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AN ACCOUNTANT'S LIABILITY TO THIRD PARTIES:  
*BILY v. ARTHUR YOUNG & CO.*

INTRODUCTION

Since Judge Benjamin Cardozo's seminal 1931 opinion in *Ultramares Corp. v. Touche, Niven & Co.*,¹ the role and responsibility of the accountant has been a source of debate.² A byproduct of this debate is the issue of whether and to what extent an accountant can be held liable in negligence to third parties who rely on information provided by the accountant. *Ultramares*, which held that privity is required for a third-party lender to recover in a negligence action,³ was the cornerstone for the development of accountant fraud and negligence liability in the United States. Although the decision still maintains a loyal following, as the accounting function has evolved accountants’ liability has gradually expanded, resulting in a wider range of third parties in negligence actions.⁴

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4. See *Restatement (Second) of Torts* § 552 (1977) (using the “reasonably foreseeable” approach to include more third parties in the accountant’s duty of care); H. Rosenblum, Inc. v.
Today, state courts apply one of three major approaches in determining the extent to which a negligent accountant or auditor is liable to relying third parties. These approaches are: (1) extending liability only to those third parties who are in contractual privity with the accountant;\(^5\) (2) limiting liability to a specific and narrow class of third parties whom the accountant actually foresees;\(^6\) and (3) extending liability to reasonably foreseeable third parties.\(^7\)

This Note begins by discussing the expanded role and responsibility of accountants in today's society.\(^8\) Although an audit report is addressed to a company's management, its primary purpose today is often to influence the actions of third party investors and lenders. This Note then describes the historical background of the accountant's common law liability for negligence as it evolved from the strict privity approach of *Ultramares* to the current trend of holding Certified Public Accountants ("CPAs") responsible to reasonably foreseeable third parties.\(^9\)

Next, this Note critically examines the recent California Supreme Court decision in *Bily v. Arthur Young & Co.*\(^{10}\) and discusses the logical implications of this decision.\(^{11}\) Finally, the Note criticizes the *Bily* case as taking a step backwards with regard to accountant liability, and instead advocates the application of a traditional negligence philosophy to accountants' negligence liability by employing the reasonably foreseeable approach.

### I. The Role and Responsibility of the Accountant

Although accountants are selected and compensated by their cli-
ents, their obligations and responsibilities may extend beyond the client to third-party investors or lenders.12

A. The Audit Function and Process

While accountants provide an array of services to clients, today the primary function of a CPA13 is auditing.14 Simply put, an audit is performed to verify an entity’s financial statements;15 this is done by examining accounting records and supporting evidence during an audit engagement.16 In an audit engagement, the auditor conducts an independent examination of the financial statements prepared by a client17 and expresses an opinion as to whether such statements fairly represent the company’s actual financial position and operations in accordance with generally accepted accounting principles (“GAAP”).18 The audited company then uses this audit report for

12. Travis M. Dodd, Accounting Malpractice and Contributory Negligence: Justifying Disparate Treatment Based Upon the Auditor’s Unique Role, 80 GEO. L.J. 909, 909 (1992).

13. The terms “CPA,” “accountant,” and “auditor” will be used interchangeably throughout this Note. An accountant is a “[p]erson who works in [the] field of accounting and is skilled in keeping books or accounts.” BLACK’S LAW DICTIONARY 19 (6th ed. 1990). An auditor is “[o]ne who checks the accuracy, fairness, and general acceptability of accounting records and statements and then attests to them.” Id. at 131. A CPA is an individual who is certified by a state board of accountancy. Each state board grants the CPA certificate to those who demonstrate their competence (1) by passing the national examination administered by the American Institute of Certified Public Accountants (“AICPA”), and (2) by satisfying educational and practical experience requirements. ANTHONY PHILLIPS ET AL., BASIC ACCOUNTING FOR LAWYERS 64 (4th ed. 1988); ROBERT O. BERGER, JR., PRACTICAL ACCOUNTING FOR LAWYERS 5-7 (1981).

14. See Gossman, supra note 2, at 213 (“For several decades, the most common service offered by large accounting firms has been auditing.”); Hagen, Effect of Compliance, supra note 2, at 66 (explaining that although a CPA performs tax and management advisory services, a CPA’s primary function is auditing).

15. The four basic financial statements are: (1) the balance sheet, (2) the income statement, (3) the statement of retained earnings, and (4) the cash flow statement.


17. Management, not the auditors, prepares the financial statements. Phillip R. Lochner, Jr., Black Days for Accounting Firms, J. ACCT., Aug. 1992, at 105, 108. Typically, auditors sample and test numbers from the financial statements prepared by the client. Id.

18. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, AICPA PROFESSIONAL STANDARDS AU § 110.01, at 61 (1993) [hereinafter AICPA STANDARDS]; see also Paschall, supra note 2, at 698-99 (describing the function of an audit); Siliciano, supra note 2, at 1931-32 (describing the audit process).

“Generally accepted accounting principles,” or “GAAP,” has been defined broadly as “a technical accounting term which encompasses the conventions, rules, and procedures necessary to define accepted accounting practice at a particular time.” AICPA STANDARDS, supra, AU § 411.02, at 485; see also MARTIN A. MILLER, COMPREHENSIVE GAAP GUIDE (1992) (containing all the promulgated and nonpromulgated accounting principles in use today, and providing explanations and in-depth illustrations of the application of specific accounting principles).
its own business planning. In addition, the audit report is used to inform outside parties as to the financial health of the audited company.

For practical reasons of cost and time, an auditor is rarely able to examine every accounting transaction of a business. Therefore, the performance of an audit requires a high degree of professional skill and judgment, as the auditor can only test the output of the entity’s accounting systems. In performing an audit, an auditor follows procedures referred to as generally accepted auditing standards ("GAAS"). Initially, a CPA plans an audit by assessing the client’s business operations and accounting systems. With this knowledge in hand, the accountant begins by making preliminary planning decisions regarding the scope, methods, and procedures which will be employed throughout the audit. The auditor then evaluates the internal control structure of the client and chooses whether or not to place reliance on some or all of the internal control systems of the client, thereby reducing the need to test actual transactions and account balances. But in order to rely on the client’s internal controls, the auditor must perform procedures which will determine if the entity’s system of internal controls is functioning properly.

19. Paschall, supra note 2, at 699.
20. Id. A company’s audited financial statements give the user an assurance that the financial status of the company is accurately represented in the financial statements. Id.
21. Bily v. Arthur Young & Co., 834 P.2d 745, 749 (Cal. 1992); see also PHILLIPS ET AL., supra note 13, at 64 (stating that an examination of 100 percent of the records is too time-consuming and costly).
22. Bily, 834 P.2d at 749.
24. Hagen, Effect of Compliance, supra note 2, at 67; see also AICPA STANDARDS, supra note 18, AU § 311, at 229-31 (providing planning and supervision standards). Audit planning involves developing an overall strategy for the expected conduct and scope of the audit. To accurately plan the audit, the auditor must acquire knowledge of the nature of the entity’s business and operations. Id.
25. Bily, 834 P.2d at 749. For a discussion of the auditor’s planning requirements, see AICPA STANDARDS, supra note 18, AU §§ 311-12, at 229-31; Hagen, Effect of Compliance, supra note 2, at 67.
26. The “internal control structure policies and procedures relevant to an audit” are defined as the policies and procedures that “pertain to the entity’s ability to record, process, summarize, and report financial data consistent with management’s assertions embodied in the financial statements.” AICPA STANDARDS, supra note 18, AU § 319.67, at 282. See generally AICPA STANDARDS. supra note 18, AU § 319, at 265-88 (discussing the consideration of the internal control structure in a financial statement audit).
27. Bily, 834 P.2d at 749; Hagen, Effect of Compliance, supra note 2, at 68.
As a result, transactions and data are sampled, confirmed, verified, and traced through the client’s records.\textsuperscript{29} Auditing standards require an auditor to obtain "\textit{[s]ufficient competent evidential matter} . . . through inspection, observation, inquiries, and confirmations to afford a \textit{reasonable basis} for an opinion regarding the financial statements under audit."\textsuperscript{30} The "sufficient competent evidential matter" requirement does not mean that the auditor must examine 100 percent of the books, records, and supporting documents of the client. Instead, it only requires audit sampling.\textsuperscript{31} As the word implies, "sampling" embodies examination of less than all of the client’s records. Thus, there is some degree of uncertainty implicit in the concept of a "reasonable basis" for an opinion as referred to above.\textsuperscript{32}

Throughout the audit process, the auditor’s findings are examined and procedures are reevaluated and modified to reflect the auditor’s discoveries.\textsuperscript{33} Throughout each step of the audit, the auditor is constantly examining his findings to determine whether additional tests and procedures are required to give the auditor a "reasonable basis" for expressing an opinion on the financial statements. For instance, "if the auditor discovers weaknesses in the internal control system of the client, the auditor must plan additional audit procedures which will satisfy himself that the internal control weaknesses have not caused any material misrepresentations in the financial statements."\textsuperscript{34} For example, if the auditor discovers that the client allows the same person to both prepare and sign company checks, this would indicate a weakness in the client’s internal control procedures. Upon discovering such a weakness, the auditor would plan additional audit procedures to satisfy himself that this weakness has not caused any material misrepresentations in the client’s financial statements, such as nonexistent vendor expense accounts.\textsuperscript{35}

The end result of an audit is the audit report, or "opinion," which evaluates the information obtained to determine whether the client’s

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\item \textsuperscript{29} Hagen, \textit{Effect of Compliance}, \textit{supra} note 2, at 66-67.
\item \textsuperscript{30} AICPA \textit{Standards}, \textit{supra} note 18, AU § 350.04, at 463-3 (emphasis added).
\item \textsuperscript{31} \textit{Id.} AU § 350.03, at 463. There are two basic approaches to audit sampling: statistical and nonstatistical. \textit{Id.}
\item \textsuperscript{32} \textit{Id.} AU § 350.07, at 463-3.
\item \textsuperscript{33} \textit{See} Hagen, \textit{Effect of Compliance}, \textit{supra} note 2, at 67-68 (describing the need for continuous reevaluations throughout the audit process).
\item \textsuperscript{34} \textit{Id.} (footnotes omitted).
\item \textsuperscript{35} \textit{Id.}
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financial statements fairly represent the financial position of the business in accordance with GAAP. The audit opinion is expressed in a letter addressed to the client and can be one of four types: an unqualified opinion, a qualified opinion, an adverse opinion, or a disclaimer opinion.

An unqualified opinion, which is the focus of this Note, is the most frequently issued opinion. The unqualified opinion is an expression of opinion by a CPA without any exceptions, reservations, or qualifications that the financial statements of the audited business fairly represent its financial position and the results of its operations.

In a qualified opinion, on the other hand, the CPA states that

36. AICPA Standards, supra note 18, AU § 110.01, at 61; Paschall, supra note 2, at 701; see Wiener, supra note 2, at 237-38 (explaining that the auditor's report "normally forms the basis for any assertion of liability against [the CPA]"); because it usually contains representations that he has conducted the audit in accordance with GAAS and that the financial statements are presented in accordance with GAAP; see also infra notes 74-82 and accompanying text (defining GAAS in further detail and illustrating the effects of an accountant's departure from GAAS).

37. Bily v. Arthur Young & Co., 834 P.2d 745, 750 (Cal. 1992); see AICPA Standards, supra note 18, AU § 509.09, at 654 (stating that the report may be addressed to the audited company, the board of directors, or the company's stockholders).


39. The standard unqualified opinion, which is addressed to the company's board of directors and shareholders, currently reads as follows:

[Introductory paragraph]
We have audited the accompanying balance sheet of X Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended. 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 audit.

[Scope paragraph]
We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

[Opinion Paragraph]
In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 19XX, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

40. See Dodd, supra note 12, at 915 (stating that an unqualified report is the typical and most favorable report).

41. Hagen, Effect of Compliance, supra note 2, at 69; Paschall, supra note 2, at 701.

42. The qualified opinion includes an explanatory paragraph which must fully describe the rea-
an improper accounting treatment has been applied to one or more items and that, consequently, the financial statements are not in compliance with GAAP. This means that "except for" or "subject to" that particular matter, the financial statements do fairly present the financial position of that entity. A qualified opinion is usually issued when there are restrictions on the scope of the auditor's examination, a lack of competent evidential matter, a departure from GAAP, changes in the accounting principles applied, or significant uncertainties that affect the client's financial statements.

A CPA will issue an adverse opinion if any items have a material and pervasive effect on the financial statement, thus destroying their fairness of presentation. An adverse opinion states that "the financial statements . . . do not present fairly, in conformity with generally accepted accounting principles, the financial position . . . or the results of its operations or its cash flows for the year then ended."

A disclaimer opinion is a statement that the accountant does not...
express an opinion on the financial statements. A disclaimer opinion is rendered when the accountant is unable to form an opinion because of serious limitations on the scope of the examination of the audit, because the financial statements were unaudited, or because the auditor was not independent with respect to the client. Because an unqualified opinion is the opinion particularly relevant to the concern of accountant negligence liability, this Note focuses on the assertions made in the unqualified opinion.

B. Assertions Made in the Unqualified Audit Opinion

Ordinarily, after completion of the audit, the auditor issues an unqualified audit opinion assuring the client that its financial statements fairly represent its economic condition in conformity with GAAP. This opinion "serves as an assurance to the client paragraph stating the reasons for the disclaimer. Id. AU § 508.71, at 669.

53. Id. AU § 508.70, at 669; see also Hagen, Effect of Compliance, supra note 2, at 71 (explaining that a CPA attempts to avoid responsibility for the financial statements by issuing a disclaimer opinion); Paschall, supra note 2, at 703 (stating that a disclaimer opinion is issued when it is not objectively possible for the auditor to determine whether the financial statements are in conformity with GAAP).

54. A serious limitation on the scope of the audit would be, for example, a company's failure to take a physical inventory. AICPA STANDARDS, supra note 18, AU §§ 504.70-.72, at 669-70.

55. An unaudited financial statement is one where GAAS have not been applied, and a lesser function, such as a compilation, has been completed. Id. AU §§ 504.05-.06, at 602.

56. ALVIN A. ARENS & JAMES K. LOEBBECHE, AUDITING: AN INTEGRATED APPROACH 43-45 (3d ed. 1984) (illustrating when disclaimer opinions are appropriate); see also Hagen, Effect of Compliance, supra note 2, at 72 (discussing situations which warrant the use of a disclaimer opinion); Paschall, supra note 2, at 703 (stating that a disclaimer opinion is rendered when an accountant cannot form an opinion because of serious limitations on the scope of the audit). For a discussion of situations warranting a disclaimer opinion by the auditor, see AICPA STANDARDS, supra note 18, AU §§ 504.09-.10, at 603.

57. This Note focuses solely on the unqualified opinion and its effects on accountant liability because the unqualified opinion results in the greatest assurances by an accountant.

58. See supra notes 39-41 and accompanying text (discussing the unqualified opinion).

59. Siliciano, supra note 2, at 1932. When the auditor states that "the financial statements . . . present fairly . . . the financial position of . . . [the company] . . . in conformity with generally accepted accounting principles," the auditor is assuring that the:

(a) Accounting principles selected by the client have general acceptance.

(b) Accounting principles are appropriate for the client.

(c) Disclosures, such as financial statement notes, are adequate to allow the user to use, understand, and interpret the financial statements.

(d) Data presented in the financial statements are classified and summarized in a reasonable manner.

(e) Underlying events and transactions, within a range of acceptable limits, are reflected in the financial statements.

(f) The financial statements have not been materially affected by changes in accounting principles.

MILLER & BAILEY, supra note 23, at 11.06.
that its own perception of its financial health is valid and that its
accounting systems are reliable.\textsuperscript{60} Significantly, the audit report
aides the client in convincing third parties\textsuperscript{61} that it is safe to extend
credit to or invest in the client.\textsuperscript{62} Such use by third parties forms the
basis for liability to third parties when the accountant acts
negligently.\textsuperscript{63}

There are several ways that the audited financial statements may
result in a material misstatement of the financial position of a cli-
ent.\textsuperscript{64} Financial statements can be materially misstated through
management fraud, clerical errors by the company, or the auditor's
negligence in conducting the audit.\textsuperscript{65} For example, through manage-
ment fraud the financial statements may be altered to disguise fi-
nancial problems when the company is in need of funds from credi-
tors or investors.\textsuperscript{66} Also, because audits are based on sampling, the
accountant may fail to detect fraud through normal auditing proce-
dures and thereby issue an unqualified opinion.\textsuperscript{67} Even when audits
are conducted correctly, they cannot guarantee complete accuracy
or the discovery of fraud.\textsuperscript{68} Audits are not insurance policies; even a
carefully conducted audit can result in misstated financial state-
ments. Such a situation, however, is not considered negligence.\textsuperscript{69} Al-

\textsuperscript{60} Siliciano, \textit{supra} note 2, at 1932. The audit report is not a “rubber stamp” for management.
Although the majority of opinions issued by auditors are unqualified, the audit fee is quite signifi-
cant for such an in-depth analysis of a company's records.

\textsuperscript{61} Third parties can include banks, lenders, suppliers, creditors, and investors. \textit{Id.}

\textsuperscript{62} \textit{Id.}

\textsuperscript{63} \textit{Id.}

\textsuperscript{64} \textit{Id.}

\textsuperscript{65} \textit{Id.}

\textsuperscript{66} \textit{Id.}

\textsuperscript{67} \textit{Id.} An unqualified opinion does not insure the absence of fraud. Hagen, \textit{Effect of Compliance}, \textit{supra} note 2, at 69. The \textit{AICPA Standards} recognize that although the auditor is not re-
quired to detect fraud, he is required to exercise proper care in conducting his audit:

The auditor should exercise (a) due care in planning, performing, and evaluating the
results of audit procedures, and (b) the proper degree of professional skepticism to
achieve reasonable assurance that material errors or irregularities will be detected.
Since the auditor's opinion on the financial statements is based on the concept of
reasonable assurance, the auditor is not an insurer and his report does not constitute a
guarantee. Therefore, the subsequent discovery that a material misstatement exists in
the financial statements does not, in and of itself, evidence inadequate planning, per-
formance, or judgment on the part of the auditor.

\textit{AICPA Standards}, \textit{supra} note 18, AU § 316.08, at 245-2.

\textsuperscript{68} Lochner, \textit{supra} note 17, at 108.

\textsuperscript{69} Thus, a CPA who carefully conducts his audit but inadvertently fails to uncover manage-
ment fraud or misstatements in the financial statements ordinarily will not be held liable for negli-
gence, even if a third party relied on the misstated financial statements to his detriment. A care-
fully conducted audit is the auditor's best defense.
ternatively, a poorly conducted audit may fail to detect unintended errors in the client’s financial statements.\(^70\)

No matter why the financial statements are misleading, the bottom line is that a third party who relies on them may be harmed. An example of this occurs when the auditor’s client becomes insolvent.\(^71\) When someone is harmed, economically or otherwise, an issue of legal liability can arise.

C. Accountant Negligence

Accountants have a duty to exercise the reasonable care, judgment, honesty, and independence of a competent member of the profession in obtaining and communicating information.\(^72\) The difficulty of complying with this standard lies in determining what is reasonable.\(^73\) In an unqualified opinion, the auditor asserts that he has audited the financial statements in accordance with GAAS;\(^74\) thus, failure to comply with GAAS can constitute negligence.\(^75\) Ten broadly phrased sets of standards and general principles that guide the audit process are included in GAAS.\(^76\) These standards are classified as general standards,\(^77\) standards of field work,\(^78\) and stan-

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70. Siliciano, supra note 2, at 1932. An auditor who poorly conducts an audit can be considered negligent.
71. Id.
72. Restatement (Second) of Torts § 552 (1977); Paschall, supra note 2, at 704; see United States v. Arthur Young & Co., 465 U.S. 805, 817-18 (1984) (noting that an auditor is ethically and professionally obligated to determine as far as possible whether the corporation’s contingent tax liabilities have been accurately stated); Dodd, supra note 12, at 913 (noting that accountants must exercise the degree of care and skill “customarily employed by reasonably competent members of their profession”); see also Gantt v. Boone, Wellford, Clark, Langschmidt & Pemberton, 559 F. Supp 1219, 1228 (M.D. La. 1983) (holding accountants to the standard of a prudent accountant practicing in the locality), aff’d, 742 F.2d 1451 (5th Cir. 1984); Halla Nursery, Inc. v. Baumann-Furrie & Co., 454 N.W.2d 905, 909 (Minn. 1990) (holding accountants to the standard of care of a person of average ability and skill engaged in the profession); Greenstein, Logan & Co. v. Burgess Mktg., Inc., 744 S.W.2d 170, 185 (Tex. Ct. App. 1987) (finding that accountants must “exercise the degree of care, skill and competence that reasonably competent members of their profession would exercise under similar circumstances”).
73. Paschall, supra note 2, at 704.
74. Id.; Miller & Bailey, supra note 23, at 11.04-05.
75. Wiener, supra note 2, at 237.
76. AICPA Standards, supra note 18, AU § 150.02, at 81-82.
77. The “generally accepted auditing standards,” as established by AICPA, are as follows:
   1. The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor. . . .
   2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors. . . .
   3. Due professional care is to be exercised in the performance of the audit and preparation of the report.
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dards of reporting. Although departure from GAAS does not constitute per se negligence, a direct showing that the auditor did not perform the audit in accordance with these standards may indicate negligence by the auditor. Likewise, the existence of a material misstatement in the financial statements creates the inference that the auditor has not complied with GAAS and has thus breached his professional duty. An audit which is properly planned and conducted is intended to ensure that the client’s financial statements are free from material misstatement. Thus, the existence of such misstatement calls into question the auditor’s planning and performance.

Generally, a question of accountant liability develops when a third party relies on negligently prepared financial statements and loses money as a result. Such accountant negligence must be the legal or proximate cause of the loss to the third party before that

Id. AU § 150.02, at 81.

78. The standards of field work provide that:

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

2. A sufficient understanding of the internal control structure is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.

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

Id.

79. The standards of reporting require that:

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

2. The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.

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

4. The report shall contain either an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor’s name is associated with financial statements, the report should contain a clear-cut indication of the auditor’s work, if any, and the degree of responsibility the auditor is taking.

Id. AU § 150.02, at 81-82.


81. AICPA STANDARDS. supra note 18, AU § 316.05, at 240. The auditor should design the audit to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements. Id.

82. Id. AU § 316.08, at 240.

83. Siliciano, supra note 2, at 1933.
party can hold the accountant liable.\textsuperscript{84} It is important to note, however, that the business's subsequent failure does not by itself indicate auditor negligence.\textsuperscript{86} In fact, if the financial statements correctly reflect the financial condition and operations of a business, and these conditions have been properly considered by the auditor in the audit report, subsequent business failure should not be surprising.\textsuperscript{86}

Historically, a business had its financial statements audited to inform its officers of any existing or potential financial and operational problems.\textsuperscript{87} Today, however, the role of the audit has changed considerably. Because of the growing need to acquire extensive funding for business operations, the accountant's key role has expanded to encompass an independent examination of the business's financial statements and the issuance of a resulting opinion on the statements' validity.\textsuperscript{88} Clearly, the "auditor's function has expanded from that of a watchdog for management to an independent evaluator of the adequacy and fairness of financial statements issued by the company's management to stockholders, creditors, and others."\textsuperscript{89}

Additionally, the accountant is viewed by some as an independent

\textsuperscript{84} Paschall, \textit{supra} note 2, at 706.
\textsuperscript{86} Dodd, \textit{supra} note 12, at 919.
\textsuperscript{87} Kirby & Davies, \textit{supra} note 2, at 576.
\textsuperscript{88} \textit{Id.} at 577.
\textsuperscript{89} H. Rosenblum, Inc. v. Adler, 461 A.2d 138, 149 (N.J. 1983); \textit{see also} United States v. Arthur Young & Co., 465 U.S. 805, 818 (1984) (stating that the independent accountant "owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public"); International Mortgage Co. v. John P. Butler Accountancy Corp., 223 Cal. Rptr. 218, 224 (Cal. Ct. App. 1986) (stating that the accountant must realize that an unqualified opinion will be relied upon by investors, creditors, lenders, stockholders or anyone else involved in the financial concerns of the audited entity).

The Supreme Court, in United States v. Arthur Young & Co., 465 U.S. 805 (1984), described the role of the independent auditor:

\begin{quote}
An independent certified public accountant performs a different role. By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust. To insulate from disclosure a certified public accountant's interpretations of the client's financial statements would be to ignore the significance of the accountant's role as a disinterested analyst charged with public obligations.
\end{quote}

\textit{Id.} at 817-18.
guarantor of the accuracy and fairness of the business's financial statements. This responsibility potentially imputes a duty on the accountant to third parties. Once this duty is in place, liability can result if the accountant breaches that duty. The role of the accountant as a guarantor of financial statements for relying third parties, however, is greatly disputed. The law fully recognizes that, just as a doctor does not guarantee a patient complete recovery from an injury or sickness nor does an attorney guarantee a client's success in litigation, an accountant performing an audit does not guarantee the accuracy of the client's financial statements. Negligence liability results only when the accountant fails to meet the standards of the accounting profession. At the heart of this debate is the determination of whether and to what extent the accountant, if negligent, should be held liable to a third party.

II. HISTORICAL BACKGROUND OF ACCOUNTANT LIABILITY TO THIRD PARTIES

Three different approaches have been developed to help answer the question of whether auditors should be liable to third parties who read and rely on audit reports. A substantial number of jurisdictions follow the lead of Chief Judge Cardozo's 1931 opinion for the New York Court of Appeals in Ultramares Corp. v. Touche, Niven & Co. Under this approach, a third party will be denied relief for auditor negligence in the absence of a third party relationship to the auditor that is "akin to privity." Most jurisdictions,
however, follow the view expressed in the Restatement (Second) of Torts, which generally imposes liability on suppliers of commercial information to third persons who are intended beneficiaries of the information.99 A handful of jurisdictions follow a third view, which allows recovery based on auditor negligence to third parties whose reliance on the audit report was “reasonably foreseeable” by the auditor.100 These three approaches will be discussed respectively.

A. The Ultramares Doctrine

Historically, under contract law, the accountant’s duty was solely to his client.101 A person performing under a contract owed duties and responsibilities only to the person with whom he had contracted.102 This relationship by contract provided the basis for “privity.”103

Still, there had not been a significant inquiry into the issue of whether accountant liability for negligence extends to a third party until 1931,104 when Judge Cardozo delivered the opinion in Ultramares Corp. v. Touche, Niven & Co.105 In this seminal case, the defendant accounting firm of Touche, Niven & Company (“Touche”) was engaged to prepare a certified balance sheet for a client, Fred Stern & Company (“Stern”).106 Stern imported and sold rubber, for which it was required to borrow extensively in order to finance its business operations.107 With the knowledge that the certified balance sheet would likely be used by Stern to secure financing, Touche completed the financial statement and supplied Stern with thirty-two copies of the report.108 Touche’s certification

99. Restatement (Second) of Torts § 552 (1977); see infra notes 139-70 and accompanying text (discussing the Restatement (Second) approach).
100. E.g., H. Rosenblum, Inc. v. Adler, 461 A.2d 138 (N.J. 1983); see infra notes 171-216 (discussing the “reasonably foreseeable” approach).
101. Kirby & Davies, supra note 2, at 578. Support for this view is found in the fact that the audit opinion is addressed to the company’s management.
102. Id. at 578-79; Zoe Holmes, Comment, Accountant Liability to Third Parties: To What Extent is Comparative Negligence a Defense?, 55 UMKC L. Rev. 608, 615 (1987).
105. Id. at 442.
106. Id.
107. Id.
was attached to the financial statements which provided that "said statement, in our opinion, presents a true and correct view of the financial condition of Fred Stern & Co., Inc., as of December 31, 1923."\(^{109}\)

Although the certified balance sheet reflected a healthy company, Stern was, in fact, insolvent.\(^{110}\) The report contained material inaccuracies because of fraud by Stern and the accountant’s negligent overvaluation of the company’s assets.\(^{111}\) The plaintiff, Ultramares, loaned Stern large sums of money in reliance on the accountant’s certified statements;\(^{112}\) as a result, Ultramares sustained financial losses when Stern suddenly declared bankruptcy.\(^{113}\) Ultramares subsequently brought an action against Touche seeking recovery under theories of both fraud and negligence.\(^{114}\)

With respect to the fraud claim, Judge Cardozo found for Ultramares.\(^{118}\) Judge Cardozo held that in a fraud claim, where the accountant knowingly sought to deceive the injured parties, or where the audit was conducted so carelessly that the accountant could not honestly believe the validity of his own conclusions, a third party can recover.\(^{116}\)

Judge Cardozo, however, disallowed recovery on negligence grounds,\(^{117}\) holding that recovery in negligence will be allowed only when the third party and the accounting firm or CPA are in privity.\(^{118}\) The court explained that "the ensuing liability for negligence is one that is bounded by the contract, and is to be enforced between the parties by whom the contract has been made."\(^{119}\) Thus, the

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\(109\) *Id.*

\(110\) *Id.*

\(111\) *Id.* Stern’s management created fictitious and nonexistent accounts receivable which the accountants negligently failed to substantiate; if properly analyzed, they would have revealed the company’s impecunious situation. *Id.* at 442-43.

\(112\) *Id.* at 443. Loans were made on the condition that Ultramares would receive a balance sheet certified by Touche stating Stern’s financial condition. *Id.* In response, Stern provided Ultramares with the balance sheet certified by Touche. Based on the presentation on the balance sheet that Stern was in good financial shape, Ultramares made loans to Stern. *Id.*

\(113\) *Id.* When Stern declared bankruptcy, Ultramares sustained financial losses from the uncollected loans because security on the loans was either nonexistent or inadequate. *Id.*

\(114\) *Id.*

\(115\) *Id.*

\(116\) *Id.* at 444; see also Siliciano, *supra* note 2, at 1935 (discussing the *Ultramares* fraud claim that allows third parties to recover).

\(117\) *Ultramares*, 174 N.E. at 448.

\(118\) *Id.*

\(119\) *Id.* at 448.
court held that the contractual requirement of privity is required for a third party to recover when an accountant is negligent.

Judge Cardozo noted that if third parties were allowed to recover from an accountant for negligence, "a thoughtless slip or blunder . . . [would] expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class." The court further reasoned that imposing such a duty was not necessary to protect third parties, noting that it was doubtful "whether the average business man [sic] receiving a certificate without paying for it and receiving it merely as one among a multitude of possible investors, would look for anything more [than legal protection against fraud]." In other words, third parties only expect an audit report to be free from fraud. The notion that the accountant's product is intended only for the benefit of his client is clearly reflected in Cardozo's statement that "public accountants are public only in the sense that their services are offered to any one [sic] who chooses to employ them."

Subsequent interpretation of Ultramares has not required strict privity of contract as a prerequisite to third party suits against auditors. For example, in Credit Alliance v. Arthur Andersen & Co., the New York Court of Appeals found an equivalent privity relationship when the primary "end and aim" of the audit was for a particular party and some "linking" conduct occurred, resulting in a nexus between the two parties "sufficiently approaching privity."

Although Credit Alliance, on the one hand, illustrates the continued acceptance of the Ultramares privity doctrine, it also illustrates a relaxation of the standard to one that "sufficiently approaches

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120. Id. at 444.
121. Id. at 448; see Siliciano, supra note 2, at 1935-36 (doubting whether the implication of such a duty was necessary to protect third parties).
122. Paschall, supra note 2, at 712-13; see Darrell D. Hallett & Thomas R. Collins, Comment, Auditors' Responsibility for Misrepresentation: Inadequate Protection for Users of Financial Statements, 44 WASH. L. REV. 139, 178 (1968) (recognizing that the use of the accountant's product is for informing management, and that any additional use by third parties is merely incidental). See generally Fiflis, supra note 2, at 102-13 (discussing the need for privity between the plaintiff and defendant in a suit for negligent misrepresentation).
123. Ultramares, 174 N.E. at 448.
124. See Credit Alliance Corp. v. Arthur Andersen & Co., 483 N.E.2d 110 (N.Y. 1985) (relaxing the strict Ultramares privity doctrine by requiring a relationship "sufficiently approaching privity").
126. Id. at 110.
privity."

In Credit Alliance, the plaintiff loaned money to the auditor's client in reliance on audited financial statements which overstated the client's assets and net worth. The plaintiff alleged that the auditor knew the plaintiff was lending money to the client and that the auditor had communicated directly with the plaintiff regarding the audit reports. The New York Court of Appeals promulgated the following three-prong test for determining whether an accountant can be held liable for negligence to a third party who has detrimentally relied on inaccurate financial statements:

1. the 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.

The court applied this new test, observing that the primary, if not exclusive, "end and aim" of these audits was to satisfy the plaintiff lender. Moreover, the auditor's "direct communications and personal meetings [with the lender] resulted in a nexus between them sufficiently approaching privity." However, a mere unsolicited phone call by a third party to the auditor is insufficient to demonstrate the existence of a relationship between the third party and the

128. The court in Credit Alliance refused to overrule Ultramares, but it recognized the near impossibility of having strict privity in an accountant-third party relationship. Credit Alliance, 483 N.E.2d at 110.
129. Id. at 112-13.
130. Id. at 113.
131. Id. at 118.
132. Id. at 120.
133. Id. More recently, the New York court was criticized for not offering a rationale for the distinct "linking" element of its rule nor specifying what conduct was required to satisfy this element. See Bily v. Arthur Young & Co., 834 P.2d 745, 754 (Cal. 1992) (criticizing the Credit Alliance holding). In Bily, the California Supreme Court further questioned whether "linking" conduct should be necessary if the auditor knows his engagement is for the express purpose of benefiting a specific, identifiable third party. In such cases, "linkage" is arguably achieved by the auditor's conduct in undertaking and carrying out the engagement with knowledge of its specific purpose and the ultimate use to be made of the audit report. Id. The "linking conduct" element appears to require not only that the existence of the third party be known by the auditor, but also that the auditor either directly convey the audit report to the third party or act in some specifically planned way to induce reliance on the report. Id. at 755. This type of conduct seems rare and unlikely to occur.
auditor sufficiently approaching privity;\textsuperscript{134} the auditor must be aware of a particular purpose for the audit engagement and must act to further that purpose.\textsuperscript{135} This additional “linking” conduct, however, is not required by the Restatement (Second) approach.\textsuperscript{136}

At least nine states continue to follow either Ultramares or the reformulation of privity rules by the Credit Alliance court, both of which restrict the liability of accountants to parties with whom they have a contractual relationship “sufficiently approaching privity.”\textsuperscript{137} Thus, for nearly forty years, the Ultramares privity doctrine dominated judicial thinking regarding accountant liability for negligence to third parties, until several courts began to reject Ultramares in favor of the Restatement (Second) approach.\textsuperscript{138}

\section*{B. The Restatement (Second) of Torts Approach}

The first case to reject altogether the privity rule under Ultramares and its progeny in favor of a more flexible standard of accountant liability was Rusch Factors, Inc. v. Levin.\textsuperscript{139} Here, the court held that the defendant accountant could be held liable to “actually foreseen and limited classes of persons.”\textsuperscript{140} In Rusch Factors, a lending institution brought an action against the defendant CPA to recover damages sustained as a result of a loan made to a


\textsuperscript{135} Id.

\textsuperscript{136} See infra notes 139-70 and accompanying text (defining the Restatement (Second) approach).

\textsuperscript{137} In five states the privity or “sufficiently approaching privity” result has been reached by decisions of their highest courts. See Colonial Bank of Ala. v. Ridley & Schweigert, 551 So. 2d 390 (Ala. 1989); Idaho Bank & Trust Co. v. First Bancorp of Idaho, 772 P.2d 720 (Idaho 1989); Citizens Nat'l Bank v. Kennedy & Coe, 441 N.W.2d 180 (Neb. 1989); Credit Alliance Corp. v. Arthur Andersen & Co., 483 N.E.2d 110 (N.Y. 1985); Landell v. Lybrand, 107 A. 783 (Pa. 1919). In four other states, the privity doctrine has been incorporated by statute. See Ark. Code Ann. § 16-114-302 (Supp. 1990); 225 ILCS 450/30.1 (1993); Kan. Stat. Ann. § 1-402(b) (1991); Utah Code Ann. § 58-26-12 (Supp. 1990). Federal court decisions have interpreted the laws of three additional states to follow this rule even though the highest courts of these states have not expressly considered the question. See Ackerman v. Schwartz, 947 F.2d 841 (7th Cir. 1991) (Indiana law); McLean v. Alexander, 599 F.2d 1190 (3d Cir. 1979) (Delaware law); Stephens Indus., Inc. v. Haskins & Sells, 438 F.2d 357 (10th Cir. 1971) (Colorado law).

\textsuperscript{138} See, e.g., O'Connor v. Ludlam, 92 F.2d 50, 53 (2d Cir. 1937) (citing Ultramares for the principle that without privity, a third party cannot recover from a negligent accountant), cert. denied, 302 U.S. 758 (1937); Canaveral Capital Corp. v. Bruce, 214 So. 2d 505 (Fla. 1968) (holding accountants not liable to nonprivity parties absent fraud or gross negligence).

\textsuperscript{139} 284 F. Supp. 85 (D.R.I. 1968).

\textsuperscript{140} Id. at 92-93.
Rhode Island corporation. The defendant negligently prepared financial statements showing the corporation to be solvent and in sound financial condition when, in fact, such was not the case.

The accountant actually knew that the plaintiff would rely on his representations in extending credit to the corporation. In reliance on the financial statements, the plaintiff loaned the corporation a large sum of money, and when the corporation later filed for bankruptcy and defaulted on its loan, the plaintiff lender suffered a financial loss.

The Rusch Factors court criticized the Ultramares rule as unfair to the injured third party. The court adhered to the position taken by a tentative draft of the Restatement (Second) of Torts in support of its argument that an accountant should be held liable for negligent financial misrepresentations if such misrepresentations are relied upon by "actually foreseen and limited classes of persons."

The Restatement (Second) of Torts, which was adopted in 1977, rejects Ultramares's restrictive privity doctrine in favor of extending liability to members of a limited class of third parties whose reliance upon the representation was actually foreseen by the accountant.

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141. Id. at 86-87.
142. Id.
143. Id. at 91. The defendant CPA knew that the financial statements were prepared for the purpose of influencing that specific lender's conduct. Id.
144. Id. at 86-87.
145. Id. at 87.
146. Id. at 90-92. The court in Rusch Factors made the following observations:

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."

Id. at 91 (citing Palsgraf v. Long Island R.R., 162 N.E. 99, 100 (N.Y. 1928)).
147. Id. at 91-93. The Restatement (Second) of Torts § 552 (Tent. Draft No. 12, 1966) was adopted verbatim in Restatement (Second) of Torts § 552 (1977).
148. Restatement (Second) of Torts § 552 (1977). The Restatement (Second) includes the following section, entitled "Information Negligently Supplied for the Guidance of Others":

(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) The liability stated in Subsection (1) is limited to loss suffered...
Under the *Restatement (Second)*, a professional who supplies false information to assist others is subject to liability for a failure to exercise reasonable care.\(^{149}\) The drafters of the *Restatement (Second)* developed a two-pronged test for addressing accountant negligence issues: liability extends to any person, or members of a limited class of persons, that the accountant intends or knows will use the financial information;\(^{150}\) and the injured party must be in a class of persons who used the financial statements for "substantially the same purpose" as the bona fide client.\(^{151}\) Both prongs of the test must be met before an accountant's duty of care is extended to the third parties.\(^{152}\)

The *Restatement (Second)* expands liability to include a larger class of third parties than does the *Ultramares* privity doctrine, but it also includes several limitations.\(^{153}\) The *Restatement (Second)* does not allow recovery in situations where a third party's reliance is

\[\text{(a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it; and} \]

\[\text{(b) through reliance upon it in a transaction that he intends the information to influence or knows that the recipient so intends or in a substantially similar transaction.} \]

Id.

\(^{149}\) See Hagen, *Accountants' Liability*, supra note 2, at 185-86 (explaining the *Restatement (Second)* approach).


\(^{151}\) *Restatement (Second)* of *Torts* § 552(2)(b) (1977).

\(^{152}\) See Kirby & Davies, supra note 2, at 584 (discussing the *Restatement (Second)'s* two-pronged test). The *Restatement (Second)* position is an attempt at reconciling Judge Cardozo's *Ultramares* and *Glanzer v. Shepard* opinions to define the extent of liability for negligent misrepresentations. CLARENCE MORRIS & C. ROBERT MORRIS JR., *MORRIS ON TORTS* 321 (1980). Cardozo distinguished the *Ultramares* case from an earlier decision, *Glanzer v. Shepard*, 135 N.E. 275 (N.Y. 1922), in which a public weigher who had certified the weight of a shipment of beans was held liable to the buyer for the price of the beans that the plaintiff had paid for but had not received. Cardozo said:

> The service rendered by the defendant in *Glanzer v. Shepard* was primarily for the information of a third person, in effect, if not in name, a party to the contract, and only incidentally for that of the formal promisee. In the case at hand [*Ultramares*], the service [is] primarily for the benefit of the Stern Company [the promisee], a convenient instrumentality for use in the development of the business, and only incidentally or collaterally for the use of those to whom Stern . . . might exhibit it thereafter.

*Ultramares Corp. v. Touche, Niven & Co.*, 174 N.E. 441, 446 (N.Y. 1931). See generally Mess, supra note 2, at 842-45 (discussing the opinions in *Ultramares* and *Glanzer*).

\(^{153}\) See Kirby & Davies, supra note 2, at 584 (discussing the limits of the *Restatement (Second)* approach).
foseeable or reasonably foreseeable to the accountant, but is not actually foreseen. For example, under the Restatement (Second) approach, an accountant who is retained to conduct an audit and to furnish an opinion for no particular purpose generally undertakes no duty to third persons. In order for the Restatement (Second) to apply, the accountant must be actually informed that an identified third party or class of third parties will be using the financial statements, even though the accountant generally "knows that the financial statements . . . are customarily used in a wide variety of financial transactions by the corporation and that they may be relied upon by lenders, investors, stockholders, creditors [and] purchasers." Additionally, the Restatement (Second) does not extend liability to third parties unless some accountant-client communications exist concerning the intended use of the report.

The Restatement (Second) position will allow recovery to an unidentified third party as long as that third party was a member of an identified class of persons whose reliance the accountant could actually foresee. For example, the accountant may be held liable to

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154. R. James Gormley, The Foreseen, the Foreseeable, and Beyond — Accountants' Liability to Nonclients, 34 Def. L.J. 75, 77 (1985); Kirby & Davies, supra note 2, at 584. This requirement that the accountant actually foresee the third party use is subjective. See infra note 170 and accompanying text (discussing the disadvantage of basing the negligent accountant's liability on the accountant's subjective mental state).


156. RESTATEMENT (SECOND) OF TORTS § 552 cmt. h, illus. 10 (1977). Such an auditor is not informed of any intended use of the financial statements; but . . . knows that the financial statements, accompanied by an auditor's opinion, are customarily used in a wide variety of financial transactions by the [client] corporation and that they may be relied upon by lenders, investors, shareholders, creditors, purchasers and the like, in numerous possible kinds of transactions. [The client corporation] uses the financial statements and accompanying auditor's opinion to obtain a loan from [a particular] bank. Because of [the auditor's] negligence, he issues an unqualifiedly favorable opinion upon a balance sheet that materially misstates the financial position of [the corporation] and through reliance upon it [the bank] suffers pecuniary loss. . . . [The auditor] is not liable to [the bank].

Bily v. Arthur Young & Co., 834 P.2d 745, 758 (Cal. 1992) (quoting RESTATEMENT (SECOND) OF TORTS § 552 cmt. h, illus. 10 (1977)); see also Larsen v. United Fed. Sav. & Loan Ass'n., 300 N.W.2d 281 (Iowa 1981) (holding that recovery was permitted by a nonprivy party who had actually paid for the accountant's services, and who was specifically designated as the one for whose benefit it was being prepared).

157. RESTATEMENT (SECOND) OF TORTS § 552(2)(a)-(b) (1977); see also Badische Corp. v. Caylor, 356 S.E.2d 198 (Ga. 1987) (holding that an accountant will be liable if the accountant was manifestly aware of the use to which the information was to be used and intended that it be so used).

158. See Pace, Note, supra note 2, at 439-40 n.50 (delineating the "limited class" of third
third party lender if the accountant is informed by the client that
the audit report will be used to obtain a loan, even if the specific
lender remains unidentified or the client names one lender and then
borrows from another. By contrast, the accountant is not liable to
other lenders when, for example, he agrees to conduct the audit with
the express understanding that the audit report will be given only to
a specified lender and is then given to other lenders. Likewise, the
accountant is not liable when the client’s transaction, as communica
ted to the accountant, changes so as to materially increase the
audit risk. For example, an accountant is not liable to a third party
who originally considers selling goods to the client on credit but
later buys a controlling interest in the client’s stock, both times act-
ing in reliance on the accountant’s audit report.

At least nineteen states have endorsed or favorably cited the Resta-
tement (Second) rule recognizing an accountant’s liability to an
actually foreseen third party. For many courts, the Resta-
tement (Second) rule has been a satisfactory compromise between the tradi-
tional Ultramares privity approach and the “specter of unlimited
liability” of the reasonably foreseeable approach.

159. RESTATEMENT (SECOND) OF TORTS § 552 cmt. h, illus. 6-7 (1977); see supra note 158
(citing cases illustrating accountant liability to limited classes of third parties).


161. Id. cmt. j, illus. 14.

162. E.g., First Nat'l Bank of Commerce v. Monco Agency Inc., 911 F.2d 1053 (5th Cir. 1990)
(Louisiana law); Ingram Indus., Inc. v. Nowicki, 527 F. Supp. 683 (E.D.Ky. 1981) (Kentucky
law); Bunge v. Eide, 372 F. Supp. 1058 (D.N.D. 1974) (North Dakota law); Rusch Factors, Inc.
P.2d 745 (Cal. 1992); First Fla. Bank N.A. v. Max Mitchell & Co., 558 So. 2d 9 (Fla. 1990);
Badische Corp. v. Caylor, 356 S.E.2d 198 (Ga. 1987); Pahre v. Auditor of Iowa, 422 N.W.2d 178
(Iowa 1978); Westerhold v. Carroll, 419 S.W.2d 73 (Mo. 1967).

159. RESTATEMENT (SECOND) OF TORTS § 552 cmt. h, illus. 6-7 (1977); see supra note 158
(citing cases illustrating accountant liability to limited classes of third parties).


161. Id. cmt. j, illus. 14.

162. E.g., First Nat'l Bank of Commerce v. Monco Agency Inc., 911 F.2d 1053 (5th Cir. 1990)
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P.2d 745 (Cal. 1992); First Fla. Bank N.A. v. Max Mitchell & Co., 558 So. 2d 9 (Fla. 1990);
Badische Corp. v. Caylor, 356 S.E.2d 198 (Ga. 1987); Pahre v. Auditor of Iowa, 422 N.W.2d 178
(Iowa 1978); Stockler v. Rose, 436 N.W.2d 70 (Mich. 1990); Bonhiver v. Graff, 248 N.W.2d 291
(Minn. 1976); Aluma Kraft Mfg. Co. v. Elmer Fox & Co., 493 S.W.2d 378 (Mo. Ct. App. 1973);
Thayer v. Hicks, 793 P.2d 784 (Mont. 1990); Spherix Inc. v. Alexander Grant & Co., 451 A.2d
1308 (N.H. 1982); Raritan River Steel Co. v. Cherry, Bekavet & Holland, 367 S.E.2d 609 (N.C.
1988); Haddon View Inv. Co. v. Cooper & Lybrand, 436 N.E.2d 212 (Ohio 1982); Bethlehem
Steel Corp. v. Ernst & Whinney, 822 S.W.2d 592 (Tenn. 1991); Shatterproof Glass Corp. v.

163. See supra notes 101-38 and accompanying text (explaining the Ultramares privity
document).

164. Briggs v. Sterner, 529 F. Supp. 1155, 1177 (S.D. Iowa 1981); see also First Nat'l Bank of
Commerce v. Monco Agency Inc., 911 F.2d 1053 (5th Cir. 1990). In First National Bank, the
Proponents of the Restatement (Second) approach argue that expressly limiting the class of third parties who can recover reduces the risk of accountants' negligence liability and favorably promotes the free flow of financial information throughout the business community. Opponents, on the other hand, point out that since most companies whose securities are publicly traded are obligated to file certified financial statements with the Securities and Exchange Commission ("SEC"), encouraging the free flow of information is unnecessary.

The Restatement (Second) rule inevitably results in some degree of uncertainty. Commentators have criticized this view as arbitrary line-drawing, protecting only those who happen to be in the "limited class" of actually foreseen third parties. Furthermore, they note that basing the extent of the negligent accountant's liability to third persons solely on the accountant's subjective mental state completely disregards the accountant's fault.

court, in holding that the Restatement (Second) view should apply in Louisiana, noted that there are potentially competing interests when considering the issue of CPA liability for negligence to third parties. The client is interested in having its financial picture presented in the best light possible, within the bounds of GAAP. Id. at 1058. This view sometimes conflicts with the public's demand for a straightforward and impartial evaluation of a company's financial performance. Id. In light of these competing interests, the court concluded that the Restatement (Second) view was the best solution, as it takes the middle ground between these two positions. Id. at 1061; see also infra notes 171-216 and accompanying text (discussing the "reasonably foreseeable" approach).

165. RESTATEMENT (SECOND) OF TORTS § 552 cmt. a (1977) (noting that limiting liability promotes the communication of financial information); see also Pace, Note, supra note 2, at 445 (noting that by "expressly limiting the class of compensable plaintiffs... the free flow of financial information" is promoted). But see Hagen, Accountants' Liability, supra note 2, at 200 (arguing that the Restatement (Second)'s point that limiting liability encourages the free flow of information seems unnecessary in today's world, where most companies whose securities are publicly traded must file certified financial reports with the SEC).

166. Securities Exchange Act of 1934, 15 U.S.C. §§ 78l(g)(1), 78q(a)-(e) (1988). Companies whose securities are traded on a national securities exchange, and companies that have assets of $1 million or more and that have equity securities held by at least 500 — but no more than 750 — persons must file an annual report containing certified financial information with the SEC. Id. § 78l(g)(1).

167. Hagen, Accountants' Liability, supra note 2, at 200.


169. See Kirby & Davies, supra note 2, at 592 (noting that the "lines established by the Restatement are vague"); Pace, Note, supra note 2, at 445-46 (recognizing that such a limitation unnecessarily protects a "sophisticated accounting profession" from liability at the expense of the less informed public).

170. Hagen, Accountants' Liability, supra note 2, at 200. By focusing on what the accountant subjectively knew, the Restatement (Second) disregards the fact that the accountant has been negligent and that third parties have been harmed by his negligence. Id.
C. The "Reasonably Foreseeable" Approach

Arguing that accountants should be held liable to third parties on the same basis as other tortfeasors, Justice Howard Wiener advocated a rejection of the Ultramares privity rule in a 1983 law review article. Instead, he proposed a rule based on the foreseeability of injury to third persons, concluding that:

Accountant liability based on foreseeable injury would serve the dual functions of compensation for injury and deterrence of negligent conduct. Moreover, it is a just and rational judicial policy that the same criteria govern the imposition of negligence liability, regardless of the context in which it arises. The accountant, the investor, and the general public will in the long run benefit when the liability of the certified public accountant for negligent misrepresentation is measured by the foreseeability standard.

The first case to alter accountants' liability by extending the accountant's duty of care to reasonably foreseeable third parties was H. Rosenblum, Inc. v. Adler. In Rosenblum, the accounting firm of Touche Ross & Company ("Touche Ross") was engaged to audit the financial statements of Giant Corporation. Unbeknownst to Touche Ross, Giant had falsely recorded assets that it did not own and omitted substantial liabilities on its books. Touche Ross conducted the audit and issued an unqualified opinion, but it failed to uncover this large-scale management fraud. Rosenblum subsequently acquired the common stock of Giant in exchange for the sale of its business to Giant, but when Giant filed for bankruptcy, Rosenblum's stock became worthless. Rosenblum then sued, alleging that because the company's reliance on the financial statements was reasonably foreseeable, the accounting firm had violated

171. Wiener, supra note 2, at 233.
172. Id. at 260.
173. 461 A.2d 138 (N.J. 1983). The New Jersey Supreme Court in Rosenblum was influenced in part by Justice Wiener's persuasive argument rejecting the privity rule of Ultramares in favor of a "reasonably foreseeable" approach. Id. at 145. The court also expressed disfavor towards the Restatement (Second) approach, stating that the Restatement (Second) was merely an extension of Ultramares, with the added requirement that the auditor need not know the identity of the beneficiaries if they belong to an identifiable group for whom the information was intended to be furnished. Id.
174. Id. at 140.
175. Id.
176. Id. at 141. The opinion stated that "the financial statements 'present[ed] fairly' Giant's financial position." Id.
177. Id. The plaintiffs, Harry and Barry Rosenblum, relied on the audited financial statements issued by the accountants in acquiring Giant's common stock. Id.
178. Id.
a duty of care by not discovering the fraudulent representations of the client.\(^7\)

The New Jersey Supreme Court in Rosenblum found no reason to treat accountants differently from other suppliers of products or services to the public, and thus endorsed the idea of granting recovery to third-party users of financial statements for economic loss resulting from negligent misrepresentation.\(^8\) The court held that an independent auditor, who furnishes an opinion without any limitation as to whom the audited entity may disseminate the financial statements, owes a duty to all reasonably foreseeable third parties who rely on the statements pursuant to a proper business use.\(^9\) Stockholders, potential investors, creditors, and potential creditors were considered by the court to be reasonably foreseeable third parties.\(^10\)

The Rosenblum court noted that the “auditor’s function has expanded from that of a watchdog for management to an independent evaluator of the adequacy and fairness of financial statements issued by management to stockholders, creditors, and others.”\(^11\) From a public policy standpoint, the court emphasized the potential deterrent effect of the expanded liability rule on the conduct and cost of

\(^7\) Id. The Rosenblums claimed that their reliance on the financial statements was reasonably foreseeable to any auditor in general. Id. In other words, parties acquiring stock of another company often view the financial statements before making their investment.

\(^8\) Id. at 142-46. Under this view, a “defective” audit is conceptually similar to a defective product which may injure consumers when injected into the stream of commerce. Id. at 152.

\(^9\) Id.; see also Hagen, Accountants’ Liability, supra note 2, at 202-03. Professor Hagen explains that as a result of the Rosenblum court’s requirement that the plaintiff prove he received the audited financial statements from the company in accordance with a proper business purpose, the scope of an accountant’s duty of care will be significantly narrowed, since the circumstances giving rise to an accountant’s negligence claim to third parties will be restricted. Id. This requirement precludes some third parties with a foreseeable risk of injury — such as institutional investors and portfolio managers — from recovery because they did not acquire the audited financial statements from the company. Id.

\(^10\) Rosenblum, 461 A.2d at 152.

\(^11\) Id. at 149. The court analyzed the evolution of the function of an audit. Initially, the primary function of an audit was to inform management of irregularities and inefficiencies in the business; today, audited financial statements are made available for use by third parties. Id. “[I]t is common knowledge that companies use audits for many proper business purposes, such as submission to banks and other lending institutions … and to suppliers of services and goods that might advance credit.” Id. The court quoted an SEC decision rendered twenty-five years earlier, stating that “the responsibility of a public accountant is not only to the client who pays his fee, but also to investors, creditors, and others who may rely on the financial statements which he certifies.” Id. (citing In re Touche, Niven, Bailey & Smart, 37 S.E.C. 629, 670 (1957)).

In providing accounting statements which all concerned may accept as disinterested expressions, based on technically sound auditing procedures and experienced judgment and expertise, the CPA serves as a kind of arbiter or umpire among all the varied interests. Id. at 150; see supra note 89 and accompanying text (describing the role of the independent accountant in today’s society).
audits. The court pointed out that by imposing a duty to foreseeable users, accounting firms may engage in more thorough reviews which, as the court noted, should in turn reduce the number of negligence claims against auditors. Additionally, in support of its holding, the court noted the apparent ability of accounting firms to obtain insurance against third party claims for negligent misrepresentation.

Two other state high courts, those of Wisconsin and Mississippi, have also endorsed the reasonably foreseeable rule. In *Citizens State Bank v. Timm, Schmidt & Co.*, the plaintiff bank extended a loan to a company in reliance on audited financial statements which were negligently prepared by its accountants. The Wisconsin Supreme Court relied on the rationales of compensation, risk-spreading, and deterrence in imposing liability on the accountants for the foreseeable injuries resulting from their negligent acts. The court explained that unless liability is imposed on the negligent accountant to reasonably foreseeable third parties, third parties who rely on the accuracy of financial statements will go unprotected and accountant negligence will go undeterred. Without recovery, the court cautioned that the cost of credit to the general public will increase because creditors will either have to absorb the cost of bad loans made in reliance on faulty financial statements, or hire independent accountants to verify the information they receive.

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185. *Id.* The court explained that firms may become more thorough by setting up stricter standards and applying closer supervision. *Id.*
186. *Id.* at 151. The court recognized that, at the time, accounting firms were able to obtain insurance against third party claims under the federal securities laws, and thus posited that the same or similar protection would be available in this instance. *Id.*
188. 335 N.W.2d 361 (Wis. 1983).
189. *Id.* at 362. The accountants were negligent in failing to conduct the audit in accordance with GAAS. *Id.* If the accountants had properly complied with GAAS, the court stated that material errors in the financial statements would have been discovered and corrected. *Id.* at 363.
190. *Id.* at 365. The court further stated that "public policy" factors inherent in a particular case may call for a limitation of liability. *Id.* at 366-67. These factors, which recognize that liability should not be imposed even if negligence is found, include determinations of whether: (1) the injury is too remote from the negligent act; (2) the injury is disproportionate to the culpability of the negligent party; (3) in retrospect, it appears too improbable that the negligence was the cause of the injury; (4) allowing the plaintiff to recover would unreasonably burden the negligent party; (5) allowing recovery would result in an increased potential for fraudulent claims; or (6) allowing recovery would create problems of indeterminate liability. *Id.* at 366.
191. *Id.* at 365.
192. *Id.*
court also noted that accountants have the ability to spread the risk through the use of liability insurance.\textsuperscript{193}

In \textit{Touche Ross & Co. v. Commercial Union Ins. Co.},\textsuperscript{194} the Mississippi Supreme Court continued the trend begun in \textit{Rosenblum}. Touche Ross, as an independent auditor for Fidelity Bank (“Fidelity”), knew that Fidelity was insured against employee fraud with a “Banker’s Blanket Bond” issued by its carrier, United States Fidelity & Guaranty Company (“USF&G”).\textsuperscript{195} Touche Ross also knew that USF&G could cancel its coverage with thirty days notice, which in fact it did four months after the Fidelity audit was completed.\textsuperscript{196} In seeking other insurers, Fidelity showed insurers the audited financial statements by Touche Ross.\textsuperscript{197} In reliance on the financial statements — which, it turned out, had been negligently prepared — Commercial Union extended coverage to Fidelity.\textsuperscript{198}

Under the facts of the case, Touche Ross would not have been liable under the \textit{Ultramares} privity doctrine\textsuperscript{199} because they did not know of Commercial Union’s reliance, nor would they have been liable under the \textit{Restatement (Second)} approach\textsuperscript{200} since they did not supply Fidelity with the audited financial information for the benefit or guidance of Commercial Union.\textsuperscript{201} The court did not, however, rely on either of these two views. Instead, the court applied the reasonably foreseeable approach and found that Touche Ross should have “reasonably foreseen that an entity such as Commercial Union Insurance Company” might rely on the audit.\textsuperscript{202} The court found that an independent auditor is liable to reasonably foreseeable users of an audit report,\textsuperscript{203} including those users who request and receive a financial statement from the audited entity for a proper

\textsuperscript{193} Id.
\textsuperscript{194} 514 So. 2d 315 (Miss. 1987).
\textsuperscript{195} Id. at 321.
\textsuperscript{196} Id.
\textsuperscript{197} Id. at 323.
\textsuperscript{198} Id. at 316. Touche Ross was negligent in failing to disclose Fidelity’s departure from GAAP.
\textsuperscript{199} Id. at 321; see supra notes 101-37 and accompanying text (discussing the \textit{Ultramares} privity doctrine).
\textsuperscript{200} Touche Ross, 514 So. 2d at 321-22; see supra notes 139-70 and accompanying text (discussing the \textit{Restatement (Second)} approach).
\textsuperscript{201} Touche Ross, 514 So. 2d at 321; see Paschall, supra note 2, at 721 (explaining that the negligent accountant would have been free from liability under either the \textit{Ultramares} privity rule or the \textit{Restatement (Second)} approach).
\textsuperscript{202} Touche Ross, 514 So. 2d at 323.
\textsuperscript{203} Id. at 322.
business purpose. To recover, they must detrimentally rely on the audit, suffering a loss which is proximately caused by the negligence of the auditor.\textsuperscript{204}

In addition to these three state supreme courts, the California Court of Appeals also adopted the reasonably foreseeable doctrine in \textit{International Mortgage Co. v. John P. Butler Accountancy Corp.},\textsuperscript{208} when it permitted recovery by a real estate developer who had relied on negligently prepared financial statements in making an agreement to purchase and sell government loans.\textsuperscript{206} The court rejected \textit{Ultramares} for being inconsistent with state negligence law, and emphasized the changing role of the independent accountant in today's society.\textsuperscript{207} The court explained that the risk of loss is more appropriately placed on the accounting profession, as it is better able to pass such risk to its customers and the consuming public.\textsuperscript{208} The \textit{International Mortgage} court also found that society would be better served by this rule because it provides a financial disincentive for negligent conduct and heightens the profession's cautionary techniques.\textsuperscript{209}

An accountant's access to insurance is one of the primary rationales for the reasonably foreseeable approach;\textsuperscript{210} it is argued that the availability of insurance alleviates the burden on accountants when holding them liable.\textsuperscript{211} This premise is disputed by some courts and commentators who claim that insurance merely causes higher premiums to the accountant.\textsuperscript{212} Ultimately, the increased

\begin{footnotesize}
\textsuperscript{204} Id. at 322-23. Although the court found the auditor's original negligence actionable, it ended up reversing the jury's determination in favor of Commercial Union due to the occurrence of an intervening cause; namely, criminal conduct by the bank's president. \textit{Id.} at 323-24.

\textsuperscript{205} 223 Cal. Rptr. 218 (Cal. Ct. App. 1986). \textit{International Mortgage} was expressly overruled by the California Supreme Court in \textit{Bily v. Arthur Young & Co.}, 834 P.2d 745 (Cal. 1992); see infra notes 217-81 and accompanying text (discussing the \textit{Bily} decision).

\textsuperscript{206} \textit{International Mortgage}, 223 Cal. Rptr. at 227.

\textsuperscript{207} Id. "We have determined the protectionist rule of privity announced in \textit{Ultramares} is no longer viable, for the role of the accountant in our modern society has changed." \textit{Id.} at 226. For a more detailed discussion, see Ann Simmons, Note, \textit{International Mortgage Co. v. John P. Butler Accountancy Corp.: Third Party Liability — Accountants Beware.}, \textit{18 Pac. L.J.} 1055 (1986).

\textsuperscript{208} \textit{International Mortgage}, 223 Cal. Rptr. at 227.

\textsuperscript{209} \textit{Id.}


\textsuperscript{212} \textit{Id.} Liability insurance premiums have increased 300 percent in the accounting profession since 1985. \textit{Id.} Additionally, the large accounting firms report an increase in premiums of 1000 percent, while the available coverage has been cut in half. \textit{Id.} In an AICPA survey of accounting firms, 40 percent of the surveyed firms indicated that they carried no insurance because of the prohibitive costs involved. James H. Thompson, \textit{Professional Liability Insurance: Go Bare or Not?}, \textit{J. Acct.}, July 1991, at 111.
\end{footnotesize}
cost of insurance and the cost of settlements or judgments are reflected in higher auditing bills which are passed on to the client.  

Regardless of this debate, the reasonably foreseeable standard marks a significant departure from the restrictive view of Ultramares and the middle ground of the Restatement (Second). It serves to expand the class of parties to whom accountants owe a legal duty of reasonable care, a change in liability which represents a trend toward making the accountant's duty commensurate with his central role in today's business world.

III. SUBJECT OPINION: BILY V. ARTHUR YOUNG & CO.

In 1986, the California Court of Appeals adopted the reasonably foreseeable doctrine in the case of International Mortgage Co. v. John P. Butler Accountancy Corp. Six years later, the California Supreme Court overruled International Mortgage and adopted the Restatement (Second) approach in Bily v. Arthur Young & Co.

A. Factual Background and Procedure

The plaintiffs were investors in Osborne Computer Corporation, a company which manufactured the first portable personal computer for the mass market. Shipment of the company's sole

213. Brodsky, supra note 211, at 15.
214. Ultramares Corp. v. Touche, Niven & Co., 174 N.E. 441 (N.Y. 1931); see supra notes 101-18 and accompanying text (discussing the Ultramares privity doctrine).
215. RESTATEMENT (SECOND) OF TORTS § 552 (1977); see supra notes 139-70 and accompanying text (discussing the Restatement (Second) approach).
216. See Paschall, supra note 2, at 721 (stating that accounting is no longer a profession in its infancy but one that has flourished financially and has enjoyed the status and prestige often associated with the legal and medical professions). One commentator notes: [A] reexamination of the assumptions and basis for Ultramares reveals that the decision is no longer valid, and its result is that accountants today generally do not have legal responsibility for their professional conduct to match their significant role in the modern business community. The accounting profession is not a new and developing profession in need of judicial protection, nor are the standards of the profession in their formative years. . . . Finally, the use of financial reports by third parties who are expected to rely on them is no longer a collateral matter to the preparation of the report for the client.
217. 223 Cal. Rptr. 218 (Cal. Ct. App. 1986); see supra notes 205-09 and accompanying text (discussing the International Mortgage case).
219. Id. at 747. The plaintiffs included individual investors as well as pension and venture capital investment funds. Id.
220. Id.
product, the Osborne I computer, began in 1981; by the fall of 1982, sales had reached $10 million per month, making the company one of the fastest growing businesses in the history of American industry.\footnote{221}

In late 1982, the company began planning for an initial public offering of its stock in early 1983. The company engaged three investment banking firms as underwriters for this venture, who suggested that the company postpone the offering for several months.\footnote{222} In need of financing to meet its capital requirements until the public offering, the company issued warrants to investors in exchange for direct loans or letters of credit to secure bank loans to the company.\footnote{223} Several of the plaintiffs had purchased warrants from the company, while others had purchased common stock of the company during early 1983.\footnote{224} One such investor, Robert Bily, who was also a director of the company, purchased 37,500 shares of stock from Adam Osborne, the company's founder, for $1.5 million.\footnote{225}

The company retained Arthur Young & Company\footnote{226} to perform audits and issue audit reports on its 1981 and 1982 financial statements.\footnote{227} Arthur Young issued an unqualified opinion\footnote{228} on both the 1981 and 1982 financial statements.\footnote{229} The 1981 financial statements showed a net operating loss of about $1 million on sales of $6

\footnote{221. Id.}
\footnote{222. Id. Postponement was suggested in part because of uncertainties caused by the company's employment of a new chief executive officer and its plans to introduce a new computer to replace the Osborne I. Id.}
\footnote{223. Id. The warrants entitled their holders to purchase blocks of the company's stock at favorable prices that were expected to yield a large profit if and when the company's public offering took place. Id.}
\footnote{224. Id.}
\footnote{225. Id.}
\footnote{226. Id. Arthur Young, at the time of the audits, was one of the "Big Eight" public accounting firms. It has since merged with Ernst & Whinney to become Ernst & Young, now one of the "Big Six" accounting firms. Id.}
\footnote{227. Id. As the company's auditor, Arthur Young's responsibility was to examine the annual financial statements prepared by the company's internal accountants, examine the books and records of the company, and issue an opinion on those financial statements. Id.}
\footnote{228. Recall that an unqualified opinion states that in the auditor's opinion, the financial statements fairly represent the financial position of the company. See supra notes 39-41, 58-63 and accompanying text (describing the unqualified opinion and the assurances that accompany it).}
\footnote{229. Bily, 834 P.2d at 747. Each opinion was on Arthur Young's letterhead, was addressed to the company, and stated in essence that: (1) Arthur Young had performed an examination of the accompanying financial statements in accordance with GAAS; (2) the statements had been prepared in accordance with GAAP; and (3) the statements "present[ed] fairly" the company's financial position. Id.; see supra notes 18, 23, 39-41, 58-63 and accompanying text (explaining GAAP, GAAS, and the unqualified opinion, respectively).}
million, while the 1982 financial statements revealed a modest net operating profit of $69,000 on sales of more than $68 million dollars. Arthur Young's audit report on the 1982 financial statements was issued on February 11, 1983, and 100 sets of the opinion were delivered to the company.

As the warrant transaction closed on April 8, 1983, the company's financial performance quickly began to falter, and sales declined sharply. When the new Osborne "Executive" model computer appeared on the market, sales of the Osborne I naturally declined, but they were not being replaced by Executive units because they could not be produced fast enough due to manufacturing problems. In June 1983, the IBM personal computer and IBM-compatible software became major factors in the small computer market, further damaging the company's sales. The public offering never materialized, and the company filed for bankruptcy in September of 1983.

The plaintiffs, having lost their investment, brought suit against Arthur Young. The plaintiffs testified that their investments were made in reliance on Arthur Young's unqualified opinion on the company's 1982 financial statements, and alleged that the firm had negligently conducted the audit. In support of their position, the plaintiffs raised three theories of recovery: fraud, negligent misrepresentation, and professional negligence.

At trial, the plaintiffs offered an expert witness, William J. Baedecker, who expressed the opinion that Arthur Young's performance amounted to gross negligence. He determined that Arthur

230. Bily, 834 P.2d at 748.
231. Id.
232. Id.
233. Id.
234. Id.
235. Id.
236. Id.
237. Id.
238. Id.
239. Id.
240. Id. at 748. With respect to liability to third parties, the jury instructions on negligence were given in accordance with International Mortgage Co. v. John P. Butler Accountancy Corp., 223 Cal. Rptr. 218 (Cal. Ct. App. 1986). The jury was told that "an accountant owes a further duty of care to those third parties who reasonably and foreseeably rely on an audited financial statement prepared by the accountant. A failure to fulfill any such duty is negligence." Bily, 834 P.2d at 749; see supra notes 205-09 and accompanying text (discussing the International Mortgage case).
241. Bily, 834 P.2d at 748. Baedecker reviewed the 1982 audit and identified more than forty
Young did not perform its examination in accordance with GAAS. Further, he determined that Arthur Young had discovered material weaknesses in the company’s accounting controls but had failed to report this knowledge to Osborne’s management.

At the trial court level, the jury exonerated Arthur Young with respect to the fraud and negligent misrepresentation allegations, but returned a verdict for the plaintiffs based on professional negligence. The appellate court affirmed this judgment, but the California Supreme Court reversed the negligence verdict. Significantly, the California Supreme Court overruled the reasonably foreseeable rule established in *International Mortgage* in favor of a negligent misrepresentation rule in accordance with Section 552 of the *Restatement (Second) of Torts*. A dissenting opinion argued that the existing law should be preserved and that negligent accountants should be held accountable for reasonably foreseeable injuries caused by the faulty performance of their professional duties in auditing financial statements.

**B. The Bily Opinions**

1. **The Majority Decision**

Writing the majority opinion for the California Supreme Court, Chief Justice Malcolm Lucas separately analyzed the requirements for liability under professional negligence and negligent misrepresentation. The majority differentiated between a cause of action deficiencies in Arthur Young’s performance. *Id.*

242. *Id.* Baedecker found the company’s liabilities on the financial statements to have been understated by approximately $3 million. As a result, the reported profit of $69,000 should have been reported as a loss of more than $3 million. *Id.*

243. *Id.* Baedecker also charged that Arthur Young had actually discovered deviations from GAAP, but failed to qualify its opinion and disclose these deviations in the audit report. *Id.*

244. *Id.* at 749. The jury awarded compensatory damages of approximately $4.3 million dollars, representing approximately 75 percent of the total investment made by the plaintiffs. *Id.*

245. *Id.*

246. *Id.* at 774.

247. *Id.* at 747.

248. *Id.* at 786 (Kennard, J., dissenting).

249. *Id.* at 760. In addition to professional negligence and negligent misrepresentation, the court discussed intentional misrepresentation (fraud). This Note, however, will only discuss the negligence and negligent misrepresentation actions. In intentional misrepresentation, the auditor’s actual knowledge of the false character of its opinion is not required. Instead, if the accountant has no belief in the truth of the statement and makes it recklessly, without knowing whether it is true or false, the accountant has also made an intentional misrepresentation. *Id.* at 773.
for pure negligence and one for negligent misrepresentation.  

(a) Negligence  

The majority held that the scope of an auditor's liability for general negligence in conducting an audit of its client's financial statements is confined to the client; other persons may not recover under a pure negligence theory, but instead may recover under a theory of negligent misrepresentation. The court based its holding on three central concerns: (1) that the auditor who is exposed to liability for negligence from all foreseeable third parties faces potential liability grossly disproportionate to his degree of fault; (2) that the potential class of third parties in accountant liability claims is generally sophisticated enough, able to conduct its own private investigation, and has its own contracting power in making prudent decisions; and (3) that the asserted advantages of accurate auditing and efficient loss-spreading, as relied upon by advocates of the foreseeability rule, are unlikely to occur.  

First, the court expressed concern that accountants would face potential liability disproportionate to their fault. It explained that mere foreseeability of harm by a third party is insufficient in relation to the possibility of multibillion-dollar professional liability, which is out of proportion to the fault of the auditor and the connection between the auditor's conduct and the third party's injury.  

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250. *Id.* at 760; see infra note 287-88 and accompanying text (discussing the dissent's argument that two such similar causes of action should not result in different outcomes depending on which action is pled).  
251. *Bily*, 834 P.2d at 767.  
252. *Id.*  
253. *Id.* at 761.  
254. *Id.*  
255. *Id.*  
256. *Id.* at 761-64. As other courts and commentators have noted, such disproportionate liability cannot be justified. See Siliciano, *supra* note 2, at 1944-45 (discussing disproportionate liability as one of the reasons courts are reluctant to allow recovery); Gormley, *supra* note 154, at 77 (discussing the fact that the independent auditor does not control the client's accounting records and processes, and concluding that a rule imposing liability on an accountant for reasonably foreseeable consequences of his negligence would be unfair). As one commentator has summarized:  

The most persuasive basis for maintaining the limited duty [of auditors] is a proportionality argument. . . . It can be argued as a general proposition in these cases that the wrongdoing of an accountant is slight compared with that of the party who has deceived him (his client) as well as the plaintiff. This rationale for nonliability is similar to the proximate cause grounds on which willful intervening misconduct insulates a "merely negligent" party from liability.  

Robert L. Rabin, *Tort Recovery for Economic Loss: A Reassessment*, 37 STAN. L. REV. 1513,
Second, the court recognized that the potential class of third parties who rely on such audits are more knowledgeable than ordinary consumers. The Bily majority noted that while the maker of consumer products has total control over the design and manufacture of its product, the auditor simply expresses an opinion about the client's financial statements, thus making the client essentially responsible for the content of those statements. The court further indicated that third parties should be encouraged to rely on their own prudence and contracting power. The court argued that such "self-reliance" will promote sound investment decision-making.

Finally, the asserted advantages of the reasonably foreseeable approach, according to the court, are unlikely to occur. Advocates of the foreseeability rule explain that such a rule will be a deterrent, leading to greater care and diligence in auditing, and that auditors should bear the loss from negligently prepared financial statements. The court, however, discounted this argument, citing a lack of supporting empirical data, and predicted that detrimental economic results are just as likely to occur. Thus, for the negligence cause of action, the court adopted the Ultramares privity doctrine. The court next addressed the plaintiffs' negligent misrepresentation claim.

1536-37 n.74 (1985).

257. Bily, 834 P.2d at 764. In discussing the prospect of private ordering, the court discounted the analogy between the auditor's opinion and a consumer product, which advocates of the foreseeability doctrine use when arguing that the privity barrier is unwarranted. See, e.g., H. Rosenblum, Inc. v. Adler, 461 A.2d 138 (N.J. 1983) (arguing that the demise of privity as a barrier to recovery for negligence in products liability cases implies its irrelevance in the area of accountant liability as well).

258. Bily, 834 P.2d at 765. The court noted that if third parties were allowed to recover, the auditor, in effect, would become an insurer of not only the financial statements, but also of bad loans and investments in general. Id.

259. See supra note 171-216 and accompanying text (describing the rationales for the reasonably foreseeable approach).

260. Bily, 834 P.2d at 765-66. For example, accountants will reduce audit services in fledgling industries where the failure rate is high, and costs of audits will increase, along with a decrease in the availability of audits, with no corresponding improvement in overall audit quality. Id.; see also Daniel R. Fischel, The Regulation of Accounting: Some Economic Issues, 52 Brook. L. Rev. 1051, 1055 (1987) (discussing how increased accountant liability will create "defensive accounting" and increase client costs); Siliciano, supra note 2, at 1960-65 (discussing the incentive for accountants to use evasive behavior rather than enhanced care in responding to increased liability and the consequences associated with expanded liability).

261. The court determined that negligent misrepresentation was a separate and distinct tort from the tort of negligence. Bily, 834 P.2d at 768. Negligent misrepresentation occurs "[w]here the defendant makes false statements, honestly believing that they are true, but without reasonable ground for such belief . . . ." Id.
b. Negligent Misrepresentation

After analyzing the three approaches for allowing third parties to recover from a negligent accountant, the court determined that the Restatement (Second) approach was the most favorable. Thus, the majority expressly overruled the reasonably foreseeable rule of International Mortgage in favor of a negligent misrepresentation rule in accordance with Section 552 of the Restatement (Second) of Torts. The court reasoned that this was a more moderate approach to the potential consequences of imposing unlimited negligence liability. The majority reasoned that the Restatement (Second) rule is justified because: (1) it requires the accountant to receive notice of potential third party claims; which in turn (2) establishes a closer connection between the accountant's negligent act and the recipient's injury; and (3) no unfairness results to the recipient because he has means of private ordering, he can establish direct communication with an auditor, and he can obtain a report for his own direct use and benefit.

The court stated that requiring notice of potential third parties to the accountant allows the accountant to discern the potential scope of his liability and make rational decisions regarding the venture. Identifying the limited class of plaintiffs as those to whom the accountant himself has directed his activity establishes a closer connection between the accountant's negligent act and the injury. This alleviates the otherwise troublesome concerns of causation and of credible proof of reliance. Finally, the court concluded that no unfairness to third parties results because they have the option of private ordering.

2. The Dissenting Opinion

The dissent argued that the majority's holding in effect gives negligent accountants broad immunity for their professional malprac-
tice in issuing unqualified audit opinions. Instead, the dissent endorsed the rule that accountants owe a duty of care to all persons who would reasonably and foreseeably rely on the accountant's professional opinion. It also disagreed with the majority in its formulation of two different rules for the general tort of negligence and the factually-related theory of negligent misrepresentation.

The proper determination of the scope of negligence liability, the dissent argued, should begin with the principle that "an individual who has acted negligently is liable for all reasonably foreseeable injuries caused by that negligence." Therefore, the dissent argued that accountants are liable for all reasonably foreseeable injuries caused by the negligent performance of their professional duties.

The dissent explained that accountants should be liable for their negligent acts unless public policy justifies a special limitation. To determine whether public policy justifies a limitation on the scope of the duty owed in a particular context, the dissent recognized the approach taken by many jurisdictions and recommended that the courts should consider: (1) whether the harm to third parties is foreseeable; (2) whether economic injury to third persons is certain; (3) whether the accountant's conduct is closely connected to the injury suffered; (4) whether the moral blame is comparable to other actionable professional negligence; (5) whether the liability prevents future harm; (6) the burden to accountants and the consequences to the community of imposing liability; and (7) the availability, cost, financial statements audited by Arthur Young contained material errors that they would have discovered had they used reasonable care in conformity with GAAS. As a result of Arthur Young's carelessness, a number of investors incurred tremendous losses when the corporation became insolvent. Had the auditors issued a qualified, adverse, or disclaimer opinion, the financial status of Osborne would have been more accurately expressed, and the third parties likely would not have had a cause of action against the auditors. See supra notes 36-56 and accompanying text (discussing the different types of audit opinions).

271. Bily, 834 P.2d at 774 (Kennard, J., dissenting). The dissent pointed out that the financial statements audited by Arthur Young contained material errors that they would have discovered had they used reasonable care in conformity with GAAS. As a result of Arthur Young's carelessness, a number of investors incurred tremendous losses when the corporation became insolvent. Id. Had the auditors issued a qualified, adverse, or disclaimer opinion, the financial status of Osborne would have been more accurately expressed, and the third parties likely would not have had a cause of action against the auditors. See supra notes 36-56 and accompanying text (discussing the different types of audit opinions).

272. Bily, 834 P.2d at 775 (Kennard, J., dissenting). Unlike the majority, the dissent would have upheld the law of International Mortgage Co. v. John P. Butler Accountancy Corp., 223 Cal. Rptr. 218 (Cal. Ct. App. 1986).

273. Bily, 834 P.2d at 775-76 (Kennard, J., dissenting). The majority allowed only the client to recover in negligence, and allowed third parties to recover under the Restatement (Second) approach in negligent misrepresentation claims. As the dissent noted, with regard to the negligence claim, the majority resurrected the "anachronistic privity barrier" in its strictest form. Id. at 783-84 (Kennard, J., dissenting).

274. Id. at 776 (Kennard, J., dissenting).

275. Id.

276. Id.
and prevalence of insurance for the risk involved. Applying these factors to the facts of the case, the dissent determined that negligent accountants should not be afforded more favorable treatment. The dissent acknowledged that holding negligent accountants liable to reasonably foreseeable third parties who detrimentally rely on faulty audit reports will: (1) compensate innocent victims; (2) encourage greater care in the performance of audits; (3) reinforce the independence of accountants from their clients; and (4) avoid misallocation of capital resources, all to the benefit of the accounting profession, the relying third parties, and the public at large.

The dissent also detailed its dislike for the Restatement (Second) view as applied in support of the tort of negligent misrepresentation. When applied to the audit opinions of independent accountants, the Restatement rule imposes liability only when the negligent accountant has actual knowledge of the client's intended use of the audited financial statements, but not when the intended use of the client — although not specifically revealed — is plainly obvious to the accountant by virtue of the client's financial situation and common business practices. The dissent felt it unreasonable to suggest, as the majority did, that third parties can protect themselves by diversifying their investment and loan portfolios and by obtaining their own audits. This results in unwarranted protection for the

277. Id. These factors have been extensively relied upon by California courts, as well as other jurisdictions, as a test for ascertaining whether the defendant owed a duty to the plaintiff. E.g., Horwarth v. Pfeifer, 443 P.2d 39, 42 (Alaska 1968); Tarasoff v. Regents of the Univ. of California, 551 P.2d 334, 342 (Cal. 1976); A.R. Moyer, Inc. v. Graham, 285 So. 2d 397, 401 (Fla. 1973); see also Wiener, supra note 2, at 244-45 (discussing the use of these factors by several courts as a generally applicable test for determining liability in negligence).

278. Bily, 834 P.2d at 783 (Kennard, J., dissenting).

279. Id. at 784 (Kennard, J., dissenting). As the dissent pointed out, the arbitrariness of this distinction has been justly condemned. Id. The effect of the Restatement (Second) is to reward ignorance and to penalize knowledge. As the dissent stated, to avoid liability, the accountant need only agree with the client to remain unaware of the report's intended distribution and future uses. Id.

Some commentators believe that there is no reason for preferring an actually foreseen third-party user over a reasonably foreseeable one. Mark D. Boveri & Brent E. Marshall, Note, The Enlarging Scope of Auditors' Liability to Relying Third Parties, 59 Notre Dame L. Rev. 281, 287 (1983). Neither party pays for the audit, and thus neither party is owed a greater duty of care from the accountant. Id. Since today's accountants fully expect third parties to rely on their opinions, the distinction is simply unjustified. Id.; see also Blue Bell v. Peat, Marwick, Mitchell & Co., 715 S.W.2d 408, 412 (Tex. Ct. App. 1986) (holding that allowing liability to turn on the fortuitous occurrence of the client specifically mentioning the person or class of persons to receive a report, when the accountant probably has that same knowledge as a matter of business practice, is too tenuous a distinction to be adopted as a rule of law).

280. Bily, 834 P.2d at 785 (Kennard, J., dissenting). In response to these claims, the dissent
"wealthy and financially savvy" at the expense of the innocent lenders and investors, "whose only faults are their modest means and their willingness to place their trust in independent audit reports."281

IV. Analysis

The *Bily* v. Arthur Young & Co.282 court had three options: it could have reverted to the *Ultramares* privity doctrine, taken a short trip back to the Restatement (Second) approach, or affirmed the "reasonably foreseeable" approach of International Mortgage. Unfortunately, the *Bily* court chose the middle ground, the Restatement (Second) approach.283 The court made this short trip backwards, and as a result has left many injured third parties uncompensated and without recourse.

It is the position of this Note that the best option would have been to affirm the reasonably foreseeable approach. In analyzing the *Bily* court's options, each approach will be discussed for the purpose of demonstrating that the reasonably foreseeable approach is, in fact, the best option. The analysis of accountant negligence begins with the question of duty: whether accountants owe a duty to reasonably foreseeable third parties. In essence it is a question of fairness, and involves the weighing of public policy factors. Upon a weighing of these factors, it will become clear that public interest is best served by imposing a duty of care on accountants to reasonably foreseeable users of financial statements.

The *Bily* majority denied recovery to a third party from a negligent accountant.284 Under the professional negligence theory, the court held that an accountant owes no general duty of care for the

noted several problems. First, it is based on the principle of caveat emptor ("buyer beware"), which conflicts with the moral and ethical responsibility of CPAs to exercise due care to avoid harm to foreseeable users. *Id.* Second, it ignores the general principle that the risk of loss should be placed on the negligent party who is best able to prevent such conduct. *Id.* Finally, it affords the least protection to the parties who need it most. *Id.* The majority's private ordering argument, that investors can conduct their own audits or obtain a separate opinion as to the status of a given client, would cause a wasteful duplication of effort and expense, resulting in the delay and disruption of business activity together with higher costs for each transaction, thus leading to higher interest charges and demands for higher investment returns. *Id.*

281. *Id.*
283. RESTATEMENT (SECOND) OF TORTS § 552 (1977); see supra notes 139-70 and accompanying text (discussing the Restatement (Second) approach).
284. *Bily*, 834 P.2d at 747.
conduct of an audit to persons other than his client.\textsuperscript{285} Thus, under a professional negligence theory, the third party has no cause of action. Alternatively, the court held that under the theory of negligent misrepresentation a third party can recover under the \textit{Restatement (Second)} approach.\textsuperscript{286} But as the dissent pointed out, these two factually similar tort theories do not warrant such drastic differences in application;\textsuperscript{287} rather, the same standard should govern when applying either theory.\textsuperscript{288}

\textbf{A. The Ultramares Approach}

The \textit{Bily} court was correct in rejecting the option of applying the \textit{Ultramares} privity doctrine, as this doctrine is no longer appropriate in today's financial environment. Historically, third party liability was not even a concern because auditors owed sole responsibility to the owner or management of a business;\textsuperscript{289} any use by a third party was merely incidental.\textsuperscript{290} The \textit{Ultramares} privity doctrine was the logical limit for accountant liability in negligence. The rarity of third party use justified requiring the third party and the accountant to be in privity before liability would extend to the third party.

This justification lost its validity over time as auditors were called upon more and more to provide lenders and investors with independent opinions on the preparation of a company's financial statements.\textsuperscript{291} Today, the audit report is largely for the benefit of third party users,\textsuperscript{292} and since the \textit{Ultramares} privity doctrine has failed to keep up with the evolution of the auditor's function, it therefore is no longer workable given the reality that accountants now provide audit reports largely for the benefit of third parties. Having shown that \textit{Ultramares} is not truly an option, the next approach to consider is the \textit{Restatement (Second)} approach.

\begin{footnotes}
\item 285. \textit{Id.}
\item 286. \textit{Id.}
\item 287. \textit{Id.} at 775-76 (Kennard, J., dissenting). As the dissent correctly observed, under both liability theories — general negligence and negligent misrepresentation — essentially the same standard of care is applied to the same conduct by the accountant. \textit{Id.} Thus, it seems anomalous that the class of persons the accountant owes a duty differs depending on which legal theory is raised. \textit{Id.} at 776 (Kennard, J., dissenting).
\item 288. \textit{Id.}
\item 289. Wiener, \textit{supra} note 2, at 249-50.
\item 290. \textit{Id.}
\item 291. \textit{Id.}
\item 292. \textit{Id.} at 250. The SEC recognizes that dependable financial information is essential for informed business decisions. \textit{Id.}
\end{footnotes}
B. The Restatement (Second) Approach

The majority opinion in Bily adopted the Restatement (Second) approach in holding accountants liable to actually foreseeable third parties and limited classes of foreseeable parties. Although the Restatement (Second) provides an improvement over the restrictive Ultramares privity standard, as it parallels the evolution of the auditor’s function, it still remains unnecessarily limited.

The Restatement (Second) advances several rationales in support of its actually foreseen or specifically foreseeable standard. For example, the user of commercial information cannot expect that a duty be extended to him when the supplier is unaware of the terms of the third-party obligation. Second, these limitations are imposed to promote the free “flow of commercial information upon which our economy rests.”

These rationales ignore reality. Auditors know that individuals throughout the business world rely on audited financial information, and the Restatement (Second), by requiring the accountant’s subjective knowledge of any third parties, results in arbitrary outcomes. For example, an auditor will escape liability where he knows a specific lender (“Bank X”) will only use the audit report to lend to the client, but where in reality a different lender (“Bank Y”) lends the funds to the client. The auditor knew that the report was going to be used for lending purposes, but because a lender other than the one specified was used, the auditor dodges liability. Another example of how the Restatement (Second) rule allows the auditor to avoid liability for negligence occurs where the auditor knows the specific third party is considering selling goods to the client on credit in reliance on the audit, but instead the third party decides to buy a controlling interest in the client, also in reliance on the audit.

While the first transaction is actually foreseeable, the second is not. Clearly, such arbitrary results are troubling.

293. Recall that the Restatement (Second) approach requires the auditor to have specific knowledge of the third-party user, or the limited class of third parties for whom the client intends as users of the audit report. See supra notes 139-70 and accompanying text (discussing the Restatement (Second) approach).


295. Frank, Comment, supra note 2, at 317; see also H. Rosenblum, Inc. v. Adler, 461 A.2d 138 (N.J. 1983) (noting that the auditors “could reasonably expect that their client would distribute the [audited] statements in furtherance of matters relating to business”).


297. Id. cmt. j, illus. 14.
Additionally, the argument in favor of the free flow of information is not safe from criticism. The free flow of information is not impeded by allowing recovery to reasonably foreseeable users of the financial statements; in fact, because of risk-spreading, the disseminated information is more reliable and can be continually improved to avoid any potential liability. Further, the justification of promoting the free flow of information is unnecessary in a world where such information is required of most companies whose securities are traded publicly and who must file certified financial reports with the SEC.

The majority opinion in Bily v. Arthur Young & Co. advanced three central concerns in its rejection of the reasonably foreseeable approach: (1) the accountant will face potential liability vastly disproportionate to its fault; (2) the class of reasonably foreseeable plaintiffs are knowledgeable and can obtain their own assurances through private ordering; and (3) the asserted advantages of deterrence and efficient loss-spreading are unlikely to occur.

These justifications are also not safe from criticism. Like the majority, critics of the reasonably foreseeable standard are concerned about indeterminate liability. However, accountants can avoid this fear of indeterminate liability by using disclaimers in their reports of financial statements. Additionally, accountants can limit their liability through agreements with the client calling for restricted distribution of the audit reports. Furthermore, accountants can obtain insurance to curb the potential costs of liability. Even if the availability of insurance is in question, it should only be a peripheral issue in determining tort liability in general. Courts have pointedly disregarded the insurance issue in other areas of enterprise liability, and it should similarly be disregarded when de-

298. Frank, Comment, supra note 2, at 318.
299. See Hagen, Accountants' Liability, supra note 2, at 200 (elaborating on the weaknesses of the Restatement's justifications).
300. 834 P.2d 745 (Cal. 1992).
301. Id. at 761.
303. Id. A disclaimer opinion would state how the audit did not meet proper auditing standards and the grounds for that failure. Id.
304. Paschall, supra note 2, at 726-29. Such disclaimers give fair notice to all potential users and prevent third parties from reasonably relying on such information. Bily, 834 P.2d at 785 (Kennard, J., dissenting).
305. Garrison, Note, supra note 2, at 211.
306. Id.
termining the extent of an accountant's liability to third parties.307

The Bily majority also claimed that third parties in such instances are adequately knowledgeable, able to diversify their investments, and can obtain their own assurances of a company's financial statements.308 As the dissent pointed out, there are several problems with this argument. First, it is based on the principle of caveat emptor ("buyer beware"), which in this context conflicts with the ethical and moral responsibility of accountants to exercise due care to avoid harm to foreseeable users.309 Second, it ignores the general principle that a risk of loss should be placed on the party who is best able to prevent its occurrence.310 Finally, it affords the least protection to those who are most in need of it.311 Requiring each investor and lender to obtain separate audit reports essentially results in wasteful duplication of expense and effort.312 The majority's rule protects the "financially savvy" at the expense of innocent lenders and investors.313

Finally, the majority claimed that the asserted advantages of deterrence and efficient loss-spreading are unlikely to occur. The majority argued that because there was no empirical data to show that the reasonably foreseeable approach has had positive effects on accountants' negligence actions, it is unworkable.314 This rationale, however, is without merit. Even if this were true, the remedy should come from legislation and not from the reduction of a legal duty by the courts.315 It is a generally accepted principle that tort liability is itself socially beneficial to the extent that it provides both an incentive for due care, thereby preventing avoidable injuries, and compensation for those who have been injured.316

307. Wiener, supra note 2, at 257. It is similarly recognized that the standard of reasonably foreseeable third party recovery will result in increased litigation and expense. There is no logic to relieving accountants of liability on such a basis, illustrated by the fact that the courts have failed to make such a trade-off in other areas of negligence law. Id.
309. Id. at 785 (Kennard, J., dissenting).
310. Id.
311. Id. Diversification would be easy for large institutional investors and lenders, but difficult or even impossible for smaller lenders and investors. Id.; see also Frank, Comment, supra note 2, at 317 (stating that the smaller investors — the ones most in need of protection — are ultimately left unprotected).
312. Bily, 834 P.2d at 785 (Kennard, J., dissenting).
313. Id.
314. Id. at 765.
315. Id. at 775 (Kennard, J., dissenting).
316. Id.
The Restatement (Second) approach remains arbitrarily limited in its application. It is overprotective of the negligent accountant when the public is better served by allowing reasonably foreseeable third parties to recover. Because the Restatement (Second) is based on a subjective inquiry317 into the accountant's knowledge, it rewards ignorance and penalizes knowledge. To avoid liability, the accountant only need agree with the client to remain "blissfully unaware" of the intended purpose of the audit report.318 The Restatement (Second) approach is neither consistent in its application nor comforting in its results.

C. The Reasonably Foreseeable Approach

It is a basic principle of tort law that an analysis of tort liability should begin with the rule that an individual who has acted negligently is liable for all reasonably foreseeable injuries caused by that negligence.319 Any exception to or limitation of this rule should be made only if public policy demands it.320 Courts look at numerous factors to determine whether public policy justifies a limitation on the scope of the duty, including: (1) the foreseeability of harm to the plaintiff; (2) the degree of certainty that the plaintiff suffered injury; (3) the closeness of the connection between the defendant's conduct and the injury suffered; (4) the moral blame attached to the defendant's conduct; (5) the policy of preventing future harm; (6) the extent of the burden to the defendant and consequences to the community of imposing a duty to exercise care with a resulting liability for breach; and (7) the availability, cost, and prevalence of insurance for the risk involved.321

In applying the seven factors, as the dissent did in Bily, it is clear

317. Recall that the Restatement (Second) approach only allows recovery for those third parties who are actually foreseen by the accountant. See supra notes 139-70 and accompanying text (discussing the Restatement (Second) approach).
318. Bily, 834 P.2d at 784 (Kennard, J., dissenting); see Boveri & Marshall, Note, supra note 279, at 287 ("[A] clever accountant could circumvent the Restatement provision by asking his client not to reveal the intended users of the statements.").
319. Bily, 834 P.2d at 776 (Kennard, J., dissenting).
320. In essence, courts should begin with the duty-risk analysis enunciated in Palsgraf v. Long Island R.R. Co., 162 N.E. 99 (N.Y. 1928), and only if public policy suggests otherwise should a limit be placed on a duty. See Wiener, supra note 2, at 254 (stating that in a negligence situation, the presumption of liability is dispensed when required by public policy).
321. Bily, 834 P.2d at 776 (Kennard, J., dissenting) (citing Rowland v. Christian, 443 P.2d 561, 564 (Cal. 1968)); see supra note 277 and accompanying text (explaining that several jurisdictions, deciding various areas of negligence law, have employed these factors to determine whether a defendant owes a duty to a particular plaintiff).
that public policy is best served by imposing a duty on accountants to exercise due care with respect to reasonably foreseeable users of their audit reports. First, harm to third persons is foreseeable, as it is generally known and accepted that most corporate businesses obtain audit reports to establish their own financial credibility in order to influence third parties. Because the normal and common uses of audit reports are well known to accountants, an accountant can readily foresee that negligence in the conduct of the audit will result in harm to parties that receive and rely on the report in their dealings with the client.

Second, economic injury to third persons is ascertainable. Unlike emotional distress, economic injury can be demonstrated through quantifiable losses. Although courts have expressed concern in tort claim cases that injury could easily be falsified, this concern arises primarily when the only injury claimed is emotional distress.

Third, an accountant's conduct is closely connected to the injury suffered, as an accountant prepares financial reports with the knowledge that third parties will rely on the information supplied. To recover for negligence, the plaintiff must prove reliance on the audit opinion and a factual nexus between the plaintiff's loss and the fact that the financial statements misrepresented or concealed information. It is important to show reliance by a third party, and that such reliance was reasonable.

Fourth, moral blame is comparable to other areas of actionable professional negligence. Accountant negligence liability only results when the accountant has failed to meet the standards of the accounting profession; an accountant is liable in negligence only upon proof of a failure to perform a reasonably careful audit in accor-

322. Bily, 834 P.2d at 776 (Kennard, J., dissenting).
323. Id. at 777 (Kennard, J., dissenting). In today's society, the role of the accountant is to serve the public function. See supra notes 13-95 and accompanying text (discussing the role and responsibilities of accountants).
324. Bily, 834 P.2d at 777 (Kennard, J., dissenting).
325. E.g., Burgess v. Superior Court, 831 P.2d 1197, 1205 (Cal. 1992) (holding that in a case of medical malpractice, the plaintiff could be compensated for emotional distress without suffering physical injuries); Molien v. Kaiser Found. Hosps., 616 P.2d 813, 821 (Cal. 1980) (holding that physical injury is not required to sustain a claim for negligent infliction of emotional distress).
326. Bily, 834 P.2d at 777 (Kennard, J., dissenting).
327. Drabkin v. Alexander Grant & Co., 905 F.2d 453, 455 (D.C. Cir. 1990) (denying recovery where no reliance was shown), cert. denied, 498 U.S. 999 (1990). An auditor can rebut a claim of reliance by showing that a reasonable investor or lender in a similar circumstance would not have relied on such information. Bily, 834 P.2d at 778 (Kennard, J., dissenting).
dance with GAAS. Thus, when such a breach of due care has been proven, the accountant's conduct is morally blameworthy to the same extent as other forms of professional malpractice for which negligence liability is routinely imposed.

Accountants themselves admit their obligation to third party users of audit opinions:

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 to maintain the orderly functioning of commerce. This reliance imposes a public interest responsibility on certified public accountants.

Because an accountant's moral, ethical, and professional responsibilities extend to reasonably foreseeable third party users of audit opinions such as lenders and investors, an accountant whose negligent conduct causes economic loss to a foreseeable user is as equally at fault as an attorney who negligently drafts a contract. In both instances, the breach of professional responsibility through lack of due care should result in liability to those to whom the professional owes a duty of care.

Fifth, imposing liability under the reasonably foreseeable approach does prevent future harm to third parties because it deters negligent conduct. Negligent auditing will be deterred because accountants, realizing that their negligence toward third party users will involve potentially great financial consequences, will use even greater care to avoid such negligence. Accountants are strongly motivated to satisfy their clients, as it is the client who pays the accountant. The accountant is thus caught between pleasing his client and his moral and ethical obligation to maintain high standards of care. The reasonably foreseeable approach resolves this conflict.

328. See supra notes 74-82 and accompanying text (discussing the requirement that an audit must be conducted in accordance with GAAS).
329. Bily, 834 P.2d at 778-80 (Kennard, J., dissenting).
330. AICPA STANDARDS. supra note 18, ET § 53.01, at 4301.
331. Bily, 834 P.2d at 780-82 (Kennard, J., dissenting); Paschall, supra note 2, at 729; see also International Mortgage Co. v. John P. Butler Accountancy Corp., 223 Cal. Rptr. 218, 227 (Cal. Ct. App. 1986) (noting that liability “provides a financial disincentive for negligent conduct and will heighten the profession’s cautionary techniques”); H. Rosenblum, Inc. v. Adler, 461 A.2d 138, 152 (N.J. 1983) (noting that liability will “cause accounting firms to engage in more thorough reviews,” which will in turn “reduce the number of instances in which liability [will] ensue”); Citizens State Bank v. Timm, Schmidt & Co., 335 N.W.2d 361, 365 (Wis. 1983) (“Unless an accountant can be held liable to a relying third party, this negligence will go undeterred.”).
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by promoting more careful auditing.

The sixth factor, the burden to accountants and the consequences to the community of imposing liability on accountants, presents a difficult issue. As the Bily dissent notes, federal securities laws require even stricter standards for accountants; an accountant who has certified any part of a registration statement containing an untrue statement of material fact is liable to any purchaser of the registered security. The continued acceptance of the federal securities law, and the rules in those states following the reasonably foreseeable standard, illustrates that a rule of liability to foreseeable users of audit opinions does not result in burdens which destroy the accounting profession or bring about consequences harmful to the public welfare. If it is demonstrated that the burden of the reasonably foreseeable liability rule is excessive, the solution would not be the arbitrary reduction of the accountant's duty, as the court did in Bily, but would rather be the creation of a cap on liability. This could be done by limiting the accountant's maximum exposure for negligence to a fixed percentage of the audited company's net worth. Additionally, the auditor's opinion could be backed by a surety bond. Either of these possible approaches would make the accountant's liability exposure less indeterminate. A decision of this sort is best left for the legislature, and thus the court should not have curtailed the accountant's duty.

Finally, insurance is available for accountants to protect themselves against large losses. As stated above, even if the availability of insurance is in question, this should only be a peripheral issue in determining tort liability, not a factor in determining the extent of an accountant's liability to third parties. Because the cost of insurance premiums has increased dramatically since 1985, and because numerous accounting firms have chosen not to carry insurance, there have been numerous calls for liability reform. The six largest public accounting firms, in speaking for the accounting profession, advocated the imposition of a proportionate liability stan-

332. Bily, 834 P.2d at 783 (Kennard, J., dissenting).
333. Id. at 782-83 (Kennard, J., dissenting).
334. See supra notes 305-07 and accompanying text (discussing accountant liability insurance).
335. See Brodsky, supra note 211, at 14 (noting that liability insurance premiums have increased 300 percent since 1985).
standard that assesses damages against each defendant based on that defendant's degree of fault. Still, if liability reform is necessary, it must come from the legislative process.

Given the problems regarding insurance for the accounting profession, there are internal methods available for accountants to limit litigation through risk management. These methods include stressing quality control within the firm by hiring qualified personnel, submitting their work to regular peer review, and participating in continuing education courses. Other risk management techniques include educating the public and clients about the nature of audit services, regular use of engagement letters, and maintenance of well-documented working papers that are routinely reviewed by management. Further, accounting firms should attempt to reduce the risk of liability by adequately screening potential clients.

The reasonably foreseeable approach will not result in unlimited liability. At worst, it will weed out those unwilling to accept their role and responsibility to the public; at best, accountants will be more diligent in their conduct, thus adding greater credibility to the profession and instilling needed confidence in the public. Because the standards of the accounting profession require the exercise of "due professional care," without limiting to whom this due care is owed, the reasonably foreseeable standard would best further compliance with the standards of the accounting profession. The reasonably foreseeable test most accurately reflects the actual use of the audit reports in today's business world, and for this reason it is the best method for determining an accountant's negligence liability to third parties.

337. Id. at 6.
339. See supra notes 305-07, 335-38 and accompanying text (discussing the insurance problems for the accounting industry).
340. Thompson, supra note 212, at 112.
341. Recently, the AICPA has required member firms to undergo peer reviews. Id.
342. Id. Many state CPA societies require a CPA to pursue continuing education courses in order to remain licensed to practice in the state. Id.
343. Id.
344. AICPA STANDARDS. supra note 18, AU §150.02, at 81.
345. Hagen, Accountants' Liability, supra note 2, at 208.
V. Impact

The majority decision in Bily v. Arthur Young & Co.\textsuperscript{346} will have an adverse effect on third party users who act in reliance on audit reports as well as the general public. This rule continues to protect the wealthy at the expense of those less knowledgeable who put their faith in the accounting profession by relying on audited financial statements. California is often regarded as a frontrunner in various areas of the law. Consequently, states who may have been considering adoption of the reasonably foreseeable approach may instead follow the holding in Bily and adopt the unfavorable, more restrictive Restatement (Second) approach.

The Restatement (Second)\textsuperscript{347} view fails to encourage due care by accountants. Accountants, knowing that they are less susceptible to liability, may fail to engage in the level of care required by the industry, resulting in inaccurate financial statements. Thus, the Restatement (Second) does not help prevent bad financial data from entering and polluting the business market. In fact, the occurrence of negligent conduct will be more prevalent, resulting in harm to a greater number of third parties. Significantly, the public will lose faith in the accounting profession, and third parties will no longer be able to rely on the audited statements. The accounting industry, which has strived to be recognized as a profession known for its independence and expertise, will lose the confidence of the public. Such a result will be disastrous to the business market as a whole.

Conclusion

Due to the role that the accountant plays in today's society,\textsuperscript{349} it is necessary to require a duty of care for accountants with respect to all reasonably foreseeable users\textsuperscript{350} of audited financial statements. Third party reliance on audited financial statements is so foreseeable as to approach certainty. The reasonably foreseeable approach satisfies two public policy concerns: it deters accountants' negligent

\textsuperscript{346} 834 P.2d 745 (Cal. 1992).
\textsuperscript{347} Restatement (Second) of Torts § 552 (1977); see supra notes 139-70 and accompanying text (discussing the Restatement (Second) approach).
\textsuperscript{348} Recall that the accounting industry has promulgated GAAS (generally accepted auditing standards). See supra note 23 and accompanying text (discussing GAAS).
\textsuperscript{349} See supra notes 13-95 and accompanying text (discussing the expanding role of the accountant in today's business economy).
\textsuperscript{350} See supra notes 171-216 and accompanying text (discussing the application of the reasonably foreseeable approach to the issue of accountants' liability).
conduct, and it compensates wrongfully injured parties.

The Bily\textsuperscript{351} decision has the unfortunate result of resurrecting the arbitrary and inconsistent rule of the Restatement (Second). Adoption of this rule betrays the expectations of third-party users whose reliance makes the audit report valuable to the audited company. In contrast, the foreseeability standard provides a just and logical limit to an accountant's liability. Without a liability rule that enforces the reasonable expectations of third-party users of audit reports and provides incentive for due care, the result will be less careful audits, increased transaction costs for loans and investments, and delay and disruption in the processes of lending and investing. By recognizing the unique purpose of an audit, the reasonably foreseeable approach best matches the scope of liability with market expectations. Such a rule is necessary so that investors and lenders will continue to have confidence in audited financial statements, and so that the usual and foreseeable users of these audit reports are fairly compensated when they have been harmed by the occasional failure of an accountant to meet the prevailing professional standards.

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