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Notes

LIMITING LIABILITY IN PUBLIC ACCOUNTING SUITS: A DESPERATE APPEAL FROM A BELEAGUERED PROFESSION

I. INTRODUCTION

Within the past two years, plaintiffs have filed a staggering number of suits against public accountants.¹ A significant number of the cases filed against certified public accountants involve alleged Securities and Exchange Commission (SEC) violations, fraud, and negligence.² A large proportion of the current

1. *E.g.*, *Pacific Mut. Life Ins. Co. v. First Republic Bank Corp.*, 806 F. Supp. 108 (N.D. Tex. 1992); *Bily v. Arthur Young & Co.*, 834 P.2d 745 (Cal. 1992); *In re Crazy Eddie Sec. Litig.*, 802 F. Supp. 804 (E.D.N.Y. 1992); *Bethlehem Steel Corp. v. Ernst & Whinney*, 822 S.W.2d 592 (Tenn. 1991); *Federal Deposit Ins. Corp. v. Ernst & Young*, 967 F.2d 166 (5th Cir. 1992); *SEC v. Price Waterhouse*, 797 F. Supp. 1217 (S.D.N.Y. 1992); *U.S. Nat'l Bank v. Miniscribe Corp.*, No. 89-CV-1031-A (Tex. Dist. Ct., Galveston Co., 1992); *Standard Chartered PLC v. Price Waterhouse*, No. 88-34414 (Ariz. Super. Ct., Maricopa Co. 1992); *In re American Continental Corp./Lincoln Sav. and Loan Sec. Litig.*, 794 F. Supp. 1424 (D.C. Ariz. 1992); *Ades v. Deloitte & Touche*, Nos. 90 Civ. 4959 (RWS), 90 Civ. 5056 (RWS), 1991 U.S. Dist. LEXIS 8978 (S.D.N.Y. July 2, 1991); *Lyne v. Arthur Andersen & Co.*, 772 F. Supp. 1064 (N.D. Ill. 1991); *Shaaban v. Arthur Andersen & Co.*, No. 91 C 7539, 1992 U.S. Dist. LEXIS 5437 (N.D. Ill. March 24, 1992); *Hydroculture, Inc. v. Coopers & Lybrand*, No. 1 Ca-CV 90-381, 1992 Ariz. App. LEXIS 255 (Ariz. Ct. App. filed Sept. 17, 1992); *In re Control Data Corp. Sec. Litig.*, 933 F.2d 616 (8th Cir. 1991); *Farlow v. Peat Marwick, Mitchell & Co.*, 956 F.2d 982 (10th Cir. 1992); *Ligon v. Deloitte, Haskins & Sells*, 957 F.2d 546 (8th Cir. 1992); *Congregation of the Passion, Holy Cross Province v. Touche Ross & Co.*, 586 N.E.2d 600 (Ill. App. Ct. 1991).

An estimated \$30 billion in damage claims currently face the entire public accounting profession. Another indicator of the number of suits being brought is the amount paid by the six largest accounting firms in total expenditures for defending lawsuits. In 1991, the total expenditure for settling and defending lawsuits was \$477 million, which was up from the 1990 figure of \$404 million. ARTHUR ANDERSEN ET AL., *THE LIABILITY CRISIS IN THE UNITED STATES: IMPACT ON THE ACCOUNTING PROFESSION, A STATEMENT OF POSITION 2*, 3 (Aug. 6, 1992). The accountant liability crisis has expanded to include international suits. The Australian government indicated that they have filed a \$750 million suit against KPMG Peat Marwick for deficiencies in a 1988 audit of a government owned merchant bank, Tricontinental Corporation. *Australian Government Wallops Peat with \$750M Suit*, ACCT. TODAY, Aug. 24, 1992, at 15. "A public accountant may be defined as an independent professional person who holds himself out as an expert in accounting theory and practice." RUFUS WIXON ET AL., *ACCOUNTANTS' HANDBOOK 26-1* (5th ed. 1970).

2. *In re Crazy Eddie Sec. Litig.*, 802 F. Supp. at 804; *Price Waterhouse*, 797 F. Supp. at 1217; *In re Control Data Corp. Sec. Litig.*, 933 F.2d at 616; *Farlow*, 956 F.2d at 982; *In re American Continental Corp.*, 794 F. Supp. at 1424.

public accounting suits are filed in attempts to reach the "deep pocket."³ To assure judgment collection in a suit, a plaintiff will search for any solvent defendant with a deep pocket; in many cases, this is the certified public accountant (CPA).⁴

Another recent phenomenon involves plaintiffs filing unwarranted suits strictly to coerce settlements for staggering dollar amounts.⁵ Despite the

Plaintiffs have sued one out of twelve New York Stock Exchange companies in the past three years. A *National Law Journal* study and report showed that out of 46 cases, 12 were filed within one day after a company disclosed less-than-anticipated earnings. Similarly, another 30 cases were filed within one week of disclosure. Senator Domenici, *Introductory Statement, Remarks on S. 3181, Securities Private Enforcement Act of 1992*, at 2, 3 (Aug. 12, 1992). In 1990 and 1991, 614 class action security cases were filed in federal courts against American companies. Senator Sanford, *Introductory Statement, Remarks on S. 3181, Securities Private Enforcement Act of 1992*, at 1 (Aug. 12, 1992).

A staggering number of securities suits are brought against accounting firms because of the potential for holding the CPA firm liable for the full cost of the business failure. John Pickering, *New Bills Promise Litigation Relief*, ACCT. TODAY, Aug. 24, 1992, at 2.

3. ANDERSEN ET AL., *supra* note 1, at 2, 4. For examples and discussions of cases supporting the theory that many public accounting cases are filed to reach a deep pocket, see John H. Cushman, *\$400 Million Paid by S&L Auditors, Settling U.S. Case*, N.Y. TIMES, Nov. 24, 1992, at A1; Susan Schmidt, *Ernst & Young Pays \$400 Million to Settle Thrift Regulators' Claims*, WASH. POST, Nov. 24, 1992, at A1; Suzanne Woolley & Zachary Schiller, *These White Shoes are Splattered With Mud*, BUS. WK., Sept. 7, 1992, at 32. For examples indicating the possible plaintiffs' use of the deep pocket theory, see the following cases: *Federal Deposit Ins. Corp.*, 967 F.2d at 166; *Bily*, 834 P.2d at 745; *Miniscribe*, No. 89-CV-1031-A; *Standard Chartered PLC*, No. 88-34414. See generally AUS Consultants, *The Economic Effects of Scapegoat Litigation*, at i (July 31, 1992) (study prepared for The American Tort Reform Association).

4. Accountants are named as co-defendants in litigation not because they engaged in deliberate fraud, but because they are able to pay large judgments. *Long-Awaited Liability Reforms Bill Introduced*, PRACTICING CPA, Sept. 1992, at 3. Plaintiffs tend to go after the deep pocket defendant in part due to the law of joint and several liability. In a state that imposes joint and several liability, the CPA firm is stuck paying the entire judgment, regardless of its percentage of fault. ANDERSEN ET AL., *supra* note 1, at 1, 6.

For an example of a court's recent affirmation of the doctrine of comparative negligence, see *McIntyre v. Balentine*, 833 S.W.2d 52 (Tenn. 1992). See also AUS Consultants, *supra* note 3, for information gathered in a study supporting the deep pocket theory of recovery.

5. ANDERSEN ET AL., *supra* note 1, at 1-3. A few recent public accounting settlement cases include Ernst & Young settling for \$41 million and Coopers & Lybrand settling for \$20 million. A related issue involves holding attorney firms liable in third-party liability actions. The firm of Kaye, Scholer, Fierman, Hays & Handler recently paid a settlement fee of \$41 million. Cushman, *supra* note 3, at A1.

Ernst & Young recently agreed to one of the largest settlements in the history of public accounting suits. Ernst agreed to pay \$400 million for its involvement in the failed S&L scandal. The Federal Deposit Insurance Corporation (FDIC), Resolution Trust Corporation (RTC), and Office of Thrift Supervision (OTS) agreed to the settlement. Schmidt, *supra* note 3, at A1.

Coopers & Lybrand settled a case brought by bondholders of Miniscribe Corporation for an estimated \$40 million in February 1992. Woolley & Schiller, *supra* note 3, at 32. Coopers & Lybrand was ordered to pay Miniscribe investors \$200 million in punitive damages in February of

increase in professional negligence cases against attorneys, it appears the legal profession is promoting the filing of suspect cases.⁶ Unable to afford the costs of either initial or extended litigation, many public accounting firms are opting to settle out of court.⁷ Although many firms may be innocent of the charges

1992. Paul Geoghan, *Punitive Damages: A Storm Over the Accounting Profession*, J. ACCT., July 1992, at 46. For more information about the *Miniscribe* case and Coopers' settlement, see *infra* notes 23-27 and accompanying text. For an additional supporting case showing the out-of-court settlement inducement, see *infra* notes 10-20 and accompanying text.

For information on past accounting litigation trends, compare the cases referred to above with DENZIL Y. CAUSEY, JR., DUTIES AND LIABILITIES OF PUBLIC ACCOUNTANTS 2 n.8 (1979). Investors and creditors filed about 100 lawsuits against public accounting firms in 1966. The settlement fees in public accounting suits in the 1970s were substantially lower than the fees currently paid by CPA firms. The December 1970 *Fortune* magazine reported that Lybrand, Ross Bros. & Montgomery (Coopers & Lybrand) paid \$4,950,000 in settlement fees to shareholders and creditors of an insolvent financial company. CAUSEY, *supra*, at 2. The July 1978 *Journal of Accountancy* listed five accounting firms paying \$44 million in settlement amounts, three firms paying \$39 million, and Peat, Marwick, Mitchell & Co. paying \$1.5 million in settlement fees. In 1977, the largest civil verdict against an accounting firm was \$30 million. *Id.* Other settlements reported in the early and mid 1970s included a \$400,000 settlement by Haskins & Sells, an \$875,000 settlement by Arthur Andersen, a \$950,000 settlement by Arthur Young & Co., and a \$1.3 million settlement by Coopers & Lybrand. *Id.*

6. See AUS Consultants, *supra* note 3, at 1, 3, 6; ANDERSEN ET AL., *supra* note 1, at 2. For a general discussion of the Savings & Loan (S&L) impact on attorneys, see Steve France, *The S&L Mess; When the '80s Meet the '90s*, A.B.A. J., May, 1991, at 52. An advertisement by a Virginia law firm which read, "Losses in the financial or stock markets? You may have a legal remedy," demonstrates how the legal profession continues to promote a litigious society. Domenici, *supra* note 2, at 2. For a more thorough discussion of how attorneys are feeding the fire regarding accountants' third-party liability crisis, see *id.*

7. Interview with Mr. Michael Crandall, CPA, Principal of Siegfried, Crandall, Vos & Lewis, P.C., in Kalamazoo, Michigan (October 10, 1992) [hereinafter Crandall Interview]. See also ANDERSEN ET AL., *supra* note 1, at 3, 4; Domenici, *supra* note 2, at 2-4.

Lawsuits Decline, but Settlements Skyrocket

	1990	1991	1992
Audit Related Litigation			
Number of suits files	192	172	141
Total amount of awards and settlements paid	\$89.6m	\$160.3m	\$752.4m
Amount of awards and settlements per audit partner	\$19,865	\$37,900	\$185,737
Number of cases settled	52	67	115
Amount of settlements	\$54.4m	\$146.6m	\$748.3m
Number of cases dismissed	23	29	79
Number of cases tried	9	7	15
Number of verdicts for defendants	3	3	12
Number of verdicts for plaintiffs	6	4	3
Total amount of award to plaintiffs	\$35.2m	\$13.7m	\$4.1m

brought against them, the high cost of litigation and the fear of disproportionate jury awards outweigh the benefits of maintaining the CPA firm's reputation and publicly vindicating itself.⁸

Two recent cases demonstrate how the current legal system and laws regarding the expansion of third-party liability in public accounting cases are producing inequitable results.⁹ In the first case, Standard Chartered Bank (Standard), a British company, brought suit against Price Waterhouse, a public accounting firm.¹⁰ Standard purchased United Bank of Arizona for fifteen

Accounting and Audit Practice Protection Costs

Gross accounting and audit revenue	\$5,257m	\$5,319m	\$5,470m
Costs of judgments, settlements and legal defense	\$367m	\$485m	\$783m
Gross costs as a percent of A&A revenue	7%	9.1%	14.3%
Insurance premiums net of insurance recoveries	\$37m	(\$8m)	(\$185m)
Net audit practice protection costs	\$404m	\$477m	\$595m
Net costs as percentage of revenue	7.7%	9%	10.9%
Average earnings per Big Six partner	\$206,000	\$190,000	\$212,000

Source Accountants Coalition, Washington, D.C. (Big Six Report to SEC)
m=millions

Footnotes, ACCT. TODAY, Jan. 24, 1994, at 2.

8. Crandall Interview, *supra* note 7; ANDERSEN ET AL., *supra* note 1, at 2-4. See also Cushman, *supra* note 3; Schmidt, *supra* note 3; Philip A. Lacovara, 'Follow the Money': Should Lawyers and Accountants Pay For the Sins of Their Clients?, WASH. POST, July 21, 1992, at A19. For the effects of punitive damages on the high cost of litigation and out-of-court settlements, see Geoghan, *supra* note 5.

9. Third-party liability involves a third-party to an action who alleges injury from the defendant's intentional or unintentional conduct. For a discussion of the broad theory behind third-party liability in a negligence action, see W. PAGE KEETON ET AL., PROSSER & KEETON ON THE LAW OF TORTS 284-300 (5th ed. 1984). One of the first cases to deal with third-party liability in negligence cases was *Palsgraf v. Long Island R.R. Co.*, 162 N.E. 99 (N.Y. 1928).

10. Standard Chartered PLC v. Price Waterhouse, No. 88-34414 (Ariz. Super. Ct., Maricopa Co. 1992). In 1985, a change in Arizona banking investment laws caused a large number of out-of-state financial institutions to buy Arizona banks. In Arizona, prior to 1985, out-of-state financial institutions were prohibited from purchasing local commercial banks. In 1985, this law was changed to allow out-of-state purchases of in-state banks. Standard Chartered chose to capitalize on the newly opened market by purchasing United Bank of Arizona. United Bank of Arizona, the fourth largest bank in the state, with \$2.2 billion in assets and a net worth of \$130 million, appeared to be a sound investment in 1985. Unfortunately, Standard's enthusiasm caused it to conduct a limited survey of United's loan portfolio. Philip R. Lochner, Jr., *Black Days for Accounting Firms*, J. ACCT., Aug. 1992, at 105.

times United's earnings.¹¹ After Standard acquired United, some of United's real estate loans proved unprofitable.¹² United's shaky financial position together with Standard's unstable loan portfolio caused Standard to sell United for a huge loss.¹³

Standard, anxious to recoup its losses, looked for a viable target to compensate it for its investment loss.¹⁴ After determining that United's shareholders would not be possible targets because of their physical dispersment across the country, Standard was left with only one other involved actor with a deep pocket, Price Waterhouse.¹⁵ Price Waterhouse performed United's audits for the two-year time period leading up to Standard's acquisition.¹⁶ Standard alleged that Price Waterhouse negligently performed its audits and that Price should have discovered the overstatement of United's actual net worth.¹⁷ Price Waterhouse blamed Standard for not conducting its own investigation of the bank prior to purchase and argued that the firm was not engaged to review United's loan portfolio before Standard purchased United.¹⁸ The Arizona jury awarded Standard \$338 million in damages, 1,000 times the accounting fees that

11. *Lochner*, *supra* note 10, at 105. Standard Chartered actually paid \$335 million for United Bank. *Id.* Standard acquired United after a year-long study and without waiting for Price Waterhouse to issue its final audit. One of United's portfolio problems was its loan-loss reserves. *Price Wins New Trial In Arizona Bank Case*, ACCT. TODAY, Jan. 4, 1993, at 2.

12. *Lochner*, *supra* note 10, at 105. In the trial, Standard's biggest contention specifically involved two of the bank's largest loans, which produced an aftertax charge of approximately \$17 million. Michael Bradford, *Auditors Fear Liability: Price Waterhouse Hit by \$338 Million Award*, BUS. INS., May 25, 1992, at 2.

13. *Lochner*, *supra* note 10, at 106. Concerned with Standard's third world portfolio, U.K. regulators were pressuring Standard to improve its capital base. *Id.* See *Lacovara*, *supra* note 8, at A19 (discussing the jury award in *Standard* and similar cases and their potential effects on the economic structure). Standard's reported loss on the United investment was an alleged \$207 million. *Price Wins New Trial in Arizona Bank Case*, *supra* note 11, at 2. Citicorp bought United from Standard in June, 1988, for \$208 million. Kerry Fehr, *Judge Voids \$338 Million Jury Verdict*, PHOENIX GAZETTE, Dec. 17, 1992, at A1. United was not a savings & loan, and consequently, Standard's sale was not the result of its failure; rather, one reason for its sale was marked by the United Bank of England applying pressure to Standard to raise its capital ratios in late 1987. Larry Black, *Price Waterhouse to pay \$338M for Audit*, INDEPENDENT, May 21, 1992, at 28.

14. *Lochner*, *supra* note 10, at 106.

15. *Id.*

16. *Id.*

17. *Id.* In addition to alleging that Price Waterhouse's audits were negligently performed, Standard alleged that Price's staff was insufficiently trained and supervised and that United possessed inadequate internal controls. *Id.*

18. Fehr, *supra* note 13, at A1. Standard did not wait for one of Price's last audits before closing the deal with United. *Id.*

Price Waterhouse charged on Standard's audits.¹⁹

The *Standard* case demonstrates how plaintiffs can selectively sue defendants with deep pockets and make a profit.²⁰ A collateral problem to the deep pocket syndrome is plaintiffs suing public accounting firms to induce out-of-court settlements.²¹ The second case, *U.S. National Bank v. Miniscribe Corp.*,²² clearly demonstrates a combination of the deep pocket syndrome and the expansion of unwarranted suits filed to induce settlement.

In *Miniscribe*, bondholders of a failed computer disk-drive manufacturer, Miniscribe Corporation, filed a malpractice suit alleging that Coopers & Lybrand (Coopers) had conspired to overstate Miniscribe's financial condition.²³ Miniscribe's former chairman was accused of deceiving its investors by inflating the company's net income by falsifying corporate records over a period of years.²⁴ The Texas jury found Coopers liable for \$4 million

19. Lochner, *supra* note 10; L.J. Patterson, *Professional Liability Comments, President's Prospectus*, MICH. CPA, Winter 1993, at 3.

An Arizona Superior Court judge recently overturned the jury verdict in the *Standard Chartered* case and ordered a new trial. *Price Wins New Trial in Arizona Bank Case*, *supra* note 11. The trial was the longest civil trial in Arizona's history, lasting 11½ months. Judge John Sticht of Maricopa County Superior Court later ordered a new trial because the jury may have been confused about the methods of calculating damages on the claims in the suit. Sticht further stated that the claims were "irreconcilably inconsistent." Brent Whiting, *Record Verdict Voided: \$338 Million Award Against Auditor Lost*, ARIZ. REPUBLIC (Phoenix, Ariz.), Dec. 17, 1992, at A1. Out of the 11-month-long trial, Price Waterhouse was only given 25 days to present its case. *Accountant Hit with Judgment of \$338 Million; Litigation: An Arizona Jury Says a Price Waterhouse Audit Led to a British Firm Making a Losing Investment in a Bank*, L.A. TIMES, May 20, 1992, at D1 [hereinafter *Accountant Hit with Judgment of \$338 Million*].

20. Cf. Geoghan, *supra* note 5 (demonstrating the effect of punitive damages on out-of-court settlements based on a 1987 study by the Institute of Civil Justice, which examined 24,000 jury trials in Cook County, Illinois, and found, in inflation-adjusted dollars, punitive damages jumped 1600% from 1965 to 1984). For two excellent articles discussing *Standard Chartered*, which arrive at opposite conclusions, see Leo R. Beus, *Failed Audits Are No Basis for Protective Legislation*, ACCT. TODAY, Feb. 7, 1994, at 9, 10, 13; Paul F. Eckstein, *Standard Chartered's Case is Based on Distortion*, ACCT. TODAY, Feb. 7, 1994, at 9, 12, 13.

21. ANDERSEN ET AL., *supra* note 1, at 1-3; AUS Consultants, *supra* note 3, at 1. For a discussion of the effects of punitive damages on out-of-court settlements, see Geoghan, *supra* note 5, at 46.

22. *U.S. Nat'l Bank v. Miniscribe Corp.*, No. 89-CV-1031-A (Tex. Dist. Ct., Galveston Co. 1992); Geoghan, *supra* note 5, at 47.

23. Woolley & Schiller, *supra* note 3, at 32.

24. Geoghan, *supra* note 5, at 46. As proof of its fraudulent conduct, Miniscribe was found to have shipped bricks, not disk drives, to its distributors and recorded the shipments as sales of disk drives. *Coopers Pays \$95M More for Miniscribe*, ACCT. TODAY, Nov. 9, 1992, at 63. A more detailed article described Miniscribe's fraudulent actions to include renting a warehouse, boxing up what appeared to be disk drives, and sending them to dealers with explicit instructions to send the boxes, unopened, back to Miniscribe. Miniscribe would charge the boxes sent out as accounts receivable, and then would mark them as inventory when they were returned unopened. These

in compensatory damages and \$200 million in punitive damages.²⁵ The *Miniscribe* jury award was excessive in light of *Miniscribe's* chairman's intentional and well-designed transactional trail of evidence supporting the appearance of normal operations and activities.²⁶

Lawsuits such as *Miniscribe* and *Standard* are being filed at an alarming rate.²⁷ In response to the increased number of suits being filed and the courts' expansion of third-party liability in public accounting cases, CPAs are now undertaking protective measures to mitigate their liability.²⁸ Lawsuits are not new to the accounting profession, and CPAs have traditionally taken internal steps to attempt to reduce the possibility of liability while providing services.²⁹ CPAs routinely engage in two steps to mitigate their liability. In the first step, CPAs require the creation of engagement letters, an employment contract

boxes were filled with bricks and not disk drives. Joseph D. Jamail, *Keep the Case Rolling and Jurors Will Follow*, NAT'L L.J., Feb. 8, 1993, at 58.

25. Geoghan, *supra* note 5, at 47. A trial judge later set aside the *Miniscribe* verdict as "contrary to the great weight of the evidence," and the case was settled out of court for about \$40 million. Woolley & Schiller, *supra* note 3, at 32. A later published article indicated that Coopers had agreed to pay an additional \$95 million to the already paid \$45 million to settle the *Miniscribe* case. Other settlements related to the same case included Hambrecht & Quist, former investment bankers, who paid \$21.5 million to *Miniscribe* investors. Coopers was paid about \$1 million for the *Miniscribe* engagement. *Coopers Pays \$95M More for Miniscribe*, *supra* note 24, at 1, 63. In addition to the settlement in the *Miniscribe* action, the same defendants agreed to pay *Miniscribe* investors an estimated \$128 million in a Denver case. *Many Big Verdicts Sealed Post-Trial to Avoid Appeals*, NAT'L L.J., Jan. 25, 1993, at S18.

26. *Coopers Pays \$95M More For Miniscribe*, *supra* note 24; see *infra* notes 39-40 and accompanying text. For another case demonstrating the problem, see the *Phar-Mor* case discussed in Woolley & Schiller, *supra* note 3, at 32.

27. ANDERSEN ET AL., *supra* note 1, at 1-4; see *supra* notes 2, 6 and accompanying text. See, e.g., *Bily v. Arthur Young & Co.*, 834 P.2d 745 (Cal. 1992), *Bethlehem Steel Corp. v. Ernst & Whinney*, 822 S.W.2d 592 (Tenn. 1991); *Pacific Mut. Life Ins. Co. v. First Republic Bank Corp.*, 806 F. Supp. 108 (N.D. Tex. 1992). For a general discussion on the vast number of public accounting suits being filed, see Domenici, *supra* note 2.

28. For a discussion of CPA actions recently undertaken to mitigate liability, see *infra* notes 256-338 and accompanying text (relating to a lack of available insurance, increased service costs, improved methods of screening clients, and declining to perform work for clients). Fifty-six percent of accounting firms polled in a *Wall Street Journal* article indicated they were limiting the industries that they would take as clients, and 79% of the firms polled were limiting services offered. Domenici, *supra* note 2, at 3.

29. The CPA profession came to the United States from England and Scotland. For a thorough historical discussion of the origin of CPAs, their functions, and introduction into America, see CAUSEY, *supra* note 5, at 13-31. The first English case against an auditor was an 1887 case, *Leeds Estate, Building and Investment Co. v. Shepherd*. CAUSEY, *supra* note 5, at 63. See also *Dantzler Lumber & Export Co. v. Columbia Casualty Co.*, 156 So. 116 (Fla. 1934); *Maryland Casualty Co. v. Cook*, 35 F. Supp. 160 (E.D. Mich. 1940); *National Surety Corp. v. Lybrand*, 256 App. Div. 226, 9 N.Y.S.2d 554 (N.Y. Sup. Ct. 1939); *Cereal Byproducts Co. v. Hall*, 132 N.E.2d 27 (Ill. 1956).

between the client and CPA.³⁰ In the second step, CPAs label their work product as an opinion after completing an audit.³¹ CPAs label their audit work product as an opinion because the term indicates the speculative nature of the processes involved in reaching the opinion.³²

Courts in recent years have ignored the binding contractual nature of the engagement letter, which is an employment contract, and have extended the CPA's duty to outside third parties.³³ In addition, the courts have tended to ignore the speculative nature of opinion letters and have treated them as express warranties of a company's financial position.³⁴ In other areas of tort and contract law, employment contracts between two parties are legally recognized as binding contracts formed between the party contracting for service and the party providing the service. Why courts have chosen to treat an employment contract formed between CPAs and their clients differently from employment contracts formed between parties who are not CPAs is not apparent and must be addressed to return uniformity to this area of law.³⁵

An additional issue appearing in the more recent cases is the practice of holding CPAs liable for failing to detect fraud and irregularities in a company's records and financial statements.³⁶ Plaintiffs in a business failure action are

30. WIXON ET AL., *supra* note 1, at 26-10 to -11; *see also Maryland Casualty*, 35 F. Supp. at 160.

31. WIXON ET AL., *supra* note 1, at 26-6 to -7.

32. WIXON ET AL., *supra* note 1, at 26-7. For a discussion on types of opinions, *see infra* part III.C. and accompanying notes. "[N]umerous aspects of accounting are based upon opinions, estimates, and judgments rather than objectively verifiable facts. After all, accounting is merely a quantification of human activities, and human activities do not lend themselves to certainty in measurement." Werner F. Ebke, *In Search of Alternatives: Comparative Reflections on Corporate Governance and the Independent Auditor's Responsibilities*, 79 NW. U. L. REV. 663, 683 (1984).

33. *Rosenblum v. Adler*, 461 A.2d 138 (N.J. 1983); *Bethlehem Steel Corp. v. Ernst & Whinney*, 822 S.W.2d 592 (Tenn. 1991); *In re American Continental Corp.*, 794 F. Supp. 1424 (D.C. Ariz. 1992). *See generally* John Siliciano, *Negligent Accounting and the Limits of Instrumental Tort Reform*, 86 MICH. L. REV. 1929, 1930 (1988).

34. *Congregation of the Passion, Holy Cross Province v. Touche Ross & Co.*, 586 N.E.2d 600 (Ill. App. Ct. 1991).

35. *See* cases listed in the chart in *infra* note 174, parts 2 and 3. For a relevant discussion of the courts' abandonment of the contract-law standard, *see* Thomas L. Gossman, *The Fallacy of Expanding Accountants' Liability*, 1988 COL. BUS. L. REV. 213, 215 n.11.

36. *E.g.*, *Bily v. Arthur Young & Co.*, 834 P.2d 745 (Cal. 1992); *Federal Deposit Ins. Corp. v. Ernst & Young*, 967 F.2d 166 (5th Cir. 1992); *In re Crazy Eddie Sec. Litig.*, 802 F. Supp. 804 (E.D.N.Y. Sept. 4, 1992).

"CPAs are rarely involved in causing a loss; rather, they are blamed for not discovering losses caused by others." Patterson, *supra* note 19, at 4. *See* 1 AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS PROFESSIONAL STANDARDS AU § 110.02 (1991) [hereinafter AICPA STANDARDS], which states:

The financial statements are management's responsibility. The auditor's responsibility is to express an opinion on the financial statements. Management is responsible for

usually management, shareholders, investors, lending institutions, or govern-

adopting sound accounting policies and for establishing and maintaining an internal control structure that will, among other things, record, process, summarize, and report financial data that is consistent with management's assertions embodied in the financial statements.

Id.

The terms concealment, forgery, and irregularities are defined as follows:

Concealment

7. Concealment is any attempt by the perpetrator of an irregularity to reduce the likelihood of detection. Concealment usually involves manipulation of accounting records or supporting documents to disguise the fact that the accounting records are not in agreement with the underlying facts and circumstances. Concealment can be skillful and elaborate or clumsy and limited. The auditor's ability to detect a concealed irregularity depends on the skillfulness of the perpetrator, the frequency and extent of manipulation, and the relative size of individual amounts manipulated.

Forgery

8. Forgery may be used to create false signatures, other signs of authenticity, or entire documents. . . . Also, unrecorded transactions are normally more difficult to detect than concealment achieved by manipulation of recorded transactions. However, the effect of concealment on the ability to detect an irregularity is dependent on the particular circumstances. For example, an attempt to mislead users of financial statements by recording large, fictitious revenue transactions late in the period without supporting documentation would be more readily detected than fictitious revenue transactions spread throughout the period, individually immaterial in amount, and supported by legitimate-appearing invoices and shipping documents. Moreover, both of these irregularities might be extremely difficult, if not impossible, to detect if collusion of customers is added to the concealment scheme.

1 AICPA STANDARDS, *supra*, at AU § 316.34 (1988).

.34 Appendix

Characteristics of Errors and Irregularities

1. Characteristics of error and irregularities that are relevant because of their potential influence on the auditor's ability to detect such matters are materiality of the effect on financial statements, level of management or employees involved, extent and skillfulness of any concealment, relationship to established specific control procedures, and the specific financial statements affected.

Level of Involvement

4. An irregularity may be caused by an employee or by management and, if by management, by a relatively high or low level of management. The experience of auditors indicates that the level of involvement often combines with other characteristics in ways that have an influence on the auditor's ability to detect.

6. Material irregularities perpetrated by senior levels of management, including an owner-manager of a small business, are infrequent, but when they do occur they often engender widespread attention. These irregularities may not be susceptible to prevention or detection by specific control procedures because senior management is above the controls that deter employees or may override these controls with relative ease

1 AICPA STANDARDS, *supra*, at AU § 316.34, Appendix (1988).

mental agencies.³⁷ CPAs are usually one of many named defendants, a group which may also include the business owners or managers, attorneys, banks, and financial advisors.³⁸ Courts are now recognizing the difficulty and uncertainty in detecting a company's management's intentional actions of fraud and concealment and have logically concluded that discovery may be beyond the scope of the CPA's duty.³⁹ However, some courts still impose liability on public accounting firms, relying on the theory that the accountants should have discovered these intentional acts of fraud and concealment.⁴⁰

Public accounting firms do not seem to be asking for preferential treatment by the courts and legislatures.⁴¹ On the contrary, public accounting firms appear to be willing to pay for their percentage of fault.⁴² However, public

37. AUS Consultants, *supra* note 3, at i; Siliciano, *supra* note 33, at 1932; *see generally* R. James Gormley, *The Foreseen, The Foreseeable, and Beyond—Accountants' Liability to Nonclients*, 14 SETON HALL L. REV. 528 (1984). "[T]he audit has since evolved to meet, in addition, the needs of investors, lenders, suppliers, and the government." *Id.* at 553.

38. Gormley, *supra* note 37, at 553.

39. For example, in a recent case a Texas judge held a CPA firm not liable for failing to detect intentional fraud committed by the company's president. *Federal Deposit Ins.*, 967 F.2d at 166; *see also Bily*, 834 P.2d at 745; *In re Crazy Eddie Sec. Litig.*, 802 F. Supp. at 804. For a recent securities fraud case where the court ruled in favor of the accounting firm, *see Ligon v. Deloitte, Haskins & Sells*, 957 F.2d 546 (8th Cir. 1992). *See generally Touche Ross v. Commercial Union Ins. Co.*, 514 So. 2d 315 (Miss. 1987).

40. *See Rosenblum v. Adler*, 461 A.2d 138 (N.J. 1983); *Congregation of the Passion, Holy Cross Province v. Touche Ross & Co.*, 586 N.E.2d 600 (Ill. App. Ct. 1991); *U.S. Nat'l Bank v. Miniscribe*, No. 89-CV-1031-A (Tex. Dist. Ct., Galveston Co. 1992). *See also Mocatta Metals Corp. v. Peat Marwick, Main & Co.*, No. M-1106, 1989 N.Y. App. Div. LEXIS 4542 (April 4, 1989), in which the Supreme Court of New York held that Peat Marwick's failing to detect fraud did not absolve it from its duty to detect that fraud. Mocatta Metals was a precious metals dealer. Mocatta's credit manager, coin trader, and client committed fraud by setting up a scheme where the credit manager allowed a client's receivable balance to increase from \$2.3 million to \$19 million from 1982 to 1984. *Id.*

Although each of the three involved in the fraudulent scheme was sent to prison for their actions, Peat Marwick, the auditor during that two year span of fraudulent activity, was sued. Peat argued at trial that Mocatta committed inside fraud and knew of the activity. The court held that negligent accountants are not free from liability because the client also conducted its business negligently. The court stated that one of the purposes of an audit was to detect problems resulting from a client's negligence. *Client's Alleged Negligence Does Not Relieve Auditors' Responsibilities*, J. ACCT., Aug. 1991, at 25. *See also supra* note 5, describing the recent out-of-court settlements by accounting firms regarding the savings and loan failures which were made after the accounting firms were held liable. *See In re American Continental Corp.*, 794 F. Supp. 1424 (D.C. Ariz. 1992). The accounting firms dropped out of *In re American Continental Corp.* and agreed to settle out of court. Arthur Andersen & Co. agreed to pay \$30 million; Arthur Young & Co., \$64 million; and Touche Ross & Co., \$7.5 million. *Tough Legal Battles Shaped Business World*, NAT'L L.J., Dec. 28, 1992, at S7.

41. ANDERSEN ET AL., *supra* note 1, at 6.

42. *Id.* What CPAs object to most is paying damages in excess of their proportion of fault. For a more thorough discussion, *see supra* note 4 and accompanying text.

accounting firms are asking for equitable legislation that, when applied by the courts, will result in helping to ebb the tide of suits brought under the deep pocket theory.⁴³ Unfortunately, under the current system in most states and at the federal level, joint and several liability forces a defendant-CPA firm to pay a judgment award disproportionate to its fault.⁴⁴

This Note will discuss the current specialized problems facing public accounting firms in litigation and examine the courts' current contradictory legal

43. ANDERSEN ET AL., *supra* note 1, at 7. The AICPA and over 300 organizations favor securities litigation reform legislation. The legislation was introduced in the House by Congressman W.J. (Billy) Tauzin and in the Senate by Senator Pete Domenici. The legislation is designed to eliminate abusive, meritless litigation regarding securities fraud. Hearings on the legislation are scheduled to be heard in 1993. *Litigation Reform Bills Introduced; Drive for Passage Builds*, J. ACCT., Nov. 1992, at 25-27. The legislation was introduced in Congress in August of 1992. *Long-Awaited Liability Reform Bill Introduced*, *supra* note 4, at 3. See *AICPA Testifies on Draft Investment Advisors Bill*, J. ACCT., Aug. 1992, at 17. For a general discussion of the proposed legislation and an explanation of Illinois' legislation to limit legal liability suits against CPAs, see *Survey Shows Extent of Members' Concern Over Legal Liability*, CPA LETTER, July-Aug. 1992, at 1. For a discussion on the proposed liability legislation, see *Bills Fall Victim to Adjournment*, J. ACCT., Dec. 1992, at 15.

Despite public accountants' enthusiasm in pushing proposed legislation through Congress, Representative James P. Moran, a Democrat from Virginia, stated, "I don't think we're going to get that legislation anytime soon." Moran further stated that the bill probably would not be approved this year because "[m]any believe that accountants and lawyers contributed to or benefited from the improprieties of Keating and Milken." Sandy Hock, *Liability Protection Measure Unlikely to Pass U.S. House*, ACCT. TODAY, June 7, 1993, at 2.

CPAs involved in auditing public companies can now help lobbying efforts in Washington by joining the Coalition to Eliminate Abusive Securities Suits (CEASS). CEASS, with over 300 members, is asking for changes in securities laws which would implement proportional liability for professionals. In addition, CEASS is asking that the proposal include a requirement that the loser in the lawsuit pay the other side's legal fees if a baseless suit is filed. For more information on the importance of CEASS's work, see Patterson, *supra* note 19, at 3, 4.

The Public Oversight Board (POB), a five-member board that oversees the SEC section of the American Institute of CPAs division for CPA firms, is also supporting legislation which would make auditors liable for "harm caused when they fail to meet their responsibilities, but not for 'the frauds, the failures, the shortcomings of others.'" *POB Annual Report Stresses Liability Crises*, J. ACCT., Feb. 1993, at 21. See *id.* for more information about the POB's suggested proposed structural and legislative changes.

Despite the efforts of the various organizations and lobbying groups supporting limiting public accountants' liability, at least one group of CPAs had decided to both aid and capitalize on the problem. *CPA Malpractice & Defense* is a monthly publication written by CPAs reporting on issues involving CPA litigation. The reporter is published in Los Angeles, California, and CPAs can receive the publication with a trial six-month subscription or a year's subscription. CPA MALPRACTICE & DEFENSE (Eldon F. Holl, CPA, ed., 1993).

For more information on how CPAs can aid their profession and get legislation passed at the local, state, and federal levels, see Gary M. Bolinger et al., *Legislating Liability Reform*, J. ACCT., July 1993, at 52-54, 56-57.

44. ANDERSEN ET AL., *supra* note 1, at 2, 6. For a discussion involving joint and several liability and damages, see KEETON ET AL., *supra* note 9, at 345-55.

liability theories in public accounting cases. A review of these theories will show their past and present impact on the CPA profession and their potential damaging effect on both the national and global economies.

Part II of this Note will describe the specific actions under which a CPA may be sued.⁴⁵ Part III of this Note will briefly explain the audit procedure and its role in increasing CPA liability in public accounting cases.⁴⁶ Part IV will begin with a brief overview of the historical application of third-party liability in public accounting cases and will offer case examples to demonstrate the development of the current doctrines used in finding liability for negligence in public accounting cases.⁴⁷ Part V of this Note examines the legal and economic effects of extending liability to accountants.⁴⁸ The courts' reactions to the problems of expanding accountants' liability is detailed in Part VI.⁴⁹ After an analysis of the pertinent cases and their effects, Part VI will also separately discuss cases brought under the Securities and Exchange Act. Separating the securities cases from the professional negligence and fraud cases will facilitate a comprehension of the unique characteristics present in each type of case and demonstrate the courts' different treatment of the cases based on those characteristics. Finally, this Note will provide a proposed solution, a model state statute, that will provide an equitable uniform standard of liability, thus eliminating the problem of expanding third-party liability to accountants.⁵⁰

II. LEGAL LIABILITY THEORIES

A. Racketeering Influenced Corruption Organization Act (RICO)

When a CPA is sued for alleged criminal acts, the suit is often brought under the Racketeering Influenced Corruption Organization Act (RICO).⁵¹ At least one commentator, concerned about whether the use of RICO in public accounting cases fits within the legitimate application of the Act's original purpose, has widely criticized the Act.⁵² RICO suits against public accountants have also contributed to the overall problem of expansion of third-party liability

45. See *infra* notes 51-83 and accompanying text.

46. See *infra* notes 84-122 and accompanying text.

47. See *infra* notes 123-204 and accompanying text.

48. See *infra* notes 205-56 and accompanying text.

49. See *infra* notes 257-339 and accompanying text.

50. See *infra* notes 340-52 and accompanying text.

51. Racketeering Influenced Corruption Organization Act (RICO), 18 U.S.C.S. § 1961 (1992); e.g., *In re American Continental Corp.*, 797 F. Supp. 1424 (D.C. Ariz. 1992). "RICO makes it unlawful 'to conduct or participate, directly or indirectly, in [the] conduct of an enterprise's affairs through a pattern of racketeering activity.'" Robert S. Peck & Charles F. Williams, *RICO's Reach*, A.B.A. J., Oct. 1992, at 50 [hereinafter *RICO's Reach*].

52. Gossman, *supra* note 35, at 215 n.11.

in public accounting cases.⁵³ Under RICO, an accountant, if found liable, can face treble damage awards.⁵⁴ The recovery of treble damages has spurred an increased number of suits brought against public accountants under RICO.⁵⁵ Accountants' fear of expanded liability, whether in a criminal or a civil case, has caused the accountants to take self-protectionist measures that may ultimately be detrimental to the suing plaintiff, the consumer, and the United States economy.⁵⁶

53. See *In re American Continental Corp.*, 797 F. Supp. 1424 (D.C. Ariz. 1992). In *Arthur Young & Co. v. Reves*, 937 F.2d 1310 (filed June 27, 1992), the Court of Appeals for the Eighth Circuit affirmed the district court's decision in granting Arthur Young summary judgment on the alleged RICO violations portion of the case. *Id.* at 1324. The court recognized that Arthur Young's involvement with the client "was limited to the audits, meetings with the Board of Directors to explain the audits, and presentations at the annual meetings." *Id.* Although the court realized that Arthur Young's involvement with its client caused it to commit "a number of reprehensible acts," the Eighth Circuit reasoned that "these acts in no way rise to the level of participation in the management or operation" of the client's business. *Id.*

The recent United States Supreme Court's decision in *Reves v. Ernst & Young*, 113 S. Ct. 1163 (1993), has the potential of limiting public accountants' liability under RICO. In a 7-2 decision, the Court held that "to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs," section 1962(c), one must participate in the operation or management of the enterprise itself." *Id.* at 1173. The Court's holding resulted in affirming the lower courts' findings that Arthur Young was entitled to summary judgment on the RICO claim, as Arthur Young's failure to act was not sufficient for liability to attach under section 1962(c) of RICO. In arriving at its decision, the Court looked at the legislative history of section 1962. Upon reviewing RICO's "liberal construction" clause the court stated, "This clause obviously seeks to ensure that Congress' intent is not frustrated by an overly narrow reading of the statute, but it is not an invitation to apply RICO to new purposes that Congress never intended." *Id.* at 1172.

Although the *Reves* decision is a step in the right direction toward limiting the application of RICO to public accountants, commentators are stressing that public accountants rely on the opinion and its application cautiously. The two dissenting opinions in *Reves* acknowledged that a fine line exists between auditing and management services, and as a result, many public accounting firms, depending on the services that they provide to a client, may still be found liable for treble damages under RICO. Quinton F. Seamons, *Reves v. Ernst Ruling Shields Auditors From RICO Liability*, ACCT. TODAY, Aug. 23, 1993, at 10, 28-29. For another analysis on the Court's holding in *Reves*, see *Supreme Court Limits RICO*, J. ACCT., May 1993, at 24. RICO reform efforts will continue to be addressed by Congress. *Bills Fall Victim to Adjournment*, *supra* note 43; see *Reves v. Ernst & Young*, 937 F.2d 1310 (8th Cir. 1991). For more information on how RICO has contributed to the increase in liability claims, see *Professional Liability Insurance: Go Bare or Not?*, J. ACCT., July 1991, at 111.

54. *RICO's Reach*, *supra* note 51, at 50. Along with the theories of negligence and fraud, Price Waterhouse was sued by Standard Chartered under Arizona's state RICO statute. The jury did not find Price had violated the Act. If the jury had found Price violated the Act, the damage award of \$338 million would have tripled to \$1 billion. *Accountant Hit with Judgment of \$338 Million*, *supra* note 19, at D1.

55. See *supra* notes 51, 53-54 and accompanying text.

56. ANDERSEN ET AL., *supra* note 1, at 3-5. For an economic analysis of the impact that accountants' self-protectionist acts and scapegoat litigation may have on the United States, see AUS Consultants, *supra* note 3. For an example of one self-protectionist measure that accountants are taking and its potential impact on the suing plaintiff, see *Bills Fall Victim to Adjournment*, *supra* note

B. Securities and Exchange Act

Aside from RICO, CPAs can also be sued under the Securities and Exchange Act.⁵⁷ The Securities and Exchange Act is enforced by the Security and Exchange Commission (SEC).⁵⁸ The SEC acts as a "watchdog" for investors and shareholders.⁵⁹ In a securities violation suit, the SEC or investors, either independently or in a class action, may bring suit against an accounting firm.⁶⁰

43, at 15. When auditors are held liable to third-parties or settle cases, auditors' insurance premiums rise. As a result of the increased insurance rates, auditors raise their service costs to the client. The client in turn charges higher rates for services and goods to compensate itself for paying higher costs for accounting services. "The imposition upon auditors of liability to third parties for negligence thus turns out to be no more than a global loss spreading technique, a vehicle for socializing individual economic risks." Ebke, *supra* note 32, at 682. For a more detailed examination of the economic effects of accountants' third-party liability crisis, see generally Ebke, *supra* note 32. See *infra* part V.B. and accompanying notes.

57. Securities and Exchange Act of 1933, 15 U.S.C. § 77a et seq. and Securities and Exchange Act of 1934, 15 U.S.C. § 78a et seq., cited in DAVID L. RATNER & THOMAS L. HAZEN, *SECURITIES REGULATION SELECTED STATUTES, RULES AND FORMS* (1991). A U.S. District Court for the Southern District of Florida recently upheld investors' rights to sue auditors for alleged securities fraud and RICO violations regarding private and public security offerings. For a more detailed case analysis, see *Right to Bring Securities Fraud and RICO Action Against Auditors Upheld*, J. ACCT., June 1992, at 29. See, e.g., *In re Sahlen & Assoc., Inc., Sec. Litig.* 773 F. Supp. 342 (S.D. Fla. 1992); *In re Sioux Ltd., Sec. Exch. Comm'n Litig.*, 914 F.2d 61 (5th Cir. 1990); *Pacific Mut. Life Ins. Co. v. First Republic Bank Corp.*, 806 F. Supp. 108 (N.D. Tex. 1992); *Ligon v. Deloitte, Haskins & Sells*, 957 F.2d 546 (8th Cir. 1991). Aside from worrying about being sued in a securities suit, auditors must also worry about the large companies "opinion shopping." When a large company dislikes an auditor's opinion, many times the company will use the threat of shopping for a new auditor to get the present auditor to acquiesce to the company's demands. This pressure also may prevent the auditor from being independent. For a more complete discussion of "opinion shopping" and the impact on accounting firms, see Daniel L. Goelzer, *The SEC and Opinion Shopping: A Case Study in the Changing Regulation of the Accounting Profession*, 52 BROOK. L. REV. 1057 (1987).

58. HAROLD S. BLOOMENTHAL ET AL., *SECURITIES LAW HANDBOOK* 1 (1991-92).

59. *Bily v. Arthur Young & Co.*, 834 P.2d 745 (Cal. 1992) (using the term "watchdog"). The 1933 Act attempted to protect the investing public by requiring publicly held companies to file an audited balance sheet and income statement prior to registering new stock issue. The 1934 Act expanded on the 1933 Act's safeguards and required that audited financial statements be included in annual reports when securities were to be listed on an exchange or in connection with a proxy statement. Lorie Soares, *The Big Eight, Management Consulting and Independence: Myth or Reality?*, 61 S. CAL. L. REV. 1511, 1512 (1988).

60. The Securities and Exchange Commission defines fraudulent financial reporting "as intentional or reckless conduct, whether act or omission, that results in materially misleading financial statements." Louis Braiotto, Jr., *Preventing Fraudulent Reporting: Auditing for Honesty*, A.B.A. J., May 1, 1992, at 76. CPAs are usually implicated in fraudulent financial reporting under the theories of questionably applied GAAP and deliberate financial record distortions. Plaintiffs usually bring suit under Rule 10b and Rule 10b-5 of the 1934 Securities Act and under the common law, alleging fraud, deceit, and negligence. CPAs are typically only one of many named defendants in SEC suits. *Id.* See cases listed in *supra* note 57; see also *Reves v. Ernst & Young*, 414 U.S.

The anti-fraud provisions are the most common sections of the Securities Act used to bring suits against public accountants.⁶¹ The frequency of public

56 (1990).

61. Under § 12(1) of the Securities Act of 1933, liability attaches for the sale of unregistered nonexempt securities. Accountants can predict with relative ease whether or not they may be liable because liability requires a transfer of securities. However, a real problem exists involving Rule 10b-5 of the Securities Exchange Act of 1934.

Rule 10b-5 forbids a false statement of material fact or omission of a necessary fact regarding the purchase or sale of any security. Any misstatement, whether intentional, reckless, or without knowledge of its veracity, can incur liability, even if a CPA did not make any omission of fact or misstatements. The generally accepted test for determining aiding and abetting is: (1) a securities law violation by someone who is otherwise liable, (2) knowledge of the violation, and (3) substantial assistance in the violation.

Aside from possible liability being attached under § 12(1) of the 1933 Act and Rule 10b-5 of the 1934 Act, a CPA may be liable under § 12(2) of the 1933 Act. Section 12(2) is similar to Rule 10b-5. Stephen M. Quinlivan, *What Every Accountant Should Know About Securities Law*, J. ACCT., July 1992, at 109.

The Federal Securities Act of 1933, 15 U.S.C. § 77i (1993), provides:

§ 12 Any person who—

- (1) offers or sells a security in violation of section 5, or
- (2) offers or sells a security (whether or not exempted by the provisions of section 3, other than paragraph (2) of subsection (a) thereof), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, upon the tender of such security, or for damages if he no longer owns the security.

The Securities Exchange Act of 1934, 15 U.S.C. § 78j (1934), provides:

§ 10 It shall be unlawful for any person, directly, indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

- (a) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.
- (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulation as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

The Rules and Regulations Under Securities Exchange Act of 1934, 17 C.F.R. § 240 (1934), provides:

accounting suits brought under the anti-fraud provisions is rising because the provisions apply even if the transaction is exempt; thus, it is now easier to bring suit under the Securities Act.⁶² One additional benefit to plaintiffs in an SEC suit is that the CPA has the burden of disproving the plaintiff's allegations.⁶³ If a CPA is found liable in an SEC suit, the Act states that the potential for liability may be the full cost of the business failure.⁶⁴

C. Common Law Torts

Negligence and fraud are two common law forms of action that may be brought against a CPA.⁶⁵ Fraud is an intentional act to deceive another.⁶⁶

Rule 10b-5 Employment of Manipulative and Deceptive Devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

- (a) To employ any device, scheme, or artifice to defraud,
 - (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were 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,
- in connection with the purchase or sale of any security.

See also RATNER & HAZEN, *supra* note 57.

62. Securities are required to be registered with the Securities and Exchange Commission prior to their offering for sale, excluding any applicable exemption. It is this exemption, such as a sale of a security without a public offering, that is required before an action under certain sections of the 1933 and 1934 Acts may be brought. Quinlivan, *supra* note 61, at 109.

The antifraud provisions of the 1933 and 1934 Acts, primarily Rule 10b-5 of the 1934 Act and § 12(2) of the 1933 Act, do not require the exemption, thus facilitating SEC suits. Liability can attach under Rule 10b-5 of the Securities Act of 1934 if a misstatement of a material fact or an omission of a necessary fact in connection with the purchase of a sale or security is intentional or reckless. Additionally, a CPA may never have made a misstatement to be liable under Rule 10b-5. *Id.* at 111-12. The case of *Ligon* stated when a primary violation occurs under § 10b and Rule 10b-5 of the 1934 Securities and Exchange Act. According to the *Ligon* court, a violation occurs when:

- 1) the primary violator acted in a manner prohibited by rule in connection with the purchase or sale of securities;
- 2) the primary violator acted with scienter;
- 3) the wrongful act or omission was material and plaintiffs relied on the act or omission; and
- 4) the plaintiffs were damaged by their reliance.

Ligon v. Deloitte, Haskins & Sells, 957 F.2d 546, 547 (8th Cir. 1992); see also *Harris v. Union Elec. Co.*, 787 F.2d 355 (8th Cir. 1986). To see the court's strict compliance requirements for properly and fully pleading an alleged violation of § 10b of the Securities and Exchange Act and RICO violations, see *Farlow v. Peat Marwick, Mitchell & Co.*, 956 F.2d 982 (10th Cir. 1992).

63. CAUSEY, *supra* note 5, at 51-54.

64. Pickering, *supra* note 2, at 2.

65. For cases demonstrating both common law actions of fraud and negligence, see *Rosenblum v. Adler*, 461 A.2d 138 (N.J. 1983) and *Mocatta Metals Corp. v. Peat Marwick, Main & Co.*, No. 23965/88 (N.Y. Cty. Sup. Ct., Apr. 8, 1991).

A recent New York federal district court ruling has the potential of greatly reducing the

Negligence is a person's departure from a reasonable person's standard of conduct.⁶⁷ A unique legal problem exists when a plaintiff brings a cause of action under the theory of accountant negligence,⁶⁸ as opposed to fraud. This problem is created when the courts apply one of three liability theories to prove negligence in public accounting cases: strict privity, section 552 of the *Restatement Second of Torts* (the *Restatement* standard), or the foreseeability standard.⁶⁹ To find liability under strict privity, a legal contractual relationship must exist.⁷⁰ The strict privity rule is easy for courts and juries to apply because the rule requires the existence of a contract; thus, the factfinder need not interpret or predict subjective intent.⁷¹

number of successful third-party suits brought against public accountants. *In re Crazy Eddie Sec. Litig.*, 802 F. Supp. 804 (E.D.N.Y. 1992), was a case where internal management and employees committed fraud in order to benefit their company. *Id.* Attempting to entice investors by enhancing its stock value, Crazy Eddie's controller inflated net income, inventory, and the company's sales figures over a two-year period. A physical inventory later revealed that the inventory was overstated by \$65 million and the company's net worth was overstated by \$86 million. After Crazy Eddie went bankrupt, the company's liquidator filed suit against KPMG Peat Marwick, the company's auditors, claiming negligence and breach of contract for failing to discover fraud in the company's financial statements. The court held that if officers of a corporation commit fraud to benefit the company, or themselves and the company, then fraud can be imputed to the corporation, thus barring claims against the auditors. *Officers' Fraud on Corporation's Behalf Bars Recovery Against Auditors*, J. ACCT., May 1993, at 24.

66. Black's Law Dictionary defines fraud as:

An intentional perversion of truth for the purpose of inducing another in reliance upon it to part with some valuable thing belonging to him or to surrender a legal right. A false representation of a matter of fact, whether by words or conduct, by false or misleading allegations, or by concealment of that which should have been disclosed, which deceives and is intended to deceive another so that he shall act upon it to his legal injury.

BLACK'S LAW DICTIONARY 660 (6th ed. 1990).

67. Black's Law Dictionary defines negligence as: "The omission to do something which a reasonable man, guided by those ordinary considerations which ordinarily regulate human affairs, would do, or the doing of something which a reasonable and prudent man would not do." BLACK'S LAW DICTIONARY 1032 (6th ed. 1990).

68. Usually when a plaintiff sues an accountant under the theory of negligence, the theory is defined as either professional negligence or negligent misrepresentation. For a case that distinguishes between the two forms of negligence theory, see *Bily v. Arthur Young & Co.*, 834 P.2d 745 (Cal. 1992). For more information on accountants' liability for malpractice, see Willis W. Hagen II, *Certified Public Accountants' Liability for Malpractice: Effect of Compliance with GAAP and GAAS*, 13 J. CONTEMP. L. 65 (1987). For more information on CPAs' liability for negligent misrepresentation, see Howard B. Wiener, *Common Law Liability of the Certified Public Accountant for Negligent Misrepresentation*, 20 SAN DIEGO L. REV. 233 (1983).

69. Gormley, *supra* note 37, at 551. For an explanation of privity, see *infra* notes 137-62 and accompanying text. For an explanation of *Restatement Second of Torts* § 552, see *infra* notes 163-81 and accompanying text. For an explanation of foreseeability, see *infra* notes 182-204 and accompanying text.

70. 4 ARTHUR L. CORBIN, CORBIN ON CONTRACTS 778 (1951)

71. *Id.*

Confusion in rule application exists between the *Restatement* standard and the foreseeability standard.⁷² The uncertainty in application exists because of the relative closeness in the terminology used in both the *Restatement* standard and the foreseeability standard.⁷³ The ambiguous terms, "foreseen" and "foreseeable," are used in both of the standards.⁷⁴ However, the unclear and undefinable meanings of both terms have caused courts to misapply or misinterpret the terms.⁷⁵ The courts' inability to correctly apply their proper jurisdictional test only adds to jury confusion, which ultimately results in judgment awards disproportionate to fault.⁷⁶ This confusion regarding the meaning and use of the terms in rule application also affects the defendants' ability to properly defend themselves in a court of law.

D. Legal Liability of Public Accounting Firms

Predictability and fairness, the fundamental objectives of our adversarial system, have become non-existent in deciding public accounting cases.⁷⁷ For

72. Gormley, *supra* note 37, at 540-52.

73. *Id.*

74. Section 552 states:

§ 552 Information Negligently Supplied for the Guidance of Others

(1) One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.

(2) Except as stated in Subsection (3), the liability stated in Subsection (1) is limited to loss suffered

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

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

(3) The liability of one who is under a public duty to give the information extends to loss suffered by any of the class of persons for whose benefit the duty is created, in any of the transactions in which it is intended to protect them.

RESTATEMENT (SECOND) OF TORTS § 552 (1977); *see also id.* § 552, cmt. g, h (delineating the scope of parties that the public accountant may reasonably foresee using the information). For a discussion on the foreseeability doctrine, *see KEETON ET AL.*, *supra* note 9, at 169-73. For an application of § 552(h), *see Citizens State Bank v. Timm*, 335 N.W.2d 361, 365-66 (Wis. 1983).

75. RESTATEMENT (SECOND) OF TORTS § 552 (1977). *See Gormley, supra* note 37, at 530-31 for a more complete discussion of the courts' confusion between the terms foreseen, foreseeable, and reasonably foreseeable.

76. U.S. Nat'l Bank v. Miniscribe Corp., No. 89-CV-1031-A (Tex. Dist. Ct., Galveston Co. 1992); Standard Chartered PLC v. Price Waterhouse, No. 88-34414 (Ariz. Super. Ct., Maricopa Co. 1992).

77. For a more detailed explanation of the adversarial system, *see generally JOHN COUND ET AL.*, CIVIL PROCEDURE CASES AND MATERIALS (5th ed. 1989).

example, many accounting firms perform audits for large national and international lending institutions and companies.⁷⁸ An accounting firm may be sued in numerous states for negligence regarding the same audit report or financial statements.⁷⁹ The auditor's liability for the same audit rests on each state's rule for determining liability in a public accounting suit.⁸⁰ Thus, lawsuits brought in different states may yield different results depending on the theory of liability applied to find negligence.⁸¹

Additionally, different states may impose various damage awards upon finding negligence, depending on that state's damage award provisions.⁸²

78. See ANDERSEN ET AL., *supra* note 1, at 4; see also *infra* text accompanying note 226. The Big Six audit 90% (4748 of 5266) of U.S. publicly traded companies with annual sales over \$1 million. ANDERSEN ET AL., *supra* note 1, at 4.

79. *E.g.*, U.S. Nat'l Bank v. Miniscribe Corp., No. 89-CV-1031-A (Tex. Dist. Ct., Galveston Co. 1992). Although Coopers and Lybrand has recently settled the *Miniscribe* case, investors sued Coopers in both Colorado and Texas regarding the same audit performed for Miniscribe. For settlement details regarding *Miniscribe*, see *supra* notes 24-25 and accompanying text.

80. An auditor may or may not be liable in a negligence suit. The auditor's liability rests upon the courts' and jurisdictions' application of either the *Restatement Second* § 552 standard, the privity rule, or the foreseeability standard. In a state applying the privity requirement, an auditor will not be found liable unless that auditor had a contractual relationship with the party bringing suit. Hagen, *supra* note 68, at 183, 184; see also *id.*, at 192-93 (discussing a court's recent holding of liability in a relationship that was so close as to approach the privity requirement).

If a state applied the *Restatement* standard, an accountant would be liable if the party bringing suit was within a class of persons whose reliance on the negligent misrepresentation was or should have been foreseen by the accountant. Under the *Restatement* standard, liability does not extend to parties whose reliance was foreseeable or reasonably foreseeable to the accountant. Gormley, *supra* note 37, at 529-30.

The foreseeability standard is, out of the three rules, the broadest for finding liability. An auditor is liable under the foreseeability standard if the party bringing suit was a foreseeable user of the auditor's work. Although the foreseeability courts tend to only find non-liability where strong public policy requires it, these courts usually review certain considerations before holding an accountant liable. The courts' considerations include:

- (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 tortfeasor; or (3) in retrospect it appears too highly extraordinary that the negligence would 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 likely to open the way for fraudulent claims, or (6) allowance of recovery would enter a field that has not sensible or just stopping point.

Gossman, *supra* note 35, at 224-25 n.60.

81. For examples of case decisions and how they can differ depending on the various applicable state law, see *infra* part IV.A-C. Theoretically, because the applicable state's theory will dictate whether a public accountant is liable for negligence, a public accountant may be found liable in one state and not in another, yet the lawsuits may be based on the *same* audit report.

82. Many states adhere to joint and several liability. For example, in a state that applies joint and several liability, a guilty defendant would be liable for the entire judgment if no other solvent defendant existed. However, other states apply the doctrine of comparative negligence, and in the same scenario would only hold the guilty defendant liable for its percentage of fault. Because

Accounting firms, like any other tort defendants, should be afforded some predictability in the applicable legal rule in order to have an opportunity to defend themselves to the best of their abilities. Public accounting firms should be subject to one clear standard for liability so that they know how to conform their conduct and avoid liability, rather than being subject to a different standard in each state where the firm does business.⁸³

III. THE ACCOUNTANT'S PRIMARY FUNCTION—THE AUDIT

The audit's importance in the financial and business world has caused this service to be one of the most highly litigated issues in public accounting cases.⁸⁴ In addition, audits represent the majority of work performed by CPAs.⁸⁵ Lawsuits may be brought against the public accounting firm for both technical preparation and interpretation of the audit. Though historically audits have always been used by and performed for clients, the increased use of audits in other areas of business and by outside third parties has contributed to the high visibility of auditing services.⁸⁶ The historical importance of the audit, and its

different states apply different remedy theories, one defendant, concerning the same action, may be liable for the full amount of the judgment award in one state and only the percentage equal to its fault in another state. For a more detailed discussion of the impact of joint and several liability on the accounting profession, see *The Liability Crisis in the United States: Impact on the Accounting Profession*, J. ACCT., Nov. 1992, at 19.

Tennessee adheres to the doctrine of comparative negligence. *McIntyre v. Balentine and East-West Motor Freight, Inc.*, 833 S.W.2d 52 (Tenn. 1992). Proportionate liability is being sought in the new federal securities bill. Proportionate liability, unlike joint and several liability, allows the guilty defendants to only pay a damage amount according to their proportion of assessed fault. *Litigation Reform Bills Introduced; Drive for Passage Builds*, J. ACCT., Nov. 1992, at 25.

83. To see how the courts' application of three different standards falls among the states, see *infra* note 174 (chart).

84. Clients request audits because third parties, in particular, the SEC and lending institutions, require an independent opinion be issued regarding a client's financial statements. Access to relevant financial information about a company is essential to a company's business planning, to those in the private sector, including shareholders and institutional lenders, and to those in the public sector, including the Internal Revenue Service. Although the company prepares its own financial statements, the job of the auditor is to evaluate the statements and render an opinion on them. The audit, therefore, is a very important accounting service to the business and financial world. Gossman, *supra* note 35, at 213, 237.

For an excellent, brief commentary outlining auditor's responsibilities and potential liability under Statements on Auditing Standards (SAS) number 54, see Donald L. Neebes et al., *Auditing: Illegal Acts: What Are the Auditor's Responsibilities?*, J. ACCT., Jan. 1991, at 82.

85. WIXON ET AL., *supra* note 1, at 26-2.

86. See Gossman, *supra* note 35, at 213-14. Many companies wishing to merge with another company or buy out a competitor use the potential acquisition's audit to determine if that company is a good risk or investment. *Standard Chartered PLC v. Price Waterhouse*, No. 88-34414 (Ariz. Super. Ct., Maricopa Co. 1992). Potential private shareholders or investors may also use the audit to determine if a company is a good investment. *U.S. Nat'l Bank v. Miniscribe*, No. 89-CV-1031-A (Tex. Dist. Ct., Galveston Co. 1992).

modern use, must be explained briefly before this Note can address the impact of the expansion of third-party liability in public accounting cases.

A. Audit Reports

CPAs perform audits for a variety of reasons. The SEC requires that publicly held corporations have independent audits performed to protect investors and shareholders.⁸⁷ Smaller businesses and non-publicly held corporations have audits performed as a means of ensuring that their financial condition is solvent.⁸⁸ As a security measure, lending institutions and bonding companies also require that audits be performed prior to the lending of funds or to insure performance.⁸⁹

Auditors are usually CPAs and must be totally independent.⁹⁰ This independence is required to assure that the CPA does not have any conflicts of interest with the client, thus providing an assurance that the audit will be performed objectively and will be beyond reproach.⁹¹ Audits are examinations that lead to the formation of opinions regarding clients' financial statements.⁹² These opinions are not about the accuracy of the value of a corporation or whether the corporation is a good investment, but only to opine on the fairness with which the statements present, in all material respects, "financial position, results of operation, and changes in financial position in conformity with generally accepted accounting principles."⁹³ CPAs perform audits by examining and reviewing a company's internal accounting system, financial

87. Gossman, *supra* note 35, at 213; *see* WIXON ET AL., *supra* note 1, at 2-9 to -15, 26-7 (containing a more in-depth discussion of SEC regulations and requirements of auditors). *See generally* CAUSEY, *supra* note 5, at 15-18 (containing a historical discussion of the SEC and its impact on public accountants).

88. Wiener, *supra* note 68, at 240.

89. Gossman, *supra* note 35, at 213; Wiener, *supra* note 68, at 237.

90. CAUSEY, *supra* note 5, at 27. To maintain an independent stature when performing professional services, the CPA must act with integrity and objectivity. A CPA must be independent in fact and appearance. When CPAs perform tax practice and management advisory services, only independence in fact (an unbiased state of mind) is required, and when CPAs perform audit services both independence in fact and appearance ("absence of affiliations or influencing factors that might lead to actual or presumptive conflicts of interest") are required. *Id.* *See also* 1 AICPA STANDARDS, *supra* note 36, ET § 101.02, § 55 (1992); Gossman, *supra* note 35, at 213; WIXON ET AL., *supra* note 1, at 26-6; *see generally* 1 AICPA STANDARDS, *supra* note 36, AU § 110 (1991).

91. *See* CAUSEY, *supra* note 5, at 27-30; *see generally* WIXON ET AL., *supra* note 1, at 26-10.

92. WIXON ET AL., *supra* note 1, at 26-6; Gossman, *supra* note 35, at 213; "The report by the auditor is the way 'he expresses his opinion or, if circumstances require, disclaims an opinion.'" Wiener, *supra* note 68, at 237.

93. 1 AICPA STANDARDS, *supra* note 36, AU § 110 (1991). *See* Gossman, *supra* note 35, at 233. "An audit report is not designed to guarantee the accuracy of the financial statements prepared by management, but only to attest to the fairness of management's presentation." *Id.*

statements, and accounting records.⁹⁴ At the conclusion of this examination, the CPA renders an opinion.⁹⁵

B. Parties To An Audit

The auditing process begins when an auditor and client enter into a contractual relationship by signing an engagement letter.⁹⁶ An engagement letter limits the type of services that the auditor will perform, describes the accounting standards and substantive tests⁹⁷ the auditor will use, and defines

94. When an auditor performs a financial examination, audit work is accomplished:

1. By a general review of the accounts and records and comparison of the figures shown on the statements with the sources from which they are drawn
2. By a study of the accounting procedures regularly followed by the company and consideration of any departures from those practices
3. By independent sampling tests (through inspection, correspondence, or other means) of the existence of assets
4. By the application of various audit tests to determine, so far as reasonably possible, that all liabilities are reflected in the balance sheet in actual or approximate amounts
5. By actual analyses, tests, and over-all review of the income and expense accounts
6. By test procedures designed to determine the authenticity and general correctness of the accounts on which the statements are based.

WIXON ET AL., *supra* note 1, at 26-12. See 1 AICPA STANDARDS, *supra* note 36, AU § 110 (1991). "The ultimate objective of an audit is to express an opinion on the fairness with which the financial statements 'present financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles.'" Wiener, *supra* note 68, at 237. Thomas Bilek, *Accountants' Liability to the Third Party and Public Policy: A Calabresi Approach*, 39 Sw. L.J. 689, 691 (1985); Hagen, *supra* note 68, at 66.

95. Hagen, *supra* note 68, at 69; 1 AICPA STANDARDS, *supra* note 36, AU § 110 (1991); see also WIXON ET AL., *supra* note 1, at 26-6.

96. A written contract should be signed by the client and auditor that states the nature, scope, and limitations of the auditor's responsibilities and the limits of the audit. "Every audit engagement is a contract, expressed or implied, in which the auditor agrees to make an audit . . ." WIXON ET AL., *supra* note 1, at 26-10.

97. Substantive tests are performed during field work. The third Standard of Field Work states how the tests are to be performed. The third standard reads, "Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination." WIXON ET AL., *supra* note 1, at 26-14. The evidence gathered in substantive tests includes:

1. Physical examination by the auditor of the thing represented in the accounts
2. Statements by independent third parties
 - a. Written
 - b. Oral
3. Authoritative documents
 - a. Prepared outside the enterprise under examination
 - b. Prepared inside the enterprise under examination
4. Statements by officers and employees of the company under examination
 - a. Formal
 - b. Informal
5. Calculations performed by the auditor

the type of opinion expected to be rendered along with any qualifications or limitations that may result.⁹⁸ This employment contract between the auditor

6. Satisfactory internal control procedures
7. Subsequent actions by the company under examination and by others
8. Subsidiary or detail records with no significant indications of irregularity
9. Interrelationships within the data examined

Id. at 26-15.

Audit techniques are methods the auditor uses to collect the evidence. The basic techniques include:

1. Physical examination and count
2. Confirmation
3. Examination of authoritative documents and comparison with the record
4. Recomputation
5. Retracing bookkeeping procedures
6. Scanning
7. Inquiry
8. Examination of subsidiary records
9. Correlation with related information
10. Observation of pertinent activities and conditions

Id. at 26-15 to -16. For a more detailed analysis of the above techniques, see *id.*, at 26-16 to -17.

98. *Id.* An example of a small firm's sample engagement letter reads as follows:

Dear _____,

We are pleased to confirm our understanding of the services we are to provide for _____ for the year ended _____. We will audit the combined balance sheet of _____ as of _____ and the related combined statements of support, revenue, and expenses, and changes in fund balances and cash flows for the year then ended. Also, the document we submit to you will include the following additional information that will be subjected to the auditing procedures applied in our audit of the combined financial statements:

1. Combining balance sheet
2. Schedule of expenses: support services and general and administrative
3. Schedule to reconcile financial statement basis support and revenue to amounts reported for cost reimbursement

Our audit will be made in accordance with generally accepted auditing standards and will include tests of the accounting records of _____ and affiliates and other procedures we consider necessary to enable us to express an unqualified opinion that the combined financial statements are fairly presented, in all material respects, in conformity with generally accepted accounting principles. If our opinion is other than unqualified, we will fully discuss the reasons with you in advance.

Our procedures will include tests of documentary evidence supporting the transactions recorded in the accounts and direct confirmation of receivables and certain other assets and liabilities by correspondence with selected funding sources, creditors, and financial institutions. We will request written representations from your attorneys as part of the engagement, and they may bill you for responding to this inquiry. At the conclusion of our audit, we will also request certain written representations from you about the combined financial statements and related matters.

An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the combined financial statements; therefore, our audit will involve judgment about the number of transactions to be examined and the areas to be tested. Also, we will plan and perform the audit to obtain reasonable assurance about whether the combined financial statements are free of material misstatement. However, because of the concept of reasonable assurance and because we will not perform a detailed examination of all transactions, there is a risk that material errors, irregularities, or illegal acts, including fraud or defalcations, may exist and not be detected by us. We will advise you, however, of any matters of that nature that come to our attention and will include such matters in the reports required by the service contracts. Our responsibility as auditors is limited to the period covered by our audit and does not extend to matters that might arise during any later periods for which we are not engaged as auditors.

We understand that you will provide us with the basic information required for our audit and that you are responsible for the accuracy and completeness of that information. We will advise you about appropriate accounting principles and their application and will assist in the preparation of your financial statements, but the responsibility for the financial statements remains with you. This responsibility includes the maintenance of adequate records and related internal control structure policies and procedures, the selection and application of accounting principles, and the safeguarding of assets.

We understand that your employees will prepare certain account analyses and schedules and will locate any source documents selected by us for testing.

Our audit is not specifically designed and cannot be relied on to disclose reportable conditions, that is, significant deficiencies in the design or operation of the internal control structure. However, during the audit, if we become aware of such reportable conditions or ways that we believe management practices can be improved, we will communicate them to you in a separate letter.

As part of our engagement we will prepare the following federal information returns for the year ended _____:

Separate return for _____, Inc.

Group (combined) return for _____ and _____.

We expect to begin our audit on approximately _____ and to complete your information returns and issue our report no later than _____.

Our fees for these services will be based on the actual time spent at our standard hourly rates. Our standard hourly rates vary according to the degree of responsibility involved and the experience level of the personnel assigned to your audit. Our invoices for these fees will be rendered each month as work progresses and are payable on presentation. Based on our preliminary estimates, the fee should approximate \$ _____ for the audit and \$ _____ for the information returns. These estimates are based on anticipated cooperation from your personnel and the assumption that unexpected circumstances will not be encountered during the audit. If significant additional time is necessary, we will discuss it with you and arrive at a new estimate before we incur

and client states the specific services the CPA will perform and the sum of money the client will pay in accordance with the terms of the letter. Both the client and the auditor recognize that the terms of the letter are legally enforceable upon either party.⁹⁹

The courts' expansion of third-party liability indicates that the legally binding contractual relationship that the engagement letter creates between the auditor and client is of *de minimis* importance.¹⁰⁰ Instead of treating the engagement letter as an enforceable contract between the auditor and the client, courts have expanded the contract to bind the auditor not only to the client, but to any other foreseeable party who would rely on the audit.¹⁰¹

Audits are currently the source of dispute in public accounting cases because clients are not the only users of the auditors' opinions.¹⁰² Third parties such as lenders, financial institutions, shareholders, and investors may

the additional costs.

We appreciate the opportunity to be of service to _____, Inc. and believe this letter accurately summarizes the significant terms of our engagement. If you have any questions, please let us know. If you agree with the terms of our engagement as described in this letter, please sign the enclosed copy and return it to us, and this letter will continue in effect until canceled by either party.

Very truly yours,

RESPONSE

This letter correctly sets for the understanding of _____, Inc.

Officer signature _____

Title: _____

Date: _____

Siegfried, Crandall, Vos & Lewis, P.C., Kalamazoo, Michigan, CPA firm.

99. WIXON ET AL., *supra* note 1, at 26-10 to -11.

100. U.S. Nat'l Bank v. Miniscribe, No. 89-CV-1031-A (Tex. Dist. Ct., Galveston Co. 1992); Standard Chartered PLC v. Price Waterhouse, No. 88-34414 (Ariz. Super. Ct., Maricopa Co. 1992).

101. *Miniscribe*, No. 89-CV-1031-A; *Standard Chartered PLC*, No. 88-34414; *see infra* note 174 (chart).

102. *See Gormley*, *supra* note 37, at 533; *see also supra* text accompanying note 88.

all refer to an auditor's opinion.¹⁰³ A major difference exists, however, between the auditor's relationship with the client and with a third party who uses the auditor's opinion. Unlike the client and the auditor, who have a legally binding contractual relationship that was created by the engagement letter, third parties who refer to the auditor's opinion have not entered into a contract that creates a legally binding relationship between them and the auditor.¹⁰⁴ Engagement letters define the terms of the employment contract between the auditor and the client, and unless expressly stated, should bind only those signing the contract.¹⁰⁵

C. Opinions Rendered

Auditors issue one of four types of opinions after they have completed the five stage process for the audit.¹⁰⁶ The four types of opinions that a CPA may

103. Siliciano, *supra* note 33, at 1932; For an analysis of cases and how the courts have expanded third-party liability, thus permitting third parties to rely on an auditor's opinion, see Gormley, *supra* note 37. For examples of the differences in courts' expansion of third-party liability, see *infra* note 174 (chart).

104. See Siliciano, *supra* note 33, at 1933. The "employment contract" is usually entered into exclusively by the auditor and the client. However, third parties may be added to the engagement letter either by their own request or the client's request. When the third party is added to the engagement letter, that third party is in privity with the auditor. *Id.* at 1956-65. For an example of how third parties may be added to an engagement letter, see *supra* note 98.

105. WIXON ET AL., *supra* note 1, at 26-10 to -11; see *supra* note 98 (engagement letter).

106. Hagen, *supra* note 68, at 69. "It must be emphasized that the word 'opinion' has been selected by independent accountants with considerable care as the best term to describe the conclusions reached through performance of an audit. It is an opinion and nothing more." WIXON ET AL., *supra* note 1, at 26-7. "The auditor does not and cannot give guaranties or assurances that financial statement are accurate or reliable. At best he can describe his examination and express the opinions he has formed through performance of that examination." *Id.*

Usually, opinion letters contain two main paragraphs, the scope and opinion paragraphs. However, depending on the type of opinion issued, other explanation paragraphs detailing the auditor's reasoning will also be included. The CPA's opinion, which is rendered after the audit, generally asserts that the client's financial statements, including the balance sheet, income statement, statement of retained earnings, statement of changes in financial position, and additional notes, taken as a whole, fairly present the client's financial position and operations for the period stated. Hagen, *supra* note 68, at 69-70, 72-76.

After an engagement letter is signed, an auditor implements a five-stage process in performing the audit. Gossman, *supra* note 35, at 213. The first stage is the planning stage. 1 AICPA STANDARDS, *supra* note 36, AU §§ 324.07, 324.10 (1992). In this stage, the auditor must gather information concerning the client's internal accounting system and controls, and the client's basic business operations. The auditor uses this information to determine how to schedule and coordinate the auditing team's efforts in order to maximize cost efficiency and work within the established accounting and reporting system. Gossman, *supra* note 35, at 214. See also 1 AICPA STANDARDS, *supra* note 36, AU §§ 319, 322, 325 (1992) (relating to overall impact of control structure from the planning stage to the reporting stage). The audit planning stage is initially performed prior to field work, and it continues throughout the audit. The term "field work" refers to the physical and quantitative auditing procedures performed (normally) at the client's physical site in the "field."

Hence, the term field work. Field work is completed as of and prior to the date of the opinion letter. Crandall Interview, *supra* note 7. The standards for field work are set forth in the Generally Accepted Auditing Standards. For a list of the substantive tests used in field work, see *supra* note 97. For a more complete discussion of the first standard of field work, see 1 AICPA STANDARDS, *supra* note 36, AU § 311 (1989). Auditors must be allowed to remain flexible to alter or change direction in the auditing process. New discoveries of relevant information that may materially affect the company's financial position may not be found until the later stages of the audit. Crandall Interview, *supra* note 7; 1 AICPA STANDARDS, *supra* note 36, AU § 435.06 (1992).

In the second stage, the auditor evaluates the client's internal control system. Sections 319 and 322 of the AICPA Professional Standards set forth the information regarding internal control structures. 1 AICPA PROFESSIONAL STANDARDS, *supra* note 36, §§ 319, 322 (1992). Section 319 states:

AU § 319 Consideration of the Internal Control Structure in a Financial Statement Audit
 .02 An entity's internal control structure, for purposes of this section, consists of three elements: the control environment, the accounting system, and control procedures.

Id. at § 319.

1 AICPA STANDARDS, *supra* note 36, Appendix B, AU § 319.67 (1993), defines the control environment as:

[T]he collective effect of various factors on establishing, enhancing, or mitigating the effectiveness of specific policies and procedures. Such factors include (1) management philosophy and operating style, (2) organizational structure, (3) the function of the board of directors and its committees, (4) methods of assigning authority and responsibility, (5) management control methods, (6) the internal audit function, (7) personnel policies and practices, and (8) external influences concerning the entity.

Id. Appendix B further defines an accounting system as: "the methods and records established to identify, assemble, analyze, classify, record, and report an entity's transactions and to maintain accountability for the related assets and liabilities." *Id.*

Control procedures are defined as "the policies and procedures in addition to the control environment and accounting system that management has established to provide reasonable assurance that specific entity objectives will be achieved." *Id.* This evaluation during the second stage helps the auditor to form a procedural checklist and to effectively gather information that will dictate the type and extent of auditing procedures to be implemented. Hagen, *supra* note 68, at 68.

The auditor performs compliance tests in the third stage. The compliance tests are designed to indicate if the client's internal control system is functioning properly. The first three stages will help the auditor to determine if the initially proposed audit program can be implemented without modification. The extent of the substantive tests is determined from the compliance tests' results. *Id.* Substantive tests are defined as: "Tests of details and analytical procedures performed to detect material misstatements in the account balance, transaction class, and disclosure components of financial statements." 1 AICPA STANDARDS, *supra* note 36, Appendix B, AU § 319.67 (1993); see also AU § 326.09-.13 (1992). Examples of substantive tests include random confirmation of accounts receivable, observing physical inventory, estimation of liabilities, and examination of management's accounting principles. Hagen, *supra* note 68, at 68.

The fourth stage requires the auditor to evaluate the audit program and based on that evaluation, to modify the audit to conform to the compliance test results. The fifth and final stage requires the auditor to evaluate the information obtained to determine if the client's financial statements accurately reflect the company's economic condition. The auditor issues an opinion after the audit is completed. Hagen, *supra* note 68, at 68. A sample Independent Auditor's Report reads as follows:

We have audited the accompanying balance sheet of _____ as of _____, and the related statements of revenue and expenses, association equity and cash flows for the

render are an unqualified, qualified, adverse, or disclaimed opinion on the company's financial position.¹⁰⁷ An unqualified opinion is the most frequently issued opinion.¹⁰⁸ CPAs issue this opinion if they do not have any exceptions, reservations, or qualifications that the financial statements present fairly the client's financial position, results of operations, and changes in financial position.¹⁰⁹ Notably, an unqualified opinion does not ensure the non-existence of fraud or that the numbers in the financial statement are accurate, nor is that its purpose.¹¹⁰

A CPA must issue a qualified opinion or an adverse opinion when an improper accounting treatment that is not in compliance with generally accepted accounting principles (GAAP)¹¹¹ is used on one or more items.¹¹² A CPA

years then ended. These financial statements are the responsibility of the Association's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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 _____ as of December 31, _____ and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

Our audits were made for the purpose of forming an opinion on the basic financial statements taken as a whole. The schedule of research and development expense for the years ended December 31, _____ is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Siegfried, Crandall, Vos & Lewis, P.C., Kalamazoo, Michigan 49008.

107. Hagen, *supra* note 68, at 69; 1 AICPA STANDARDS, *supra* note 36, AU § 411 (1993).

108. Hagen, *supra* note 68, at 69. See generally Crandall Interview, *supra* note 7.

109. Hagen, *supra* note 68, at 69; 1 AICPA STANDARDS, *supra* note 36, AU §§ 411.01-.04 (1993)

110. Hagen, *supra* note 68, at 69. An unqualified opinion is labeled as a short form opinion because of its brevity. *Id.*

111. 1 AICPA STANDARDS, *supra* note 36, AU §§ 508.38-.69 (1992). The standards and principles used in performing audits and other CPA services were formulated and approved by the American Institute for CPAs (AICPA). The AICPA is a national organization. The AICPA bylaws state the organization's goals and purposes. WIXON ET AL., *supra* note 1, at 26-31; 2 AICPA STANDARDS, *supra* note 36, BL § 101 (1988). GAAP and Generally Accepted Auditing Standards (GAAS) were developed to give the public accounting profession standards and guidelines that offer the client continuity in the performance of audits. See 1 AICPA STANDARDS, *supra* note 36, U.S.

Auditing Standards (1988).

RULE 203.01—Accounting Principles. A member shall not (1) express an opinion or state affirmatively that the financial statements or other financial data of any entity are presented in conformity with generally accepted accounting principles or (2) state that he or she is not aware of any material modifications that should be made to such statements or data in order for them to be in conformity with generally accepted accounting principles, if such statements or data contain any departure from an accounting principle promulgated by bodies designated by Council to establish such principles that has a material effect on the statements or data taken as a whole. If, however, the statements or data contain such a departure and the member can demonstrate that due to unusual circumstances the financial statements or data would otherwise have been misleading, the member can comply with the rule by describing the departure, its approximate effects, if practicable, and the reasons why compliance with the principle would result in a misleading statement.

2 AICPA STANDARDS, *supra* note 36, ET § 203.01 (1993). The auditing standards are listed below:

AU § 150

.01 Auditing standards differ from auditing procedures in that “procedures” relate to acts to be performed, whereas “standards” deal with measures of the quality of the performance of those acts and the objectives to be attained by the use of the procedures undertaken. *Auditing standards* as distinct from *auditing procedures* concern themselves not only with the auditor’s professional qualities but also with the judgment exercised by him in the performance of his audit and in his report.

.02 The generally accepted auditing standards as approved and adopted by the membership of the American Institute of Certified Public Accountants are as follows:

General Standards

1. The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.
3. Due professional care is to be exercised in the performance of the audit and the preparation of the report.

Standards of Field Work

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
2. A sufficient understanding of the internal control structure is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.
3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.

Standards of Reporting

1. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.
2. The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.
3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
4. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed,

gives a qualified opinion if an improperly accounted for item is included that would have a material, but not pervasive, effect on the financial statements.¹¹³

the reasons therefore should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking.

.03 These standards to a great extent are interrelated and interdependent. Moreover, the circumstances which are germane to a determination of whether one standard is met may apply equally to another. "Materiality" and "audit risk" underlie the application of all the standards, particularly the standards of field work and reporting.

.04 The concept of materiality is inherent in the work of the independent auditor. There should be stronger grounds to sustain the independent auditor's opinion with respect to those items which are relatively more important and with respect to those in which the possibilities of material misstatement are greater than with respect to those of lesser importance or those in which the possibility of material misstatement is remote. For example, in an entity with few, but large, accounts receivable, the accounts individually are more important and the possibility of material misstatement is greater than in another entity that has a great number of small accounts aggregating the same total. In industrial and merchandising enterprises, inventories are usually of great importance to both financial position and results of operations and accordingly may require relatively more attention by the auditor than would the inventories of a public utility company. Similarly, accounts receivable usually will receive more attention than prepaid insurance.

.05 The consideration of audit risk has an important bearing on the nature of the audit. Cash transactions are more susceptible to irregularities than inventories, and the work undertaken on cash may therefore have to be carried out in a more conclusive manner without necessarily implying a greater expenditure of time. Arm's-length transactions with outside parties are usually subjected to less detailed scrutiny than intercompany transactions or transactions with officers and employees, where the same degree of disinterested dealing cannot be assumed. The effect of internal control structure on the scope of an audit is an outstanding example of their influence on auditing procedures of a greater or lesser degree of risk of misstatement; i.e., the more effective the internal control structure, the less the degree of control risk.

Services Other than Examinations of Financial Statements

.06 In addition to audits of financial statements, the ten generally accepted auditing standards, to the extent that they are relevant in the circumstances, apply to all other services governed by Statements on Auditing Standards unless the Statement specifies otherwise. [As amended, effective after August 31, 1982, by Statement on Auditing Standards No. 43.]

1 AICPA STANDARDS, *supra* note 36, U.S. Auditing Standards, AU § 150 (1989).

In addition, GAAP and GAAS are legally recognized standards that prevent the auditor from voluntarily escaping liability. CPAs can also limit their liability during an audit by not allowing the issuance of certain forms of opinion. Hagen, *supra* note 68, at 70-72.

112. 1 AICPA STANDARDS, AU § 410 (1993):

.01 The first standard of reporting is:

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

Opinion qualifications are usually stated in the opinion paragraph. 1 AICPA STANDARDS, AU § 508.38-.66 (1992). See generally WIXON ET AL., *supra* note 1, at 26-28.

113. Hagen, *supra* note 68, at 70.

The reasons for giving a qualified opinion include: lack of competent evidential matter, restrictions on the scope of an auditor's examination, departures from GAAP in the financial statements, and changes in applied accounting principles or significant uncertainties which may affect the financial statements.¹¹⁴ A CPA renders an adverse opinion if the reasons stated above have a material and pervasive effect on the financial statements such that the fairness of presentation is destroyed.¹¹⁵

A CPA uses a disclaimer opinion to avoid responsibility for the financial statements.¹¹⁶ The disclaimer states that the CPA does not express an opinion on the financial statements.¹¹⁷ A disclaimer of opinion can only be issued if the CPA cannot objectively identify that the financial statements are in accordance with GAAP, and cannot be issued merely to avoid liability.¹¹⁸

Opinion letters only assert an opinion¹¹⁹ and are not an express warranty.¹²⁰ Unfortunately, the legal community and judiciary appear to have conveniently treated the opinion letter (the audit) as an express warranty that imposes strict liability on the auditor.¹²¹ One commentator has stated that "an

114. Hagen, *supra* note 68, at 70-71.

115. 1 AICPA STANDARDS, *supra* note 36, AU § 508.67-.69 (1988). An adverse opinion states that the financial statements do not present fairly the client's current or changed financial position and are not in conformity with GAAP. 1 AICPA STANDARDS, *supra* note 36, AU § 508.67 (1988).

116. Hagen, *supra* note 68, at 71; *see generally* 1 AICPA STANDARDS, *supra* note 36, AU § 504.05 (1993).

117. Hagen, *supra* note 68, at 71; 1 AICPA STANDARDS, *supra* note 36, AU § 504.05-.13 (1993), AU § 508.70-.72 (1988).

118. Hagen, *supra* note 68, at 72. For an example of a case where a court acknowledged and based its dismissal of state claims of securities law violations, fraud, and negligence on a firm's proper use of disclaimers and qualifications, *see In re VMS Limited Partnership Sec. Litig.*, 976 F.2d 362 (7th Cir. 1992). For a brief summary of this case and its impact, *see Fraud Charges Against Pannell Kerr Forster Dismissed*, J. ACCT., April 1993, at 20.

119. Webster's Dictionary definition of opinion is: "Opinion-1a: a view, judgment, or appraisal formed in the mind about a particular matter . . . 2a: belief stronger than impression and less strong than positive knowledge" WEBSTER'S NINTH NEW COLLEGIATE DICTIONARY 828 (9th ed. 1991).

120. WIXON ET AL., *supra* note 1, at 26-7.

121. While stating its reasons for rejecting *Ultramares v. Touche*, 174 N.E. 441 (N.Y. 1931), the court in *Haddon View Inv. Co. v. Coopers & Lybrand* declared: "To require a plaintiff in such a situation to be in privity with the defendant-accountant ignores the modern verity that accountants make reports on which people other than their clients foreseeably rely in the ordinary course of business." *Haddon View Investment Co. v. Coopers & Lybrand*, 436 N.E.2d 212, 214 (Ohio 1982). *See Rosenblum v. Adler*, 461 A.2d 138 (N.J. 1983). The *Rosenblum* court maintained that a defective audit was similar to a defective product, and stated:

If recovery for defective products may include economic loss, why should such loss not be compensable if caused by negligent misrepresentation? The maker of the product and the person making a written representation with intent that it be relied upon are, respectively, impliedly holding out that the product is reasonably fit, suitable and safe

audit report is not designed to guarantee the accuracy of the financial statements prepared by management, but only to attest to the fairness of management's presentation."¹²² Some courts have treated audit reports and opinions as express warranties, thereby making the auditors liable to both the client and third parties.

IV. HISTORICAL APPLICATION OF THIRD-PARTY LIABILITY IN PUBLIC ACCOUNTING SUITS

The history of the courts' expansion of third-party liability in public accounting suits covers a relatively short period of time in the lengthy history of public accounting. However, perhaps a more alarming concern is the dramatic upward trend in the courts' severity and strictness of interpretation and application of accountants' liability.¹²³ Courts have jumped from the equitable strict privity rule¹²⁴ of *Ultramares Corp. v. Touche*¹²⁵ to the very broad foreseeability standard in the 1983 decision of *Rosenblum v. Adler*.¹²⁶

The courts have imposed the legal theory of foreseeability in the area of

and that the representation is reasonably sufficient, suitable and accurate.
Id. at 147.

In acknowledging how many courts feel about the accounting profession, the *Monco* court stated that "the accounting profession is sophisticated and obligated to provide the public with accurate financial information." *First Nat'l Bank of Commerce v. Monco Agency Inc.*, 911 F.2d 1053, 1059 (5th Cir. 1990). The *Arthur Young* Court stated:

By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporations' creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.

United States v. Arthur Young & Co., 465 U.S. 805, 817-18 (1984). *But cf.* *Ebke*, *supra* note 32. *Ebke* states that "auditing is an art, not a science." *Id.* at 683.

122. Gossman, *supra* note 35, at 233. "[T]he independent auditor does not control the client's accounting records and processes. . . . The auditor, however, is an outsider; he is never as close to the accounting processes as the client's general and accounting officers who govern these processes." Gormley, *supra* note 37, at 552.

123. *See supra* part I. Because cases brought against CPAs under RICO are criminal charges, this note will be limited to discussing primarily common law liability actions and a few SEC cases.

124. *Credit Alliance Corp. v. Arthur Andersen & Co.*, 483 N.E.2d 110 (N.Y. 1985). In *Credit Alliance*, the privity requirement in *Ultramares* was expanded to include third parties enjoying a relationship with the accountants that "sufficiently approaches privity." *Id.*

125. *Ultramares Corp. v. Touche*, 174 N.E. 441 (N.Y. 1931).

126. *Rosenblum v. Adler*, 461 A.2d 138 (N.J. 1983).

professional negligence to assure just and fair results in litigation.¹²⁷ However, courts should not be so quick to overlook legal rules, such as privity, just because the rules represent a rigid formal approach to imposing liability. A legal system needs rigid rules to delineate the boundaries of a legal action, as well as flexibility to apply these rules. In addition, courts need to step back and ask if foreseeability, although a working compatible standard in some areas of tort law, is the most equitable and just standard when applied to public accounting suits.¹²⁸

The foreseeability standard and the *Restatement* standard¹²⁹ place a disproportionate burden of liability on CPAs by ignoring pre-contractual relations between the client and the CPAs and expanding the classes of third parties who might recover. The *Restatement* standard also removes predictability from court decisions regarding accountants' liability because courts have the discretion to apply the standard either narrowly or broadly.¹³⁰

The courts originally applied the foreseeability standard and the *Restatement* standard to provide an incentive for the CPA to tighten and improve auditing controls and procedures and to assert more care when undertaking an audit.¹³¹ However, time has shown that these doctrines have failed their purpose and are destroying the CPA profession, the very group the doctrines are intended to regulate.¹³² Courts, however, continue to justify extending CPAs' liability on the premise that public accounting firms can best bear the loss.¹³³ Many

127. For a discussion about the Cardozo and Andrews approaches to applying foreseeability and their application to CPA cases, see Willis Hagen II, *Accountants Common Law Negligent Liability to Third Parties*, COL. BUS. L. REV. 181, 200-06 (1988); see also Gossman, *supra* note 35, at 222-28 (discussing the foreseeability standard and judicial acceptance).

128. See *supra* note 127.

129. The *Restatement* standard is similar to the foreseeability standard applied in *Rosenblum*. Under the *Restatement* standard, an accountant's liability is limited to the class of persons who are foreseen to rely upon the negligent misrepresentation of the audit. This limitation on the class of persons requires that the class be a known and intended class. Gormley, *supra* note 37, at 530, 551.

130. *Id.*

131. See Wiener, *supra* note 68, at 256; *Rosenblum v. Adler*, 461 A.2d 138 (N.J. 1983); Gossman, *supra* note 35, at 238.

132. For the doctrines' effects on the CPA profession, see ANDERSEN ET AL., *supra* note 1, at 1-7. *But see* Wiener, *supra* note 68, at 250. "There is no empirical data to suggest the accounting profession has withered as a result of increased liability. To the contrary, accountancy as a business seems to have flourished. The fees charged by firms have risen commensurate with the 'accountants' increased sophistication, and the complexity and risk associated with their endeavors.'" *Id.* Keep in mind, however, that Wiener's article was written in 1983. For a recent study demonstrating findings opposite of Wiener's opinion, see AUS Consultants, *supra* note 3.

133. *Rusch Factors, Inc. v. Levin*, 284 F. Supp. 85 (D.C.R.I. 1968); *Rosenblum*, 461 A.2d at 138. See also Bilek, *supra* note 94, at 698. Bilek concluded that the third party should bear the loss, and noted: "Accountants, rather than third parties, should bear the loss only if such imposition minimizes the costs to society." *Id.*

courts view CPAs to be in the best position to spread the costs of imposed liability by purchasing insurance or increasing service rates.¹³⁴ Unfortunately, the insurance industry is not in sync with the courts, and CPAs have encountered increased difficulty in obtaining liability insurance.¹³⁵ If CPAs are fortunate enough to obtain insurance, many times the coverage is less than anticipated and the premium rates are astronomical.¹³⁶

The absence of predictability in legal decisions leaves accountants in an unfair position of uncertainty as to when and how courts will impose liability. The unpredictability in the law regarding liability rules in public accounting cases places CPAs at a disadvantage to protect themselves legally. Although no area of the law is entirely predictable, the area of public accountants' liability is especially tenuous. Courts need to apply standards consistently in public accounting suits so that uniformity and predictability may result. In order for courts to apply the standards consistently, the standards will have to be more objective than subjective. A review of some of the landmark decisions and the standards applied in those cases, along with a discussion of recently decided cases involving the problem of expanded accountants' liability, will serve to explain and impress upon the reader the seriousness of the situation relative to the accounting profession.

A. *The Privity Requirement*

The common law requirement that privity exist between two parties before liability can be found was first realized in the English case of *Winterbottom v. Wright*.¹³⁷ In that case, a passenger was injured while riding in a mail coach. The passenger sued the mail coach company for negligently manufacturing a wheel, which broke and caused the accident. The court held that the passenger did not have a cause of action because of the lack of privity between the passenger and the mail coach company.¹³⁸ The court reasoned that allowing the plaintiff, a third party, to bring a suit for negligence would extend liability to be found in almost any circumstance.¹³⁹

134. *Rusch*, 284 F. Supp. at 85; *Rosenblum*, 461 A.2d at 138. *But see* *Bily v. Arthur Young & Co.*, 834 P.2d 745 (Cal. 1992). The *Bily* court stated that "it might be doubted whether auditors are the most efficient absorbers of the losses from inaccuracies in financial information." *Id.* at 766. *See also* Siliciano, *supra* note 33, at 1973 (stating that investors as a class are a "broad social base upon which the costs of accounting errors can be spread"). *See also* Bilek, *supra* note 94, at 705-07 (supporting a theory that limits accountants' liability).

135. *See infra* notes 205-16 and accompanying text.

136. ANDERSEN ET AL., *supra* note 1, at 3; *see infra* note 211 (chart).

137. *Winterbottom v. Wright*, 10 M. & W. 109, 152 Eng. Rep. 402 (1842).

138. *Id.*

139. *Id.*

Historically, privity has been recognized as a necessary element in maintaining a suit in contract law.¹⁴⁰ Prior to the extension of tort law, accounting suits were brought under the theory of contract law because of the existing contract between the auditor and the client.¹⁴¹ As courts began to expand CPAs' liability to outside third parties other than the client, the privity rule had to be replaced with a more flexible and subjective rule.¹⁴² Although *Winterbottom* set out the privity requirement in a contract action, courts have misinterpreted the holding to mean that an action in tort was also precluded from being brought by a third party.¹⁴³

Later, the doctrine of privity in *Lawrence v. Fox*¹⁴⁴ was expanded so that privity, as applied in contract law, included persons who were clearly designated as beneficiaries of a promise. In 1922, the New York Court of Appeals decided the case of *Glanzer v. Shepard*¹⁴⁵ and expanded liability to a seller who misweighed beans and certified the weight to a buyer. The *Glanzer* court found liability because the transmission of the certificate was the "end and aim of the transaction."¹⁴⁶ This expansion of liability was short lived, however, because in 1931, the holding in *Ultramares Corp. v. Touche* curbed this expansion of liability.¹⁴⁷

The *Ultramares* case involved an action for negligent misrepresentation and fraudulent misrepresentation against an accounting firm.¹⁴⁸ The defendant-accounting firm was hired by Stern & Co. (Stern) to prepare balance sheets specifically at its request and for its use. The plaintiff, a lending institution, lent funds to Stern relying on the balance sheet figures prepared by the

140. CORBIN, *supra* note 70, at 778.

141. *E.g.*, *East Grand Forks v. Steele*, 141 N.W. 181 (Minn. 1913).

142. *See supra* note 73 and accompanying text.

143. KEETON ET AL., *supra* note 9, at 668.

144. *Lawrence v. Fox*, 20 N.Y. 268 (n.d.), *cited in Ultramares Corp. v. Touche*, 174 N.E. 441, 445 (N.Y. 1931).

145. *Glanzer v. Shepard*, 135 N.E. 275 (N.Y. 1922).

146. *Id.*

147. *Ultramares*, 174 N.E. at 441. The *Glanzer* court's holding has since been cited by various courts (*see, e.g.*, *Rusch Factors, Inc. v. Levin*, 284 F. Supp. 85 (D.C.R.I. 1968); *Security Pac. Bus. Credit, Inc. v. Peat Marwick Main & Co.*, 597 N.E.2d 1080, 1087 (N.Y. 1992) (claiming, by the dissent, that the majority applied *Glanzer*)) who wish to depart from the later decision in *Ultramares*, which reinstates the requirement of privity in extending third-party liability. *Glanzer* and *Ultramares* are conflicting decisions that Judge Cardozo decided. However, the unusualness of these cases is minimized because *Ultramares*, the latter of the two cases, does not overrule *Glanzer*, but rather, distinguishes it on technical factual grounds. Although a valid distinction could be drawn from the two cases, it appears as though Judge Cardozo may have had a difficult time admitting that *Glanzer* may have been wrongly decided.

148. *Ultramares Corp. v. Touche*, 174 N.E. 441 (N.Y. 1931).

defendant.¹⁴⁹ Stern later went bankrupt, and the lender sued the accounting firm.¹⁵⁰

The *Ultramares* court held that “ensuing liability for negligence is to be enforced between the parties by whom the contract has been made.”¹⁵¹ The *Ultramares* court distinguished *Glanzer* by reasoning that the defendant’s service in *Glanzer* was primarily for the information of a third person, an indirect party to the contract, and was only incidentally for the benefit of the formal promisee.¹⁵² In the *Ultramares* case, however, the court reasoned that the service was performed primarily for the benefit of the Stern corporation, and was only incidentally for the use of those whom Stern might later involve.¹⁵³ The *Ultramares* court reasoned that the extension of liability to third parties would expand the field of liability for negligent speech so that it would be nearly the same as liability for fraud.¹⁵⁴ The court also considered the possible effects of an expanded liability theory to other similarly situated professions such as title companies and lawyers.¹⁵⁵ The *Ultramares* court further emphasized the fact that a reasonable business person receiving a certificate without paying for it, and receiving it as one of many possible investors, would look for more outside assurance than the audit.¹⁵⁶

The *Ultramares* holding requiring privity of contract to extend liability to accountants was modified in *Credit Alliance Corp. v. Arthur Andersen*.¹⁵⁷ In *Credit Alliance*, the court held that an accountant cannot be liable in negligence to a non-contractual party unless the accountant was aware that the financial statements were to be used for a particular purpose in furtherance of which a known party was intending to rely.¹⁵⁸ The *Credit Alliance* court further held that the known party and the accountant must be linked by some portion of the accountant’s conduct.¹⁵⁹ The link between the accountant and the known party demonstrates the accountant’s understanding and awareness that the party relied on the financial reports.¹⁶⁰ The court further held that for liability to attach to an accountant in a negligence action, the accountant and the party must have

149. *Id.*

150. *Id.*

151. *Id.* at 448.

152. *Ultramares Corp. v. Touche*, 174 N.E. 441, 446 (N.Y. 1931).

153. *Id.*

154. *Id.*

155. *Id.* at 441.

156. *Id.* at 448.

157. *Credit Alliance Corp. v. Arthur Andersen*, 483 N.E.2d 110 (N.Y. 1985).

158. *Id.*

159. *Id.* at 110.

160. *Id.* at 118.

a relationship that "sufficiently approaches privity."¹⁶¹ Although *Credit Alliance* expanded the *Ultramares* requirement of strict privity, the *Ultramares* privity requirement is still basically intact after the *Credit Alliance* modification.¹⁶²

B. *The Restatement of Torts Standard*

Ultramares was the standard that courts used when determining the existence of third-party liability, until the *Restatement Second of Torts* was drafted in the 1960s.¹⁶³ The *Restatement* created an alternative test for determining third-party liability. The *Restatement* extended an auditor's liability for negligence to an identified narrow group, but not necessarily to the specific membership within that group.¹⁶⁴ The *Restatement* only required a third party to be a member of a limited group whose existence is known to the auditor.¹⁶⁵ The *Restatement's* standard is not problematic; rather, the courts' interpretation and application has led to a range of conflicting decisions that has tended to expand the auditor's liability.¹⁶⁶

*Rusch Factors, Inc. v. Levin*¹⁶⁷ was one of the first cases to apply the *Restatement* standard. The *Rusch* court held that in a negligence action, an accountant should be liable for careless financial misrepresentation relied on by actually foreseen and limited classes of persons.¹⁶⁸ In arriving at its decision, the *Rusch* court considered and dismissed the *Ultramares* decision by

161. *Id.* at 119.

162. The modification of the privity requirement in *Credit Alliance* was instrumental in reversing an earlier case. See *Westpac Banking Corp. v. Deschamps*, 484 N.E.2d 1351 (N.Y. 1985).

163. See *supra* note 73 and accompanying text.

164. *Id.*; see, e.g., *First Nat'l Bank of Commerce v. Monco Agency, Inc.*, 911 F.2d 1053, 1059-60 (5th Cir. 1990).

165. Gossman, *supra* note 35, at 218. "[T]he Restatement limits the persons to whom he owes a duty to his client, to intended identifiable beneficiaries and to any unidentified member of the intended classes of beneficiaries. The only extension in the Restatement beyond *Ultramares* and *Glanzer* appears to be that the auditor need not know the identity of the beneficiaries if they belong to an identifiable group for whom the information was intended to be furnished." *Rosenblum v. Adler*, 461 A.2d 138, 145 (N.J. 1983).

166. E.g., *Bily v. Arthur Young & Co.*, 834 P.2d 745 (Cal. 1992). For a court's different application of the *Restatement*, see *Bethlehem Steel Corp. v. Ernst & Whinney*, 822 S.W.2d 592 (Tenn. 1991).

167. *Rusch Factors, Inc. v. Levin*, 284 F. Supp. 85 (D.C.R.I. 1968). *Rusch* was decided in 1968, and excluding *Biakanja v. Irving*, 320 P.2d 16 (Cal. 1958), most courts had adhered to the *Ultramares* rule regarding the requirement for limited privity. Since the *Rusch* decision, a vast number of states have applied the *Restatement* standard. Gossman, *supra* note 35, at 219. For a discussion and listing of other cases applying the *Restatement* standard, see *Accountants Not Liable to Investors in Company*, LAW ALERT, Oct. 12, 1992, at 16.

168. *Rusch*, 284 F. Supp. at 92-93.

distinguishing the case on its facts.¹⁶⁹ The *Rusch* court identified the plaintiff as a "member of an undefined, unlimited class of remote lenders and potential equity holders not actually foreseen but only foreseeable."¹⁷⁰ The *Rusch* court identified with the holding in the *Glanzer* case and the tentatively proposed *Restatement (Second) of Torts* § 552 and held that the plaintiff could not recover against the defendant-accountants.¹⁷¹ An interesting aspect of the *Rusch* case is that the court appeared to have left open the possibility of applying full limits of foreseeability to accountants for negligent misrepresentation.¹⁷²

Biakanja v. Irving,¹⁷³ decided by the California Supreme Court in 1958, was the first case to break away from the *Ultramares* decision. *Biakanja* considerably expanded third-party liability in negligence actions.¹⁷⁴ Although

169. *Id.* at 91.

170. *Id.*

171. *Rusch Factors, Inc. v. Levin*, 284 F. Supp. 85, 91, 92 (D.C.R.I. 1968).

172. *Id.* at 93.

173. 320 P.2d 16 (Cal. 1958).

174. *Id.* Although the *Biakanja* court held that a balancing test is required when deciding the existence of third-party liability, other authorities have classified this case as one applying the *Restatement (Second) of Torts* § 552. *Accountants Not Liable to Investors in Company*, *supra* note 167, at 16.

How the Courts Are Split

1. Courts holding that an auditor is liable only to its own clients:

Alabama	<i>Colonial Bank of Alabama v. Ridley & Schwegert</i> , 551 So. 2d 390 (Ala. 1989).
Colorado	<i>Stephens Indus., Inc. v. Haskins & Sells</i> , 438 F.2d 357 (10th Cir. 1971).
Delaware	<i>McLean v. Alexander</i> , 599 F.2d 1190 (3d Cir. 1979).
Idaho	<i>Idaho Bank & Trust Co. v. First Bancorp of Idaho</i> , 772 P.2d 720 (Idaho 1989).
Indiana	<i>Ackerman v. Schwartz</i> , 947 F.2d 841 (7th Cir. 1991).
Nebraska	<i>Citizens Nat'l Bank v. Kennedy & Coe</i> , 441 N.W.2d 180 (Neb. 1989).
New York	<i>Credit Alliance Corp. v. Arthur Andersen</i> , 483 N.E.2d 110 (N.Y. 1985).
Pennsylvania	<i>Landell v. Lybrand</i> , 107 A. 783 (Pa. 1919).

2. Courts adopting the *Restatement* view (liability to clients and known third parties):

Florida	<i>First Florida Bank, N.A. v. Max Mitchell & Co.</i> , 558 So. 2d 9 (Fla. 1990).
Georgia	<i>Badische Corp. v. Caylor</i> , 356 S.E.2d 198 (Ga. 1987).
Iowa	<i>Pahre v. Auditor of State</i> , 422 N.W.2d 178 (Iowa 1988).
Kentucky	<i>Ingram Indus., Inc. v. Nowicki</i> , 527 F. Supp. 683 (E.D. Ky. 1981).

the case did not involve an action against an auditor or public accountant, the rule of law set forth was later applied in public accounting cases.¹⁷⁵ The *Biakanja* court held that when determining if a defendant will be held liable to a third party not in privity, a question of policy arises and involves a balancing of factors.¹⁷⁶ The factors that the court considered were: "the extent to which the transaction was intended to affect the plaintiff, the foreseeability of harm to him, the degree of certainty that the plaintiff suffered injury, the closeness of the connection between the defendant's conduct and the injury suffered, the moral blame attached to the defendant's conduct, and the policy of preventing future harm."¹⁷⁷ The court reconciled its holding with *Glanzer* by stating that the "end and aim" of the transaction was to provide the service to the plaintiff.¹⁷⁸ The *Biakanja* court applied a balancing test that approached the foreseeability

Louisiana	First Nat'l Bank of Commerce v. Monco Agency, Inc., 911 F.2d 1053 (5th Cir. 1990).
Michigan	Law Offices of Lawrence J. Stockler, P.C. v. Rose, 436 N.W.2d 70 (Mich. Ct. App. 1989).
Minnesota	Bonhiver v. Graff, 248 N.W.2d 291 (Minn. 1976).
Missouri	Aluma Kraft Mfg. Co. v. Elmer Fox & Co., 493 S.W.2d 378 (Mo. Ct. App. 1973).
Montana	Thayer v. Hicks, 793 P.2d 784 (Mont. 1990).
New Hampshire	Spherex, Inc. v. Alexander Grant & Co., 451 A.2d 1308 (N.H. 1982).
Ohio	Haddon View Inv. Co. v. Coopers & Lybrand, 436 N.E.2d 212 (Ohio 1982).
Rhode Island	Rusch Factors, Inc. v. Levin, 284 F. Supp. 85 (D.C.R.I. 1968).
Tennessee	Bethlehem Steel Corp v. Ernst & Whinney, 822 S.W.2d 592 (Tenn. 1991).
Texas	Shatterproof Glass Corp. v. James. 466 S.W.2d 873 (Tex. Civ. App. 1987).
Washington	Haberman v. Washington Pub. Power Supply Sys., 744 P.2d 1032 (Wash. 1987).
West Virginia	First Nat'l Bank v. Crawford, 386 S.E.2d 310 (W. Va. 1989).

3. Courts holding that an auditor is liable to anyone who may foreseeably rely on a report:

Mississippi	Touche Ross & Co. v. Commercial Union Ins. Co., 514 So. 2d 315 (Miss. 1987).
New Jersey	Rosenblum, Inc. v. Adler, 461 A.2d 138 (N.J. 1983).
Wisconsin	Citizens State Bank v. Timm, Schmidt & Co., 335 N.W.2d 361 (Wis. 1983).

Id.

175. *International Mortgage Co. v. John P. Butler Accountancy Corp.*, 223 Cal. Rptr. 218 (Cal. App. 4 Dist. 1986), *overruled by Bily v. Arthur Young & Co.*, 834 P.2d 745 (Cal. 1992).

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

177. *Id.*

178. *Id.*

standard.¹⁷⁹

Many states have since followed the *Rusch* court's or the *Biakanja* court's lead and have applied the *Restatement* standard when determining whether third-party liability can be extended to public accountants.¹⁸⁰ One problem with the *Restatement* standard is that the courts are given a large amount of discretion to place more weight on some factors than on others.¹⁸¹ This discretion creates an inconsistency in judgments due to the subjectivity of the application of the test. Some courts decided that the *Restatement* standard did not provide sufficient protection for the plaintiff and instead applied the foreseeability standard.

C. Foreseeability Standard

A court first applied unlimited foreseeability in the 1983 case of *Rosenblum v. Adler*.¹⁸² In *Rosenblum*, the plaintiff alleged that he had relied on audited financial statements of Giant Stores Corporation, which were prepared by the defendant, Touche Ross & Co. Based on his reliance of Touche's audit, the plaintiff claimed to have sold his business to Giant, and in return received Giant stock.¹⁸³ Public trading of Giant's stock ceased after a discovery that Giant had committed fraud by manipulating its books, and the stock became worthless.¹⁸⁴ Because of plaintiff's reliance on the audit, the *Rosenblum* court held that when an independent auditor gives an opinion without a limitation as to whom the client may disseminate the financial statements, the auditor has a duty to all who should reasonably be foreseeable as recipients of the information from the client, provided that the recipients rely on the information pursuant to the business purposes of the opinion.¹⁸⁵

The *Rosenblum* court reasoned that because Touche's audit did not contain any limitation as to dissemination, it was reasonably foreseeable that Giant would distribute the audit to further its business and that Touche had placed the audit into the economic stream.¹⁸⁶ Therefore, Touche was responsible for its

179. *Id.* For an application of the *Biakanja* balancing standard, see *Aluma Kraft Mfg. Co. v. Elmer Fox & Co.*, 493 S.W.2d 378 (Mo. Ct. App. 1973).

180. *Biakanja v. Irving*, 320 P.2d 16 (Cal. 1958). See *supra* note 174 (cases in chart under both *Restatement* section and foreseeability section).

181. *E.g.*, *First Nat'l Bank of Commerce v. Monco Agency, Inc.*, 911 F.2d 1053, 1062 (5th Cir. 1990) (rejecting an attempt to broaden Louisiana's application of the *Restatement* and clarifying Louisiana's narrow interpretation regarding the *Restatement's* parameters).

182. *Rosenblum v. Adler*, 461 A.2d 138 (N.J. 1983).

183. *Id.* at 140.

184. *Id.* at 138.

185. *Id.* at 153.

186. *Id.* at 154-55.

careless misrepresentations, and owed a duty to those parties who justifiably relied on the audit.¹⁸⁷ Although the court's holding was far reaching, the court's dicta indicated that the classification of recipients would be limited and would not include stockholders who purchased stock after the audit's preparation, or institutional investors or portfolio managers who did not obtain the financial statements from the client.¹⁸⁸ However, in justifying imposing the broad doctrine of foreseeability, the *Rosenblum* court stated that the defendant's ignorance as to the financial statements' precise use would not eliminate the auditor's obligation.¹⁸⁹

Shortly after the *Rosenblum* decision was handed down, the Wisconsin Supreme Court decided *Citizens State Bank v. Timm, Schmidt & Co.*¹⁹⁰ In *Timm*, the court held that an accountant may be liable to a third party not in privity for negligently preparing an audit report.¹⁹¹ The accountant's liability extends to the foreseeable injuries resulting from the negligent preparation of the audit unless the court decides, based on the specific facts of a case, that as a matter of public policy, recovery should be denied.¹⁹² Wisconsin was the second state to judicially apply the foreseeability standard to extend accountants' liability to third parties.¹⁹³ The *Timm* court reasoned that Wisconsin's fundamental principle of negligence law "is that a tortfeasor is fully liable for all foreseeable consequences of his act except as those consequences are limited by policy factors."¹⁹⁴ After examining the *Ultramares* privity standard and the *Restatement* standard, the court stated that the *Restatement's* effect of limiting liability to certain third parties was too restrictive in its policy factors, and that the accountants' liability to third parties would be determined according to the accepted principles of Wisconsin's negligence law.¹⁹⁵

Four years later, the Supreme Court of Mississippi also extended the foreseeability standard to cases determining the liability of accountants to third parties. In *Touche Ross & Co. v. Commercial Union Insurance Co.*, the court discussed the three standards that courts have used when determining an accountant's liability to a third party: the *Ultramares* privity requirement, the *Restatement* standard, and the foreseeability standard.¹⁹⁶ The *Commercial Union* court dismissed the possibility of using the *Ultramares* test because

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

188. *Id.* at 153.

189. *Id.* at 155.

190. 335 N.W.2d 361 (Wis. 1983).

191. *Id.* at 366.

192. *Id.*

193. Gormley, *supra* note 37, at 557.

194. *Citizens State Bank v. Timm, Schmidt & Co.*, 335 N.W.2d 361, 366 (Wis. 1983).

195. *Id.*

196. *Touche Ross & Co. v. Commercial Union Ins. Co.*, 514 So. 2d 315, 322-23 (Miss. 1987).

requiring privity is forbidden under Mississippi law.¹⁹⁷ Similarly, the *Commercial Union* court dismissed the *Restatement* approach, stating that the *Restatement* approach is like the privity requirement because it also draws an arbitrary limit on the potential class of plaintiffs.¹⁹⁸ The *Commercial Union* court ultimately held that "an independent auditor is liable to reasonably foreseeable users of the audit, who request and receive a financial statement from the audited entity for a proper business purpose, and who then detrimentally rely on the financial statement, suffering loss, proximately caused by the auditor's negligence."¹⁹⁹ The *Commercial Union* court reasoned that this approach would simultaneously protect third parties, who request and rely on the financial statements, and the auditor from an unlimited number of potential users who may read a published financial statement.²⁰⁰ The *Commercial Union* court further recognized the auditor's right to limit the dissemination of the opinion in a separate agreement with the client.²⁰¹

Thus far, three states have judicially implemented the unlimited foreseeability standard when extending third-party liability to public accountants.²⁰² Additionally, many of the states that have adopted the *Restatement* standard have interpreted and applied the test quite liberally.²⁰³ The disparaging results of the courts' decisions to expand liability in public accounting suits have directly affected how public accounting firms are now doing business, which has ultimately affected the United States's economy.²⁰⁴

197. *Id.* at 321.

198. *Id.*

199. *Id.* at 322.

200. *Touche Ross & Co. v. Commercial Union Ins. Co.*, 514 So. 2d 315, 320-23 (Miss. 1987).

201. *Id.* at 323.

202. *See supra* note 174 (the cases under the Foreseeability section).

203. *See supra* note 174 (the cases under the *Restatement* section).

204. Increases in accounting services due to the expansion of third-party liability cause price increases in the finance, insurance, and business service sectors. As a result of legal, accounting, and investment costs rising due to increased malpractice insurance costs, business service price levels increased 0.25%, and finance and insurance services price levels increased 0.54%. AUS Consultants, *supra* note 3, at 9. The higher capital costs cause a decrease in business investment, which produces a loss of output. In return, the lower output will cause an increase in inflation.

Due to the impact of scapegoat litigation, the entire economy, measured by the GNP deflator, will be 0.3% higher by 1996. *Id.* In addition, the increased cost of legal, accounting, and investment banking services, due to increased insurance costs, will raise the cost of new investments more than 1.0% annually from 1992 to 1996. *Id.* at 7. The effect that scapegoat litigation will have on the cost of capital will be to increase the costs of raising small amounts of equity capital more than the cost of large issues.

The effect of scapegoat litigation on international competitiveness and the trade imbalance is dramatic. U.S. manufacturing has the highest level of productivity losses due to scapegoat litigation. Between 1992 and 1996, almost 40% of the total reduction in output caused by scapegoat litigation will be in the manufacturing sector. *Id.* at 13. The reduction in business investment, and therefore the associated decrease in productivity growth, adversely affect the U.S. manufacturers domestically

V. CURRENT PROBLEMS OF EXTENDING LIABILITY TO ACCOUNTANTS

A. Summary Of Accountants' Problems

Liability insurance costs and limited availability of insurance coverage are two reasons that demonstrate the necessity for limiting third-party liability to accountants. CPAs' liability insurance costs have continued to increase dramatically each year that tort reform in this area has been ignored.²⁰⁵ Insurance premiums and deductibles have increased, and coverage has decreased.²⁰⁶ The basic liability insurance policy covers allegations of acts and errors or omissions by accountants acting within their professional capacity.²⁰⁷ Currently, many policies now cover on a "claims made" or a "discovery" basis as opposed to the occurrence coverage that was used in the past.²⁰⁸ This new coverage only extends to claims reported within policy effective dates, and occurrence dates are not considered.²⁰⁹ Such a change in coverage severely limits the CPA firm's ability to insure against prior acts that have not yet been reported.²¹⁰

Several insurance surveys indicate recent startling results as to accounting

and in the competitive international markets.

The "high-tech" areas of the manufacturing sector will be the hardest hit by the scapegoat litigation because of their dependence on capital and investment. The "high-tech" areas that will be affected the most are: pharmaceutical, non-electrical machinery and equipment, electrical machinery and equipment, motor vehicles, aircraft and aerospace, and instruments. *Id.* at 13-14. The "high-tech" industries are 34% of the total manufacturing output. *Id.* at 14. The U.S. trade balance gains will be threatened by scapegoat litigation because investments in the U.S. will be more expensive, thereby reducing the productivity growth. The reduction in productivity growth will in turn make the U.S. products less competitive in the international marketplace. *Id.* at 7-18.

205. AUS Consultants, *supra* note 3, at 7; *see infra* note 206 and accompanying text.

206. James H. Thompson & Laurie J. Henry, *Professional Liability Insurance: Go Bare or Not?*, J. ACCT., July 1991, at 111. In response to the number of claims insurance companies now have to pay out to cover expanding accountants' liability, some insurers are either increasing insurance premiums or leaving the market. Under many circumstances, insurance may not be available for CPA firms, even at a high premium rate. Ebke, *supra* note 32, at 690-91.

207. Thompson & Henry, *supra* note 206, at 111.

208. *Id.* at 112.

209. Thompson & Henry, *supra* note 206, at 111. A "prior acts" exclusion clause that denies coverage for any work performed before the policy's effective date usually restricts the policy's scope. If a firm's policy is canceled or the firm does not renew the policy, a gap in coverage can result. To assure a firm has insurance during the gap periods, most insurance companies offer tail policies that cover prior acts for earlier unreported claims. Two layers of liability insurance, primary and excess, are available to accountants. Primary layers consist of a basis policy that states the risks, people covered, and the policy limits and period. "Additional coverage or endorsements for special risks or events may be purchased at additional cost." *Id.* at 112. Firms, depending on their size, can purchase several primary layer amounts of insurance. Excess layers can extend a firm's coverage if a firm's litigation risks exceed the primary layers. *Id.*

210. Thompson & Henry, *supra* note 206, at 111.

firms and their insurance.²¹¹ One survey indicated that 96% of the surveyed

211. *Id.* Listed below is a portion of a questionnaire that was mailed in 1990 to 474 randomly chosen firms throughout the United States. The questionnaire had a 32.5% response rate, representing 44 states. The questions dealt with insurance coverage from 1985 to 1989. *Id.* at 114-16.

Nature of insurance coverage

All respondents and by region

	All regions	Northeast	Southeast	North Central	South Central
Insurance					
Yes	71.3%	70.6%	64.5%	77.8%	62.5%
No	28.7	29.4	35.5	22.2	37.5

...

Reason for lack of ins.

Cost	97.4%	90%	100%	100%	100%
Unable to find	0	0	0	0	0
Low exposure	2.6	10	0	0	0
Had trouble finding	17.7	15.4	14.3	10	25

...

	Northwest	Southwest
Insurance		
Yes	100%	70%
No	0	30

...

firms with fifty or more CPAs reported a 300% increase in liability insurance premiums since 1985.²¹² The survey also indicated that smaller firms must now carry larger amounts of liability insurance coverage.²¹³ The high deductibles for the insurance have caused many smaller firms to forego extra insurance coverage, which results in the small accounting firms paying many of the medium-sized court awards themselves.²¹⁴ The median deductible amount for smaller and medium-sized public accounting firms is currently \$240,000, an amount that is nearly six times the 1985 median amount of \$42,000.²¹⁵ Larger accounting firms are hit even harder, with deductibles exceeding \$25 million for the first loss.²¹⁶

These increases in liability insurance costs and expanded liability problems have caused CPA firms to dramatically raise service costs.²¹⁷ The increased service costs are passed on to the client and then to the consumer.²¹⁸ The courts originally assumed that accountants were an effective catalyst that would

Reason
for lack
of ins.

Cost	0%	100%
Unable to find	0	0
Low ex- posure	0	0
Had trouble finding	20%	23.5%

....
Id. at 112.

212. ANDERSEN ET AL., *supra* note 1, at 3.

213. *Id.*

214. *Id.* In addition to the smaller accounting firms having to use firm assets to pay a larger proportion of the judgments issued against them, the increased insurance costs may put a small accounting firm totally out of business. Many larger firms, particularly the Big Six, may be able to absorb or distribute an item of increased cost, but smaller firms do not have the capital base to absorb or pass on an increased cost. The outcome of expanding third-party liability in accounting cases could be to bankrupt the smaller and medium-sized firms, thus leading to a monopoly in the auditing market. Ebke, *supra* note 32, at 691.

215. ANDERSEN ET AL., *supra* note 1, at 3.

216. *Id.*

217. *The Liability Crisis in the United States: Impact on the Accounting Profession*, J. ACCT., Nov. 1992, at 19.

218. AUS Consultants, *supra* note 3, at 9.

be able to effectively spread the cost of liability.²¹⁹ However, imposing expanded liability on accountants results in a number of clients being unable to afford the higher service costs.²²⁰ Unable to pay the increased cost, many clients, especially newly established businesses, either have been unable to or will be unable to obtain audits.²²¹ Bearing in mind the necessity of audits for publicly held corporations and those companies wishing to obtain financing, this inability to pay for an audit has jeopardized business growth in the United States.²²²

Investors are skeptical to invest in an enterprise that does not have an independent audit performed.²²³ This skepticism has led to investors investing in foreign companies.²²⁴ The American economy is directly affected when businesses cannot obtain funding and support from investors.²²⁵ Additionally,

219. For courts supporting the view that accountants can spread the cost of liability through purchasing insurance, see *International Mortgage Co. v. John P. Butler Accountancy Corp.*, 223 Cal. Rptr. 218 (Cal. App. 4 Dist. 1986), *overruled by Bily v. Arthur Young & Co.*, 834 P.2d 745 (Cal. 1992); *Rosenblum v. Adler*, 461 A.2d 138 (N.J. 1983); *Rusch Factors, Inc. v. Levin*, 284 F. Supp. 85 (D.C.R.I. 1968). For an economic analysis using the Calabresi model to demonstrate why accountants should bear the loss in third-party liability cases, see Bilek, *supra* note 94, at 698.

The accountant also has a better opportunity than the third party to prevent a loss from occurring. While the accountant can detect irregularities and defalcation through the auditing process, the third party has very limited access to the corporate records. Since a third party cannot protect himself from a negligent audit, the risk of loss should be shifted from the blameless creditor or investor to the accountant, the party who can prevent the loss by performing a more thorough audit.

Hagen, *supra* note 127, at 207. Even if an audit could be conducted to provide exact results, the price of conducting such an audit would not be cost beneficial to either the accountant or the client. Crandall Interview, *supra* note 7.

But see Gossman, *supra* note 35, at 228-29. Courts have premised their notion that the accountant maintains the superior position to bear the risk of liability on the following three factors: 1) the accounting profession can best spread the risk, (2) insurance is available to accountants, 3) expanded liability has not had an adverse effect on the accounting profession. Insurance is readily available to third parties, if not more than to accountants. *Id.* The further advantage of shifting the risk to the third parties is the third parties have assumed the risk. Many of the third parties are institutional creditors and investors who have willingly accepted the risks in anticipation of gain; therefore, they should accept the losses as well. For a further discussion of why accountants are not good risk bearers, see *id.*

220. See ANDERSEN ET AL., *supra* note 1, at 4; AUS Consultants, *supra* note 3, at 1, 2, 5; Gossman, *supra* note 35, at 229-30.

221. ANDERSEN ET AL., *supra* note 1, at 5; Siliciano, *supra* note 33, at 1967. "Industry . . . cannot afford to pay more for audits because there are fewer audit firms, or have auditing services disrupted because auditors stop doing business because of liability suits that exceed insurance coverage." Bob Okell, *Against the Liability Crisis*, ACCT. TODAY, Nov. 23, 1992, at 3.

222. See ANDERSEN ET AL., *supra* note 1, at 5; AUS Consultants, *supra* note 3, at 2, 5, 9-18; see also *supra* note 204 and accompanying text.

223. See generally ANDERSEN ET AL., *supra* note 1.

224. *Id.*; see also *supra* note 204 and accompanying text.

225. See ANDERSEN ET AL., *supra* note 1, at 4; AUS Consultants, *supra* note 3, at 13, 18.

the companies themselves are placed in a financially precarious position, and many times, must curtail operations or fold.²²⁶ If this occurs, our economic growth and capital system are severely impaired.²²⁷

In addition to the market effects, expanding liability has caused CPAs to engage in an alarming number of out-of-court settlements.²²⁸ Out-of-court settlements are no longer an option for many accounting firms, but are a necessity. The costs of litigation and the high risk for loss at trial have left settlement the only alternative for accounting firms. Many accounting firms would rather settle out of court than risk losing even more at trial.²²⁹ Unfortunately, this has become the rule for accounting firms, and not the exception.²³⁰

The past two years have evidenced members of the Big Six accounting

226. *Id.* The AICPA addresses the needs of the smaller operated public accounting firms by having a Private Companies Practice Section (PCPS). The PCPS recently began a campaign to educate the public about the danger of the high legal costs associated with defending a lawsuit and the filing of meritless lawsuits and the impact on the accounting profession in general, and more specifically, on the small businesses. To broaden the numbers of those who might be informed, the PCPS had advertisements offering free educational brochures about the problem placed in several well-known newspapers and periodicals. *PCPS Joins Liability Fight*, CPA LETTER, Sept. 1993, at 2. For more information about the PCPS's efforts in this area, see *PCPS Addresses Unreasonable Liability*, PRACTICING CPA, July 1993, at 2; Gary M. Bolinger & Stanton G. Bonta, *Legislating Liability Reform*, J. ACCT., July 1993, at 56. For more information on the PCPS survey on small businesses and liability, see *Liability Costs Hurt Small Business, Says PCPS Survey*, J. ACCT., Oct. 1993, at 17, 18.

227. The Big Six currently handles the following audits: "494 of the *Fortune* 500 industrials; 97 of the *Fortune* 100 fastest growing companies; 99 of the *Fortune* 100 largest commercial banks; 92 of the top 100 defense contractors; and 195 of the 200 largest insurance companies." ANDERSEN ET AL., *supra* note 1, at 4. With statistics like this, it is easy to see how expanded liability affecting the Big Six will impact the entire national economy. *Id.*; see generally AUS Consultants, *supra* note 3. See also *supra* note 204 and accompanying text.

The effects that the frivolously filed suits against accountants will have on the United States's ability to compete internationally is evident in the statistic that 60-times more suits are filed in the United States than in Japan. A company's legal costs constitute a large portion of the budget that the company could be spending on research and upgrading. Okell, *supra* note 221, at 3.

228. See *supra* part I and accompanying notes; see also *supra* note 7 (chart).

229. *Standard Chartered PLC v. Price Waterhouse*, No. 88-34414 (Ariz. Super. Ct., Maricopa Co. 1992); *U.S. Nat'l Bank v. Miniscribe Corp.*, No. 89-CV-1031-A (Tex. Dist. Ct., Galveston Co. 1992).

230. *Id.* "In 1991, total expenditures for settling and defending lawsuits were \$477 million-nine percent of auditing and accounting revenues in the United States." ANDERSEN ET AL., *supra* note 1, at 2-3. This figure does not include indirect costs, but only covers costs of legal services, settlements and judgments, and liability insurance premiums minus insurance reimbursements. The figure is up from 1990 when the figure was 7.7% of audit and accounting revenues. Reports as of June 30, 1992, do not indicate a decline in the increased costs. *Id.*

firms²³¹ paying huge settlement fees to avoid litigation.²³² In June, 1991, Coopers & Lybrand was sued for failing to detect a client's shaky financial condition.²³³ As a result, Coopers agreed to pay the FDIC a total sum of \$20 million over a three year period.²³⁴ In another 1991 case, Ernst & Young settled a case involving Resolution Trust Corporation for \$40 million.²³⁵ The year 1993 also saw several major out-of-court settlements.²³⁶ One recent major settlement involved the Lincoln Savings & Loan scandal, which produced an onslaught of suits against members of the Big Six.²³⁷ Thus far, Deloitte and Touche has paid \$7.5 million, Arthur Andersen has paid \$22 million, and Ernst & Young has paid the record sum of \$400 million in settlements involving the Lincoln scandal.²³⁸

Although the Big Six and their connection with expanded liability is highly

231. The Big Six is composed of the six largest public accounting firms in the United States: Arthur Andersen & Co., Coopers & Lybrand, Deloitte & Touche, Ernst & Young, KPMG Peat Marwick, and Price Waterhouse. ANDERSEN ET AL., *supra* note 1, at 1-2.

232. ANDERSEN ET AL., *supra* note 1, at 2; Domenici, *supra* note 2, at 1; *Standard Chartered PLC*, No. 88-34414; *Miniscribe*, No. 89-CV-1031-A.

233. Woolley & Schiller, *supra* note 3, at 32.

234. *Id.*

235. For a discussion about out-of-court settlements, see Rick Telberg, *E&Y Wins a Round in Lincoln S&L Failure*, ACCT. TODAY, July 22, 1991, at 2.

236. See generally *supra* notes 5-27 and accompanying text; Geoghan, *supra* note 5.

237. See generally Cushman, *supra* note 3; Schmidt, *supra* note 3; Pickering, *infra* note 238; Abraham Briloff, *Accountants' Bottom Line: Home Free*, NEWSDAY, Jan. 5, 1993, at 69.

238. John Pickering, *D&T Settles Lincoln Case for \$7.5 Million*, ACCT. TODAY, July 6, 1992, at 5. The Ernst & Young settlement is a global settlement that will relieve E&Y of any all liability surrounding the S&L scandal. Most of the charges against E&Y were related to the following failed savings and loans: the Vernon Savings Association of Dallas, the Silverado Banking, the Savings and Loan Association of Denver, the Western Savings Association of Phoenix, and the Lincoln Savings and Loan Association of California. Cushman, *supra* note 3, at A1. Three hundred million dollars of E&Y's settlement will be covered by the firm's various insurers with the remaining \$100 million to be financed from revenue generated over the next four years. Schmidt, *supra* note 3, at A1.

Deloitte & Touche has recently attempted to settle with the Resolution Trust Corporation (RTC) for its involvement in various failed Savings & Loan institutions. However, settlement talks broke down before Deloitte was able to reach a global settlement, much like the Ernst & Young \$400 million dollar settlement. For a good explanation of the some of the cases that RTC has filed against Deloitte & Touche, see Ken Rankin, *The RTC vs. Deloitte: Failed S&Ls, Disputed Audits*, ACCT. TODAY, July 19, 1993, at 10. The suits that RTC has filed against Deloitte & Touche (formally Deloitte Haskins & Sells) as a result of the breakdown in the settlement talks amount to over \$1 billion in damages. For more information on the case breakdown, which when added together equal \$1 billion dollars in damages, see Ken Rankin, *RTC Hits Deloitte for \$1B in Suits*, ACCT. TODAY, July 5, 1993, at 1, 37.

Arthur Andersen recently made an eight-figure settlement with the Resolution Trust Corporation (RTC) absolving its firm from all professional liability charges made by the RTC. For more information about Andersen's involvement with various savings and loans and the settlement reached with the RTC, see Ken Rankin, *Feds Absolve Andersen of S&L Liability—For a Price*, ACCT. TODAY, Aug. 23, 1993, at 2.

publicized, medium-sized and small firms are also suffering the same plight as the Big Six.²³⁹ Laventhol & Horwath, the seventh-largest accounting firm in the United States, declared bankruptcy in 1990.²⁴⁰ A former CEO of the firm indicated that the cost of winning, not the cost of losing, cases cost them their firm.²⁴¹ The demise of the seventh-largest accounting firm in the country caused many other accounting firms to stand up and take notice of the seriousness of the situation.²⁴²

B. Accounting Firms React To Increased Liability

Realizing that their internal controls and long-established procedures are not affording them protection, CPAs are now seeking alternative protection.²⁴³

239. See *Lochner*, *supra* note 10, at 105.

240. ANDERSEN ET AL., *supra* note 1, at 3.

241. *Id.*

242. *Id.*

243. Siliciano, *supra* note 33, at 1963-67; ANDERSEN ET AL., *supra* note 1, at 4-7; *BDO Forges New Legal Weapon*, ACCT. TODAY, Dec. 7, 1992, at 8; *C&L Countersues 5 Phar-Mor Execs for Fraud*, ACCT. TODAY, Sept. 21, 1991, at 2. CPAs are taking other self-protectionist measures to limit their liability. One measure CPAs are taking is to drop a client at the first hint of potential liability problems. Ernst & Young declined to bid again for International Telecharge's audit. Ernst claimed that International's increase in net losses and the recently filed suits against the company caused Ernst to be concerned with a potential liability issue. *E&Y Drops Out as Auditor for Dallas Client*, ACCT. TODAY, Nov. 9, 1992, at 20. Schumacher & Associates, Inc., also recently withdrew its engagement as auditor for Universal Capital Corp. Schumacher voiced a concern over the company's ability to generate reliable information in its financial statements. *Schumacher Drops Universal Capital as Client*, ACCT. TODAY, Nov. 9, 1992, at 20. Deloitte & Touche recently resigned as the independent accountant for Advanced NMR Systems. Deloitte had pressured Advanced to investigate certain transactions involving company stock, and after much discussion, Advanced complied. However, Deloitte added several paragraphs to its report detailing the uncertainty of the company's ability to market its product. *Deloitte Resigns, Demands Probe*, ACCT. TODAY, Nov. 9, 1992, at 20. CPAs are also using clear engagement letters and careful client screening techniques to reduce their liability. Mark F. Murray, *Litigation: When a Client is a Liability*, J. ACCT., Sept. 1992, at 54. Unfortunately, the accountant liability crisis may have reached a new low. Fearing the chance of being the only defendant left to pay damages, CPAs are now engaged in suing each other regarding allegedly performed audits. Deloitte recently sued Price Waterhouse and Ernst & Young for \$8 billion in connection with their audits of Bank of Credit and Commerce International. John Pickering, *Price Slammed Over BCCI*, ACCT. TODAY, Oct. 19, 1992, at 1.

For an explanation of internal auditing, see WIXON ET AL., *supra* note 1, at 1-5 to -6. For an in-depth article on the role of internal audit committees, see Braiotta, *supra* note 60, at 76. The internal audit committee, although its effectiveness is currently questioned, is one resource that independent outside auditors can use to help reduce their potential liability when auditing a company. *Auditing Audit Committees: An Education Opportunity for Auditors*, J. ACCT., June 1992, at 112. The audit committee was recently identified by the National Commission on Fraudulent Financial Reporting as "an essential part of any system designed to prevent fraudulent financial reporting" *Id.* "The audit committee, with its constant access to the internal auditor and other corporate personnel, often is the first nonmanagement group to catch a whiff of irregularity. And if it does,

One protective measure in which CPAs are now engaging is a careful process of screening clients, which includes learning to identify certain characteristics in prospective clients that indicate potential liability problems.²⁴⁴ An additional protective measure is to compose a clear and specific engagement letter,²⁴⁵ one that clearly informs the client as to the services the CPA will perform, the procedure that will be implemented, and the limitations on those services.²⁴⁶

it can direct the external auditor to scrutinize the problem, thereby forestalling a faulty audit." *Id.*

A crucial problem currently existing with most internal audit committees is their lack of independence.

One likely reason for the lack of attention to independence is the flexibility of New York Stock Exchange rules for large, publicly held corporations' audit committee appointments. Even persons with obvious conflicts of interest, including a corporation's consultants, significant vendors, major lenders and investment bankers as well as partners of the law firms representing it, can serve on or even chair its audit committee.

Curtis C. Verschoor, *Auditing: Benchmarking the Audit Committee*, J. ACCT., Sept. 1993, at 59. Although an obvious leniency exists in not assuring total independence of the corporate internal auditing committee's members, the banking industry has recently been hit with FDICIA requirements that "all insured depository institutions with assets of more than \$500 million have an independent audit committee." *Id.* For more information about recent changes required by the FDICIA and American Law Institute's (ALI) recommendations for audit committees, see *id.*

244. Murray, *supra* note 243, at 54-55. The article lists the following potential liability characteristics of a client:

- 1 — A company that has present or pending financial or organizational difficulty. Specific warnings are "[i]nsufficient working capital, an industry experiencing many business failures, a company with high turnover in key positions[,] . . . management responsibilities vested in one person when they should be shared by several[,] . . . poor credit, dependence on a few customers for products or services and companies that invest other people's money."
- 2 — A client's involvement in suspicious transactions.
- 3 — A client's unreasonableness or uncooperativeness.
- 4 — Other problem characteristics include: "[b]laming the accountant for the company's financial problems[,] . . . [u]nfavorable tax laws and rulings that affect the company as well as other circumstances beyond the accountant's control[,] . . . vague, guarded responses to inquiries[,] . . . [t]hreats to take the company's business elsewhere[,] . . . [r]equests for changes in the engagement[,] . . . [f]ee pressures[,] . . . [r]efusal to sign engagement and representation letters[,] . . . [d]emand for risky services[,] . . . [and] [i]ncompatible personality."

Id.

Certain characteristics are more obvious, such as: "[s]eeking an auditor toward yearend[,] . . . [w]eakness in or absence of internal controls[,] . . . [l]ack of organization[,] . . . [p]oorly maintained records and collection difficulties[,] . . . [f]ailure to file income tax returns for several years[,] . . . [and] [f]requent involvement in litigation." *Id.* at 55.

245. Murray, *supra* note 243, at 55. One consideration that many public accounting firms should investigate is adding a binding arbitration clause to their engagement letter. While not limiting liability in public accounting cases, it is one way in which public accountants can reduce litigation costs.

246. *Accountants Not Liable to Investors in Company*, *supra* note 167, at 16.

An effective client screening process is now imperative prior to a CPA accepting a new client.²⁴⁷ Although CPAs attempt to limit their liability by drafting “air-tight” engagement letters and other documentation before, during, and after an audit, courts are still reluctant to enforce the documents as valid, binding contracts between the contracting parties.²⁴⁸ To improve the screening process, CPAs have identified several types of businesses that are potential liability traps,²⁴⁹ including high-tech industries and new businesses.²⁵⁰ Unfortunately, it is these same businesses that need the auditing services the most to continue operations or to obtain investors.²⁵¹ The unavailability of auditing services or other professional financial services has caused investors to look for new investment opportunities in more secure enterprises, and this in turn has affected the potential growth of our economy.²⁵²

247. Murray, *supra* note 243, at 55. The following procedures are guidelines for accountants to use in the client screening process:

1. If the client approaches the practitioner, ask why the client is changing accountants.
2. Visit the potential client's business to determine the condition of its management, finances and internal controls. Some practitioners require an analysis of all new client's internal controls.
3. Meet a prospect's accounting and tax personnel to determine financial needs and the condition of accounting records.
4. Check all potential clients' references to determine their reputation for honesty, credit history and rating, financial stability, cooperativeness and litigation history, possible conflicts of interest, management quality, personnel competency, personality and potential to be sources of new clients.
5. Be aware of high-risk industries. Those in which CPAs are especially vulnerable to litigation include savings and loans, health care, property and casualty insurance and not-for-profit organizations. . . .
6. After receiving necessary client authorization, contact the prospect's former accountant, current attorney, bankers, credit bureaus and current and former business associates and employees. Inquiries to the Better Business Bureau, the Chamber of Commerce or trade associations can be especially productive. CPAs should document all communications.

Id. at 55.

248. *See supra* note 174 (chart).

249. AUS Consultants, *supra* note 3, at 13-18; Murray, *supra* note 243, at 54.

250. Murray, *supra* note 243, at 54.

251. *See* AUS Consultants, *supra* note 3, at 13-14.

252. Lochner, *supra* note 10, at 105. An additional protective step that CPAs are now finding necessary to take in order to protect themselves against fraudulently filed suits includes countersuing the plaintiff. One CPA firm has taken an independent stand and has countersued a plaintiff. This case involves Phar-Mor drug chain shareholders who filed suit under RICO against Coopers Lybrand for not discovering fraud by Phar-Mor executives. The Phar-Mor executives allegedly embezzled company funds and then reported them as nonexistent profits. *See generally* Woolley & Schiller, *supra* note 3. Coopers' engagement letter had warned the client that “attempts at concealment through collusion and forgery” might prevent the detection of fraud. *C&L Countersues 5 Phar-Mor Execs for Fraud*, *supra* note 243, at 2. Countersuing appears to be a way that CPA firms can turn the tables on the plaintiff in order to protect themselves. *Id.* The country's tenth-largest public accounting firm, BDO Seidman, appears to have also taken the counter-offensive and recently

Some CPAs have found it necessary to combat the imposition of expanded liability by engaging in risk reduction practices, which include limiting or foregoing their audit practices altogether.²⁵³ Other accounting firms have retained their auditing service, but are now "going bare" and not obtaining liability insurance.²⁵⁴ A recent AICPA survey indicated that forty percent of accounting firms surveyed are not seeking insurance coverage due to the unmanageable cost.²⁵⁵

In summary, the courts' refusal to apply a consistent uniform liability standard in public accounting cases has caused unavailability and increases in liability insurance, which has resulted in CPAs taking self-protection measures that hurt consumers and the economy.²⁵⁶

received the first settlement in a countersuit against its client for fraud. The settlement ends a 14-year-old counterclaim against BDO's client, Cenco, Inc. *BDO Forges New Legal Weapon*, *supra* note 243, at 8.

253. *Long-awaited Liability Reforms Bill Introduced*, *supra* note 4, at 3.

254. *Id.*

255. *Id.*

256. The Big Six have also decided to take note of the issue of CPA professional legal liability and have written a Statement of Position. The Statement of Position outlines the current professional liability problem affecting CPAs, the Big Six's position, and proposed action regarding the problem. ANDERSEN ET AL., *supra* note 1, at 1. The AICPA has also urged reform in this area, and has written a resolution regarding legal liability. *AICPA Board Urges Tort Reform, Endorses Large-Firm Position Paper*, CPA LETTER, Oct. 1992, at 1. Accounting firms, however, are taking an aggressive stance at the state and federal level by proposing legislation that would curb the tide of expanding liability in public accounting suits. Currently a few states have adopted laws that limit liability suits against CPAs. The law in Illinois "eliminates joint liability in negligence cases where the CPA is found to be less than twenty-five percent responsible for the total damage suffered by a plaintiff, and bars any recovery by a plaintiff who is more than fifty percent responsible for the total damages." *Survey Shows Extent of Members' Concern Over Legal Liability*, CPA LETTER, July-Aug. 1992, at 1. Governor Jim Edgar signed Illinois Senate Bill 2119 in September, 1992. Patterson, *supra* note 19, at 3. More legislative work is being done at the federal level than at the state level. Proposed federal legislation is currently pending which would involve limiting CPA liability in SEC 10b-5 suits and would apply proportionate liability when assessing damages. *Long-awaited Liability Reforms Bill Introduced*, *supra* note 4, at 3. The federal legislation is supported by the Big Six lobbying group, Coalition to Eliminate Abusive Securities Suits, the AICPA, and investment brokers, who tend to be named as co-defendants in security suits. *Pickering*, *supra* note 2, at 2. The AICPA surveyed 5000 accounting firms, including sole practitioners, but not including large firms. The survey received 1700 responses which indicated the following responses:

47% of respondents believe that their firms' exposure to legal liability has increased over the past five years, and 54% feel that their firms' exposure will increase over the next five years. 74% of accounting firms believe that Congress or state legislatures should act to impose reasonable limitations on accountants' legal liability.

Survey Shows Extent of Members' Concern Over Legal Liability, *supra*, at 1. For a more complete discussion, see *Litigation Reform Bills Introduced; Drive for Passage Builds*, J. ACCT., Nov. 1992, at 26; *AICPA Board Endorsement*, J. ACCT., Nov. 1992, at 18. For more information regarding the proposed federal legislation, see generally Domenici, *supra* note 2; Sanford, *supra* note 2. For a summary of the proposed legislation, see *News Report*, J. ACCT., Nov. 1992, at 25.

VI. THE COURTS REACT TO THE PROBLEMS OF EXPANDING ACCOUNTANTS' LIABILITY

Various state and federal courts have recently begun to recognize how unjust and unrealistic many court decisions have been that have expanded accountants' liability in public accounting suits.²⁵⁷ In 1992, several states issued landmark decisions limiting the liability of accountants for the services they perform. Three states, California, Texas, and New York, are among the states that have recently ruled in favor of accountants.²⁵⁸

A. Privity Affirmed

One New York case, *Security Pacific Business Credit, Inc. v. Peat Marwick Main & Co.*,²⁵⁹ reaffirmed the New York courts' application of the near privity rule. The court rejected a broader standard that would hold accountants liable to third parties who merely alleged that they relied on the accountants' prepared financial statements.²⁶⁰ This ruling impacts all states following the New York courts' application of the near privity rule,²⁶¹ and will have a persuasive effect on those courts that still permit unlimited accountant liability.

In *Security Pacific*, an institutional lender, Security Pacific Business Credit, Inc. (SPBC), sued the defendant, Peat Marwick Main & Co., for allegedly

257. *E.g.*, *Bily v. Arthur Young & Co.*, 834 P.2d 745 (Cal. 1992); *McGonigle v. Combs*, 968 F.2d 810 (9th Cir. 1992), *cert. dismissed*, 113 S. Ct. 399 (1992); *Federal Deposit Ins. Corp. v. Ernst & Young*, 967 F.2d 166 (5th Cir. 1992). A Maryland appeals court recently held that a client was barred from recovering against an accountant who failed to discover embezzlement because of the client's contributory negligence in failing to take appropriate steps to prevent the embezzlement. *Wegad*, an accountant, was hired by Howard Street Jewelers. Mr. Wegad was to compile financial statements and specifically issued an engagement letter disclaiming any duty to disclose fraud or other irregularities. Although outside of his scope of employment, Wegad informed Howard Street after cash shortages were discovered. Despite Wegad's limited duties as set forth in the engagement letter, Howard Street sued him for failing to detect the embezzlement. In ruling for Wegad, the court of appeals stated that "we do not believe that an accountant's negligent failure to report shortages completely insulates the client who consistently leaves the company's cash unattended and fully accessible to all employees and customers." *Gilbert v. Howard Street Jewelers, Inc.*, 605 A.2d 123, 128 (Md. 1993), *cited in Client's Negligence Absolves Accountant's Negligence*, J. ACCT., March 1993, at 21.

258. *SEC v. Price Waterhouse*, 797 F. Supp. 1217 (S.D.N.Y. 1992); *Federal Deposit Ins. Corp. v. Ernst & Young*, 967 F.2d 166 (5th Cir. 1992); *Security Pac. Business Credit, Inc. v. Peat Marwick Main & Co.*, 597 N.E.2d 1080 (N.Y. 1992).

259. 597 N.E.2d 1080 (N.Y. 1992).

260. *Id.* at 1085-87. *See also AICPA Brief Aids New York Court in Reaffirming Favorable Ruling*, CPA LETTER, Sept. 1992, at 3.

261. *See supra* note 174 (chart).

negligently performing an audit for Top Brass Enterprises, Inc. (Top Brass).²⁶² SPBC allegedly relied on Peat Marwick's unqualified audit opinion and financial statements when deciding to loan Top Brass forty million dollars on a fifty million dollar line of credit.²⁶³ SPBC allegedly relied on the opinion based on a ten-minute telephone call that it made to Peat Marwick's audit partner in order to discuss Top Brass's audit report.²⁶⁴

The *Security Pacific* court affirmed New York's near privity rule by reaffirming *Credit Alliance* and the requirement for an existing relationship between the accountant and the third party that "sufficiently approaches privity."²⁶⁵ The *Security Pacific* court held that SPBC did not establish a relationship between itself and Peat Marwick that sufficiently approached privity.²⁶⁶ The *Security Pacific* court reasoned that SPBC's reliance on a ten-minute telephone call did not establish a sufficient privity relationship because SPBC's inquiries during the call were "limited to generalities that nothing untoward had been uncovered in the course of the audit and that an unqualified opinion would issue, certifying the tentative draft which plaintiff had received from Top Brass itself."²⁶⁷ The court further stated that a non-client cannot impose negligence liability on an accountant by alleging reliance on the audit report.²⁶⁸

The *Security Pacific* court also recognized an absence of sufficient conduct to establish a relationship between SPBC and Peat Marwick.²⁶⁹ In addition, the court stressed the observations made by the *Credit Alliance* court that "if a lender can secure possible loan recourse against a borrower's auditor by the simple act of calling the auditor before advancing a loan and announcing reliance on the auditor's opinion, then every lender's due diligence list will in the future mandate such a telephone call."²⁷⁰ Additionally, the *Security Pacific* court recognized the absence of any evidence showing that Peat Marwick performed the audit opinion for a specific purpose, other than the SEC's requirement for

262. *Security Pac.*, 597 N.E.2d at 1080. *Security Pacific* claimed that Peat Marwick's unqualified opinion overstated Top Brass's accounts receivables and merchandise inventory. *Id.*

263. *Security Pac. Business Credit, Inc. v. Peat Marwick Main & Co.*, 597 N.E.2d 1080 (N.Y. 1992).

264. *Id.* at 1082.

265. *Id.* at 1083.

266. *Id.*

267. *Security Pac. Business Credit, Inc. v. Peat Marwick Main & Co.*, 597 N.E.2d 1080, 1085 (N.Y. 1992)

268. *Id.*

269. *Id.*

270. *Id.* at 1085-86.

publicly held companies to file audits.²⁷¹

The New York court's holding was a reaffirmation of its reliance on the near privity rule and its reluctance to extend accountants' liability in suits that fall short of the privity requirements.²⁷² This case also demonstrates the New York court's careful policy considerations when applying a narrow definition of duty to non-contractual parties.

B. The Restatement Approach Narrowed Further

Although some courts have demonstrated a willingness to adopt the privity rule, other courts are not willing to limit accountants' liability to the narrow privity rule.²⁷³ However, a number of courts, recognizing the need for limited third-party liability in accountant suits, have narrowed their application of the *Restatement* standard. Three recent court decisions in Texas, California, and North Carolina have applied a narrow application of the *Restatement* standard.²⁷⁴

In 1992, Texas affirmed its application of the *Restatement* standard in *Federal Deposit Insurance Corporation (FDIC) v. Ernst & Young*.²⁷⁵ In this case, Woods, as the sole owner of Western Capital Corporation (Western),

271. *Security Pac. Business Credit, Inc. v. Peat Marwick Main & Co.*, 597 N.E.2d 1080, 1085-96 (N.Y. 1992).

272. For an explanation of the recent New York case, *Merchant Factors Corp. v. Wolfson, Kapit, Melzer, Milowsky, Etinger and Wieseltheir* (unreported decision; no citation available), in which a New York court found privity existed in a public accountant case, see *New York Court Finds Privity Exists in Accountant's Case*, J. ACCT., Nov. 1993, at 22. A New York state supreme court recently ended a 15-year legal battle by finding Coopers & Lybrand innocent of charges brought against them by Teachers' Insurance & Annuity Association. After Coopers won the \$28 million lawsuit, Coopers' general counsel stated, "This sends a message that sophisticated investors and lenders who lose money in bad investments can't expect to recover their losses by suing innocent accounting firms." *Coopers & Lybrand Wins \$28 Million Lawsuit*, ACCT. TODAY, March 15, 1993, at 4.

273. Kansas recently upheld its strict privity statute in *Gillespie v. Seymour*. 796 P.2d 1060 (Kan. 1990), *rev'd in part, aff'd in part*, 823 P.2d 782 (Kan. 1991). In *Gillespie*, trust beneficiaries sued a trustee for investing trust funds in a company controlled by the trustee's son and husband. The trust beneficiaries also sued the accountant for the company, alleging negligence and breach of duty. The court dismissed the action against the accountant because of a lack of privity between the trust beneficiaries and the accountant. The law, however, does not affect third-party beneficiaries' rights to sue for breach of trust. *Kansas Upholds Strict Privity Statute*, J. ACCT., March 1991, at 27.

274. See, e.g., *Federal Deposit Ins. Corp. v. Ernst & Young*, 967 F.2d 166 (5th Cir. 1992); *Bily v. Arthur Young & Co.*, 834 P.2d 745 (Cal. 1992); *Venturtech II v. Deloitte Haskins & Sells*, 790 F. Supp. 576 (E.D.N.C. 1992). All of these cases are discussed at *infra* notes 275-312 and accompanying text.

275. *Federal Deposit Ins.*, 967 F.2d at 166.

pursued complex commercial ventures that were based on unsound underwriting practices.²⁷⁶ After Woods violated numerous Bank Board regulations, thereby receiving a Cease and Desist Order, he hired Arthur Young (now Ernst and Young) to conduct independent audits.²⁷⁷ The audits set Western's net worth at \$41 million, when in reality, Western was insolvent by \$100 million.²⁷⁸ The FDIC sued, alleging that Woods had made false entries on Western's books to defraud depositors and creditors.²⁷⁹

The district court held that neither Woods nor Western relied on the audit prepared by Arthur Young; therefore, Arthur Young was not liable for Woods' falsification of the business record.²⁸⁰ The Fifth Circuit Court of Appeals affirmed based on the district court's reasoning.²⁸¹ Additionally, the appeals court rejected Western's argument that Arthur Young's negligently prepared audit caused the losses, because if the audits had been accurate, a government regulator or Western's creditor could have saved Western.²⁸² The appeals court reasoned that the argument was inappropriate because Western could not argue that a third party would have rescued it for something that it was aware of and chose to ignore.²⁸³

Although the court's holding in *Federal Deposit Insurance Corp. v. Ernst & Young* was in favor of the accounting firm, the court warned that the holding is narrowly applied to the facts of this case.²⁸⁴ The outcome of *Federal Deposit* was dependent upon the plaintiff's misfortune of improperly bringing suit as the company's assignee. The accounting profession should not broadly interpret this holding and should scrutinize a case's facts before relying on this ruling.²⁸⁵ Arthur Young was sued for professional negligence in this case, and the decision did not exonerate Arthur Young for failing to uncover the fraud. Suits similar to this, in which the client's internal management and officers have intentionally committed fraud against the company and the CPA firm has failed to uncover the fraud, are common. Courts have only recently begun to

276. *Id.* at 168.

277. *Id.*; see also *supra* notes 89-90 and accompanying text.

278. *Federal Deposit Ins. Corp. v. Ernst & Young*, 967 F.2d 166, 168 (5th Cir. 1992).

279. *Id.* at 169. Wood's intentional false entries caused Western's net worth to be understated. The FDIC sued as Western's assignee; therefore the suit was brought by its client against its auditor. *Id.* The FDIC, bringing suit as Western's assignee, did not have a cause of action because Western did not have a cause of action. *Id.* at 171.

280. *Federal Deposit*, 967 F.2d at 172.

281. *Id.* at 170-71.

282. *Federal Deposit Ins. Corp. v. Ernst & Young*, 967 F.2d 166, 171 (5th Cir. 1992).

283. *Id.* at 171.

284. *Id.* at 172.

285. For an opposite opinion regarding *Federal Deposit's* holding, see *Judge Nixes FDIC Suit Against E&Y*, ACCT. TODAY, Oct. 21, 1991, at 1.

recognize reasonable limits on CPAs' abilities to uncover internal fraud.²⁸⁶

In addition to narrowly applying the *Restatement* standard in negligent misrepresentation cases, a recent landmark California case reversed that state's approach to extending accountants' liability in professional negligence cases.²⁸⁷ In *Bily v. Arthur Young & Company*, investors in the Osborne Company brought suit against Arthur Young alleging fraud, negligent misrepresentation, and professional negligence.²⁸⁸ The *Bily* court held that an auditor owes no general duty of care to non-clients.²⁸⁹ However, auditors may be liable for negligent misrepresentations in audit reports to persons who act in reliance on those misrepresentations in a transaction that the auditor intended to influence.²⁹⁰ The *Bily* court discussed the vagueness of New York's privity approach²⁹¹ and the foreseeability standard, and dismissed both as not furthering California's policy objectives.²⁹² The *Bily* court ruled that not all foreseeable third-party users of audit reports will be permitted to sue the auditor on a theory of professional negligence.²⁹³

The *Bily* court premised its reasoning on three concerns:

(1) Given the secondary "watchdog" role of the auditor, the complexity of the professional opinions rendered in audit reports, and the difficult and potentially tenuous causal relationships between audit reports and economic losses from investment and credit decisions, the auditor exposed to negligence claims from all foreseeable third parties faces potential liability far out of proportion to its fault;

(2) The generally more sophisticated class of plaintiffs in auditor liability cases (e.g., business lenders and investors) permits the

286. *Federal Deposit Ins. Corp. v. Ernst & Young*, 967 F.2d 166 (5th Cir. 1992). The financial statements are controlled by a company's management, and CPAs only render an opinion on management's accounts and records. Not all fraud is detectible. For a further discussion, see *supra* notes 36, 39, 40 and accompanying text.

287. *Bily v. Arthur Young & Co.*, 834 P.2d 745 (Cal. 1992); see *International Mortgage Co. v. John P. Butler Accountancy Corp.*, 223 Cal.Rptr. 218, 227 (Cal. App. 4 Dist. 1986), *overruled by Bily*, 834 P.2d at 745. By rejecting the *Ultramares* standard and adopting the *Restatement*, the *International* court broadened California's negligence law regarding an accountant's liability to third parties. The court held that "an independent auditor owes a duty of care to reasonably foreseeable plaintiffs who rely on negligently prepared and issued unqualified audited financial statements." *International Mortgage*, 223 Cal. Rptr. at 218.

288. *Bily*, 834 P.2d at 745-49.

289. *Id.* at 767.

290. *Id.* at 768.

291. *Bily v. Arthur Young & Co.*, 834 P.2d 745, 753-55 (Cal. 1992).

292. *Id.* at 757.

293. *Id.* at 766-68.

effective use of contract rather than tort liability to control and adjust the relevant risks through "private ordering"; and

(3) The asserted advantages of more accurate auditing and more efficient loss spreading relied upon by those who advocate a pure foreseeability approach are unlikely to occur; indeed, dislocations of resources, including increased expense and decreased availability of auditing services in some sectors of the economy, are more probable consequences of expanded liability.²⁹⁴

The *Bily* court further stated that auditors are only watchdogs and not bloodhounds.²⁹⁵ In recognizing the economic and commercial reality that audits are performed in a "client-controlled environment," the court gave adequate consideration to the fact that the auditor may not have been aware of the existence of a third-party transaction that caused the claim.²⁹⁶ The *Bily* holding reinstates the *Restatement* standard and applies the privity requirement to actions asserting a general duty of care owed by the accountant.²⁹⁷ The *Bily* court narrowly applies the *Restatement* standard and holds that liability only attaches when an auditor receives notice that a specific third party would be given a copy of the audit.²⁹⁸ The California court's approach is novel, and the *Bily* court's discussion of limiting the application of the *Restatement* standard and the necessity of requiring strict privity to hold an accountant liable for a general duty of care should be seriously considered as a reasonable balance of the rights of accountants and their clients.²⁹⁹

294. *Id.* at 762.

295. *Bily v. Arthur Young & Co.*, 834 P.2d 745, 762 (Cal. 1992).

296. *Id.*

297. *Id.* at 774.

298. *Accountants Not Liable to Investors in Company*, LAW ALERT, Oct. 12, 1992, at 17.

299. *Bily v. Arthur Young & Co.*, 834 P.2d 745 (Cal. 1992). In addition to the *Bily* court's holding regarding general duty of care and negligence, the court also held that an auditor may be liable to reasonably foreseeable third parties for intentional fraud in the preparation and dissemination of an audit. *Id.* at 747. A 1993 California Court of Appeals decision has ruled that the application of the *Bily* case is retroactive. *Industrial Indemnity v. Touche Ross & Co.*, 17 Cal. Rptr.2d 29 (Cal. Ct. App. 1993). In *Industrial Indemnity*, the California court restated the *Bily* holding that an auditor's liability for general negligence regarding an audit of a client's financial statements was limited to "the client[,] i.e., the person who contracts for or engages the audit services." *Id.* at 33. After applying *Bily*, the *Industrial* court found that no evidence existed that the plaintiffs had engaged or contracted for Touche's audit service. *Id.* The *Industrial Indemnity* opinion not only establishes that *Bily* has retroactive effect on California cases, but in addition, it gives an excellent summary of the *Bily* decision and its applicability.

Another 1993 case was recently decided in favor of public accountants. In *Brown v. KPMG Peat Marwick*, 856 S.W.2d 742 (Tex. Ct. App. 1993), the court affirmed the trial court's summary judgment ruling in favor of KPMG Peat Marwick, public accountants, and held that the discovery "rule does not toll limitations in a suit filed against an auditor by a non-client who charges negligence in the performance of an audit." *Id.* at 749. In reaching its decision, the *Brown* court

Another court, the United States District Court for the Eastern Division of North Carolina, recently applied a strict interpretation of the *Restatement* standard and granted summary judgment in favor of an accounting firm, Deloitte Haskins & Sells.³⁰⁰ In *Venturtech II v. Deloitte Haskins & Sells*, three venture capital firms invested in a company called Learning Resources, Inc. (LRI).³⁰¹ LRI created and marketed educational audiovisual tapes.³⁰² Needing additional capital, LRI convinced several other venture capitalist firms to invest in its operations.³⁰³ After continuously contributing increasingly more capital to LRI, the venture capitalist firms refused to invest any further in 1988, and LRI's remaining assets were sold.³⁰⁴

In an attempt to recoup its investment losses, the venture capitalists sued Deloitte Haskins & Sells (DH&S), alleging LRI's 1982 through 1986 financial statements contained material misrepresentations.³⁰⁵ In determining whether plaintiffs were intended third-party beneficiaries of the LRI-Deloitte audit engagement, the court looked at the circumstances surrounding Deloitte's accounting services, as a written contract between LRI and Deloitte was non-existent.³⁰⁶ The court found that general factors such as "the primary purpose of an audit, the usual reliance of investors on audited financial statements, DH&S's status as an international accounting firm, and the application of national standards" was "too generic to support a finding that LRI and DH&S intended these plaintiffs to benefit from their contract."³⁰⁷ In reference to its findings, the court stated, "A finding to the contrary would make every venture capital investor an intended beneficiary of every auditing engagement between an accounting firm and its client. It is to prevent such expansive liability from attaching solely on the basis of generalities that strict construction against the party seeking enforcement is required."³⁰⁸ The *Venturtech* court found, with the exception of the 1982 financial report, that no evidence existed showing that Deloitte knew that the venture capitalist investors would use its financial statements.³⁰⁹ Based on its evidentiary findings, the *Venturtech* court held that the plaintiffs were not intended third-party beneficiaries of Deloitte's and LRI's

applied the *Restatement* standard and used the *Bily* and *Ultramares* decisions as support for its findings. *Id.* at 747-49.

300. *Venturtech II v. Deloitte Haskins & Sells*, 790 F. Supp. 576 (E.D.N.C. 1992).

301. *Id.* at 580.

302. *Id.*

303. *Id.*

304. *Venturtech II v. Deloitte Haskins & Sells*, 790 F. Supp. 576, 580 (E.D.N.C. 1992).

305. *Id.* at 579.

306. *Id.* at 582.

307. *Id.* at 583.

308. *Venturtech II v. Deloitte Haskins & Sells*, 790 F. Supp. 576, 583 (E.D.N.C. 1992).

309. *Id.* at 583.

audit engagement.³¹⁰

After applying the *Restatement* standard, the *Venturtech* court also concluded that Deloitte's knowledge that venture capitalists invested in LRI in the past, and that those investors generally rely on financial statements, was insufficient to establish that Deloitte owed a duty to the investors and held that the investors could not state a claim for negligent misrepresentation.³¹¹ The *Venturtech* court also granted Deloitte summary judgment on the claims of common law fraud, breach of fiduciary duty, and state securities law violations.³¹²

In addition to courts narrowly applying the *Restatement* standard, public accountants may now receive liability protection under some states' application of contributory negligence.³¹³ After its employee admitted to embezzlement, Howard Street Jewelers sued its CPA, Mr. Wegad, for professional malpractice.³¹⁴ Although Wegad's engagement letter specifically limited the scope of service he was to provide Howard Street Jewelers, Wegad did inform Howard Street when he discovered that someone was stealing from the business.³¹⁵ In deciding whether defective jury instructions were given on contributory negligence, the Maryland Court of Appeals reiterated that a defense for contributory negligence is based on "whether the plaintiff took appropriate precautions to protect his own interests."³¹⁶ The court further stated, "The client . . . should not be permitted an absolute and unqualified right to rely on the accountant's advice and thereby be completely insulated from responsibility for his or her own shortcomings."³¹⁷

In deciding whether a client was contributorily negligent, the Maryland court applied the *Restatement (Second) of Torts* section 552A, which provides, "The recipient of a negligent misrepresentation is barred from recovery for pecuniary loss suffered in reliance upon it if he is negligent in so relying."³¹⁸ The Maryland court found that Howard Street admitted that an accountant may

310. *Id.*

311. *Id.* at 585.

312. *Id.* at 587-89.

313. *Wegad v. Howard Street Jewelers*, 605 A.2d 123 (Md. 1992).

314. *Id.* at 125.

315. Mr. Wegad's annual engagement letter to Howard Street stated that Wegad's services "did not include an audit and would 'not be designed and cannot be relied upon to disclose fraud, defalcations or other irregularities.'" *Id.* at 127. However, the letter also stated that Wegad would inform Howard Street "of any matters that come to our attention which cause us to believe that the information furnished us is not correct." *Id.* at 127 n.3.

316. *Id.* at 128.

317. *Id.*

318. *Wegad v. Howard Street Jewelers*, 605 A.2d 123, 128 (Md. 1992).

not always be in a better position to “appreciate the risk.”³¹⁹ The court further stated, “[T]he client cannot always discharge the duty to protect itself merely by relying on an accountant’s advice. Rather, a client’s reliance on its accountant must be reasonable.”³²⁰ After restating the Maryland courts’ standard for determining the existence of contributory negligence in public accounting cases, the court held that the lower court judge did not err in his jury instructions and that upon remand, judgment in favor of Wegad would be reinstated.³²¹

C. SEC Cases—Court Limitations On Accountants’ Liability

Another court recently re-examined its state’s liability laws as applied in public accounting cases. In *SEC v. Price Waterhouse*, a federal district court in New York dismissed a suit that the Securities and Exchange Commission brought against Price Waterhouse, alleging both primary violations and aiding and abetting violations of the Securities and Exchange Act.³²² In *Price Waterhouse*, Price Waterhouse conducted audits for the fiscal year ending July 31, 1980, of AM International (AMI), a producer of business equipment.³²³

In 1976, after a new CEO was hired by AMI, the company began to purchase other business equipment companies.³²⁴ However, the earnings of AMI declined, and the costs of the newly purchased companies increased; therefore, a planned public offering was to take place in 1980.³²⁵ This offering did not occur because of the reactions of the company’s investment advisors to the 1980 financial statements.³²⁶ Although the statements showed a decline from the previous year, AMI’s management stated in its annual report that despite the overall decline, there were quarter-to-quarter improvements.³²⁷ AMI replaced its CEO and hired Arthur Andersen to review the 1980 audit.³²⁸ Arthur Andersen indicated that the 1980 audit report was absent entries, and

319. *Id.*

320. *Id.*

321. *Id.* at 130. The court appeared to shift some of the responsibility of running a business back on the owner when it stated,

While businesses may rely on an accountant’s advice and need not carry out the functions that the accountant is employed to perform, the fact that an accountant has not discovered or disclosed employee theft does not completely excuse the employer from taking reasonable measures and exercising reasonable vigilance to prevent theft.

Id.

322. *SEC v. Price Waterhouse*, 797 F. Supp. 1217, 1244 (S.D.N.Y. 1992).

323. *Id.* at 1221.

324. *Id.* at 1219.

325. *Id.*

326. *SEC v. Price Waterhouse*, 797 F. Supp. 1217, 1219 (S.D.N.Y. 1992).

327. *Id.* at 1219-20.

328. *Id.* at 1220.

Price Waterhouse was replaced by Arthur Andersen.³²⁹ AMI subsequently filed for bankruptcy.³³⁰

The *Price Waterhouse* court denied the SEC's request for an injunction because the SEC had failed to prove both the necessary elements for a securities fraud violation and the aiding and abetting violations.³³¹ The court discussed the necessary elements of liability for violations of the Securities Act: "a misrepresentation or omission of a material fact, made with scienter and made in connection with the purchase or sale of securities." The court then restated the definitions of the terms scienter³³² and recklessness³³³ and determined that recklessness satisfies the requirement of scienter.³³⁴ Establishing that the standard requires more than a misapplication of accounting principles, the court stated that the SEC had to prove that Price Waterhouse's accounting principles were so deficient that the audit, in effect, was not an audit at all, or that the accounting judgments were such that no reasonable accountant would have made the same decision if confronted with identical facts.³³⁵

Using this heightened standard, the court concluded that the SEC failed to prove the requisite scienter and therefore, had failed to prove that Price Waterhouse violated the Securities and Exchange Act.³³⁶ In reaching this conclusion, the *Price Waterhouse* court rejected the SEC's argument that Price Waterhouse's concern for retaining its client and its fees implies fraud.³³⁷ The court concluded, "It is highly improbable that an accountant would risk surrendering a valuable reputation for honesty and careful work by participating in a fraud merely to obtain increased fees."³³⁸

329. *Id.*

330. SEC v. Price Waterhouse, 797 F. Supp. 1217, 1220 (S.D.N.Y. 1992).

331. *Id.* at 1243.

332. *Id.* at 1240. Scienter is the "intent to deceive, manipulate, or defraud." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 185 (1976).

333. *Price Waterhouse*, 797 F. Supp. at 1240. "[R]ecklessness" was defined by the court in a securities fraud action against an accountant as highly unreasonable conduct that requires an extreme departure from the standards of ordinary care, not just simple or inexcusable negligence, and which presents a danger of misleading buyers or sellers, known to the defendant or so obvious that the actor must have been aware. *Hochfelder*, 425 U.S. at 185.

334. SEC v. Price Waterhouse, 797 F. Supp. 1217, 1240 (S.D.N.Y. 1992).

335. *Id.*

336. *Id.* at 1240-41.

337. *Id.* at 1242.

338. SEC v. Price Waterhouse, 797 F. Supp. 1217, 1242 (S.D.N.Y. 1992); see also DiLeo v. Ernst & Young, 901 F.2d 624, 629 (7th Cir.), cert. denied, 498 U.S. 941 (1990). In reaching its conclusion that the SEC had failed to prove its allegations of aiding and abetting violations, the *Price Waterhouse* court reasoned that the necessary element of scienter was absent. The court further stated that even if the violations had existed, the SEC had failed to demonstrate the need for injunctive relief. The test for injunctive relief as stated by the court is, "whether the defendant's past conduct indicates that there is a reasonable likelihood of further violation in the future." *Price*

The *Price Waterhouse* opinion demonstrates how courts are just now beginning to carefully review and analyze the facts, and apply sound policy judgments when deciding complicated cases alleging SEC violations. This case emphasizes the seriousness of securities violation allegations and the need for courts to place strict requirements on the SEC to make the necessary evidentiary proofs to maintain an action.³³⁹

VII. PROPOSED REFORM

The problems associated with the expansion of accountants' liability to third parties could be eliminated if states adopt a specific statute that governs those public accounting cases brought under common law actions of civil fraud and negligence. The current proposed federal legislation regarding SEC 10b-5 and RICO suits is long overdue; however, its scope of application is limited to those specific violations. This legislation does not address the vast majority of suits against accountants because most suits are brought under the common law actions of fraud and negligence.³⁴⁰

However necessary the proposed federal legislation is, many of the accountants' collateral concerns will still not be addressed. One concern in particular is the large number of out-of-court settlements for vexatious or

Waterhouse, 797 F. Supp. at 1243; see also *SEC v. Monarch Fund*, 608 F.2d 938, 943 (2d Cir. 1979).

339. *Price Waterhouse*, 797 F. Supp. at 1243.

Despite strong support from several major corporations' CEOs and presidents, the accounting profession's proposed changes in the current securities regulations were not well received by federal securities regulators. Testimony was heard before the Senate Banking Committee and subcommittee on securities in the summer of 1993. EMC's corporate chairman testified that the threat of SEC suits forces many corporations to "constantly think short-term in order to deliver acceptable financial results every 90 days, rather than focusing on the long-term development of technologies and processes." Ken Rankin, *War on Abusive Lawsuits Meets Capitol Opponents*, ACCT. TODAY, July 19, 1993, at 2, 34. EMC's chairman contended that the constant threat of suit puts U.S. corporations at a disadvantage because their foreign competitors do not have to worry about such suits.

Supporting the EMC chairman's position, the ADAPTEC's president stated that "there is not a CEO in the Silicon Valley or any other high technology area who does not dread these capricious, abusive suits." *Id.* However, despite corporate support, many others disagree with the accounting profession's attempts to change securities regulations in order to reduce abusive securities suits. Joel Seligman, a University of Michigan law professor, stated, "[T]here is little objective data at this time that suggests there is a need for significant reform of the Federal securities law." *Id.* Seligman blamed "some of the litigation 'crisis' that (CPAs) seek to correct" on failed auditing and accounting practices. *Id.*

340. The federal legislation will only impact Rule 10b-5 security suits, and state legislation is mostly designed to decrease the amount of damages that the accountant will have to pay. ANDERSEN ET AL., *supra* note 1, at 2, 3. For a view opposing the proposed federal legislation, see Melvyn I. Weiss, *Auditors, Public Both Need Tough Liability Rules*, ACCT. TODAY, Jan. 24, 1994, at 9.

frivolous suits. These out-of-court settlements result in the accounting firms paying huge amounts for unwarranted and unfounded claims.³⁴¹ These disproportionate out-of-court settlements ultimately affect the price that accounting firms will charge for services, and in return, this will affect the national economy.³⁴²

For example, the S&L failure has currently produced an onslaught of out-of-court settlements by many defendants, including CPAs, lawyers, and bankers.³⁴³ Two major reasons for the large numbers of out-of-court settlements surrounding the S&L crisis are cost and reputation. It is no longer cost effective for many CPAs, especially those involved in technical suits such as SEC suits, to defend themselves in court.³⁴⁴ For example, a CPA may receive \$20,000 in fees for an audit, yet defending the opinions in that audit may cost thousands more than the audit work itself was ever worth. Legal and court costs also contribute to the large numbers of out-of-court settlements.³⁴⁵ Out-of-court settlements are also more frequent in S&L failure suits because of the defendants' concern for their reputations. Any association with, for example, Charles Keating or his cohorts is detrimental to the health of any financial institution. With the widespread national exposure of the S&L failure, defendants are trying to distance themselves as quickly as possible from the event and those associated with it.³⁴⁶

341. *E.g.*, U.S. Nat'l Bank v. Miniscribe, No. 89-CV-1031-A (Tex. Dist. Ct., Galveston Co. 1992); Standard Chartered PLC v. Price Waterhouse, No. 88-34414 (Ariz. Super. Ct., Maricopa Co. 1992).

Although not a public accounting case, *Greenfield v. U.S. Healthcare*, 1993 U.S. Dist. LEXIS 8982 (E.D. Pa., July 6, 1993) may effectively help reduce the number of strike suits brought against public accountants. The *Greenfield* decision demonstrated that when enough evidence exists, courts are now applying Rule 11 sanctions against attorneys for filing baseless suits. In *Greenfield*, the United States District Court for the Eastern District of Pennsylvania applied Rule 11 sanctions against a law firm when the firm, relying only on a Wall Street Journal article, asked a client to be a plaintiff in a class action suit. After realizing that he had a conflict of interest and could not verify the complaint, the client requested that the firm withdraw the complaint. The defendant brought Rule 11 sanctions against the law firm, and the court held that the firm violated Rule 11. In making its decision, the court stated that it had not seen any evidence "to suggest that Malone will be deterred from future conduct in the violation of Rule 11." *Id.* at *24. For a summary of the case, see *Plaintiffs' Sanction in Shareholder Lawsuit*, J. ACCT., June 1993, at 21.

342. *Scapgoat Litigation Drains U.S. Economy, Study Asserts*, J. ACCT., Oct. 1992, at 20.

343. Cushman, *supra* note 3, at A1; Schmidt, *supra* note 3, at A1. "Economically, in the 1980s many high-flying ventures, including thrifts, crashed and burned, with their managements' professional advisers as the only solvent—and sometimes only un-indicted—parties left standing when investors, government regulators and bank loan officers arrived on the scene." Gail Diane Cox, *Unlimited Liability*, NAT'L L.J., Dec. 21, 1992, at 1.

344. See generally ANDERSEN ET AL., *supra* note 1; AUS Consultants, *supra* note 3.

345. Schmidt, *supra* note 3, at A1.

346. See *supra* note 343. For a discussion of Charles Keating and the S&L crisis, see *supra* note 43.

Reputation and cost are also the two largest factors in CPAs settling out of court in cases outside the S&L failure. Self-preservation, either economically or in appearance, is necessary to be a national and world competitor. Accounting firms are no different than other business professions and must weigh cost factors and the detrimental effects of lawsuits on the firms' reputations in deciding whether to actively defend themselves. Plaintiffs recognize these economic and reputation factors and will use these factors as a benefit when filing questionable suits. This practice must be stopped. These frivolous or unwarranted suits affect not only the parties involved, but the national economy and the consumer as well.³⁴⁷

The only way to reduce the number of suits being brought is to effectively limit the expansion of liability to accountants in public accounting suits. The California Supreme Court's holding in *Bily v. Arthur Young & Company*³⁴⁸ is a fair ruling for both the accountant and the non-client third party. The *Bily* court endorsed the privity requirement for cases brought under professional negligence and the *Restatement* standard for negligent misrepresentation.³⁴⁹ This approach takes public policy into consideration, without allowing the policy to dictate the result.

A few states have proposed legislation that will help end the third-party liability problem in accounting cases.³⁵⁰ However, this legislation concentrates

347. See *supra* note 342.

The American Tort Reform Association's recent study of the S&L failure has produced the following results:

- 224,000 jobs a year between 1992 and 1996 will be lost,
- The federal budget deficit will increase by an average of \$3.7 billion a year,
- State and local government surpluses will be cut approximately \$1.2 billion a year,
- The real output in manufacturing will be reduced by \$6.9 billion a year.

AUS Consultants, *supra* note 3, at iii, 11, 12.

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

349. *Id.* at 774.

350. *Survey Shows Extent of Members' Concern Over Legal Liability*, *supra* note 256, at 1. Illinois is one state that has passed legislation which requires the existence of privity between an accountant and a third-party before a third-party can bring a tort action against the accountant. The U.S. District Court for the Northern District of Illinois, Eastern Division, recently applied section 30.1 of the Illinois Public Accounting Act in *Robin v. Falbo*, No. 91 C 2894, 1992 U.S. Dist. LEXIS 11075 (N.D. Ill., July 23, 1992), and dismissed a third-party negligence action brought against a public accounting firm. The Illinois Public Accounting Act states that "no person, partnership or corporation licensed to practice public accountancy under the Act shall be liable for civil damages to person not in privity of contract." 225 ILL. COMP. STAT. 450/30.1 (West 1993), formerly ILL. REV. STAT., ch. 111, para. 5535.1 (1991). In applying the Act, the court also stated, "It is not the function of this court to comment on the sensibility of the statutes or the legislative workings which preceded its passage." *Robin*, No. 91 C 2894, 1992 U.S. Dist. LEXIS 11075, at *25. The court also dismissed securities law claims and RICO claims brought against the public accountants. *Robin*, No. 91 C 2894, 1992 U.S. Dist. LEXIS 11075, at *4. For a brief analysis of

on applying a rule of comparative negligence in public accounting cases.³⁵¹ Although the premise behind these proposals is valid, these laws appear to only treat a symptom of a much larger problem. As opposed to treating the symptoms of the problem, it is far more effective to treat the problem itself. A proposed model state statute that addresses the common law actions of civil fraud, professional negligence, and negligent misrepresentation would cure the problem. This model state statute could serve as a guide to future state legislation, or it could be adopted without change by the states. The proposed statute alleviates the uncertainty surrounding third-party liability in public accounting cases for the courts, the juries, and the parties involved. This statute directly addresses the problems of expanding third-party liability in public accounting cases. Therefore, state statutes regarding the application of comparative negligence in public accounting cases would not be needed.

The proposed statute is based on the premises that engagement letters are valid written contracts that establish a legal relationship between the parties who enter into the agreement and that opinion letters are merely 'opinions and not express warranties. The statute is not meant to be adopted at the federal level because this is particularly a state problem. Recognition and respect for states' autonomy and federalism concerns require that this statute be adopted at the state level of government.

LEGAL LIABILITY OF ACCOUNTANTS

Section 101. Definitions

As used in this statute, the term—

Party	refers to any person, corporation, or entity either collectively or singly, who brings a lawsuit against an accountant.
Accountant	refers to any persons, corporations, partnerships, sole proprietorships, or entities who hold themselves out to be an expert in accounting theory and practice. Included as accountants are certified public accountants (CPAs) who have been licensed either by the AICPA or an equivalent state professional licensing board.

the case and its impact on the accounting profession, see *Court Dismisses Securities Claim*, J. ACCT., Sept. 1993, at 28.

351. *Id.*

**Professional
Negligence**

is defined as intentional or unintentional conduct by any person(s), who holds himself or herself as having the knowledge, training, and skill of an ordinary member of that person's profession in good standing, which fails to be consistent with the conduct of a person who is in good standing in that profession.

Strict Privity

refers to a contractual relationship between two parties.

Third Party

refers to any party not in strict privity with the accountant.

**Negligent
Misrepresentation**

refers to a form of deceit which occurs when a party makes false statements, honestly believing their veracity, but without reasonable grounds for that belief. A party's representation is treated as a material fact if that party communicates either directly or indirectly that it possesses superior knowledge or special information or expertise regarding the subject matter, and the plaintiff is in a position to reasonably rely on the party's proposed knowledge, information, or expertise.

***Restatement (Second)
of Torts***

refers to the *Restatement (Second) of Torts* § 552. In applying the *Restatement* § 552, the definition of the class of persons who an accountant is liable to is limited to those for whose benefit and guidance the accountant intends to supply the information or knows that the recipient of the information intends to supply it, and through the reliance on the information in a transaction that the accountant intends the information to influence or knows that the recipient of the information so intends. The accountant must know with substantial certainty that a person or class of persons will rely on the representation in the course of the transaction.

Civil Fraud

is defined according to the common law principles of fraud, and is distinguished as used in this statute from criminal fraud.

Section 102. Professional Negligence

A party suing an accountant alleging professional negligence is required to be in strict privity with that accountant. If the party is not in strict privity with that accountant, then the party will not be deemed by the court to have standing to sue that accountant.

Section 103. Negligent Misrepresentation

When a third-party plaintiff or client sues an accountant alleging negligent misrepresentation, the court shall apply the *Restatement (Second) of Torts* § 552 to determine the accountant's liability to that third party or client regarding the specified negligent misrepresentation.

Section 104. Privity Requirement

A party plaintiff is required to be in strict privity with an accountant before that party can bring an action alleging civil fraud against that accountant. When considering an action of civil fraud brought against an accountant, the court shall consider and balance the following factors when determining the accountant's liability as to the alleged fraudulent conduct:

- (a) The plaintiff's business background, including reputation and experience. The court can apply either local, regional, or national standards in reviewing the factors in this sub-section.
- (b) Whether the plaintiff's actions, either passively or actively, were a deliberate attempt to perpetrate fraudulent actions of a financial nature.
- (c) A plaintiff's degree of control over its internal accounting structure and management.
- (d) If the alleged fraud concerns an audit, the speculative nature of the audit, and the processes used to interpret the financial statements and internal accounting structure.

VIII. CONCLUSION

The expansion of third-party liability in public accounting cases can best be alleviated by states adopting a uniform standard that applies the strict privity requirement in professional negligent cases, and the *Restatement* standard in negligent misrepresentation cases. In applying these standards, the courts should

also keep in mind the specific policy objectives set forth in *Bily*.³⁵² If states implement the proposed model statute, the need for legislation directed at replacing joint and several liability with comparative negligence in public accounting cases will be unnecessary.

The proposed statute will provide for equitable results in public accounting cases. In addition, the model state statute will give courts, juries, and parties a consistent standard to apply and rely on in public accounting cases. The provision of a consistent liability standard will effectively stop courts' expansion of third-party liability in public accounting cases. With the courts no longer expanding third-party liability in public accounting suits, the accounting profession will have a fair chance of surviving the liability storm, and the negative impact of accountants' third-party liability on the national and global economies will be alleviated.

Julie Faussié*

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

* This note is dedicated to Mr. Michael J. Crandall, an honorable member of the CPA profession. Many Thanks!

