

ACCOUNTANTS' DUTY TO THIRD PARTIES: A SEARCH FOR A FAIR DOCTRINE OF LIABILITY

Bily v. Arthur Young & Co., 834 P.2d 745 (Cal. 1992).

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I. INTRODUCTION

Adam Osborne founded Osborne Computer Corporation, a manufacturer of portable personal computers, in 1980.¹ The company grew rapidly, and by fall 1982, sales reached \$10 million per month.² Late in 1982, Osborne planned an initial public stock offering and engaged Arthur Young & Company to audit the company's financial statements.³ Arthur Young issued unqualified audit opinions on the 1981 and 1982 financial statements.⁴

In order to obtain funds to finance the company until the public offering was consummated, Osborne issued warrants⁵ to certain venture capitalists.⁶ In exchange for the warrants, the investors provided either letters of credit or direct loans to the company.⁷ The warrants entitled the holders to purchase stock at favorable prices, which would result in large profits to the holders when, and if, the public offering took place.⁸

Shortly after the warrant transaction closed in April 1983, the company's financial performance faltered.⁹ Sales of the company's new portable computer sagged due to production problems.¹⁰ As these events unfolded, International Business Machines, Inc. (IBM)

1. *Bily v. Arthur Young & Co.*, 834 P.2d 745, 747 (Cal. 1992).

2. *Id.*

3. *Id.*

4. *Id.* at 748. Sales for 1981 amounted to \$6 million and generated a loss of \$1 million. Sales for 1982 amounted to \$68 million and generated a small profit of \$69,000. *Id.*

5. A warrant is a right to purchase an amount of securities at a particular time and price. AMERICAN BAR ASSOCIATION SECURITIES LAW GLOSSARY (1991). Warrant holders do not have voting rights and have no rights to dividends. *Id.* Because warrants do not represent rights in the assets of the issuer, they are considered more speculative than certain other types of investments. *Id.*

6. Appellant Arthur Young & Co.'s Opening Brief at 4, *Bily v. Arthur Young & Co.*, 834 P.2d 745 (Cal. 1992) (No. S017199). Venture capitalists fund new companies or turnaround ventures that involve speculative and often high risk in exchange for the potential for above average profits. BLACK'S LAW DICTIONARY 1556 (6th ed. 1990). Twelve sophisticated venture capitalists participated in the warrant purchase and joined as plaintiffs in the Shea suit. Appellant Arthur Young & Co.'s Opening Brief at 4, *Bily* (No. S017199). All plaintiffs claimed reliance on the audited financial statements in their decisions to invest in the warrants. Opposition Brief of Respondents J.F. Shea Co., Inc., et al. at 2, *Bily* (No. S017199).

7. Appellant Arthur Young & Co.'s Opening Brief at 4, *Bily* (No. S017199).

8. *Id.*

9. Appellant Arthur Young & Co.'s Opening Brief at 4, *Bily* (No. S017199).

10. *Id.*

introduced its own personal computer and IBM software that soon dominated the market.¹¹ Principally, as a result of these factors, Osborne's public stock offering never materialized, the warrants and company stock became worthless, and the company filed for bankruptcy in September 1983.¹²

Investors Robert R. Bily¹³ and J.F. Shea Co.¹⁴ sued Arthur Young, claiming that the accounting firm failed to conduct its audit in conformity with generally accepted auditing standards.¹⁵ The investors further claimed that as a result of Arthur Young's negligence, the company's financial statements understated liabilities and losses for 1982 by approximately three million dollars.¹⁶ The plaintiffs alleged fraud, negligent misrepresentation, and professional negligence.¹⁷ After a thirteen week trial, the jury returned verdicts absolving Arthur Young from liability for fraud and negligent misrepresentation, but awarded damages in the amount of \$4.3 million for professional negligence.¹⁸ The California appellate court affirmed the trial court's judgment,¹⁹ and Arthur Young successfully petitioned for review to the California Supreme Court.

On appeal, the California Supreme Court reversed the verdict against Arthur Young for professional negligence.²⁰ HELD: Only a client can recover from an auditor under a general negligence theo-

11. *Id.*

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

13. Robert R. Bily invested \$148,000 in Osborne Computer Corporation stock in 1981 and was given a seat on the Board of Directors. Respondent Robert R. Bily's Opening Brief at 3-5, *Bily* (No. S017199). As an outside director Bily was not actively involved in the management of the company. *Id.* at 4. When the company decided to go public in 1982, Bily agreed to buy an additional \$1.5 million of stock. Appellant Arthur Young & Co.'s Opening Brief at 7, *Bily* (No. S017199). See *supra* note 6.

14. The Shea plaintiffs are 12 institutions and individuals that invested \$4,137,500 in stocks or warrants of the Osborne Computer Corporation between February and April 1983. Opposition Brief of Respondents J.F. Shea Co., Inc., et al. at 2, *Bily* (No. S017199). This group includes two pension funds, six investment funds and four private individuals or firms. *Id.* See *supra* note 6.

15. *Bily*, 834 P.2d at 748. An expert witness for the plaintiffs testified at trial that there were more than 40 audit deficiencies which, according to the expert, amounted to gross negligence. *Id.* Furthermore, the expert testified that Arthur Young discovered material weaknesses in the company's internal control procedures but failed to report the deficiencies to management. *Id.*

16. *Id.*

17. *Id.* at 748-49.

18. *Bily*, 834 P.2d at 749.

19. *Bily v. Arthur Young & Co.*, 271 Cal. Rptr. 470, 494 (Ct. App. 1990).

20. *Bily*, 834 P.2d at 768.

ry.²¹ Although Bily and the Shea plaintiffs were investors in Osborne Computer Corporation, they were not clients of Arthur Young and therefore were not entitled to recoup investment losses from the accounting firm.²² The court adopted the Restatement rule for accountant liability to third parties, which holds that an auditor may be liable to third parties under a theory of negligent misrepresentation, but only if the third party was an “intended beneficiary” in a specific transaction known to the auditor.²³ According to the court, the plaintiffs were not intended beneficiaries, and thus were not entitled to recover from Arthur Young.²⁴ The court rejected the foreseeable user doctrine adopted in *International Mortgage Co. v. John Butler Accountancy Corp.*,²⁵ which held that an auditor may be liable for negligent misrepresentation to reasonably foreseeable third-party users of audited financial statements.²⁶

Bily is significant because the court's rejection of the foreseeable user doctrine represents a shift in policy away from protecting the rights and reasonable expectations of investors, lenders, and the public in favor of a policy that shields accountants from the financial consequences of their own negligence. Prompted by concerns about accountants' liability relative to fault, as well as expanding auditor liability and its potentially detrimental economic impact, the court essentially retrenched to applying the more conservative Restatement approach. The *Bily* decision is a major victory for the accounting profession that has national implications. In many states there is contention and ongoing controversy over the accountant's role in society and the scope of the auditor's duty to financial statement users. The *Bily* decision will influence this debate in favor of more limited accountant liability and may serve as the catalyst for other states to follow California in a full-scale retreat from the foreseeable user doctrine. The ultimate effect of rejecting the foreseeable user doctrine will be to reduce the potential remedies afforded to those

21. *Id.* at 767.

22. *Id.*

23. *Id.* at 773. See *infra* notes 89–98 and accompanying text for a discussion of the Restatement rule on liability to third parties.

24. *Id.* at 774.

25. 223 Cal. Rptr. 218 (Cal. Ct. App. 1986).

26. *Id.* at 227. In rejecting the foreseeable user doctrine, the *Bily* court noted that only one California court, the Court of Appeal for the Fourth Appellate District in *International Mortgage*, recognized the foreseeable user doctrine. *Bily*, 834 P.2d at 771.

who rely on auditors' reports by providing immunity to accountants who perform negligent audits.

Part II of this Note describes the function of an audit and traces the historical development of accountant liability. The Note reviews various common law doctrines, as well as statutes specifying auditor liability and responsibility, to provide a framework for scrutinizing the *Bily* case. In Part III, the Note analyzes the *Bily* court's reasons for rejecting the foreseeable user doctrine in favor of the more restrictive Restatement approach toward accountant liability. The Note then examines the dissenting opinion that advocates the retention of the foreseeable user doctrine as a broad concept of liability consistent with the public's perception of auditor responsibility. In Part IV, the Note critically analyzes the court's opinion and argues that the court erred in rejecting the foreseeable user doctrine. Finally, in Part V, the Note recommends the retention and expanded use of the foreseeable user doctrine, combined with a proposal for proportional liability and the abrogation of joint and several liability in the accountant liability context.

II. HISTORICAL OVERVIEW

A. Function of an Audit

An independent auditor²⁷ performs an audit to express an opinion on the “fairness” of a company's financial statements.²⁸ The auditor's opinion must state whether the financial statements fairly present the financial position and results of operations consistent with generally accepted accounting principles.²⁹ The independent

27. An auditor is an accountant who checks the accuracy, fairness, and general acceptability of accounting records and financial statements; *e.g.* a Certified Public Accountant (CPA). BLACK'S LAW DICTIONARY 131 (6th ed. 1990). A CPA is an accountant who attests to financial statements and has satisfied certain requirements to be licensed as a public accountant. *Id.* at 19. In order to be licensed, a CPA must pass the Uniform CPA Examination and must meet certain educational and business experience requirements. *Id.* This Note uses the terms auditor, accountant, and CPA interchangeably to mean one who is authorized under applicable law to practice public accounting.

28. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS [hereinafter AICPA], CODIFICATION OF STATEMENTS ON AUDITING STANDARDS AU § 110.01 (CCH 1990).

29. *Id.* The AICPA recommends the following standard language for a “clean” or “unqualified” auditor's report:

We have audited the . . . [financial statements of XYZ Company]
These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements

audit provides a vital service to the client company, and, more importantly, to outside third parties.³⁰ Audited financial statements are an essential ingredient in decisions made by investors, bankers, creditors, credit rating services, regulators, and others.³¹ In conducting audits, accountants are required to follow generally accepted auditing standards promulgated by the profession.³² Principal standards of performance require that the auditor be adequately trained,³³ that the auditor be independent from the client,³⁴ and that the auditor exercise due professional care.³⁵

Additionally, a fundamental objective of the audit is to enhance credibility of management's representations in financial statements.³⁶ The accounting profession maintains that management is responsible for financial statements and for establishing an account-

based on our audits.

We conducted our audits 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 audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of [XYZ] Company as of [dates], and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

AICPA, UNDERSTANDING AUDITS AND THE AUDITOR'S REPORT 16 (1989) [hereinafter UNDERSTANDING AUDITS].

30. Audits of financial statements are frequently, if not universally, used to establish financial credibility. *Bily v. Arthur Young & Co.*, 834 P.2d 745, 751 (Cal. 1992). An unqualified audit report is often a necessary prerequisite for a company to gain access to venture capital markets to raise funds for its survival and growth. *Id.*

31. UNDERSTANDING AUDITS, *supra* note 29, at 1.

32. AICPA, CODIFICATION OF STATEMENTS ON AUDITING STANDARDS AU § 110.09 (CCH 1990). For a comprehensive guide to generally accepted accounting principles (GAAP) and interpretive comments, see PATRICK R. DELANEY ET AL., GAAP — INTERPRETATION AND APPLICATION OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES 1992).

33. AICPA, CODIFICATION OF STATEMENTS ON AUDITING STANDARDS AU § 210.01 (CCH 1990).

34. *Id.* AU § 220.01.

35. *Id.* AU § 230.01. Auditing standards provide that one who offers professional services to another assumes a duty to exercise reasonable care and diligence and represents to that person that the auditor has the requisite skills commonly possessed by others in the profession. *Id.* AU § 230.03. The guide cautions that if representations are false the auditor commits a fraud on those that rely on the auditor's skill. *Id.*

36. UNDERSTANDING AUDITS, *supra* note 29, at 2.

ing system that adequately discloses the entity's financial position and operations.³⁷ Thus, audited financial statements require a collaborative effort between management and the auditor. This unique relationship is not well-understood by most financial statement users.³⁸ Users perceive the auditor as a guarantor of financial statement accuracy, but auditors have steadfastly rejected this expectation.³⁹

B. The "Expectation Gap"

The accountant's role as mere "bookkeeper" in the early part of this century was transformed into the role of indispensable "watchdog" for the public with the enactment of the 1930s securities regulations.⁴⁰ For the first time, the auditor became an essential component in providing access to the capital markets, because sales of securities traded on the national exchanges could not occur without an auditor's participation.⁴¹ The United States Supreme Court, in

37. *Id.* at 5. Even in small companies where the CPA may be relied on to maintain accounting records, the accounting profession believes that management must be sufficiently knowledgeable about its business and underlying transactions to make critical judgments concerning the appropriateness of financial statements. *Id.* at 17.

38. Users have been defined as "present and potential investors and creditors who lack the authority to prescribe the information they want directly from the business enterprises." AICPA, REPORT OF SPECIAL COMMITTEE ON FINANCIAL REPORTING, EXECUTIVE SUMMARY 1 (July 1992). Many financial statement users do not understand what an audit involves. Abraham D. Akresh, *Common Myths About Audits*, 5-90 J. ACCT. 110 (May 1990). In his article, Akresh states that many business people and investors have a misconception that an unqualified audit opinion indicates that financial statements are correct. *Id.* Akresh maintains that an audit merely implies that any misstatements contained in audited financial statements "aren't large enough to affect a typical user's judgment." *Id.* Furthermore, Akresh asserts that audits cannot provide absolute assurance that material misstatements or fraud will be detected. *Id.*

39. UNDERSTANDING AUDITS, *supra* note 29, at 11. See *infra* notes 40-50 and accompanying text for a discussion of the public's expectation of the auditor's role regarding financial statements.

40. In describing the public's perception of the accountant's role in society, Harris J. Amhowitz offered the following colorful description of the auditor's duty: "Accountants were to play the role of platonic guardians of the investing public, an army in eyeshades that would provide an independent bulwark against dishonesty and precipitous financial distress." Harris J. Amhowitz, *The Accounting Profession and the Law: The Misunderstood Victim*, 5-87 J. ACCT. 356, 360 (1987).

41. John C. Burton, *SEC Enforcement and Professional Accounts: Philosophy Objectives and Approach*, 28 VAND. L. REV. 19, 19-20 (1975). Regulation S-X requires that financial statements filed with the SEC must be prepared in accordance with generally accepted accounting standards and must be audited by an accountant. 17 C.F.R. § 210.1-02(d) (1993).

1984, further affirmed this “public watchdog” function in *United States v. Arthur Young & Co.*⁴² by observing that the independent auditor has a public responsibility beyond the employment relationship with the client.⁴³

Investors consider the audit opinion to be a “clean bill of health”⁴⁴ and the “touchstone of reliability.”⁴⁵ Yet, the accounting profession denies that auditors are guarantors of financial accuracy.⁴⁶ This misconception, often referred to as the “expectation gap,”⁴⁷ has spawned considerable debate and litigation over the role and responsibility of the auditor in society. The accounting profession has responded to criticism regarding its perceived responsibilities by continuing to revise its auditing standards and by modifying its standard audit report.⁴⁸ Yet, despite efforts to improve communication, the expectation gap has not narrowed. The financial debacles of

42. 465 U.S. 805, 817–18 (1984).

43. *Id.* at 817. The public watchdog role of the accountant requires that the accountant maintain independence from the client and demands “complete fidelity to the public trust.” *Id.* at 818.

44. UNDERSTANDING AUDITS, *supra* note 29, at 12.

45. Amhowitz, *supra* note 40, at 360.

46. UNDERSTANDING AUDITS, *supra* note 29, at 11. The accounting profession maintains that audits provide a reasonable level of assurance that the financial statements are free of material misstatements, rather than a guarantee of accuracy. AICPA, THE NEW AUDITOR'S REPORT (Product No. 022014) (1993).

While the accounting profession does not guarantee the accuracy of audited financial statements, it nevertheless recognizes that it owes a duty to the public who relies on its services:

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.

2 AICPA PROFESSIONAL STANDARDS ET § 53.01 (CCH 1990).

47. AICPA, THE EXPECTATION GAP STANDARDS at iii (1993). The public has a different perception of the responsibility of the auditor than what auditors themselves consider their obligations to be. *Id.*

48. The AICPA's Auditing Standards Board in 1988 issued nine Statements on Auditing Standards (SAS) to deal with the “expectation gap.” AICPA, THE EXPECTATION GAP STANDARDS at iii (1993). These SASs were designed to: “(1) increase the auditor's responsibility to detect and report errors; (2) improve audit effectiveness; and (3) improve auditor communications with financial statement users.” *Id.*

For example, under SAS 53, effective January 1, 1989, “the auditor should design the audit to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements.” AICPA, CODIFICATION OF STATEMENTS ON AUDITING STANDARDS AU § 316.05 (CCH 1990).

the savings and loan industry, and other well-publicized failures, have raised issues concerning the auditor's independence and credibility.⁴⁹ Litigation against accounting firms is at an all-time high, and litigation costs are the most rapidly rising costs for the accounting profession.⁵⁰ Clearly, the expectation gap remains wide, and users of financial statements continue to seek redress from the accounting profession under a variety of legal theories.

C. Auditor's Liability

Third parties, such as investors, lenders, and trade creditors, sue auditors when audited financial statements contain material errors that auditors should have discovered.⁵¹ Lawsuits against auditors generally allege professional negligence,⁵² negligent misrepresentation,⁵³ and may additionally allege fraud if collusion with

49. See, e.g., James L. Costello, *The Auditor's Responsibilities for Fraud Detection and Disclosure: Do the Auditing Standards Provide Safe Harbor?*, 43 ME. L. REV. 265, 265-66 (1991). In describing the expectation gap, Costello provided examples of corporate and banking failures of the past decade, which, he maintained, have seriously tarnished the auditor's reputation. *Id.*

50. AICPA, MEETING THE FINANCIAL NEEDS OF THE FUTURE: A PUBLIC COMMITMENT FROM THE PUBLIC ACCOUNTING PROFESSION 5 (June 1993). For example, Laventhol & Horwath, one of the nation's largest accounting firms, was forced into bankruptcy as a result of litigation claims exceeding \$2 billion. AICPA, IN THE PUBLIC INTEREST: A SPECIAL REPORT BY THE PUBLIC OVERSIGHT BOARD 8 n.3 (Mar. 5, 1993). In 1992, accountants defended themselves in 4,000 suits demanding more than \$15 billion in damages. Thomas McCarroll, *Who's Counting?*, TIME, Apr. 13, 1992, at 48. In the same year, the largest six accounting firms paid more than \$300 million to settle such suits. *Id.* In one example, Coopers & Lybrand was ordered to pay \$200 million to bondholders of Miniscribe, a computer parts maker, for failing to detect a massive fraud perpetrated by senior managers who shipped boxes of bricks labeled as disk drives. *Id.* In another 1992 case, Price Waterhouse was ordered to pay \$338 million in damages to Standard Charter Bank, a British bank holding company, who sued the auditor for failing to properly value the loan portfolio of an Arizona savings and loan acquired by Standard Charter. Philip R. Lochner, Jr., *Black Days for Accounting Firms*, WALL ST. J., May 22, 1992, at A10.

51. The third-party plaintiff claims reliance on the representations contained in the auditor's opinion letter. See *supra* note 29 for the text of the standard auditor's opinion.

52. The elements of professional negligence are: (1) the defendant owed a duty to the plaintiff; (2) the defendant breached the duty; (3) the breach of duty proximately caused the injury; and, (4) the plaintiff suffered damage. See *H. Rosenblum, Inc. v. Adler*, 461 A.2d 138, 152 (N.J. 1983).

53. Negligent misrepresentation requires a showing of the same elements as a negligence claim, *supra* note 52, with the additional requirements that the defendant is in the profession of supplying information and does so for the guidance of the plaintiff. *Raritan River Steel Co. v. Cherry, Beckaert & Holland*, 367 S.E.2d 609, 618 (N.C. 1988).

the audit client is suspected.⁵⁴ In determining accountant liability in third-party suits against auditors, courts have applied one of three common law tort theories: privity of contract;⁵⁵ Restatement (Second) of Torts, section 552;⁵⁶ or the foreseeable user doctrine.⁵⁷ If the audit client is a publicly-traded company, statutory violations of federal securities laws may also apply.⁵⁸ Common law doctrines evolved primarily from cases which arose subsequent to the enactment of the federal securities laws of the 1930s.

D. Federal Securities Laws Impose Auditor Liability

The precipitous collapse of the stock market in 1929 and the ensuing depression thrust the accounting profession into its public role with the passage of the Securities Act of 1933 (1933 Act)⁵⁹ and the Securities and Exchange Act of 1934 (1934 Act).⁶⁰ The 1933 Act requires the filing of an audited financial statement prior to the registration of a new stock issue.⁶¹ Section 11 of the 1933 Act expressly imposes civil liability on any person who prepares any part of a registration statement containing materially false or misleading information.⁶² This statutory remedy extends to any purchaser of

54. The elements of fraud are: (1) a material representation was made; (2) the representation was false; (3) when the representation was made, the speaker knew it was false, or made it recklessly without any knowledge of its truth as a positive assertion; (4) the speaker made the representation with the intention that it should be acted on; (5) that party acted in reliance upon the representation; and (6) that party suffered injury. *Blue Bell, Inc. v. Peat, Marwick, Mitchell & Co.*, 715 S.W.2d 408, 415 (Tex. Ct. App. 1986).

55. See *infra* notes 73–88 and accompanying text for a discussion of the privity of contract doctrine.

56. See *infra* notes 89–98 and accompanying text for a discussion of the Restatement rule.

57. See *infra* notes 99–129 and accompanying text for a discussion of the foreseeable user doctrine.

58. See *infra* notes 59–72 and accompanying text for a discussion of auditor liability under federal securities laws.

59. 15 U.S.C. §§ 77a-77aa (1993).

60. *Id.* §§ 78a-78ll.

61. Schedule A of the 1933 Act requires that the balance sheet and income statements submitted as part of the registration statement be certified by an independent public accountant. *Id.* § 77g.

62. Section 11(a) of the 1933 Act imposes liability on certain persons, enumerated in subparts 1 through 5, for a registration statement that contains an untrue statement of material fact or omits a material fact required to make the statement not misleading.

stocks required to be registered under the 1933 Act.⁶³ Accordingly, auditors may be held liable to investors for material misstatements or omissions in audited financial statements.⁶⁴ In order to recover losses, a plaintiff need only show that there was a material error or misleading statement or omission and that the plaintiff suffered loss proximately caused by the error.⁶⁵ To avoid liability, the auditors must prove that they exercised due diligence in the performance of the audit.⁶⁶

The 1934 Act⁶⁷ prohibits anyone from using manipulative or deceptive devices in connection with the purchase or sale of any security whether registered on a national exchange or not.⁶⁸ Rule 10b-5 provides the basis for a private right of action by any purchaser or seller against the auditor for any material errors or omissions in the financial statements.⁶⁹ In order to prevail in a 10b-5 action, the plaintiff must prove that the auditor acted with "scienter," the standard established in *Ernst & Ernst v. Hochfelder*.⁷⁰ The

Id. § 77k. Subparts 1 through 5 include the following persons: persons who signed the registration statement, directors, persons named to become directors, accountants, underwriters, and others whose reports are included in the registration statement. *Id.*

63. Section 11(a) of the 1933 Act, 15 U.S.C. § 77k (1993).

64. Section 11(a)(4) of the 1933 Act imposes liability on any accountant who prepared or certified a financial statement made part of a registration statement that contained an untrue statement of material fact or omitted a material fact required to make the statement not misleading. 15 U.S.C. § 77k (1993).

65. Section 11(a) of the 1933 Act. 15 U.S.C. § 77k (1993).

66. Section 11(b) of the 1933 Act provides that any person listed in § 11(a) that is liable for any untrue or misleading statements shall have the burden to prove that he had grounds, after reasonable investigation, to believe (and, in fact, did believe) that the statements in the registration statement were materially true and not misleading. 15 U.S.C. § 77k (1993).

67. Section 10(b) of the 1934 Act. 15 U.S.C. § 78j (1993).

68. Securities and Exchange Commission Rule 10b-5 makes it unlawful for anyone involved with the purchase or sale of any security to do the following:

- (a) To employ any device, scheme, or artifice to defraud,
- (b) To make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or
- (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

17 C.F.R. § 240.10b-5 (1993).

69. Section 18 of the 1934 Act provides that any person who makes a false or misleading statement with respect to any material fact shall be liable to any person that has purchased or sold a security in reliance on the false or misleading statement. 15 U.S.C. § 78r (1993).

70. 425 U.S. 185, 193 (1976).

scienter standard, like fraud, requires an intent to deceive,⁷¹ and initially appears to provide ample safety for the merely negligent auditor. The *Hochfelder* court failed to answer the question whether reckless behavior satisfies the scienter standard. However, other federal courts have since held that reckless conduct does constitute scienter.⁷² Thus, a grossly negligent auditor may violate Rule 10b-5 and be held liable to a multitude of investors.

E. The Privity of Contract Approach

Almost every discussion of common law accountant liability includes an analysis of the seminal opinion by Justice Cardozo in *Ultramares Corp. v. Touche*.⁷³ The stature of this eminent jurist is convincingly illustrated in his pragmatic logic, and today, sixty years later, twelve states still adhere to the doctrine of privity advocated by Cardozo.⁷⁴ In *Ultramares*, a financing company relied on audited financial statements prepared by Touche when it loaned money to Fred Stern & Company, a rubber importer.⁷⁵ Accounts receivable and other assets turned out to be fictitious, and Stern was forced into bankruptcy.⁷⁶ *Ultramares* suffered loan losses and sued

71. *Id.* at 194-214.

72. *See, e.g.,* Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 44 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978) (answering affirmatively the question of whether reckless conduct was sufficient to constitute scienter). *See* G.A. Thompson & Co., Inc. v. Partridge, 636 F.2d 945, 961 (5th Cir. 1981).

73. 174 N.E. 441 (N.Y. 1931).

74. Five states have adopted the common law privity doctrine: Alabama, *see* Colonial Bank of Ala. v. Ridley & Schweigert, 551 So. 2d 390, 395 (Ala. 1989); Idaho, *see* Idaho Bank & Trust Co. v. First Bancorp of Idaho, 772 P.2d 720, 722 (Idaho 1989); Nebraska, *see* Citizens Nat'l Bank v. Kennedy & Coe, 441 N.W.2d 180, 182 (Neb. 1989); Credit Alliance v. Arthur Andersen & Co., 483 N.E.2d 110, 119 (N.Y. 1985); Pennsylvania, *see* Landell v. Lybrand, 107 A. 783, 783 (Pa. 1919).

Four states have enacted privity statutes: Arkansas, *see* ARK. CODE ANN. § 16-114-302 (Michie Supp. 1990); Illinois, *see* ILL. REV. STAT. ch. 111, para. 5535.1 (Supp. 1990); Kansas, *see* KAN. STAT. ANN. § 1-402(b) (1987); Utah, *see* UTAH CODE ANN. § 58-26-12 (Supp. 1990).

Federal court decisions have held that the privity doctrine represents the law in the following states whose highest courts have not expressly considered the question: Delaware, *see* McLean v. Alexander, 599 F.2d 1190, 1202 (3d Cir. 1979); Colorado, *see* Stephens Indus., Inc. v. Haskins & Sells, 438 F.2d 357, 359-60 (10th Cir. 1971); Indiana, *see* Ackerman v. Schwartz, 947 F.2d 841, 846-47 (7th Cir. 1991).

For additional discussion of third-party liability doctrines adopted by states, *see* GEORGE SPELLMIRE ET AL., ACCOUNTANTS' LEGAL LIABILITY GUIDE § 11.04 (Miller 1990).

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

76. *Id.* at 442-43.

Touche.⁷⁷ The court held that Touche had no duty to Ultramares since there was no “privity of contract” between the auditor and Ultramares.⁷⁸ In holding that accountants owed no duty to third parties, Cardozo penned the essence of the rationale supporting the privity doctrine: “If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class.”⁷⁹

The court distinguished the *Ultramares* case from its earlier opinion in *Glanzer v. Shepard*.⁸⁰ In *Glanzer*, the court held that a public weigher who certified false weights was liable to the buyer, even though the weigher was hired by the seller and had no privity of contract with the buyer.⁸¹ In drawing the distinction, Justice Cardozo reasoned that in the *Glanzer* case, the delivery of the weight certificate to the buyer was “not merely one possibility of many” but was the “end and aim” of the transaction.⁸² Because the accountant in *Ultramares* had no knowledge of who would receive the audit report, or how it would be used, the *Ultramares* court reasoned that the *Glanzer* rule did not apply.⁸³

Assaults against Cardozo's “citadel of privity”⁸⁴ have been launched in recent years and have succeeded in loosening the strict confines of the rule. In *Credit Alliance v. Arthur Andersen & Co.*,⁸⁵ the New York Court of Appeals held that an accountant may be held

77. *Id.*

78. *Id.* at 448.

79. *Ultramares*, 174 N.E. at 444. The *Ultramares* court made it clear that lack of privity would protect the accountant only in cases of negligence and not in cases of fraud where the auditor had no genuine belief in the accuracy of his representations. *Id.* at 448. Cardozo's opinion reflects the notion, prevalent in the 1930s, that the role and responsibility of the accountant was minimal. After excusing the accountant for his “honest blunders,” Cardozo doubted that the “average business man receiving a certificate without paying” would put much reliance on the auditor's report. *Id.* Given the expanded role of the accountant's responsibility since the 1930s and the high expectations of the public in the 1990s, it is doubtful that Cardozo's assessment of the business person's perception of the auditor's duty is still viable. See *supra* notes 40–50 and accompanying text for a discussion of the public's perception of the auditor's role in society.

80. 135 N.E. 275 (N.Y. 1922).

81. *Id.* at 278.

82. *Ultramares*, 174 N.E. at 445.

83. *Id.*

84. *Id.*

85. 483 N.E.2d 110, 120 (N.Y. 1985).

liable for negligent misrepresentation to noncontractual third parties, provided that the following prerequisites are met:

- (1) the accountant must have been aware that the financial reports were to be used for a particular purpose;
- (2) the accountant must have been aware that the financial report was to be used in furtherance of which a known party was intended to rely; and,
- (3) there must have been some conduct on the part of the accountant linking the accountant to the known party which evinces the accountant's understanding of that party's reliance.⁸⁶

The third condition of the *Credit Alliance* test, the accountant's conduct and understanding of third-party reliance, significantly eroded the pure privity doctrine originally espoused by Cardozo. The privity rule, as modified by *Credit Alliance*, closely resembles the Restatement approach,⁸⁷ since the standard simply requires that the accountant know of the intended reliance and act in conformity with that reliance.⁸⁸

F. The Restatement Approach

The Restatement (Second) of Torts, section 552,⁸⁹ entitled "Information Negligently Supplied for the Guidance of Others," is the most widely applied doctrine regarding liability of professionals for negligent misrepresentation.⁹⁰ The doctrine holds that one who sup-

86. *Id.* at 118. The court consolidated two separate cases in this appeal and applied its three-prong test to separate factual scenarios. In the first case, the court held that the auditor, Arthur Andersen, had no liability to a third-party lender who claimed that the auditor should have known the lender would rely on the financials. *Id.* at 112. The court held that the auditor was not directly aware of the lender's purpose in receiving statements or on his reliance on the auditor's report. *Id.* In the second case, the court held that the auditor, Strauhs & Kaye, was liable to the third-party lender since the auditor was aware of pending financing with that lender, communicated directly with the lender concerning the financial condition of the company, and charged the client additional fees for extra services to the lender. *Id.* at 114.

87. See *infra* notes 89–98 and accompanying text for a discussion of the Restatement approach.

88. GEORGE SPELLMIRE ET AL., ACCOUNTANTS' LEGAL LIABILITY GUIDE § 11.05 (Miller 1990).

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

90. Eighteen states follow the Restatement § 552 doctrine of third-party liability: Florida, see *First Fla. Bank v. Max Mitchell & Co.*, 558 So. 2d 9 (Fla. 1990); Georgia, see *Badische Corp. v. Caylor*, 356 S.E.2d 198 (Ga. 1987); Iowa, see *Pahre v. Auditor of State*,

plies false information for the guidance of others may be held liable to that person if the supplier fails to exercise reasonable care and competence.⁹¹ However, such liability is limited to a specific class of persons defined as:

- (1) a 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,
- (2) 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.⁹²

The rationale for limiting liability to a certain class is that the duty of care required of the professional implies a commitment to adhere to a relative standard.⁹³ Unless the auditor knows who is using the information provided, and for what purpose the information will be used, the auditor cannot reasonably define and exercise the appropriate level of care in preparing the report.⁹⁴ Under this test an auditor could never be negligent without knowing who would be using the financial statements and for what purpose. Some critics have disparaged the Restatement rationale by noting that the accounting profession has promulgated auditing standards that man-

422 N.W.2d 178 (Iowa 1988); Kentucky, *see* *Ingram Indus., Inc. v. Nowicki*, 527 F. Supp. 683 (E.D. Ky. 1981); Louisiana, *see* *First Nat'l Bank of Commerce v. Monco Agency Inc.*, 911 F.2d 1053 (5th Cir. 1990); Michigan, *see* *Law Offices of Lawrence J. Stockler, P.C. v. Rose*, 436 N.W.2d 70 (Mich. 1989); Minnesota, *see* *Bonhiver v. Graff*, 248 N.W.2d 291 (Minn. 1976); Missouri, *see* *Aluma Kraft Mfg. Co. v. Elmer Fox & Co.*, 493 S.W.2d 378 (Mo. Ct. App. 1973); Montana, *see* *Thayer v. Hicks*, 793 P.2d 784 (Mont. 1990); New Hampshire, *see* *Spherex, Inc. v. Alexander Grant & Co.*, 451 A.2d 1308 (N.H. 1982); North Carolina, *see* *Raritan River Steel Co. v. Cherry, Bekaert & Holland*, 367 S.E.2d 609 (N.C. 1988); North Dakota, *see* *Bunge Corp. v. Eide*, 372 F. Supp. 1058 (D.N.D. 1974); Ohio, *see* *Haddon View Inv. Co. v. Coopers & Lybrand*, 436 N.E.2d 212 (Ohio 1982); Rhode Island, *see* *Rusch Factors, Inc. v. Levin*, 284 F. Supp. 85 (D.R.I. 1968); Tennessee, *see* *Bethlehem Steel Corp. v. Ernst & Whinney*, 822 S.W.2d 592 (Tenn. 1991); Texas, *see* *Shatterproof Glass Corp. v. James*, 466 S.W.2d 873 (Tex. Civ. App. 1971); Washington, *see* *Haberman v. Washington Pub. Power Supply Sys.*, 744 P.2d 1032 (Wash. 1988); West Virginia, *see* *First Nat'l Bank v. Crawford*, 386 S.E.2d 310 (W. Va. 1989).

For additional discussion of third-party liability doctrines adopted by states, see GEORGE SPELLMIRE ET AL., ACCOUNTANTS' LEGAL LIABILITY GUIDE § 11.04 (Miller 1990).

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

92. *Id.* § 552(2).

93. *Id.* § 552 cmt. a.

94. *Id.*

date the standard of care the auditor must adhere to, irrespective of the category or class of prospective financial statement users.⁹⁵

Historically, complications have arisen in defining “protected class,” and courts have had difficulty in applying the Restatement rule because there is no bright line to distinguish one type of user from another in any given situation.⁹⁶ The Restatement reporter, Professor William Prosser, was dissatisfied with the text believing that no one paragraph defining protected classes would be fair and reasonable in every circumstance.⁹⁷ Despite these concerns, numerous jurisdictions still find the Restatement's pragmatic middle-ground approach preferable to either the restrictive privity doctrine, or the foreseeable user doctrine, which potentially can lead to significant auditor liability.⁹⁸

95. See Howard B. Wiener, *Common Law Liability of the Certified Public Accountant for Negligent Misrepresentation*, 20 SAN DIEGO L. REV. 233, 251–52 (1983).

The accounting profession has their own professional standards (GAAS and GAAP) for the conduct of an audit, and an auditor's obligations to follow these standards are independent of who may use the report. AICPA, CODIFICATION OF STATEMENTS ON AUDITING STANDARDS AU §§ 508.49, 621.02 (1990). The inference that an auditor can apply different standards of care depending on the persons who may use the report contradicts the profession's own reporting standards. *Amicus Curiae* Brief of the Resolution Trust Corporation in Support of Respondent's Position, *Bily* (No. S017199). See *supra* notes 27–35 and accompanying text for a discussion of professional audit standards.

96. Courts have had to refine the Restatement rule to meet specific case applications. For example, in *Aluma Kraft v. Elmer Fox & Co.*, 493 S.W.2d 378 (Mo. Ct. App. 1973), the court set forth a four-part test to determine whether third parties are a protected class under Restatement § 552:

- (1) the extent to which the transaction was intended to affect the plaintiff;
- (2) the foreseeability of harm to him;
- (3) the degree of certainty that the plaintiff suffered injury; and,
- (4) the closeness of the connection between the defendant's conduct and the injury suffered.

Id. at 383.

97. RESTATEMENT (SECOND) OF TORTS § 552 (Tentative Draft No. 11, § 552 at 56 (Apr. 15, 1965)).

98. See *supra* notes 99–129 and accompanying text.

G. The Foreseeable User Approach

The foreseeable user approach, now followed by three states,⁹⁹ holds that accountants should be held liable to all reasonably foreseeable recipients of financial statements.¹⁰⁰ The rationale supporting the doctrine is that imposing liability will protect third parties and deter negligent conduct.¹⁰¹ In his widely cited article proposing the foreseeable user standard for accountant liability, Justice Wiener argued that imposing liability for negligence not only provides a means to compensate the injured party, but also discourages a potential tortfeasor from engaging in wrongful conduct.¹⁰²

New Jersey was the first state to adopt the foreseeable user doctrine.¹⁰³ In *H. Rosenblum, Inc. v. Adler*, the New Jersey Supreme Court held that an independent auditor has a duty to all those whom the auditor reasonably can foresee as recipients of financial statements, provided the recipients relied on the auditor's opinion and used the statements for a proper business purpose.¹⁰⁴ In defining the scope of auditor liability, the *Rosenblum* court reasoned that the auditor is responsible for careless misrepresentations once the audit report is inserted into the "economic stream."¹⁰⁵ The court dismissed the specter of financial catastrophe to accountants resulting from enhanced duty by delineating built-in limits to liability.¹⁰⁶ For example, plaintiffs must prove proper business purpose, proxi-

99. Wisconsin, New Jersey and Mississippi follow this approach. GEORGE SPELLMIRE ET AL., ACCOUNTANTS' LEGAL LIABILITY GUIDE § 11.04 (Miller 1990). California adopted the foreseeable user approach in *International Mortgage Co. v. John Butler Accountancy Corp.*, 223 Cal. Rptr. 218, 227 (Cal. Ct. App. 1986), then abrogated the doctrine in favor of the Restatement approach in *Bily v. Arthur Young & Co.*, 834 P.2d 745, 769 (Cal. 1992).

100. See *infra* notes 103–15 and accompanying text for a discussion of the elements of the foreseeable user liability doctrine.

101. See, e.g., *Citizens State Bank v. Timm, Schmidt & Co.*, 335 N.W.2d 361, 365 (Wis. 1983).

102. Wiener, *supra* note 95, at 256.

103. *H. Rosenblum, Inc. v. Adler*, 461 A.2d 138, 154–56 (N.J. 1983).

104. *Id.* at 153. In *Rosenblum*, the plaintiffs, owners of a New Jersey retail catalog company, agreed to merge with Giant, a publicly traded discount department store, in exchange for stock in Giant. *Id.* at 140–41. The partner of the auditing firm attended the merger meetings. *Id.* at 141. As it turned out, Giant had manipulated its books by falsifying assets, and the certified statements were in fact erroneous. *Id.* Giant was forced into bankruptcy, the stock received by the plaintiffs became worthless, and the auditing firm was held liable for the plaintiffs' losses. *Id.*

105. *Rosenblum*, 461 A.2d at 155.

106. *Id.* at 152.

mate cause, and actual loss due to the auditor's negligence.¹⁰⁷ In addition to these built-in limits, the auditor can expressly confine the use of the audit report to specific purposes and persons.¹⁰⁸ In adopting the foreseeable user doctrine, the court recognized that audited statements are intended for the use of third parties, and that auditors have a responsibility not only to their clients, but to investors, creditors and others who rely on certified financial statements.¹⁰⁹

Other states have followed New Jersey's lead in accountant liability reform. The Wisconsin Supreme Court adopted the foreseeable user standard in *Citizens State Bank v. Timm, Schmidt & Co.*¹¹⁰ The *Citizens State Bank* court held that accountants should be liable to foreseeable users unless recovery is denied on grounds of "public policy."¹¹¹ The court found no public policy considerations to bar recovery when a foreseeable bank lender could show justifiable reliance on the auditor's report.¹¹² The court abrogated the Restatement rule as "too restrictive" and held the auditor liable to the lending bank.¹¹³ Denying protection to banks who rely on the audited financial statements of their borrowers would force banks to absorb the losses resulting from negligent auditors and, according to the court,

107. *Id.*

108. *Id.*

109. *Id.* at 149.

110. 335 N.W.2d 361, 366-67 (Wis. 1983). In *Citizens State Bank*, the auditor allegedly knew that the bank plaintiff received audited financial statements from the client and relied on their accuracy to extend loans to the company. *Id.* at 363. The court concluded that the Restatement rule, then the common law in Wisconsin, did not extend the auditor's liability to the bank. *Id.* at 364. The court chose to adopt the foreseeable user doctrine rather than deny recovery to the bank. *Id.* at 366.

111. *Id.* at 366. The court considered the following public policy factors:

- (1) The injury is too remote from the negligence; or
- (2) the injury is too wholly out of proportion to the culpability of the negligent tort-feasor; or
- (3) in retrospect it appears too highly extraordinary that the negligence should have brought about the harm; or
- (4) because allowance of recovery would place too unreasonable a burden on the negligent tort-feasor; or
- (5) because allowance of recovery would be too likely to open the way for fraudulent claims; or,
- (6) allowance of recovery would enter a field that has no sensible or just stopping point.

Citizens State Bank, 335 N.W.2d at 366.

112. *Id.*

113. *Id.*

would drive up the cost of credit to the general public.¹¹⁴ Furthermore, the court concluded that accountants could spread the risk of their own negligence through the use of liability insurance.¹¹⁵

Texas, a state that has retained the Restatement rule, has enlarged the scope of the rule so that it approaches the foreseeable user doctrine. In *Blue Bell, Inc. v. Peat, Marwick, Mitchell & Co.*,¹¹⁶ the Texas Court of Appeals interpreted the Restatement rule to include not only third parties actually known to the auditor, but also those parties that the auditor "should have known" would rely on the audit report, such as trade creditors.¹¹⁷ The court stated that limiting the class of third parties that could recover to persons specifically known to the auditor was too artificial and tenuous a distinction to adopt as a rule of law.¹¹⁸

Rather than manipulate the definition of protected classes in the Restatement rule as Texas did, California adopted the foreseeable user rule for accountants in *International Mortgage Co. v. John Butler Accountancy Corp.*¹¹⁹ In this case, the California Court of Appeals held that an accountant owes a duty to those third parties who reasonably and foreseeably rely on audited financials.¹²⁰ Prior to *International Mortgage*, among all professionals in California, only the accountant enjoyed immunity from third-party suits afforded by the privity rule.¹²¹ Earlier California courts had steadily chipped away at the privity doctrine until notary publics,¹²² lawyers,¹²³ physicians,¹²⁴ architects,¹²⁵ engineers,¹²⁶ and other profes-

114. *Id.* at 365.

115. *Id.*

116. 715 S.W.2d 408, 408 (Tex. Ct. App. 1986).

117. *Id.* at 412-13.

118. *Id.* at 412. The court decided that the fortuitous occurrence that a client might specifically mention persons or class of persons that would receive the audit report was "too tenuous a distinction" on which to base a theory of accountant liability. *Id.*

119. 223 Cal. Rptr. 218, 227 (Cal. Ct. App. 1986).

120. *Id.*

121. *Id.* at 226.

122. *Biakanja v. Irving*, 320 P.2d 16, 19 (Cal. 1958).

123. *Heyer v. Flaig*, 449 P.2d 161, 165 (Cal. 1969).

124. *Molien v. Kaiser Found. Hosps.*, 616 P.2d 813, 817 (Cal. 1980).

125. *Huber, Hunt & Nichols, Inc. v. Moore*, 136 Cal. Rptr. 603, 616-17 (Cal. 1977).

126. *M. Miller Co. v. Central Contra Costa Sanitary Dist.*, 18 Cal. Rptr. 13, 15 (Cal. 1961).

sionals¹²⁷ all lost immunity.¹²⁸ As a result of the *International Mortgage* decision, California began holding all professionals liable to reasonably foreseeable users of professional services.¹²⁹

III. THE BILY COURT'S REASONING

A. The Majority

The majority analyzed auditor liability to third parties for audit opinions in the context of three causes of action: professional negligence, negligent misrepresentation and intentional misrepresentation.¹³⁰ After examining these theories, the court concluded that Arthur Young owed no duty to Bily or the Shea plaintiffs,¹³¹ and consequently, these investors could not recover for economic losses resulting from Arthur Young's failure to conduct a proper audit.¹³²

1. Negligence

The court began its analysis by recognizing that privity of contract is not necessary in order to find a legal duty in cases of professional negligence.¹³³ However, in this case, the court declined to

127. *International Mortgage*, 223 Cal. Rptr. at 226. Tool manufacturers, general contractors, and psychiatrists lost immunity from foreseeable third parties. *Id.*

128. *Id.*

129. *Id.* Furthermore, California Civil Code provides that "[e]veryone is responsible . . . for an injury occasioned to another by his want of ordinary care or skill in the management of his property or person . . ." CAL. CIV. CODE § 1714 (West 1992).

See also *Rowland v. Christian*, 443 P.2d 561, 568 (Cal. 1968) (holding that all persons are required to use ordinary care to prevent injury to others); *Biakanja v. Irving*, 320 P.2d 16, 19 (Cal. 1958) (noting with approval Justice Cardozo's statement in *Palsgraf v. Long Island R.R.*, 162 N.E. 99, 100 (N.Y. 1928), that "[t]he risk reasonably perceived defines the duty to be obeyed").

130. *Bily v. Arthur Young & Co.*, 834 P.2d 745, 768-74 (Cal. 1992).

131. See *supra* notes 1-26 and accompanying text for facts of the case and the court's holding.

132. See *infra* notes 133-62 and accompanying text.

133. *Bily*, 834 P.2d at 761. The court enumerated the following factors that should be considered in determining whether to find a legal duty in the absence of privity of contract:

- (1) extent to which the transaction was intended to affect the party;
- (2) foreseeability of harm to the party;
- (3) degree of certainty that harm results;
- (4) closeness of connection between the acting party and the injured party;
- (5) moral blame associated with the acting party; and,
- (6) policy of preventing future harm.

allow a foreseeable third-party user of financial statements to sue for simple negligence because such a result would expose the auditor to potential liability disproportionate to fault.¹³⁴ The court reasoned that financial statement users are generally sophisticated business persons who can protect themselves through "private ordering."¹³⁵ Additionally, the court doubted that holding accountants to expanded liability inherent in a pure foreseeability approach would enhance the accuracy of audits.¹³⁶ According to the majority, unlimited negligence liability was more likely to increase the cost of audits and possibly reduce the availability of audit services.¹³⁷

Because of the complex nature of audits, the court refused to engage in economic regulation designed to affect the relationship between the auditor and the users of financial statements.¹³⁸ Instead, the court invited the legislature to address the issue by enacting statutes defining the liability of auditors to third parties.¹³⁹ In the absence of legislative directive, the court would not endorse expanded auditor liability.¹⁴⁰ By confining the auditor's liability for negligence to the client, the court concluded that third parties may not recover from auditors under a negligence theory.¹⁴¹

Id. These factors were first espoused in *Biakanja v. Irving*, 320 P.2d 16, 19 (Cal. 1958) (holding that a will beneficiary was able to recover from a negligent notary public who failed to properly attest the will).

134. *Bily*, 834 P.2d at 762–64. The court noted that the auditor's role in the preparation of financial statements and distribution of the audit report is secondary to the primary responsibility which rests with management. *Id.* at 763. In the event of bankruptcy, the auditor is often the only solvent one left to sue, which raises the prospect of unlimited financial exposure through litigation. *Id.*

135. A third party who would otherwise rely on audited financial statements has the opportunity to expend his own resources to verify an organization's financial condition. *Bily*, 834 P.2d at 765. This option of conducting one's own audit is defined as "private ordering." John A. Siliciano, *Negligent Accounting and the Limits of Instrumental Tort Reform*, 86 MICH. L. REV. 1929, 1956–57 (1988).

136. *Bily*, 834 P.2d at 765. The court cited with favor Daniel R. Fischel, *The Regulation of Accounting: Some Economic Issues*, 52 BROOK. L. REV. 1051, 1055 (1987). Fischel asserted that higher quality audits do not necessarily decrease the number of lawsuits, and he believed that auditors will be sued whenever there is a business failure regardless of the quality of the audit. *Id.* at 1055–56.

137. *Bily*, 834 P.2d at 766. See Siliciano, *supra* note 135, at 1960–65.

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

139. *Id.*

140. *Id.*

141. *Id.* The court conceded that under certain circumstances a third party expressly identified in an audit contract as an intended third-party beneficiary would possess rights under the contract. *Id.* at 767 n.16. However, audit engagement letters which

2. Negligent Misrepresentation

Audit opinions are affirmative representations and, if materially false, may provide the basis for third parties to sue auditors for negligent misrepresentation.¹⁴² The court stated that if the auditors had no reasonable grounds for their opinion, recipients of audited financial statements may be able to recover from the auditors for negligent misrepresentation.¹⁴³ However, the court noted that not all financial statement users can recover from auditors.¹⁴⁴ Under the Restatement (Second) of Torts, section 552,¹⁴⁵ adopted by the court, the class of persons entitled to rely on representations, and therefore entitled to recover, is restricted to those to whom the representations were made and who were "intended beneficiaries."¹⁴⁶

The court interpreted the Restatement rule to require that the supplier of information have notice of actual third-party recipients so that the supplier can evaluate the magnitude of potential liability and make rational decisions concerning the venture.¹⁴⁷ The court stated that the supplier must inform a specific person regarding an identified transaction in order for that recipient to be an "intended beneficiary" covered by the Restatement rule.¹⁴⁸ The court noted that if the supplier merely knows of the possibility of third-party users, the supplier has no legal responsibility.¹⁴⁹

The court described three factors that must be evaluated in determining whether a supplier is liable for information supplied to persons not in privity with the supplier: (1) whether information is supplied to a person for guidance; (2) whether the person relies on

form the basis of contracts between the client and the auditor rarely designate intended third-party users, so this hypothetical circumstance is more theoretical than practical. See *supra* notes 26-37 and accompanying text for a discussion of the auditor's responsibilities. The *Bily* court concluded that the plaintiffs did not qualify as "clients" and therefore were not entitled to recover on a pure negligence theory. *Bily*, 834 P.2d at 767.

142. *Bily*, 834 P.2d at 768.

143. *Id.* Negligent misrepresentation is a tort of deceit. *Id.* It involves an assertion by one who has no reasonable grounds for believing it to be true. *Id.*

144. *Id.*

145. RESTATEMENT (SECOND) OF TORTS § 552(2) (1977). See *supra* note 92 and accompanying text for the pertinent language of this section.

146. *Bily*, 834 P.2d at 768.

147. *Id.* at 769.

148. *Id.* at 769-70.

149. *Id.*

the information supplied; and, (3) whether the supplier intends to influence the person with the information.¹⁵⁰ The court emphasized that “*intent to influence*” is the threshold issue in finding liability.¹⁵¹ Without intent, no liability exists, even if the use of and reliance on the information supplied is reasonably foreseeable.¹⁵² The court held that Bily and the Shea plaintiffs, investors who had received financial statements from the company, were not intended beneficiaries; and accordingly the plaintiffs could not recover from Arthur Young under a theory of negligent misrepresentation.¹⁵³

The court acknowledged the criticism of the Restatement rule as vague and arbitrary.¹⁵⁴ Nevertheless, the court recognized the Restatement approach as a logical and reasonable rule compared to the potential for unlimited liability under the foreseeable user doctrine.¹⁵⁵ In adopting the Restatement rule, the *Bily* court rejected *International Mortgage Co. v. John Butler Accountancy Corp.*,¹⁵⁶ that had held auditors liable for negligent misrepresentations to foreseeable third-party users of an accountant's audited financial statements.¹⁵⁷

3. Intentional Misrepresentation

The majority recognized that different policy considerations apply when an auditor engages in intentional fraud rather than mere negligent misrepresentation.¹⁵⁸ Any policy considerations to limit liability for negligent acts are overshadowed by the moral imperative to hold one accountable for intentional misconduct.¹⁵⁹ In the case of intentional misrepresentation, an auditor has no belief in the

150. *Bily*, 834 P.2d at 771.

151. *Id.* (quoting *Stagen v. Stewart-West Coast Title Co.*, 196 Cal. Rptr. 732 (Cal. Ct. App. 1983)).

152. *Id.*

153. *Id.* at 774.

154. *Id.* at 769. Justice Wiener advocated a foreseeable user rule and criticized the Restatement rule. *See Wiener, supra* note 95, at 251–52.

155. *Bily*, 834 P.2d at 769.

156. 223 Cal. Rptr. 218 (Cal. Ct. App. 1986).

157. *Id.* at 227. *See supra* notes 25–26, 119–29 and accompanying text.

158. *Bily*, 834 P.2d at 773. The RESTATEMENT (SECOND) OF TORTS § 531 (1977) provides that “[o]ne who makes fraudulent misrepresentations is subject to liability to the persons . . . whom he intends or has reason to expect to act or to refrain from acting in reliance upon the misrepresentation”

159. *Bily*, 834 P.2d at 773.

truth of his statement or makes it recklessly, thus satisfying the element of scienter.¹⁶⁰ In contrast, in a case of negligent misrepresentation, an auditor has no design or intent to defraud the person relying on his opinion.¹⁶¹ The *Bily* court concluded that when an auditor intends to defraud a particular class, the auditor is liable to those class members and to other persons that the auditor reasonably should have anticipated would rely on the auditor's representations.¹⁶²

B. The Kennard Dissent

Justice Kennard criticized the majority for abandoning the foreseeable user rule adopted in *International Mortgage*, and warned that limiting liability to third parties that the auditor intended to influence would give auditors broad immunity for professional malpractice in conducting audits.¹⁶³ Justice Kennard disagreed with the majority's assertion that public policy requires limiting auditor liability to third parties.¹⁶⁴ The dissent maintained that audit reports are primarily used to establish financial credibility and are widely used by investors, financial institutions, and others in making business decisions.¹⁶⁵ Applying a *Tarasoff* concept that stresses "foreseeability" as the most important element in negligence liability, Justice Kennard concluded that the risk of harm to third parties resulting from misleading audit reports is clearly foreseeable.¹⁶⁶

The dissent asserted that the auditor's conduct is closely connected to third parties who rely on the audit opinion, and presuming a third party can prove reliance, that party should be able to recover

160. *Id.*

161. *Id.*

162. *Id.*

163. *Bily*, 834 P.2d at 775 (Kennard, J., dissenting). Justice Kennard criticized the Restatement rule for permitting recovery to third parties only when the auditor has "specific knowledge of the client's intended use of the audit report" as being arbitrary and indefensible. *Id.* at 784. Justice Kennard maintained that it is obvious to the auditor that his report will be used by investors and lenders. *Id.* Thus, allowing liability to depend on the chance occurrence that the client specifies a particular user to the auditor is too tenuous to adopt as a rule of law. *Id.* The dissent contended that such a rule rewards ignorance by allowing the auditor to unfairly avoid liability simply by being oblivious to the identity of financial statement users. *Id.* at 784.

164. *Bily*, 834 P.2d at 777.

165. *Id.*

166. *Id.* at 777.

from the auditor.¹⁶⁷ Justice Kennard proposed a three-part test to determine reliance: (1) whether the party reviewed the financial statements; (2) whether the party would not have proceeded with the transaction if the financial statements exposed the true facts; and, (3) whether the auditor issued an unqualified audit opinion on the statements.¹⁶⁸ If the reliance test is met and the third-party user was reasonably foreseeable, then the auditor should be liable to that party for negligence.¹⁶⁹

Justice Kennard contended that liability not only provides a remedy for an injured party, but also prevents harm by deterring negligent conduct.¹⁷⁰ Avoidance of shoddy auditing is especially important in the accounting profession, because lenders and investors depend on the integrity and expertise of the independent auditor.¹⁷¹ According to the dissent, lenders who are forced to suffer substantial losses because they cannot rely on audited financial statements will pass these costs onto customers through higher interest rates and fees.¹⁷² Furthermore, the dissent maintained that investors, unable to rely on financial statements, would be reluctant to finance risky ventures, and instead would concentrate their investments in well-established companies to the detriment of start-up and high-technology companies.¹⁷³ Conversely, if accountants are held financially liable for their negligence, it is logical that they will use more care in auditing, and investors will have greater confidence in financial re-

167. *Id.*

168. *Bily*, 834 P.2d at 777. As additional support for a broad concept of liability, Justice Kennard stated that the auditor has a public responsibility. *Id.* at 778. Relying on the New Jersey Supreme Court's opinion in *H. Rosenblum, Inc. v. Adler*, Justice Kennard explained that broad responsibility extends not only to the client but to "investors, creditors, and others who may rely on the financial statements." *Id.* at 779 (quoting *H. Rosenblum, Inc. v. Adler*, 461 A.2d 138, 149 (N.J. 1983)). See *supra* notes 104–09 and accompanying text for a discussion of the *Rosenblum* case.

Furthermore, Justice Kennard disputes the majority contention that a foreseeability rule would create unlimited liability by noting that liability would arise only when the auditor failed to meet the profession's own standards. *Bily*, 834 P.2d at 779. The justice explained that the standards applicable to the accounting profession do not require, nor does the law recognize, that an audit guarantee the accuracy of financial statements. *Id.*

169. *Bily*, 834 P.2d at 777.

170. *Id.* at 780–82.

171. *Id.* at 781.

172. *Id.*

173. *Id.*

ports.¹⁷⁴

The dissent disputed the majority's opinion that third parties can protect themselves from an auditor's negligence by conducting their own audits through "private ordering."¹⁷⁵ Justice Kennard attacked this proposition as an impractical and socially wasteful duplication of effort and expense.¹⁷⁶ Moreover, "private ordering" would be available only to wealthy investors because separate audits would be prohibitively expensive; thus, small investors and lenders would be disadvantaged.¹⁷⁷ The dissent concluded by proposing that absent any disclaimers made by the auditor,¹⁷⁸ the law should protect the reasonable expectations of third parties who rely on audited financial statements for general business purposes.¹⁷⁹

IV. CRITICAL ANALYSIS

In *Bily v. Arthur Young & Co.*, the California Supreme Court erred in rejecting the foreseeable user approach in favor of the re-

174. *Bily*, 834 P.2d at 781. Justice Kennard postulated that most clients want an unqualified audit opinion more than a careful audit. *Id.* Because clients pay the auditor's fees they can put considerable pressure on the auditor to provide an unqualified opinion. *Id.* The auditor is pressured to provide an unqualified audit and to maintain high standards of care. *Id.* Furthermore, the threat of third-party liability acts as a motivating factor in this conflicting situation. *Id.*

Justice Kennard noted that three states, New Jersey, Mississippi and Wisconsin, follow the foreseeable user doctrine, and there is no evidence that the rule as adopted in those states has resulted in any detrimental consequences to the accounting profession. *Bily*, 834 P.2d at 782. The justice also noted that the federal securities laws provide an even stricter rule than the foreseeable user doctrine in that any investor of a regulated security may sue the auditor for a statement that is materially false or misleading, although the auditor has an affirmative defense of due diligence. *Id.* at 783 (citing 15 U.S.C. § 77k (1993)). See *supra* note 66 and accompanying text.

Justice Kennard stated that auditors can obtain professional malpractice insurance to cover losses due to their negligence. *Bily*, 834 P.2d at 783. He concluded that there is no evidence to establish that insurance is unavailable or prohibitively expensive. *Id.*

175. *Bily*, 834 P.2d at 785. See *supra* note 135 and accompanying text.

176. *Id.*

177. *Id.*

178. *Id.* at 786. Justice Kennard proposed that the auditor could limit his exposure by disclaiming in his audit opinion liability to third parties. *Id.* Consequently, third parties would be on notice of this disclaimer and could not reasonably rely on the auditor's opinion for their own private transactions. *Bily*, 834 P.2d at 786. Justice Kennard opposed the notion that accountants can have it both ways: they profit from the value of anticipated reliance by third parties, but claim they have no liability for their negligence causing losses to those relying third parties. *Id.*

179. *Id.*

strictive Restatement rule for determining accountant liability to third persons.¹⁸⁰ First, the court failed to recognize the duty auditors have to the investing public who justifiably relies on the expertise and independence of the auditor.¹⁸¹ Second, the court provided no clear policy reason why the accounting profession should be singled out from other professions and given a special exemption from tort liability.¹⁸² In granting the accounting profession an exemption, the court mistakenly believed that third parties are better suited than accountants to absorb losses and to protect themselves from auditor negligence by "private ordering."¹⁸³ Third, the Restatement rule adopted by the *Bily* court is arbitrary and inappropriate in the accountant liability context.¹⁸⁴ Finally, fairness to investors, lenders, and other foreseeable users who ordinarily rely on an auditor's report mandates that such third-party users be able to recover losses due to an auditor's negligence.¹⁸⁵

A. Auditors Owe a Duty to Investors and Lenders

The auditor's role has changed substantially since Justice Cardozo wrote his landmark opinion in *Ultramares Corp. v. Touche*¹⁸⁶ over sixty years ago. At that time, accountants provided services essentially for the benefit of their clients.¹⁸⁷ Moreover, the purpose of the audit in *Ultramares* was to ensure that the balance sheet was in agreement with the account books.¹⁸⁸ The audit was not directed toward determining whether the underlying accounts were themselves accurately stated. Today, auditors render financial state-

180. See *supra* notes 142–56 and accompanying text for a discussion of the majority court's reasoning for rejecting the foreseeable user doctrine.

181. See *infra* notes 186–97 and accompanying text for a discussion of the auditor's duty to investors and lenders.

182. See *infra* notes 198–205 and accompanying text for a discussion of why accountants should not be entitled to special immunity.

183. See *supra* note 135 and accompanying text for a discussion of "private ordering."

184. See *infra* notes 206–18 and accompanying text for a discussion of the Restatement rule as being arbitrary.

185. See *infra* notes 219–34 and accompanying text for a discussion of policy considerations supporting the foreseeable user doctrine.

186. 174 N.E. 441 (N.Y. 1931). See *supra* notes 38–41 and accompanying text for a discussion of the auditor's changing role.

187. See *supra* notes 73–79 and accompanying text for a discussion of the privity of contract doctrine, under which auditors owe a limited duty to third parties.

188. *Ultramares*, 174 N.E. 441 at 448.

ments principally for the benefit of third-party users¹⁸⁹ who consider the auditor to be a “public watchdog.” This “public watchdog” role was not forced on the profession. The profession has prospered and grown substantially in response to this need for independently audited financial statements.¹⁹⁰ Through its public proclamations and ethical standards, the profession has long recognized that the public it serves consists of clients, creditors, investors, the business community, and others who rely on its services to facilitate the flow of commerce.¹⁹¹

The *Bily* majority rejected this well-recognized duty to third parties by holding that Arthur Young owed no duty to Bily and the Shea investors.¹⁹² In essence, the court resurrected the anachronistic “privity of contract” doctrine of *Ultramares* in support of its holding that only the client can recover from the auditor under a negligence theory.¹⁹³ This position is inconsistent with the fundamental tort theory espoused in *Palsgraf v. Long Island R.R.*¹⁹⁴ which held that the “risk reasonably to be perceived defines the duty to be obeyed”¹⁹⁵ California explicitly adopted the *Palsgraf* duty concept in *Biakanja v. Irving* by holding professionals liable for negligent performance when there is foreseeable harm to third parties.¹⁹⁶

In the *Bily* case, Arthur Young was aware of the intended bridge financing and warrant sale and should have reasonably foreseen that Bily and the Shea investors would rely on the audited

189. The audit of public companies today is largely for the benefit of third parties. Wiener, *supra* note 95, at 250.

190. Opposition Brief at Respondents J.F. Shea Co., Inc., et al. at 12, *Bily* (No. S017199).

191. AICPA, CODE OF PROFESSIONAL CONDUCT — PRINCIPAL RULES (adopted Jan. 12, 1988). See *supra* note 46 and accompanying text for a discussion of the certified public accountant's duty to the public.

192. See *supra* notes 20–26 and accompanying text for a summary of the *Bily* court's holding.

193. *Bily*, 834 P.2d at 775. The dissent characterized the majority view as more restrictive than the harsh privity rule in *Credit Alliance v. Arthur Andersen & Co.*, 483 N.E.2d 110, 118 (N.Y. 1985). *Bily*, 834 P.2d at 784 (Kennard, J., dissenting). See *supra* notes 85–88 and accompanying text.

194. 162 N.E. 99, 99 (N.Y. 1928). See *supra* note 129.

195. *Palsgraf*, 162 N.E. at 100.

196. *Biakanja v. Irving*, 320 P.2d 16 (Cal. 1958) (holding that a person who negligently drafts a will is liable to the beneficiary for the loss of benefits caused by the will's invalidation). See *supra* notes 119–29 and accompanying text for a discussion of the cases eliminating immunity for professionals in California.

financial statements in the stock and warrant purchase transactions.¹⁹⁷ Because Bily and Shea were foreseeable users of Arthur Young's audit report, the court should have followed the *Biakanja* rule of professional duty, which supports the notion that auditors owe a duty to foreseeable third parties.

B. Accountants Not Entitled to Special Immunity

The court declined to apply a foreseeable user standard to accountants and by so doing, the court bestowed a special immunity on auditors that no other professional enjoys.¹⁹⁸ The conceptual immunity for many professionals that arose in the wake of the *Ultramares* "privity of contract" doctrine eroded over time.¹⁹⁹ In a series of cases, California courts stripped all professionals, including accountants, of their special immunity.²⁰⁰ Until the *Bily* case, California had consistently held that all professionals are responsible for injury to third parties resulting from failure to exercise ordinary care.²⁰¹

Because California has traditionally recognized a professional's duty to third parties,²⁰² the *Bily* court should have held that negligent accountants are liable to third parties. Yet, the court exonerated Arthur Young without explaining why accountants should be held to a lower standard of duty than other professionals.²⁰³ In fact, it seems only logical that the accountant's duty to the public would be even broader than the duties of other professionals, because the public unquestionably relies on the accountant's work product.²⁰⁴ The court's decision to limit negligence liability to the client is inconsistent with the foreseeable user doctrine applicable to other professionals. The court's failure to explain the preferential treatment bestowed on accountants stands as a serious weakness in the court's reasoning.²⁰⁵

197. Respondent Robert R. Bily's Opening Brief at 5–7, *Bily* (No. S017199).

198. See *supra* notes 119–29 and accompanying text.

199. *International Mortgage*, 223 Cal. Rptr. at 221.

200. See *supra* notes 119–29 and accompanying text.

201. See *supra* notes 119–29 and accompanying text.

202. See *supra* notes 119–29 and accompanying text.

203. See *supra* notes 133–62 and accompanying text.

204. See *supra* notes 40–50 and accompanying text for a discussion of the public's expectation of the accountant's role.

205. The majority stated that because investors and lenders are sophisticated business people, they could protect themselves through "private ordering," i.e. engaging their

C. The Restatement Rule is Arbitrary

After holding that only a client may recover from the auditor on a theory of negligence, the court further restricted recovery by third parties by adopting a narrow doctrine of negligent misrepresentation.²⁰⁶ The Restatement rule adopted by the court is inherently flawed because, although it provides the court with a means to limit liability, it does so arbitrarily and without sound reasoning.²⁰⁷

The rationale of the Restatement is no longer applicable to the accounting profession in today's sophisticated business environment. First, the Restatement observes that the duty of care in commercial transactions implies an undertaking to observe a relative standard of care.²⁰⁸ The logic of the Restatement position, and thus the justification for limiting liability, is that the user of information cannot reasonably expect the supplier to undertake an obligation unless the terms of the obligation are known to the supplier.²⁰⁹ This concern is simply not relevant in the context of an auditor's report. Auditors are required to follow generally accepted auditing standards promulgated by the American Institute of Certified Public Accountants for all audit engagements, regardless of who the intended recipient of the audit report might be.²¹⁰

The Restatement rule rationalizes a limitation on liability to third parties by stating that such a restriction promotes the public policy of encouraging the flow of commercial information.²¹¹ However, the *Bily* court did not cite to any evidence showing that the use of audit reports or the availability of audit services has been adversely affected in states that have adopted a foreseeable user rule.²¹² As the dissent postulates, if such adverse consequences had resulted, the

own auditors. *Bily*, 834 P.2d at 764–65. The majority's proposal would be duplicative and costly, and furthermore, such an alternative would not be available to the small investor whose transactional value would not justify the cost of a separate audit. *Id.* at 785. See *supra* notes 175–79 for the dissent's discussion of this alternative.

206. *Bily*, 834 P.2d at 772–73. For the majority court's analysis of negligent misrepresentation, see *supra* notes 142–57 and accompanying text.

207. See *infra* notes 208–18 and accompanying text.

208. RESTATEMENT (SECOND) OF TORTS § 552 cmt. a (1977).

209. *Id.*

210. See *supra* notes 32–35 and accompanying text.

211. RESTATEMENT (SECOND) OF TORTS § 552 cmt. a (1977).

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

legislature would have abrogated the foreseeable user rule.²¹³ Nor is there any evidence that limited liability has encouraged wider distribution of information. Even if the Restatement rationale is accepted, whether wider distribution of poorer quality financial statements will improve the flow of commercial information remains debatable.

In addition to questionable policy reasons, the Restatement rule suffers from vagueness, and its application produces illogical results in certain circumstances. The Restatement attempts to limit liability by allowing only a "limited group" of persons to sue, and then only if the supplier intended to influence a third party in a "substantially related" transaction.²¹⁴ Recovery depends on fortuitous conditions such as whether the name of a specific lender or investor was mentioned to the auditor, a circumstance that has nothing to do with the auditor's negligence or the third party's reasonable reliance.²¹⁵ For example, a lender who receives a copy of the financial statements from the company and relies on the audit report to advance loans would generally not be able to recover from the auditor under the Restatement rule.²¹⁶ However, if the lender attended meetings with company management and discussed the financial statements with the auditor, the auditor would be liable to the lender under the Restatement rule.²¹⁷ In both examples, the lender suffers substantial loss due to the auditor's negligence. In the first case the lender does not recover, yet in the second instance the lender does recover. The disparity resulting from application of the Restatement rule illustrates its capriciousness.²¹⁸ The *Bily* court

213. *Id.*

214. *See supra* text accompanying note 92.

215. *See supra* note 118 and accompanying text.

216. This scenario is taken from the case of *Credit Alliance v. Arthur Andersen & Co.*, 483 N.E.2d 110 (N.Y. 1985), where the court held that under these circumstances the auditor could not be held liable to the lender for auditor negligence that resulted in substantial losses to the lender.

217. *Id.* These additional circumstances mirror the facts of *European Am. Bank & Trust Co. v. Strauhs & Kaye*, 483 N.E.2d 110 (N.Y. 1985), a case decided in the same opinion as *Credit Alliance*. *Id.* at 112–14.

218. RESTATEMENT (SECOND) OF TORTS § 552 cmt. h, illus. 5 (1977) further underscores the arbitrariness of the Restatement rule. In illustration 5, if the client tells the auditor that the financial statements will be used to secure a \$50,000 loan from Bank X, but instead the client secures the same loan from Bank Y, the auditor will not be liable to Bank Y although the financial statements materially misstate the financial position of the client and Bank Y suffers a loan loss as a consequence. *Id.*

should have rejected the Restatement rule as a basis for accountant liability because the rule does not measure the culpability of the auditor's negligence, but merely exonerates the auditor from liability to third parties who rely on the auditor's opinion.

D. "Fairness" and Other Policy Considerations

The *Bily* court should have followed the *Rosenblum* doctrine which holds that the auditor is responsible to parties who justifiably rely on the auditor's opinion once the audit report is inserted into the "economic stream."²¹⁹ Auditors know that third parties will rely on their report and, in fact, this dependence creates the demand for the auditors' services. Accountants reap substantial rewards providing audit services,²²⁰ and it appears only fair that they should be held responsible for their careless misrepresentations.²²¹

Competition in the accounting profession is keen; in order to attract and retain clients, accountants must be responsive to client demands.²²² Client companies hire auditors, pay their fees, and can change audit firms at management's discretion.²²³ As a consequence of these competitive factors, auditors may be pressured to approve management's favorable evaluation of financial results rather than insist on scrupulous accuracy.²²⁴ The auditor's independence is threatened by immense pressure to meet client demands.²²⁵ Some commentators maintain that auditors will be more independent and will exercise greater care in their work if they are held liable to third parties for the consequences of their negligent audits.²²⁶ The threat of liability to third parties reinforces the auditor's independence and prevents client loyalty from clouding the auditor's professional judgment.²²⁷ Therefore, any rule which substantially limits

219. *H. Rosenblum, Inc. v. Adler*, 461 A.2d 138, 155 (N.J. 1983).

220. Opposition Brief of Respondents J.F. Shea Co., Inc., et al. at 12, *Bily* (No. S017199).

221. *See Rosenblum*, 461 A.2d at 155.

222. Opposition Brief of Respondents J.F. Shea Co., Inc., et al. at 42, *Bily* (No. S017199).

223. *Id.*

224. *Id.*

225. *Id.*

226. *See, e.g.*, Samuel S. Paschall, *Liability to Non-Clients: The Accountant's Role and Responsibility*, 53 MO. L. REV. 693, 729 (1988); Wiener, *supra* note 95, at 256-60.

227. *Bily*, 834 P.2d at 781-82.

accountability for auditor negligence, such as the Restatement rule, may have the unintended effect of reducing the vigilance and independence of the auditor.

In comparing accountants with third-party users, accountants are better risk bearers because they are in a superior position to avert the loss caused by negligent audits.²²⁸ Accountants can evaluate the risk of loss through audit procedures which include an assessment of the client's internal accounting policies.²²⁹ The auditor evaluates internal accounting controls and conducts sample tests to verify compliance with approved procedures.²³⁰ If the auditor finds that controls are weak, the auditor can expand the scope of the audit to compensate for the weaknesses found or issue a qualified audit opinion.²³¹ The auditor is in the unique position to assess the risks of accuracy of the client's financial statements because of the auditor's independent expertise and access to company records. Third-party users do not have the access and expertise to evaluate company records and, therefore, cannot protect themselves from the possibility of misleading financial statements. Because auditors are in the best position to avoid the harm caused by misleading financial statements, the auditor should bear a portion of the financial losses resulting from auditor negligence.²³²

Auditors can distribute the loss more efficiently through insurance.²³³ Because the auditor can more easily evaluate the risk associated with third-party reliance on an audit, the auditor can project the cost to insure against those risks. Of course, these costs will have to be passed on to clients through higher fees. But by spreading the costs to their clients, accounting firms can protect themselves from catastrophic losses, and foreseeable users can thus recover damages resulting from negligent audits. Moreover, third parties are unable to obtain insurance for auditor malpractice. Without the ability to protect themselves from loss, investors and lenders

228. Opposition Brief of Respondents J.F. Shea Co., Inc., et al. at 48, *Bily* (No. S017199).

229. *Id.* at 48–49.

230. See *supra* notes 27–39 and accompanying text for a discussion of the function of an auditor.

231. See *supra* notes 27–39 and accompanying text.

232. Opposition Brief of Respondents J.F. Shea Co., Inc., et al. at 48, *Bily* (No. S017199).

233. See *supra* note 115 and accompanying text.

will concentrate their investments in well-established companies with low risk to the detriment of small start-up companies essential to long-term growth of the economy.²³⁴ Thus, accountants should be liable for losses to foreseeable users arising from their own negligence because they are the better risk bearers and can protect against the loss through insurance.

E. Claims of “Unlimited Liability” Appear Exaggerated

The *Bily* court's concern with protecting the auditor from unlimited liability may be warranted and deserves careful consideration. Given the recent history of large verdicts against accountants, the court properly concluded that some limits to liability are necessary.²³⁵ However, the court's belief that a foreseeable user doctrine would impose “unlimited liability”²³⁶ is unfounded. There are built-in limitations to liability in any tort rule, and the foreseeable user rule is no exception.²³⁷

Liability under the foreseeable user doctrine is limited in several ways. First, the third party must prove reliance on the audit report.²³⁸ Second, the third party must prove that the auditor's negligence was the proximate cause of the loss.²³⁹ Third, the third party's reliance on the audit report must be both reasonable and foreseeable.²⁴⁰ In addition to these built-in limits, the *Bily* dissent offered two proposals that would directly limit auditor liability: cap the auditor's liability at a percentage of the net worth of the company, or require that the audit be backed by a surety bond.²⁴¹

234. *Bily*, 834 P.2d at 781.

235. See *supra* note 50 and accompanying text for a discussion of the litigation crisis facing the accounting profession.

236. *Bily*, 834 P.2d at 769.

237. See *supra* notes 106–08 and accompanying text.

238. *Rosenblum*, 461 A.2d at 152–53.

239. *Id.* at 152.

240. *Id.* The court in *Rosenblum* held that plaintiffs would have to establish that they received the financials from the company for a “proper company purpose.” *Id.* As a further reduction to liability, the accounting firm could seek indemnification from the company and the officers and directors of the company. *Id.*

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

V. AN ALTERNATIVE PROPOSAL:
PROPORTIONAL LIABILITY

Courts are reluctant to expose the accounting profession to liability to foreseeable third parties. All but three states have adopted either the Restatement rule or the more restrictive "privity rule," or have applied some variation of these rules.²⁴² Yet, these approaches have done little to stem the tidal wave of litigation against accountants in recent years.²⁴³ The subjective nature of the Restatement rule, in particular, still leaves plenty of room for juries to award staggering verdicts in cases of auditor negligence.²⁴⁴

An equally important consideration, at least to scholars and commentators on tort theory, is that the "privity" and Restatement rules often force investors and other foreseeable third parties to absorb huge losses resulting from misleading financial statements with no recourse against blatantly negligent auditors.²⁴⁵ The "privity" rule employs a draconian solution by denying recourse to virtually all third parties.²⁴⁶ The Restatement rule is more subtle when it denies protection to most third parties by arbitrarily manipulating vague definitions of "intent to benefit" and "limited classes."²⁴⁷ Aside from limiting liability for its own sake, and its appeal as a "middle of the road" solution, the Restatement rule has been heavily criticized.²⁴⁸

The public expects auditors to be financially responsible for their negligence.²⁴⁹ Rather than attempt to limit this duty by arbitrarily defining a narrow class of protected persons, a fair doctrine of accountant liability should focus on the degree of negligence and the allocation of fault. As an alternative to the Restatement and privity doctrines, a proportional liability rule allocating fault between the auditor and the client should be the basis for auditor liability to third parties.

242. See *supra* notes 73–98 and accompanying text.

243. See *supra* note 50 and accompanying text.

244. See *supra* note 50.

245. In his dissent, Justice Kennard indicated that the Restatement rule adopted by the majority offers "broad immunity" to the negligent accountant. *Bily*, 834 P.2d at 775 (Kennard, J., dissenting).

246. See *supra* note 79 and accompanying text.

247. See *supra* notes 214–18 and accompanying text.

248. *E.g.*, Wiener, *supra* note 95, at 233.

249. See *supra* notes 41–51 and accompanying text.

A proportional liability rule would initially recognize that an auditor has a duty to foreseeable third-party users of financial statements when third parties reasonably rely on the auditor's opinion. Under this premise, the auditor would have a legal duty to third parties such as investors, lenders, and others who could prove that they relied on the auditor's report to engage in specific transactions. This scope of duty to third parties could be modeled after the foreseeable user rules adopted in New Jersey, Wisconsin, and Mississippi, or the California foreseeable user rule in effect prior to the *Bily* decision.²⁵⁰

A proportional liability rule would apply in the event of a failed audit. To apply the rule, the trier of fact must first decide the threshold issues of whether the financial statements were materially misleading and whether the auditor was negligent. If the financial statements were misleading, and presuming the plaintiffs can prove the elements of their tort claims,²⁵¹ the trier of fact would be instructed to allocate the fault that generated the misleading financial statements between the client company and the auditor.

In allocating fault between the client company and the auditor, the court would instruct the jury to follow a three-step process. First, the jury should measure the auditor's degree of negligence in conducting the audit against established standards promulgated by the accounting profession,²⁵² and grade the auditor's performance on a scale of one to one hundred. Second, the jury should assess the client company's contribution to the misleading financial statements. In this step, the jury should evaluate the client company's performance relative to standards and practices followed by other companies of similar size and comparable financial complexity. In gauging the client company's performance, the jury should consider such factors as management's financial skills and experience, existence of and adherence to internal accounting control procedures, and the involvement and oversight functions of the board of directors. The jury should also consider the presence or absence of outside board members, the existence of an independent audit committee, and perhaps, most importantly, management's knowledge of

250. See *supra* notes 99–115, 119–29 and accompanying text.

251. See *supra* note 52 for a discussion of the elements of professional negligence tort claims.

252. See *supra* notes 27–35 and accompanying text.

and culpability in the specific reporting practices that gave rise to the misleading financial statements. After considering these factors, the jury should score the client company on a scale of one to one hundred.

In the final step, the jury would allocate fault between the client company and the auditor by computing a ratio between the client's score and the auditor's score. Financial damages actually proved by the plaintiff would then be charged against the auditor and the client in proportion to this ratio. The following steps illustrate the method of allocating loss between the auditor and the client based on the concept of proportional liability:²⁵³

253. Unless the plaintiff was in some way contributorily negligent, the entire damages would be allocated between the auditor and the company in accordance with the illustrated three-step formulas. The auditor is measured against standards applicable to accountants; the company is measured against financial management standards of similarly sized companies in like industries. In a hypothetical example, if the auditor received a score of 75 on a scale of 100, and the client company received a score of 50 on a scale of 100, the loss would be allocated one-third to the auditor and two-thirds to the client.

A proportional allocation of loss eliminates the inequitable “all or nothing” approach inherent in all other models of accountant liability.²⁵⁴ Under a theory of proportional liability, blatantly negligent auditors will be accountable for misconduct, but minimally deficient auditors will not be forced out of practice as a result of catastrophic awards far out of proportion to their fault. Large awards will still be levied against grossly negligent auditors under a proportional liability scheme because the trier of fact presumably will allocate most of the fault to such an actor; but perhaps ridding the profession of the reckless and incompetent auditor is a desirable consequence of large awards.

Proportional allocation of fault is a concept well suited to the client-auditor relationship. First, financial statements are primarily the responsibility of management.²⁵⁵ Auditors can only test transactions and must rely on management to disclose much of the information necessary to certify financial statements. Second, many companies are staffed with financial experts responsible for reporting financial results to outsiders. Often, these financial managers are Certified Public Accountants with considerable experience and financial reporting acumen. It seems only fair to hold the company and its management at least partly responsible for the loss resulting from a failed audit, particularly if experienced financial managers failed to disclose important information to the auditor.

The proportional liability approach must be accompanied by an abrogation of joint and several liability so that the auditor would be held accountable for only his share of the loss. In many cases where third parties sue for misleading financial statements, the client company is bankrupt and the auditor is the only solvent party re-

254. Under either the Restatement rule or the privity rule once the auditor is found to be negligent he becomes liable for all the damages that flow from the misleading financials. The degree of negligence is irrelevant, as are any nefarious acts of the client which may have contributed or caused the misleading financials. Because this “all or nothing” approach can produce staggering liability awards, courts have responded by narrowing the class of third parties that have standing to sue.

255. See *supra* note 29, 37 and accompanying text.

maining.²⁵⁶ If plaintiffs could recoup all their losses from the auditor under a theory of joint and several liability, there would be little purpose in adopting a proportional liability approach. Allocating all the loss to the auditor just because the client is insolvent certainly is not equitable to the auditor, especially if company management was chiefly at fault for the losses. At any rate, partial recovery from auditors under a proportional liability rule is arguably better than no recovery under a Restatement rule that fails to recognize the rights of foreseeable users.²⁵⁷

As a result of tort reform initiatives, thirty-three states have abrogated or modified the doctrine of joint and several liability.²⁵⁸ Those states that have abrogated or modified joint and several liability hold that a tortfeasor may be held liable for only the proportion of the total loss caused by the tortfeasor.²⁵⁹ Thus, the majority of states may now adopt a proportional liability scheme for accountant liability compatible with their existing tort liability principles.

The proportional approach combined with the foreseeable user doctrine would achieve two important goals. First, foreseeable users of financial statements will be protected, at least partially, from negligent auditors, an expectation the public already assumes. Second, because auditors will only be held accountable for their own fault, the minimally negligent auditor will not be subjected to disproportionate liability.

VI. CONCLUSION

The accounting profession promulgates standards for auditing financial statements and the public expects auditors to conduct careful, thorough audits. Investors, lenders, and others rely on the auditor's opinion when making business decisions involving a company's financial condition. The *Bily* court betrayed the reasonable expectations of these parties by refusing to recognize an auditor's duty to foreseeable financial statement users. Instead, the *Bily* court endorsed the Restatement rule, a doctrine which provides broad immunity to auditors for negligence and denies recovery to foreseeable

256. *See supra* note 134.

257. *See supra* note 163 and accompanying text.

258. AMERICAN TORT REFORM ASSOC., TORT REFORM RECORD 3-7 (June 1993).

259. *Id.*

third parties who suffer economic loss.

The *Bily* court should have retained the foreseeable user standard for several reasons. First, auditors owe a duty to investors, lenders, and other third parties. In its own ethical pronouncements, the accounting profession recognizes its duty to the public, and auditors prosper by providing opinions to third parties who rely on the auditor's report. Second, all other professionals in California are liable to foreseeable third parties, so there is no reason to bestow special immunity on accountants. Third, the Restatement rule arbitrarily limits an auditor's liability to a select class of third parties, those intended by the auditor to be influenced by the financial statements. The rule provides immunity to the negligent auditor even when the financial statement user is clearly foreseeable and the user's reliance on the audit report is reasonable. Fourth, auditors are the best risk bearers for negligent audits since they can evaluate the risk inherent in auditing financial statements and can protect against losses by procuring malpractice insurance. Finally, the foreseeable user approach, like all accountant liability doctrines, has certain built-in safeguards which limit liability, such as requirements that the audit report user prove reasonable reliance and proximate cause.

Despite these built-in safeguards to avoid "run-away" jury verdicts, all existing theories of accountant liability still hold the auditor liable to third parties for the entire loss, without regard to the degree of auditor negligence or client misconduct. This "all or nothing" scheme too frequently results in catastrophic awards levied against minimally negligent auditors. To avoid ruinous awards, the foreseeable user doctrine should be modified to allocate fault proportionately to the auditor and the client. Under such a proposal, the auditor would be held accountable only for the portion of financial losses directly related to the auditor's negligence.

The *Bily* court should have ruled that Arthur Young owed a legal duty to Bily and the Shea plaintiffs, because these investors were foreseeable users that justifiably relied on Arthur Young's audit report. The court should have remanded the case to the trial court with instructions to hear evidence as to the standards of care employed by the auditor and the company during the preparation and audit of the company's financial statements. After hearing evidence on auditor and client misconduct, the trial court should then charge damages to the auditor and the client in proportion to their

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fault.

Richard S. Panttaja