, was not complete. Several state courts have recently reaffirmed the privity requirement in accountant negligence cases.⁴²

II. JUDICIAL EROSION OF THE PRIVACY REQUIREMENT

Erosion of the privity requirement for accountant negligence began in the late 1960s, during a period of general tort liability expansion. Every jurisdiction "stormed the citadel" and rejected the privity defense for defective product claims;⁴³ commentators and courts began to accept the expanded liability theories of tort reform.⁴⁴ By the late 1960s, commentators began to suggest the expansion of accountant liability.⁴⁵ Subsequently, courts that have questioned the privity requirement of *Ultramares* have taken one of two approaches: the *Restatement* rule⁴⁶ or the foreseeability rule.⁴⁷ Nevertheless, despite widespread judicial approval and numerous attempts in the literature to justify expanded accountant liability,⁴⁸ the arguments advanced in support of each approach

41. See *infra* notes 43-49 and accompanying text.

42. See, e.g., *Toro Co. v. Krouse, Kern & Co.*, 827 F.2d 155 (7th Cir. 1987); *Idaho Bank & Trust Co. v. First Bancorp of Idaho*, 772 P.2d 720 (Idaho 1989); *Credit Alliance v. Arthur Andersen & Co.*, 65 N.Y.2d 536, 493 N.Y.S.2d 435, 483 N.E.2d 110 (1985).

43. R. EPSTEIN, C. GREGORY & H. KALVEN, *CASES AND MATERIALS ON TORTS* 424-25 (1984). Because the privity requirement had been universally accepted, the erosion of the privity defense is often referred to as "storming the citadel."

44. "[T]ort reform emphasize[d] the benefits of expansive liability This growth was reflected in the development of a rich body of scholarly literature, judicial dissatisfaction with privity defenses and warranty disclaimers in the products context, and the emergence of strict liability as the dominant regime for defective products." Siliciano, *supra* note 18, at 1937. See also Owen, *Rethinking the Policies of Strict Products Liability*, 33 VAND. L. REV. 681 (1980); Priest, *The Invention of Enterprise Liability: A Critical History of the Intellectual Foundations of Modern Tort Law*, 14 J. LEGAL STUD. 461 (1985); Stewart, *Crisis in Tort Law? The Institutional Perspective*, 54 U. CHI. L. REV. 184 (1987).

45. Solomon, *Ultramares Revisited: A Modern Study of Accountants' Liability to the Public*, 18 DE PAUL L. REV. 56 (1968); Comment, *Auditors' Responsibility for Misrepresentation: Inadequate Protection for Users of Financial Statements*, 44 WASH. L. REV. 139 (1968).

46. See *infra* notes 50-57 and accompanying text.

47. See *infra* notes 58-83 and accompanying text.

48. See, e.g., Besser, *Privity? - An Obsolete Approach to the Liability of Accountants to Third Parties*, 7 SETON HALL 507 (1976); Fiflis, *Current Problems of Accountants' Responsibilities to Third Parties*, 28 VAND. L. REV. 31 (1975); Marinelli, *The Expanding Scope of Accountants' Liability to Third Parties*, 23 CASE W. RES. 113, 117-22 (1971); Seavey, *Mr. Justice Cardozo and the Law of Torts*, 52 HARV. L. REV. 372, 398-404 (1939); Solomon, *Ultramares Revisited: A Modern Study of Accountants' Liability to the Public*, 18 DEPAUL L. REV. 56 (1968); Weiner, *Common Law Liability of the Certified Public Accountant for Negligent Misrepresentation*, 20 SAN DIEGO L. REV. 233 (1983); Note, *H. Rosenblum, Inc. v. Adler: A Foreseeably Unreasonable Extension of an Auditor's Legal Duty*, 48 ALA. L. REV. 876 (1984); Comment, *Adjusting Accountants' Liability for Negligence:*

are not irrefutable.⁴⁹ Consequently, the debate continues, leaving the accountants and third parties uncertain in states where the courts have not recently addressed the issue.

A. Restatement's Position and the Foreseeability Rule

The *Restatement*⁵⁰ expands the duty of care beyond the *Ultramares* doctrine but does not extend liability to all parties foreseeable by the accountant. Section 552 provides that the liability of a professional who negligently supplies false information is limited to the 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.⁵¹

The drafters of the *Restatement* took a moderate position in the expansion of liability. The *Restatement* extends the duty of care beyond *Ultramares* and *Glanzer*, but only to those third parties who belong to an identifiable group that the accountant intended to influence.⁵² Thus, it limits negligence claims to specifically foreseen third parties, rather than to "merely foreseeable" or "reasonably foreseeable" parties.⁵³ Although

Recovery for Reasonably Foreseeable Users of Financial Statements, 13 BALT. L. REV. 301 (1984); Note, *Rosenblum, Inc. v Adler: CPA's Liable at Common Law to Certain Reasonably Foreseeable Third Parties Who Detrimentally Rely on Negligently Audited Financial Statements*, 70 CORNELL L. REV. 335 (1985); New Jersey Developments, *Rosenblum v. Adler: The New Jersey Supreme Court Expands Accountants' Liability*, 37 RUTGERS L. REV. 161 (1984); Comment, *The Citadel Falls? — Liability for Accountants in Negligence to Third Parties Absent Privity: Credit Alliance Corp. v. Arthur Andersen & Co.*, 59 ST. JOHN'S L. REV. 348 (1985); Comment, *Auditors' Responsibility for Misrepresentation: Inadequate Protection for Users of Financial Statements*, 44 WASH. L. REV. 139 (1968).

Given the efforts of academic writers to advance tort reform in general, it is not surprising that both the Restatement rule and the foreseeability rule have received wide acceptance by commentators. Siliciano, *supra* note 18, at 1979; Priest, *supra* note 4.

49. See *infra* notes 84-136 and accompanying text.

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

51. *Id.* § 552(2)(a), (b).

52. *H. Rosenblum, Inc. v. Adler*, 93 N.J. 324, 338, 461 A.2d 138, 145 (1983).

53. RESTATEMENT (SECOND) OF TORTS § 552 (1977). See *Badische Corp. v. Caylor*, 257 Ga. 131, 356 S.E.2d 198 (1987); *Touche Ross & Co. v. Commercial Union Ins. Co.*, 514 So. 2d 315 (Miss. 1987); *Lindner Fund v. Abney*, 770 S.W.2d 437 (Mo. Ct. App. 1989); *Raritan River Steel Co. v. Cherry, Bekaert & Holland*, 367 S.E.2d 609 (N.C. 1988) (describing the *Restatement* position as the moderate position between the privity requirement and the foreseeability rule because it does not

several states have adopted the *Restatement* approach⁵⁴—apparently as a compromise position between the privity requirement⁵⁵ and the foreseeability rule⁵⁶—the uncertainties of the *Restatement* position prevent accountants from estimating potential liability exposure. Similarly, prior to litigation, third parties can only speculate whether they will be included in the class of properly reliant financial statement users.⁵⁷

Clearly, the more radical departure from *Ultramares* is the foreseeability rule, which maintains that accountants have a duty to all persons when the auditor should reasonably foresee as recipients of the certified statements.⁵⁸ Although only a minority of states have taken this position,⁵⁹ many commentators⁶⁰ support the foreseeability rule as a proper extension of tort reform.⁶¹

New Jersey was the first state to adopt the foreseeability rule. In *H.*

require the accountant to acknowledge the reliant third party, but it does restrict liability to a limited class).

54. See, e.g., *Ingram Indus. Inc. v. Nowicki*, 527 F. Supp. 683 (E.D.Ky. 1981); *Seedkem Inc. v. Safranek*, 466 F. Supp. 340 (D. Neb. 1979); *Rusch Factors, Inc. v. Levin*, 284 F. Supp. 85 (D.R.I. 1968); *Pahre v. Auditor of Iowa*, 422 N.W.2d 178 (Iowa 1988); *Raritan River Steel Co. v. Cherry*, *Bekaert & Holland*, 367 S.E.2d 609 (N.C. 1988); *Badische Corp. v. Caylor*, 257 Ga. 131, 356 S.E.2d 198 (1987); *Blue Bell, Inc. v. Peat, Marwick, Mitchell & Co.*, 715 S.W.2d 408 (Tex. 1986); *Haddon View Inv. Co. v. Coopers & Lybrand*, 70 Ohio 2d 154, 436 N.E.2d 112 (1982); *Spherex, Inc. v. Alexander Grant & Co.*, 122 N.H. 898, 454 A.2d 1308 (1982); *Aluma Craft Manufacturing Co. v. Elmer Fox & Co.*, 493 S.W.2d 378 (Mo. Ct. App. 1973).

55. See *supra* notes 21-42 and accompanying text.

56. See *infra* notes 58-83 and accompanying text.

57. Because § 552 of the Restatement does not require that the accountant acknowledge the reliant third party and because the definition of "limited class" is vague, neither the accountant nor the third party knows, at the time the user relies on the financial statements, whether the accountant can be held liable to the third party for negligence. On the other hand, in jurisdictions that have enacted accountant privity statutes, both the accountant and the reliant third party know in advance whether the user can bring a potential negligence claim against the accountant. See *infra* notes 141-44 and accompanying text.

58. *Rosenblum*, 93 N.J. at 352, 461 A.2d at 153.

59. See, e.g., *Touche Ross & Co. v. Commercial Union Ins. Co.*, 514 So. 2d 315 (Miss. 1987); *International Mortgage Co. v. John P. Butler Accountancy Corp.*, 177 Cal. App. 3d 806, 223 Cal. Rptr. 218 (Cal. Ct. App. 1986); *Citizens State Bank v. Timm, Schmidt & Co.*, 113 Wis. 2d 376, 335 N.W.2d 361 (1983); *H. Rosenblum, Inc. v. Adler*, 93 N.J. 324, 461 A.2d 138 (1983).

60. See *supra* note 48. In contrast to the widespread approval in legal periodicals, the accountants were understandably concerned about the potential for unlimited liability. See, e.g., Collins, *Malpractice Prevention and Risk Management*, J. ACCT., July 1986, at 52; Collins, *Professional Liability: The Situation Worsens*, J. ACCT., Nov. 1985, at 57; Gavin, Hicks & Decosimo, *CPA's Liability to Third Parties: The Risk Is Increasing*, J. ACCT., June 1984, at 80; Miller, *supra* note 7, at 57; Minow, *Accountants' Liability and the Litigation Explosion*, J. ACCT., Sept. 1984, at 70.

61. See *authorities cited supra* note 44.

Rosenblum, Inc. v. Adler,⁶² the Supreme Court of New Jersey held that an accountant who fails to detect fraudulent entries in a client's financial statements breaches a duty to all persons who he should reasonably foresee will receive and rely upon the report for a proper business purpose.⁶³ The accountant in *Rosenblum* failed to detect fraudulent entries in the client's financial statements. The client entered bankruptcy after using the financial statements to induce the plaintiffs to acquire common stock of the client. The court held that the accountant owed a duty of care to the plaintiffs even though he was not notified that statements would be issued to prospective investors.

Although the foreseeability rule remains the minority position, some state courts⁶⁴ and numerous commentators⁶⁵ have adopted and expanded the *Rosenblum* rationale. Because foreseeability represents the more extreme position with regard to expunging the privity requirement, the remainder of this section will focus on the justifications for the rule, as well as the oversights in such arguments.

B. Justifications for the Foreseeability Rule

To support expanded accountant liability, proponents typically compare accountant liability with product liability and point to the deterrent value of expanded liability. In addition, these commentators cast the accountant in the role of public protector, presenting the third party as an innocent investor. Finally, they argue that insurance will protect the accountant.

1. Accountant Statements as Defective Products

Proponents of the foreseeability rule argue that because courts have discarded privity in the defective product context,⁶⁶ courts should also permit third parties to recover from negligent accountants without a contractual relationship.⁶⁷ The accountant's opinion about the accuracy of the financial statement is the "product." Under this argument, once the accountant inserts the product into the stream of commerce, the negli-

62. 93 N.J. 324, 461 A.2d 138 (1983).

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

64. *See supra* note 59.

65. *See supra* note 48.

66. *See supra* notes 24-26 and accompanying text.

67. *See, e.g.,* H. Rosenblum, Inc. v. Adler 93 N.J. 324, 341, 461 A.2d 138, 147; International Mortgage Co. v. John P. Butler Accountancy Corp., 177 Cal. App. 3d at 818-19, 223 Cal. Rptr. at 226.

gent accountant should be responsible to parties who justifiably relied upon the opinion without regard to privity.⁶⁸

2. *Deterrent Effect of Expanded Liability*

Advocates of the foreseeability rule also contend that expanding the duty of care deters negligence. An increase in the accountant's potential liability, they argue, will result in greater care and diligence. The *Rosenblum* court concluded that liability to all foreseeable users would encourage accountants to conduct more thorough audits.⁶⁹ Subsequent courts adopted this rationale, holding that a higher duty of care would "heighten the profession's cautionary techniques"⁷⁰ and insure that accountant "negligence [would not] go undeterred."⁷¹

3. *Role of the Accountant*

Proponents of the foreseeability rule also justify abandoning the privity requirement by noting the changing perception of the accountant's role in modern society. In *Ultramares Corp. v. Touche, Niven & Co.*, Cardozo stated that "public accountants are public only in the sense that their services are offered to any one [sic] who chooses to employ them."⁷² Fifty-five years later, when a California court adopted the foreseeability rule in *International Mortgage Co. v. John P. Butler Accountancy Corp.*,⁷³ the court noted acknowledgement by the American Institute of Certified Public Accountants (AICPA), the self-governing body for public accountants, of the accounting profession's responsibility to the public.⁷⁴ *International Mortgage* also cited the Supreme Court's recognition of the accountant's expanded role as the "public watchdog."⁷⁵ Advocates of the foreseeability rule argue that the accountant's position of public trust

68. *Rosenblum*, 93 N.J. at 356, 461 A.2d at 155.

69. *Id.* at 350, 461 A.2d at 152.

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

71. *Citizens State Bank v. Timm, Schmidt & Co.*, 113 Wis. 2d at 384, 335 N.W. 2d at 365.

72. *Ultramares*, 255 N.Y. at 188, 174 N.E. at 448.

73. 177 Cal. App. 3d 806, 223 Cal. Rptr. 218 (Cal. Ct. App. 1986).

74. "[T]he profession's responsibility to the public . . . has grown as the number of investors has grown, as the relationship between corporate managers and stockholders has become more impersonal, and as government increasingly relies on accounting information." *International Mortgage*, 177 Cal. App. 3d at 817, 223 Cal. Rptr. at 224-25 (quoting AICPA, PROFESSIONAL STANDARDS (CCH 1984) ET § 51.04 (1981)). The Court in *Rosenblum* also noted the accountant's increased responsibility to the public. 93 N.J. at 346, 461 A.2d at 149.

75. 177 Cal. App. 3d at 817, 223 Cal. Rptr. at 225 (quoting *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984)). See also 177 Cal. App. 3d at 819-20, 223 Cal. Rptr. at 226-27.

justifies expanded accountant liability.⁷⁶

4. *Third Party as Innocent Investor*

Shifting the economic harm from the “innocent” creditor or investor to the negligent accountant is another justification offered for the abandonment of the *Ultramares* privity requirement.⁷⁷ The accountant can reasonably expect the client to distribute the financial statements for business purposes and third parties to rely on those statements to extend credit or invest in the business.⁷⁸

Under the foreseeability rule, allowing the reliant third party to recover damages from the negligent accountant shifts the loss from the innocent creditor who can no longer collect from the insolvent client.⁷⁹ The risk of loss, the argument concludes, should be placed on the accounting profession, which is better able to allocate such risk to its customers and the public.⁸⁰

5. *Insurance Protects the Accountant*

In response to Cardozo’s concerns in *Ultramares* regarding liability for an indeterminate amount to an indeterminate class,⁸¹ advocates of the foreseeability rule argue that insurance will protect accountants from financial ruin. Malpractice insurance protects the accounting industry and provides an efficient method to allocate the risk.⁸² The *Rosenblum* court stated that it had “no reason to believe” that accountants would be unable to acquire malpractice insurance to cover liability to reliant third parties resulting from negligent audits.⁸³ Thus, ignoring any long-term

76. *International Mortgage*, 177 Cal. App. 3d. at 820, 223 Cal. Rptr. at 226-27.

77. See, e.g., *Rosenblum*, 93 N.J. at 351, 461 A.2d at 152; *International Mortgage*, 177 Cal. App. 3d at 820, 223 Cal. Rptr. at 227.

78. See, e.g., *Rosenblum*, 93 N.J. at 356, 461 A.2d at 155; *International Mortgage*, 177 Cal. App. 3d at 820, 223 Cal. Rptr. at 227.

79. *Rosenblum*, 93 N.J. at 351, 461 A.2d at 152.

80. *International Mortgage*, 177 Cal. App. 3d at 820, 223 Cal. Rptr. at 227. See also *Rosenblum*, 93 N.J. at 351-52, 461 A.2d at 153 (quoting *Rusch Factors, Inc. v. Levin*, 284 F. Supp. 85, 91 (D.R.I. 1968)).

81. See *supra* notes 29-31 and accompanying text.

82. See, e.g., *Citizens State Bank*, 335 N.W.2d at 365; *Rosenblum* 93 N.J. at 349, 461 A.2d at 151.

83. *Rosenblum*, 93 N.J. at 349, 461 A.2d at 151. The court in *Rosenblum* based its belief that accountants would have little difficulty obtaining insurance on a 1976 survey. *Id.* at 349-50 n.11, 461 A.2d at 151 n.11 (quoting Note, *Accountants’ Liability For Negligence—A Contemporary Approach For A Modern Profession*, 48 *FORDHAM L. REV.* 401, 415 n.81 (1979)). For a more current discussion of accountant malpractice insurance availability, see *infra* notes 124-36 and accompanying text.

ramifications, the court determined that insurance would assure accountant survival despite indeterminate liability.

C. *Weaknesses in the Foreseeability Rule Rationale*

Based on commentators' predictions of the demise of the privity requirement for accountant negligence claims,⁸⁴ one might infer that the foreseeability rule was the "correct" approach. Yet continuing debate⁸⁵ and contrary holdings by various state courts⁸⁶ demonstrate that the foreseeability rule is not universally accepted. For each of the arguments discussed favoring foreseeability,⁸⁷ there are several counterarguments for retaining the accountant-privity doctrine.⁸⁸

1. *Accountant Statements as Defective Products*

Courts have justified abandoning the privity requirement for accountant negligence by comparing the audit opinion to a manufacturer's product and the third-party creditor or investor to the "innocent victim" of a defective product.⁸⁹ The analogy of an audit to a manufactured product, however, is strained. The manufacturer is responsible for the production and distribution of the manufactured product. The accountant, on the other hand, is a secondary, rather than primary, participant in an audit.⁹⁰ The primary responsibility for a financial statement's accuracy rests with client management.⁹¹ Thus, because the accountant must rely on the cli-

84. See *supra* note 48.

85. Compare authorities cited *supra* note 48 (commentators supporting expanded accountant liability) with Siliciano, *supra* note 18 and Goldberg, *Accountable Accountants: Is Third-Party Liability Necessary?*, 17 J. LEGAL STUD. 295 (1988) (discussing problems with expanded accountant liability).

86. Compare authorities cited *supra* note 42 (cases which reaffirm the privity requirement) with authorities cited *supra* note 54 (cases which apply the Restatement approach) and authorities cited *supra* note 59 (cases which apply the foreseeability rule).

87. See *supra* notes 66-83 and accompanying text.

88. One commentator has noted that the "superficial character" of the arguments supporting the foreseeability rule continues to go unnoticed in scholarly publications. "[S]cholarly authority is tapped selectively, and the legitimate policy arguments of those subject to the new rules are treated with derision. In essence, a new citadel has been raised by the would-be heirs of those who long ago successfully stormed the privity defense for defective products." Siliciano, *supra* note 18, at 1979-80.

89. See *supra* notes 66-68 and accompanying text. See also Siliciano, *supra* note 18, at 1976 (the "effort to remake the accountant in the image of the product manufacturer obscures the true characteristics of the parties").

90. Mednick, *Accountants' Liability: Coping With the Stampede to the Courtroom*, J. ACCT., Sept. 1987, at 122.

91. *In re Interstate Hosiery Mills, Inc.*, 4 S.E.C. 706, 721 (1939). See *supra* notes 11-12 and accompanying text.

ent for necessary information, it is more difficult to control audit risk than to control a defective manufacturing process.⁹² Arguably, accountants themselves are at times victims of fraud by their clients.⁹³

Compensation is another factor that distinguishes the accountant from the manufacturer. Typically, the manufacturer is compensated based on the value of the transaction, and thus receives compensation commensurate with the relative magnitude of its potential liability. The accountant, on the other hand, is usually paid on the basis of time spent performing the audit. As a result, the complexity of the client's accounting system, rather than the size of third-party transactions—unknown to the accountant in any event—determines the time required to conduct an audit. Under the foreseeability rule, therefore, the accountant's compensation does not reflect the magnitude of potential third-party transactions.⁹⁴

2. *Deterrent Effect of Expanded Liability*

The deterrence value of abandoning the privity requirement⁹⁵ is also disputed. Unique characteristics of the audit function diminish the deterrent effect of an expanded duty of care. Auditing is labor intensive and consists of a series of subjective judgments.⁹⁶ Although a manufacturer can correct product defects by refining the production process, an infinite array of subjective decisions prevents an accountant from implementing a standard procedure to eliminate the risk of an errant interpretation of client data.⁹⁷

Additionally, the accountant already has incentives, other than potential liability, to perform careful audits. Reputation is a valuable com-

92. Siliciano, *supra* note 18, at 1961. See generally Carmichael, *The Auditor's New Guide to Errors, Irregularities and Illegal Acts*, J. ACCT., Sept. 1988, at 40.

93. Mednick, *supra* note 90, at 122.

94. *Id.*

95. See *supra* notes 69-71 and accompanying text.

96. See generally Akresh & Tatum, *Audit Sampling—Dealing With the Problems*, J. ACCT., Dec. 1988, at 58; Callahan, Jaenicke & Neebes, *SAS nos. 56 and 57: Increasing Audit Effectiveness*, J. ACCT., Oct. 1988, at 56; Conner, *Enhancing Public Confidence in the Accounting Profession*, J. ACCT., July 1986, at 76; Ellingsen, Pany & Fagan, *SAS no. 59: How to Evaluate Going Concern*, J. ACCT., Jan. 1989, at 24; Mednick, *The Auditor's Role in Society: A New Approach to Solving the Perception Gap*, J. ACCT., Feb. 1986, at 70.

97. Siliciano, *supra* note 18, at 1961-62. At some point, increasing personnel or increasing the length of the audit may lead to increased, rather than decreased, audit risk. Increased personnel present potential supervision problems. Extended audits increase the risk that accounting data will become dated and thus more difficult to audit. *Id.* at 1962.

modify for an accountant. Clients insist on competent audits because they rely on the quality of information produced.⁹⁸ In addition, the accountant's reputation may enhance the client's ability to obtain credit.⁹⁹ In a competitive service industry, incompetent accountants will not survive.¹⁰⁰ Proponents of the foreseeability rule have not conclusively established that an expansion of potential plaintiffs will significantly further deter accountant negligence.

3. *Role of the Accountant*

The accountant's role as "public watchdog"¹⁰¹ is perhaps the least persuasive justification for the erosion of *Ultramares*. The expanded role of public accountants since *Ultramares*¹⁰² does not require abandonment of the privity requirement. In fact, the argument that the expanded perception of the accountant's role in society justifies an expanded duty of care is based on a misinterpretation of both the Supreme Court decision in *United States v. Arthur Young & Co.*¹⁰³ and the AICPA Professional Standards. In *International Mortgage Co. v. John P. Butler Accountancy Corp.*, the case through which California adopted the foreseeability rule, the court cited both the Supreme Court's comparison of the accountant to a "public watchdog"¹⁰⁴ and the AICPA's acknowledgement of a responsibility to the public¹⁰⁵ as authority for abandoning the privity requirement. The *International Mortgage* court, however, failed to identify the context of the quotes it used.¹⁰⁶

98. Goldberg, *supra* note 85, at 302.

99. Siliciano, *supra* note 18, at 1953.

100. The AICPA, along with similar organizations for each state, seeks to protect the reputation of the public accounting industry by regulating licensing of certified public accountants (CPAs). A 150-hour post secondary education requirement, AICPA, BYLAWS § 2.2.3 (1988), a uniform examination, *id.* at § 2.2.2, continuing practice education, *id.* at § 2.3.3, and peer reviews, *id.* at § 2.3.4, are examples of methods established by the AICPA to protect the public from incompetent accountants. In addition, the AICPA sanctions substandard performances with suspension or expulsion of the offending member. *Id.* at § 7.

101. *See supra* notes 72-76 and accompanying text.

102. *See supra* note 72 and accompanying text. *See also* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 218 (1976) (Blackmun, J., dissenting) (quoting *In re Touche, Niven, Bailey & Smart*, 37 S.E.C. 629, 670-71 (1957) ("in certifying statements the accountant's duty 'is to safeguard the public interest, not that of his client'")).

103. 465 U.S. 805 (1984).

104. *See supra* note 75 and accompanying text. *See also infra* notes 107-109 and accompanying text.

105. *See supra* note 74 and accompanying text. *See also infra* notes 110-114 and accompanying text.

106. For example, in *International Mortgage*, the quote from *Arthur Young* begins: "An in-

In *Arthur Young*, an accounting firm claimed a work-product privilege while contesting an IRS subpoena for tax accrual work papers prepared during an audit engagement. The Supreme Court distinguished the accountant's work product from the attorney's work product¹⁰⁷ by noting that the attorney's role as the client's advocate is to present the client's case in the most favorable light.¹⁰⁸ Conversely, the Court noted that by certifying the financial statements of the client, the CPA assumes a public responsibility, a "public watchdog" function, which redefines the accountant's role as a disinterested analyst.¹⁰⁹ In *Arthur Young*, the Supreme Court addressed only the evidentiary issue of the accountant work-product privilege. Consequently, *Arthur Young* is not persuasive authority for extending accountant liability for negligence.

Similarly, the AICPA standards do not support the foreseeability rule.¹¹⁰ As the court in *International Mortgage* noted, the standards promulgated by the AICPA emphasize the profession's public responsibility.¹¹¹ However, this responsibility to the public, read in light of the related standards that are the philosophical foundation of the AICPA Rules of Conduct,¹¹² means merely that "those who depend upon a certified public accountant . . . have a right to expect . . . that he is a person of

dependent certified public accountant performs a different role." *International Mortgage Co. v. John P. Butler Acct. Corp.*, 177 Cal. App. 3d at 817, 223 Cal. Rptr. at 225. The court, however, failed to discuss the context in which the Supreme Court was defining the accountant's role. The following discussion clarifies this context.

107. See *Hickman v. Taylor*, 329 U.S. 495 (1947).

108. *Arthur Young*, 465 U.S. at 817.

109. *Id.*

110. See *supra* note 74 and accompanying text.

111. AICPA, PROFESSIONAL STANDARDS ET § 51.04 (CCH 1984). See *supra* note 74 and accompanying text.

112. *Id.* § 51.08. In fact, when *International Mortgage* was decided, the AICPA Rules of Conduct did not discuss the accountant's responsibility to the public. AICPA, BYLAWS AND RULES OF CONDUCT 37-43 (1981). In order to promote public confidence in the accounting industry, the AICPA amended the Code of Professional Conduct on January 12, 1988. AICPA, CODE OF PROFESSIONAL CONDUCT (1988). The new Code of Professional Conduct explicitly recognized the accountant's responsibility to the public. Article II of the Code provides:

The Public Interest

Members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism. A distinguishing mark of a profession is acceptance of its responsibility to the public. The accounting profession's public consists of clients, credit grantors, governments, employers, investors, the business and financial community, and others who rely on the objectivity and integrity of certified public accountants . . .

In discharging their professional responsibilities, members may encounter conflicting pressures from among each of those groups. In resolving those conflicts, members should

competence and integrity."¹¹³ There is a substantial difference between a responsibility to perform an audit with "competence and integrity" and liability to all who foreseeably rely on a client's financial statements.¹¹⁴

4. *Third Party as Innocent Investor*

Casting the reliant third party in the role of innocent victim,¹¹⁵ while emotionally appealing, is often unrealistic. This characterization is based on the premise that the third party could not reduce his risk of loss. Plaintiffs in accountant negligence suits, however, usually are sophisticated commercial creditors who willingly participate in business ventures that reward financial risk.¹¹⁶ Expanding the privity requirement gives third parties a windfall guaranty.¹¹⁷ Without a privity requirement, the creditor benefits from risk reduction and the accountant bears the additional cost. The added security provided by this judicially established guaranty creates an illogical incentive for creditors to relax their efforts to control the risks inherent in the transaction.¹¹⁸

Available means of protection also should estop third parties from

act with integrity, guided by the precept that when members fulfill their responsibility to the public, clients' and employers' interests are best served.

Those who rely on certified public accountants expect them to discharge their responsibilities with integrity, objectivity, due professional care, and a genuine interest in serving the public.

Id. at 4.

Thus, the accountants acknowledge a responsibility to the public to perform with objectivity and integrity. Recognition of this duty, however, does not support the erosion of the privity doctrine.

113. AICPA, PROFESSIONAL STANDARDS, *supra* note 111, § 51.03.

114. In fact, an accountant who is not disinterested and nevertheless compromises his integrity by issuing certified financial statements would be liable to nonprivity third parties under *Ultramares* because privity is not a defense to fraud. See *supra* note 36 and accompanying text.

115. See *supra* notes 77-80 and accompanying text.

116. Siliciano, *supra* note 18, at 1955. A review of the landmark accountant liability cases supports this sophisticated creditor characterization. *International Mortgage Co. v. John P. Butler Acct. Corp.*, 177 Cal. App. 3d 806, 223 Cal. Rptr. 218 (1986) (subsidiary of a major real estate developer); *H. Rosenblum, Inc. v. Adler*, 93 N.J. 324, 461 A.2d 138 (1983) (owners of retail catalog showrooms); *Credit Alliance v. Arthur Andersen & Co.*, 65 N.Y.2d 536, 483 N.E.2d 110, 493 N.Y.S.2d 435 (1985) (major financial service company); *Ultramares Corp. v. Touche, Niven & Co.*, 255 N.Y. 170, 174 N.E. 441 (1931) (corporation engaged in business as a factor); *Citizens State Bank v. Timm, Schmidt & Co.*, 113 Wis. 2d 376, 335 N.W.2d 361 (1983) (bank).

117. Establishing accountant liability to third parties is "equivalent to making [the accountant] a guarantor against an elastically defined set of unfortunate events." Goldberg, *supra* note 85, at 296. "The fuzzy contours of the accountant's court-determined guarantee increase the costs of providing that guarantee. The open-endedness of the foreseeability standard and the court's temptation to fine-tune the package by manipulating such doctrines as foreseeability, reasonable reliance, and the content of negligence makes fuzziness nearly inevitable." *Id.* at 306.

118. Siliciano, *supra* note 18, at 1948. See *supra* notes 27-28 and accompanying text for a brief

claiming helplessness. Under the *Glanzer* exception to *Ultramares*,¹¹⁹ a third party can recover for accountant negligence if the purpose of the audit was to provide information to the third party.¹²⁰ Third parties can also contract to receive the additional assurance of certified financial statements.¹²¹ If the third-party chooses not to contract with the accountant, numerous other methods, such as guaranties and security interests in specific assets, are available to enable the third-party creditor to obtain the desired level of assurance.¹²² Thus, creditors remain unprotected third parties by choice.¹²³

Without the privity requirement, the accountant cannot identify reliable third parties and adjust fees to reflect adequately the potential liability exposure. Under *Ultramares*, third parties can obtain assurance through contracts that define the scope of accountant liability. Given this ability, a third party who chooses not to obtain the available assurance should not gain windfall legal protection through the foreseeability doctrine.

5. Insurance Protects the Accountant

Reliance on the insurance mechanism to protect accountants from the indeterminate liability of the foreseeability rule¹²⁴ is problematical at best. The *Rosenblum* court cited insurance statistics to support its belief that accountants could obtain malpractice insurance to cover liability to

discussion of the hazards associated with allowing third parties to recover for economic loss in general.

The same rationale applies to individual investors as well as creditors. An individual makes a conscious decision to accept risk when he forgoes the lower return of low-risk investments (such as treasury bills) and seeks the higher return of more risky investments. The investor has methods to reduce risk, such as diversification, but a guaranty from an accountant overcompensates the risk-seeking investor in relation to the risk-averse investor by reducing the risk of high-return investments. See Siliciano, *supra* note 18, at 1973.

119. See *supra* notes 32-35 and accompanying text.

120. *Ultramares*, 255 N.Y. at 182-83, 174 N.E. at 445-46.

121. See Goldberg, *supra* note 85, at 312 ("If investors want assurance against losses arising from accountant negligence or other causes, they can purchase it. . . . The accountant's liability to third parties should be determined *entirely* by voluntary agreement." (emphasis added)); Siliciano, *supra* note 18, at 1956 (It is reasonable to expect the third party to contract with the accountant, because "[i]n contrast to the product consumer, the sophisticated third party creditor in the accounting cases is in a direct bargaining relationship with the primary risk creator—the accountant's client.").

122. Goldberg, *supra* note 85, at 305.

123. *Id.* at 302.

124. See *supra* notes 81-83 and accompanying text.

all foreseeable third parties.¹²⁵ The court, however, failed to consider the long-term effects of this response. A radical expansion of accountant liability, such as the abandonment of the privity requirement, will certainly have an impact on insurance availability.

The "tort crisis" of the mid-1970s demonstrated that insurance can be an ineffective means to support expanded liability.¹²⁶ Insurance premiums are based on both the magnitude of potential loss and risk predictability.¹²⁷ Insurers react to uncertainty in tort liability by charging higher premiums, not only to cover higher claim payments, but also to compensate for the risk of unanticipated losses.¹²⁸ Insurance companies responded to expanded liability for medical malpractice and product liability during the mid-1970s by increasing premiums on many policies several hundred percent per year. Several insurance companies went so far as to refuse to issue some types of liability policies.¹²⁹ The severe disruption caused by expanded medical malpractice liability during this period¹³⁰ resulted in legislative intervention to ameliorate the disturbance

125. See *supra* note 83 and accompanying text.

126. See H. STEINER, MORAL ARGUMENT AND SOCIAL VISION IN THE COURTS 103-04 (1987); Danzon, *Tort Reform and the Role of Government in Private Insurance Markets*, 13 J. LEGAL STUD. 517 (1984).

127. Berger, *The Impact of Tort Law Development on Insurance: The Availability/Affordability Crisis and Its Potential Solutions*, 37 AM. U.L. REV. 285, 300 (1988).

128. *Id.* See also Abraham, *Making Sense of the Liability Insurance Crisis*, 48 OHIO ST. L.J. 399, 404-05 (1987); Schmit, *Insurance Versus Indemnification: An Argument for Stare Decisis*, 34 DEF. L.J. 125, 129-30 (1985). Insurers establish premiums based on past experience with similar risks. "If the information accumulated about the experience of comparable ventures in the past is both substantial and accurate, an actuary usually can project the average incidence and the average cost of the harmful experience with sufficient precision for an insurer to establish an appropriate premium." R. KEETON & A. WIDISS, *INSURANCE LAW: A GUIDE TO FUNDAMENTAL PRINCIPLES, LEGAL DOCTRINES, AND COMMERCIAL PRACTICES* § 1.3(b)(2) (1988). However, if liability exposure increases, past experience becomes outdated and unreliable. Consequently, projection of the average incidence and average cost of losses becomes less accurate and insurers must increase premiums to compensate for the increased risk of unexpected losses.

129. Danzon, *supra* note 126, at 517.

130. See generally Grad, *Medical Malpractice and the Crisis of Insurance Availability: The Waning Options*, 36 CASE W. RES. 1058 (1986); Londrigan, *The Medical Malpractice Crisis*, 21 TRIAL, May 1985, at 22; Nye, Gifford, Webb & Dewar, *The Causes of the Medical Malpractice Crisis: An Analysis of Claims Data and Insurance Company Finances*, 76 GEO. L.J. 1495 (1988); Redlich, *Ending the Never-Ending Medical Malpractice Crisis*, 38 ME. L. REV. 283 (1986); Redlich, *Understanding the Medical Malpractice Crisis*, 57 N.Y. ST. B. J. Oct. 1985, at 38 (1985); Robinson, *The Medical Malpractice Crisis of the 1970's: A Retrospective*, 49 LAW & CONTEMP. PROBS. 5 (Spring 1986); Note, *The Medical Malpractice Crisis: Will No-Fault Cure the Disease?*, 9 U. HAW. L. REV. 241 (1987); Note, *Arbitration: An Antidote to New York's Medical Malpractice Crisis*, 11 VT. L. REV. 577 (1986); Note, *Perspectives on the Insurance Crisis*, 5 YALE J. ON REG. 367 (1988).

in the insurance market.¹³¹

Expanded accountant liability already has affected accountant malpractice insurance. From 1984—the year after *Rosenblum* was decided—through 1987, insurance premiums for large CPA firms increased 500%, coverage was cut in half, and deductibles were increased.¹³² The impact on smaller firms has been even greater, causing many of them to drop insurance coverage¹³³ or go out of business.¹³⁴ Many insurance carriers no longer offer accountant liability insurance.¹³⁵ In short, the accountant malpractice insurance problem is nearing a crisis stage, similar to that experienced a few years ago by the medical profession.¹³⁶ As with medical malpractice liability, state legislation designed to limit accountant liability may prove necessary to resolve the emerging accountant insurance crisis.

III. LEGISLATIVE RESPONSE: ACCOUNTANT PRIVACY STATUTES

Although arguments for the foreseeability rule have some appeal,¹³⁷ the benefits derived from expanded accountant liability do not outweigh the costs of allowing recovery for economic damages without a privity

131. See generally, Quinn, *Health Care Malpractice Claims Statute: Maryland's Response to the Medical Malpractice Crisis*, 10 U. BALT. L. REV. 74 (1980); Note, *A Cure for the Medical Malpractice Crisis*, 37 ALA. L. REV. 183 (1985); Note, *The 1985 Medical Malpractice Reform Act: The New York State Legislature Responds to the Medical Malpractice Crisis with a Prescription for Comprehensive Reform*, 52 BROOKLYN L. REV. 135 (1986); Comment, *An Analysis of State Legislative Responses to the Medical Malpractice Crisis*, 1975 DUKE L.J. 1417; Note, *Improved Regulation of Maine Physicians: One Solution to the Medical Malpractice Crisis*, 38 ME. L. REV. 449 (1986); Comment *Recent Medical Malpractice Legislation—A First Checkup*, 50 TUL. L. REV. 655 (1976); Note, *Ohio's Attempts to Halt the Medical Malpractice Crisis: Effective or Meaningless?*, 9 U. DAYTON L. REV. 361 (1984); Note, *Medical Malpractice Legislation: The Kansas Response to the Medical Malpractice Crisis*, 23 WASHBURN L.J. 566 (1984); Note, *Medical Malpractice Damage Caps: Navigating the Safe Harbors*, 65 WASH. U.L.Q. 565 (1987).

132. AICPA, *Everyone Pays: The Harsh Trends of Civil Suits*, J. ACCT, Sept. 1987, at 119.

133. Goldberg, *supra* note 85, at 296; AICPA, *supra* note 132, at 119 ("One out of five firms responding to a recent Wisconsin Institute of CPAs survey of its members indicated that it had been forced to drop its professional insurance coverage").

134. Goldberg, *supra* note 85, at 303.

135. See Berton, *Small CPA Firms' Liability Rates Soar*, Wall St. J., Nov. 19, 1985, at 6, col. 1 (of the dozens of insurance carriers that had offered coverage to small and middle-size accounting firms, only three remain); Miller, *supra* note 7, at 57.

136. Siliciano, *supra* note 18, at 1950 ("precipitous rate surges, in turn, may trigger the fatal 'unraveling' of insurance risk pools, as those accounting firms that can best manage and regulate risk opt out in favor of self-insurance").

137. See *supra* notes 66-83 and accompanying text. See *supra* notes 89-136 and accompanying text for weaknesses in the arguments for the foreseeability rule.

requirement. The expansion of accountant liability in some states,¹³⁸ along with the potential for privity erosion in others, is likely to trigger an accountant liability crisis.¹³⁹ State legislatures, rather than courts, are better suited to weigh the competing policy issues and define the rights and responsibilities of both the accountant and third parties.¹⁴⁰ In addition, experience with medical malpractice insurance shows that legislative response to the emerging accountant insurance crisis is necessary. The issue of accountant liability is ripe for legislative consideration.

A. Privity Statutes Provide Certainty

Three state legislatures have intervened in response to the developing problems caused by expanded accountant liability. Illinois,¹⁴¹ Arkansas,¹⁴² and Kansas,¹⁴³ recently enacted privity statutes. Although the

138. See *supra* notes 54 and 59.

139. See *supra* notes 126-136 and accompanying text.

140. Without guidance from state legislatures, courts are left to decide cases and establish case law based on equitable principles. Admittedly, time constraints, political pressures, and an inability to predict the future prevent legislatures from enacting statutes to govern every conceivable dispute. However, when a substantial debate over a policy issue arises, it is preferable to resolve the dispute through the legislative process. By the time a case reaches the courts, a party has been injured and a court must decide who will bear the loss. The legislature, however, can design a statute that specifically defines rights and duties before the harm has occurred, thus making results more predictable.

In addition, statutes can correct unpopular court decisions. Danzon, *supra* note 126, at 517 ("Statutory tort reform may be viewed as a collective choice to override the private choices reflected in the evolution of common law").

141. ILL. REV. STAT. ch. 111, para. 5535.1 (1987), entitled "Liability—Privity of contract," provides as follows:

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

(1) such acts, omissions, decisions or conduct that constitute fraud or intentional misrepresentations, or

(2) such other acts, omissions, decisions or conduct, if such person, partnership or corporation was aware that a primary intent of the client was for the professional services to benefit or influence the particular person bringing the action; provided, however, for the purposes of this subparagraph (2), if such person, partnership or corporation (i) identifies in writing to the client those persons who are intended to rely on the services, and (ii) sends a copy of such writing or similar statement to those persons identified in the writing or statement, then such person, partnership or corporation or any of its employees, partners, members, officers or shareholders may be held liable only to such persons intended to so rely, in addition to those persons in privity of contract with such person, partnership or corporation.

142. ARK. STAT. ANN. § 16-114-302 (1987), entitled "Liability of accountants," provides:

No person, partnership, or corporation licensed or authorized to practice under the Public Accountancy Act of 1975, § 17-12-101 et seq., or any of its employees, partners, mem-

statutes are not identical, the effect of each is essentially the same. The statutes require the accountant, client, and third parties to determine their respective rights and duties before the third party relies on the financial statements.¹⁴⁴

Accountant privity statutes provide certainty, thus permitting all parties in financial transactions to make better informed business decisions. To the extent that expanded liability deters accountant negligence,¹⁴⁵ the statutes promote efficiency because the accountants can adjust audit procedures if they know before performing the audit that they may be liable to additional parties. Precise definition of the circumstances under

bers, officers, or shareholders shall be liable to persons not in privity of contract with the person, partnership, or corporation for civil damages resulting from acts, omissions, decisions, or other conduct in connection with professional services performed by such person, partnership, or corporation, except for:

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

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

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

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

143. KAN. STAT. ANN. § 1-402 (1987), entitled "Liability for professional negligence; restrictions," provides:

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

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

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

144. The statutes specifically relate only to accountant negligence. ARK. STAT. ANN. § 16-114-302(1) (1987); ILL. REV. STAT. ch. 111, para. 5535.1(1) (1987); KAN. STAT. ANN. § 1-402 (1987). Thus, the statutes do not change the common-law rule that privity is not a defense to fraud or intentional misrepresentations. *See supra* note 36 and accompanying text. Nor do the state statutes affect suits based on federal laws. *See supra* note 39.

145. The deterrent effect of expanded accountant liability is questionable. *See supra* notes 69-71 and 95-100 and accompanying text.

which the third parties can recover for accountant negligence permits the client, investors, and third-party creditors to negotiate more efficiently.¹⁴⁶ Moreover, the statutes unequivocally establish the state's position without leaving the policy determination to the courts.

B. Comparison of Enacted Privy Statutes

Because certainty is a key element of accountant privacy legislation,¹⁴⁷ the language of these statutes should specifically identify the requirements for third-party reliance. The Illinois, Arkansas, and Kansas statutes each resolve the problem of indeterminate accountant liability by limiting third-party negligence claims. The differences between the Illinois and Arkansas statutes are insignificant.¹⁴⁸ The Kansas statute, however, applies an alternative approach with several significantly different requirements for third-party reliance.

Under the Illinois and Arkansas statutes, liability for negligence arises only if the accountant was aware that the client intended to use the accounting services to influence a third party.¹⁴⁹ Additionally, Illinois and Arkansas limit liability to specifically identified third parties if the accountant sends written notice to both the client and the third party acknowledging the reliance.¹⁵⁰ The Kansas statute requires written identification of both third parties and the covered transactions.¹⁵¹ Kansas allows third-party identification after the time of the engagement, provided that both the accountant and the client agree.¹⁵² Although neither approach is clearly superior, this section will evaluate the effectiveness of each approach in terms of the certainty provided by the requirements for third-party reliance.

Both approaches allow third-party recovery only if the accountant knew that the third party would rely on the accounting services. The

146. *See supra* notes 115-123 and accompanying text. The third party has the option to demand inclusion in the statutorily defined group that can hold the accountant liable for negligence. The decision to comply with the statutory requirements for inclusion in this group—like the demand for collateral, a personal guaranty, or a higher interest rate—is determined by the third party's risk tolerance and desired return.

147. *See supra* note 126-128 and accompanying text.

148. *See supra* notes 141-142. Because of the similarity, for the purposes of the following statute comparison, the Illinois and Arkansas statutes are grouped together as one approach.

149. ARK. STAT. ANN. § 16-114-302(2) (1987); ILL. REV. STAT. ch. 111, para. 5535.1(2) (1987).

150. ARK. STAT. ANN. § 16-114-302(2)(A) and (B) (1987); ILL. REV. STAT. ch. 111, para. 5535.1(2)(i) and (ii) (1987).

151. KAN. STAT. ANN. § 1-402(b) (1987).

152. *Id.*

Kansas statute specifies that the accountant and client may agree either before or after the engagement.¹⁵³ The Illinois and Arkansas statutes, however, do not state when the identification of third parties must occur.¹⁵⁴ Although accountant knowledge of third-party reliance before the audit is sufficient to establish liability under either statute, the Illinois and Arkansas statutes leave open the question whether the accountant can consent after the engagement. In order to clarify the requirements of third-party reliance, to encourage freedom of contract, and to promote the free flow of information, future accountant privity statutes should follow the Kansas approach and clearly specify that consent after the engagement is sufficient to bind the accountant.

The two approaches also differ as to which transactions accountant liability is extended. Under the Kansas statute, accountant liability to third parties is limited to "services rendered in connection with specified transactions described in writing."¹⁵⁵ In contrast, the accountant need only be aware that the services would influence a "particular person" under the Illinois and Arkansas statutes.¹⁵⁶ Limiting liability to certain persons addresses the "indeterminate class" problem,¹⁵⁷ but does not settle the concern of "liability in an indeterminate amount."¹⁵⁸ Future accountant privity statutes should follow the Kansas approach and restrict third-party recovery to liability arising from agreements that specify both reliant third parties and covered transactions.¹⁵⁹ This approach would encourage agreement between the accountant, client, and third parties, and resolve the impending accountant liability crisis by limiting the accountant's exposure to determinate amounts.

Finally, the documentation requirements of the two approaches also differ. While the Illinois and Arkansas statutes require only that the accountant be "aware" that the primary intent of the client was to influence the third party,¹⁶⁰ the Kansas statute demands written

153. *Id.* § 1-402(b)(1).

154. *See supra* notes 141-142.

155. KAN. STAT. ANN. § 1-402(b)(2).

156. ARK. STAT. ANN. § 16-114-302(2) (1987); ILL. REV. STAT. ch. 111, para. 5535.1(2) (1987).

157. *See supra* note 31 and accompanying text.

158. *Id.* For example, an accountant's acquiescence to a particular bank's reliance on financial statements to finance a small piece of machinery subjects the accountant to much less liability than consent to allow that bank to rely on the statements while issuing unlimited loans to the client.

159. Identification of the covered transaction will not be a substantial burden once the parties agree on which third parties can rely on the accountant's work. In fact, written transaction identification is merely a record of the parties' intent as to the scope of intended reliance.

160. The Illinois and Arkansas statutes allow negligence suits by third parties if the accountant

documentation of intended reliance.¹⁶¹ Third-party claims for accountant negligence, by definition, involve at least three participants: the accountant, the client, and the reliant third party. In actual business transactions, the number of participants, and therefore the possibility of miscommunication, is likely to be greater. The Kansas approach, mandating a written agreement, provides a simple mechanism to reduce the chance of misunderstanding the accountant's duty to third parties.

Although the Kansas statute requires written identification of third parties, the accountant is not required formally to acknowledge this expanded duty. The Illinois and Arkansas statutes, on the other hand, permit the accountant to limit liability by sending confirmations to certain third parties, who then are alone in being entitled to rely upon the accountant's work product.¹⁶² Requiring evidence of the accountant's knowledge that certain third parties are intended to rely on the financial statements increases the effectiveness of the accountant privity statute. The required confirmation of third-party reliance in Illinois and Arkansas provides more certainty because the third party knows before reading a financial statement whether he can recover from the accountant if the statements are negligently prepared. Potential reimbursement from the negligent accountant can then be a factor in the third party's decision to extend credit or invest in the client.

IV. CONCLUSION

Proponents of the foreseeability rule for accountant negligence have advanced several arguments to support their position. Defenders of the privity requirement have advocated their position with the same vigor. As the debate continues, the increased liability in some jurisdictions and uncertainty in others seem likely to bring about a liability crisis in the accounting industry. In light of the continuing debate, the most prudent course may lie in accountant privity statutes. State legislatures are

was "aware that a primary intent of the client was for the professional services to benefit or influence the particular person bringing the action." ARK. STAT. ANN. § 16-114-302(2) (1987); ILL. REV. STAT. ch. 111, para. 5535.1(2) (1987). Whether or not the accountant was "aware" of a client's intent is not always readily discernable. Thus, these provisions of the statutes do not provide certainty for the accountant or the third party. Both the Illinois and Arkansas statutes, however, have optional provisions that provide a more definite method of liability determination before the third-party reliance. See *infra* note 162 and accompanying text.

161. KAN. STAT. ANN. § 1-402(b)(1).

162. ILL. REV. STAT. ch. 111, para. 5535.1(2)(i)-(ii) (1987); ARK. STAT. ANN. § 16-114-302(2)(A)-(B) (1987).

uniquely qualified to balance the competing policy issues and establish specific procedures for defining the scope of accountant liability to third parties. Ironically, the issue of accountant liability has now come full circle. Judge Cardozo suggested the solution nearly sixty years ago in *Ultramares Corp. v. Touche, Niven & Co.*: “[a] change so revolutionary . . . [in the accountant’s duty of care] must be wrought by legislation.”¹⁶³

Eric R. Fencil

163. *Ultramares*, 255 N.Y. at 187, 174 N.E. at 447.