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Rosenblum v. Adler: Auditors' Liability for Negligent Misrepresentation-"The Explosive Power Resident in Words"

Steven E. Stark

Rosenblum v. Adler: Auditors' Liability for Negligent Misrepresentation—"The Explosive Power Resident in Words"

I. INTRODUCTION

H. Rosenblum, Inc. and its subsidiary, Summit Productions, operated retail catalogue showrooms in New Jersey in the early 1970's.[1] In November of 1971, the companies' principal owners, the Rosenblums, began merger negotiations with Giant, a Massachusetts corporation. Giant operated discount department stores, retail catalogue showrooms, and gift shops. Its stock was publicly traded on the American Stock Exchange.[2] Giant's auditors were Touche, Ross and Company (Touche), a prominent national accounting firm. Touche prepared audit reports concerning Giant's financial statements starting in 1969, when Giant initially filed with the Securities and Exchange Commission, until 1972. Giant included these audit opinions in its annual 10-K report[3] and in its annual report to its stockholders.

On December 14, 1971, Giant offered 360,000 shares of is common stock to the public.[4] The merger negotiations continued throughout this period. The offering prospectus[5] included income statements for each of the four fiscal years from January 31, 1967 through January 30, 1971. The prospectus also included the corporation's balance sheets for the same period, as well as Touche's

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1. Rosenblum v. Adler, 93 N.J. 324, 330, 461 A.2d 138, 140-41 (1983).

2. *Id.*

3. Many companies must file, within 90 or 120 days of the end of each fiscal year, an annual report, Form 10-K, that contains certified financial statements. The Securities Exchange Act of 1934 requires that companies include independent certified financial statements in these annual reports; almost all companies that have assets of at least $1,000,000.00 and 500 holders of a class of equity securities must file the reports. *Id.* at 345 n.9, 461 A.2d at 149 n.9 (citing 15 U.S.C.A. § 78(1)(g)(1) (West Supp. 1981)).

4. *Rosenblum*, 93 N.J. at 330, 461 A.2d at 141.

5. A prospectus is "[a] document published by a . . . corporation . . . setting forth the nature and objects of an issue of shares, debentures, or other securities created by the company or corporation, and inviting the public to subscribe to the issue." BLACK'S LAW DICTIONARY 1100 (5th ed. 1979). Under federal securities law the term " 'prospectus' means any prospectus, notice, circular, advertisement, letter or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security. . . ." Securities Act of 1933, 15 U.S.C. § 77b(10) (1982). The Securities Act of 1933 requires that the prospectus filed with respect to public offerings of securities include certified financial statements. 15 U.S.C.A. §§ 77g, 77aa (West Supp. 1981).

opinion report on the financial statements as a whole.[6] The opinion stated that "the financial statements 'present[ed] fairly' Giant's financial position."[7]

Frankel, a partner in Touche, attended a number of the merger negotiations but did not directly participate in the discussion.[8] Nevertheless, the Rosenblums alleged that Frankel attended the meeting at which they received the 1971 audited statements, and that Frankel "stated during one meeting that the preliminary figures of the 1972 audit . . . indicated that it was going to be a 'very strong year for Giant Stores, it is probably going to be the best in history . . . .'"[9] The negotiations resulted in a merger agreement executed on March 9, 1972. The agreement required the Rosenblums to sell their operations to Giant in exchange for Giant common stock.[10] "Giant [also] agreed that as of the closing it would represent and warrant that there had 'been no material adverse change in the business, properties or assets of Giant and its

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6. *Rosenblum*, 93 N.J. at 330, 461 A.2d at 141.

7. *Id.* The American Institute of Certified Public Accountants [hereinafter cited as AICPA] identifies four types of standard opinions that an auditor may use in reporting on financial statements: the unqualified, the qualified, the adverse, or the disclaimer of opinion. The latter is used when an "auditor has not performed an examination sufficient in scope to enable him to form an opinion on the financial statements" and when the report states that no opinion is expressed on the statements. "An adverse opinion states that financial statements do not present fairly [the company's financial position] . . . ." and is used when the auditor determines that the statements taken as a whole are not fairly presented in conformity with generally accepted accounting principles (GAAP). "A qualified opinion states that 'except for' or 'subject to' the effects of a matter to which the qualification relates, the financial statements present fairly the financial position . . . ." It is used when there is a lack of sufficient competent evidential matter or when there is a scope restriction that precludes an unqualified opinion. An unqualified opinion, the type that Touche Ross expressed on Giant, when used for comparative financial statements states:

> We have examined the balance sheets of ABC Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.
>
> In our opinion, the financial statements referred to above present fairly the financial position of ABC Company as of December 31, 19X2 and 19X1, and the results of its operations and the changes in its financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

AICPA, *Statements on Auditing Standards*, 1 AICPA PROFESSIONAL STANDARDS AU § 505.03 (1983).

8. *Rosenblum*, 93 N.J. at 330-31, 461 A.2d at 141.

9. *Id.* at 331, 461 A.2d at 141.

10. *Id.*

subsidiaries since July 31, 1971.' "[11] Thereafter, Giant released the 1972 audited statements. The Rosenblums relied on these statements and closed the transaction on June 12, 1972.[12]

The Securities and Exchange Commission (SEC) suspended trading in Giant common stock in April, 1973.[13] Giant's management had manipulated the company's books—they recorded fictitious assets and omitted large amounts of accounts payable.[14] Because Touche failed to uncover these erroneous entries, the audited financial statements were also incorrect. In May, Touche withdrew its opinion on the results of the 1972 audit.[15] Giant corporation declined quickly thereafter; it filed for bankruptcy in September, 1973. The Rosenblums' stock became worthless.

The Rosenblums instituted the present action against Touche in the New Jersey Superior Court, alleging fraudulent misrepresentation, gross negligence, negligence, and breach of warranty in connection with the 1971 and 1972 audits.[16] The defendants moved for partial summary judgment, seeking dismissal of the negligence claim for the 1971 audit and of the negligence, gross negligence, and fraud claims for the 1972 audit.[17] The trial court granted the motion as to the 1971 financial statements, but denied the motion as to the 1972 statements.[18] The Appellate Division affirmed the court's order concerning the 1971 audit but refused to grant defen-

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11. *Id.*

12. *Id.*

13. *Id.* The *Rosenblum* court noted that the SEC found that Touche's 1972 audit did not meet professional standards and entered a consent order of censure against them. 93 N.J. at 331 n.1, 461 A.2d at 141 n.1 (citing *In re* Touche Ross & Co., Securities Exchange Act Release No. 15978, FED. SEC. L. REP. (CCH) D 72, 175 A (1979)).

14. Other repercussions of the management fraud included criminal indictment and conviction of several of the company's officers. Gormley, *The Foreseen, The Foreseeable, and Beyond—Accountants' Liability to Nonclients*, 14 SETON HALL L. REV. 553 (1984). The SEC is concentrating its enforcement resources into a massive crackdown on a growing area of financial fraud—"cooking the books." These investigations focus primarily on companies that falsify their books and records in order to distort their true financial condition. As part of this effort, the SEC is also targeting companies and their outside auditors who misapply generally accepted accounting principles in what has come to be known as "cute accounting." Middleton, *Hot Item at the SEC: 'Cooking the Books,'* THE NAT'L L.J., Aug. 13, 1984, at 1. Although the crackdown has sparked criticism from "[s]ecurities lawyers who contend that it amounts to second-guessing by the agency of the good-faith judgments of management, their accountants and lawyers," SEC officials say that the trend toward increased enforcement in the area is likely to continue. *Id.* at 24.

15. *Rosenblum*, 93 N.J. at 331, 461 A.2d at 141. The AICPA, in AU § 561.08, mandates withdrawal of the auditors' report.

16. *Rosenblum*, 93 N.J. at 332, 461 A.2d at 141-42.

17. *Id.*

18. *Id.*

dant's motion for leave to appeal the ruling on the 1972 audit.[19] The Supreme Court of New Jersey granted both parties' motions for leave to appeal and combined the cases for argument.[20]

The Supreme Court of New Jersey affirmed the trial court's denial of the defendant's summary judgment motion on the 1972 audit and reversed and remanded the order granting the defendant's motion on the 1971 audit. The court held that when an independent auditor furnishes an opinion to a company without limit as to who may receive the statements, the auditor has a duty to all reasonably foreseeable parties who receive the statements from the audited company for a "proper business purpose" to exercise reasonable care in the performance of the audit.[21]

II. PRIOR LAW

The common law liability of public accountants has remained relatively unchanged over the last half century. The judicial opinions that reflect this dormancy cite the reasoning of Judge Cardozo in *Ultramares Corp. v. Touche*[22] and *Glanzer v. Shepard*[23] for support. These cases held that accountants have no duty to refrain from negligence toward third parties not in privity of contract with the auditor, unless they are the primary beneficiaries of the contract.

In *Ultramares*, plaintiff, a factor,[24] loaned the Stern Company large amounts of money based on financial statements certified by Touche. The statements listed fictitious assets, which the auditors failed to detect; the company subsequently went bankrupt. Chief Judge Cardozo, speaking for a unanimous court, restricted the auditor's liability to those whom the auditor knew would directly benefit from the service. The court wanted to avoid exposing accountants to unlimited liability[25] at a time when the accounting profession was a fledgling industry. Burdening the accounting in-

19. Rosenblum v. Adler, 183 N.J. Super. 417, 444 A.2d 66 (1982).

20. *Rosenblum*, 93 N.J. at 332, 461 A.2d at 142.

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

22. 255 N.Y. 170, 174 N.E. 441 (1931).

23. 233 N.Y. 236, 135 N.E. 275 (1922).

24. A factor is a commercial banker or finance company that specializes in providing financial services to producers and dealers (e.g., the discounting of accounts receivable). WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 813 (1981).

25. *Ultramares*, 255 N.Y. at 179, 174 N.E. at 444 ("If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class.").

dustry with such broad liability would mean hindering the capital markets that rely on audited financial statements.[26] Therefore, Cardozo rejected the general negligence standard and limited an accountant's liability to those in privity with him.[27]

The New York Court of Appeals had previously discarded the traditional privity requirement for products liability actions in *Macpherson v. Buick Motor Co.*[28] Nevertheless, Cardozo distinguished *Ultramares*: "[Here] [w]e are . . . asked to say that a like liability attaches to a circulation of a thought or a release of the explosive power resident in words."[29] Throughout the opinion, Cardozo emphasized that the main purpose of the accountant's audit was to give management an indication of its position so that it could evaluate its operations and make any necessary corrections. Furthermore, he pointed out that "[p]ublic accountants are public only in the sense that their services are offered to anyone who chooses to employ them,"[30] and that any liability for an "honest blunder" should be bounded by the contract and enforced between the contracting parties only.[31] He stated that the average businessman is one of a large group of possible investors who receive the certificate free of charge and who, under the circumstances, expect nothing more.[32] Several commentators have criticized this rationale

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26. In support, Cardozo cited Moch Co. v. Renselaer Water Co., 247 N.Y. 160, 164, 159 N.E. 896, 897 (1928). It should be noted that *Moch* also involved an important fledgling industry, public water works, that could have been greatly hampered by such expansive liability. *See* Seavey, *Mr. Justice Cardozo and the Law of Torts*, 52 HARV. L. REV. 372, 392 (1939).

27. *Ultramares*, 255 N.Y. 170, 174 N.E. 441.

28. 217 N.Y. 382, 111 N.E. 1050 (1916).

29. *Ultramares*, 255 N.Y. at 181, 174 N.E. at 445.

30. *Id.* at 188, 174 N.E. at 448.

31. *Id.* at 189, 174 N.E. at 448.

32. This view of the role of the public accountant, perhaps accurate in 1931, is no longer valid today. In the words of Justice Weiner, accountants have become "high priest willing for a fee to translate, through the added mystique of computer software, the jargon of almost incomprehensible financial transactions into neat, tabulated and word-processed form . . . ." Weiner, *Common Law Liability of the Certified Public Accountant for Negligent Misrepresentation*, 20 SAN DIEGO L. REV. 233, 235 (1983).

The AICPA, in reports on the objectives of financial accounting, addressed its attention only to sophisticated users—i.e., creditors and investors with knowledge of economics, business, and accounting. The proposals seem to "[accept] the principle that in the area of financial statements and their understandability, . . . [accountants] have to assume that the average layman cannot comprehend them and that, like the mysteries of ancient Egypt, you need an elite priesthood to define and interpret what appears in the financial statements." Stranger, *Developments in the Conceptual Framework for Financial Accounting and Reporting, and Their Impact Upon Legal Considerations*, 33 BUS. LAW 2447, 2448 (1978). With the myriad of financial information available today, even the sophisticated users must rely on the accountant to put this data in usable form. The Director of the Office of Man-

because they believe that the assumptions that underlie the decision are no longer valid.[33] Nevertheless, the courts take a different view and continue to treat *Ultramares* as the leading authority on auditors' liability.[34]

Nine years before the *Ultramares* decision, the New York Court of Appeals decided *Glanzer v. Shepard.*[35] In *Glanzer*, a buyer of beans brought suit against a public weigher. The weigher contracted with the seller to certify weight sheets that the buyer relied on to pay for the beans. When the buyer discovered discrepancies between the certified weight and the actual amount received, it brought suit against the weigher to recover the amount overpaid for the purchase.

Judge Cardozo affirmed a directed verdict for the plaintiff and held that where "[t]he plaintiffs' use of the certificates was not an indirect, direct, or collateral consequence that, to the weigher's *knowledge*, was the end aim of the transaction,"[36] the defendant had a duty to use due diligence in the actual weighing and preparation of written certifications. Judge Cardozo said that duty extended not only to the person who ordered the service, but also to those persons who relied upon it.[37]

The appellant in *Ultramares* argued that the *Glanzer* ration-

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agement and Budget confessed " '[n]one of us really understands what's going on with all these numbers . . . .' " Weiner, *supra*, at 235 (quoting Greider, *The Education of David Stockman*, ATL., Dec. 1981, at 38). *See also* Bradley, *Liability to Third Persons for Negligent Audit*, 1966 J. BUS. L. 190, 196 ("The legal duties of the auditor ought to be coextensive with his professional pretensions. He aspires to more than being a rubber stamp for management, so his legal duties ought to go beyond that status . . . ."); Solomon, Ultramares *Revisited, A Modern Study of Accountants' Liability to the Public*, 18 DEPAUL L. REV. 56 (1968); Comment, *Auditor's Responsibility for Misrepresentation: Inadequate Protection for Users of Financial Statements*, 44 WASH. L. REV. 139, 178 (1968) ("Under present conditions, the principal effect of the auditor's opinion to management is to meet the requirements of, and influence the actions of, third parties with whom the auditor has no contract.").

33. They argue that the main purpose of financial statements has shifted to third party users, and that with the expansion of the accounting industry and the availability of malpractice insurance for auditors, the concerns that troubled Cardozo in 1931 are no longer applicable. *See supra* note 32 & *infra* notes 77-81 and accompanying text; Besser, *Privity?—An Obsolete Approach to the Liability of Accountants to Third Parties*, 7 SETON HALL L. REV. 507 (1976); Seavey, *supra* note 26, at 398-404. *But see* Gormley, *supra* note 14 (noting that the language of *Ultramares*, which recognized the various uses of financial statements, but which nevertheless affirmed the necessity of restricted liability, contradicts the argument that it is fairer to impose the cost of a negligent audit on the accountant in light of the modern role of the accounting profession).

34. *See infra* note 40 and accompanying text.

35. 233 N.Y. 236, 135 N.E. 275 (1922).

36. *Glanzer*, 233 N.Y. at 238-39, 135 N.E. at 275 (emphasis added).

37. *Id.* at 239, 135 N.E. at 276.

ale favored the imposition of liability upon the auditors. Judge Cardozo distinguished the two cases, stating that the service in *Glanzer* primarily benefited a third party, whereas the audit report in *Ultramares* mainly benefited Stern Company.[38] These distinctions, however, are superficial. Although the *Ultramares* auditors did not specifically prepare a report for the plaintiff, they did provide thirty-two copies of their report to Stern. Stern gave one of these copies to the plaintiffs. Stern probably also used a number of the other reports for similar purposes. It is therefore reasonable to assume that Touche knew, or should have known, that some of the copies would be used to induce banks, lenders, and investors to loan the Stern Company money or to purchase its stock. Nevertheless, Judge Cardozo rejected this argument and limited the auditor's liability to those parties in privity with the auditor or to those parties that were primary beneficiaries of the underlying contract.[39]

III. THE PRESENT LEGAL ENVIRONMENT

Today, courts differ in their views on auditors' liability. A number of jurisdictions continue to apply Judge Cardozo's "primary benefit" test.[40] Another group of courts extend the auditor's

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38. Cardozo distinguished *Glanzer* by stating that even though the *Glanzer* rule is stated in terms of a legal duty, the court "could [have] reach[ed] the same result by stating it in terms of contract." *Ultramares*, 255 N.Y. at 182, 174 N.E. at 445. In *Glanzer*, a privity relationship existed. The service performed primarily benefited a third party, whereas in *Ultramares* the service performed primarily benefited the Stern Company: "a convenient instrumentality for use in the development of the business." *Id.* at 183, 174 N.E. at 446. Cardozo found that there was no contractual relationship establishing any duty on the part of the defendants to the indeterminate class of persons dealing with the Stern Company. *Id.*

39. One commentator felt that "Cardozo weakened his opinion by making distinctions where there are no differences" and that the true basis for the opinion was the "unknowable extent of possible liability" as well as the difficulty in obtaining complete insurance protection were such a duty imposed upon the accountant. Seavey, *supra* note 26, at 400-01. For the *Rosenblum* court's perception of the insurance argument, see *infra* notes 79-81 and accompanying text.

40. Of the twenty-four jurisdictions with reported decisions, eight apply *Ultramares* strictly and allow negligence actions against parties in privity alone, leaving third parties to pursue their remedy based on gross negligence or fraud. *See* Stephens Indus., Inc. v. Haskins and Sells, 438 F.2d 357 (10th Cir. 1971) (although plaintiff-purchaser of client's majority stock interest was known to the auditor, the court, construing Colorado law, believed that *Ultramares* predominated and that only substantial evidence would suffice to show that Colorado had aligned itself with the trend towards auditor liability to foreseen persons); McLean v. Alexander, 599 F.2d 1190 (3d Cir. 1979) (in a minor pendent claim to a federal securities law claim, the court, applying Delaware law in a diversity case, determined that even if the plaintiff was known to the auditor, *Ultramares* prevails in Delaware); Koch Indus. v. Vosko, 494 F.2d 713 (10th Cir. 1974) (the court determined that Kansas follows

liability to members of a limited group who the auditor intends to supply audit information to or knows that the client will supply audit information to.[41] The latter position is derived from the American Law Institute's Restatement (Second) of Torts.[42] In the

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Ultramares); Investors Tax Sheltered Real Estate, Ltd. v. Laventhol, Krekstein, Horwath & Horwath, 370 So. 2d 815 (Fla. 3d DCA 1979); MacNerland v. Barnes, 129 Ga. App. 367, 199 S.E.2d 564 (1973) (follows *Ultramares*), *modified*, Travelers Indem. Co. v. Pullen & Co., 161 Ga. App. 784, 289 S.E. 2d 792 (1982) (negligence action lies "where the third party is in a limited class of persons known to be relying upon representations of accountants." *Id.* at 786, 289 S.E.2d at 795); Western Sur. Co. v. Loy, 3 Kan. App. 2d 310, 312, 594 P.2d 257, 260 (1979) ("the question of privity of contract is important in a suit against a certified public accountant by a third person nonclient . . . ."); Dworman v. Lee, 83 A.D.2d 507, 507, 441 N.Y.S.2d 90, 91 (1981) ("there can be no doubt that the rule in *Ultramares* remains authoritative, as it was in fact reaffirmed in *White v. Guarante*"), *aff'd mem.* 56 N.Y.2d 816, 438 N.E.2d 103, 452 N.Y.S.2d 570 (1982); U.S. Nat'l Bank of Oregon v. Fought, 46 Or. App. 635, 612 P.2d 754 (Ct. App. 1980) (the case involved an action for fraud and never reached the negligence issue, but the trial court, citing *Ultramares*, found negligence could not be the basis for recovery); Landell v. Lybrand, 264 Pa. 406, 107 A. 783 (1909), *distinguished in* Coleco Indus. Inc. v. Berman, 423 F. Supp. 275 (E.D. Pa. 1976) (applying Pa. & N.J. law—adopting *Glanzer-Busch*), *modified*, 567 F.2d 569 (1977).

41. *See*, Ingram Indus. Inc. v. Nowicki, 527 F. Supp. 683 (E.D. Ky. 1981) (the federal court found no state precedent but predicted that the Kentucky Supreme Court would adopt the Restatement (Second) position. It also determined that gross negligence is equivalent to fraud but that a claim predicated on both gross negligence and fraud independently is allowed); Seedkem, Inc. v. Safranek, 466 F. Supp. 340 (D. Neb. 1979) (interpreting Nebraska and Indiana law. The court found no cases in either state but opined that each would adopt a Restatement-like standard. Nevertheless, the court's holding merely denied a motion to dismiss a claim based on reckless and wanton conduct (gross negligence)); Merit Ins. Co. v. Colao, 603 F.2d 654 (7th Cir. 1979) (applying Illinois law); Hochfelder v. Ernst & Ernst, 503 F.2d 1100 (7th Cir. 1974); Brumley v. Touche, Ross & Co., 123 Ill. App. 3d 636, 463 N.E.2d 195, 200 (1984) (the court adopted the test from an attorney malpractice case and held that an accountant owes a duty to a third party if the accountant "was acting at the direction of or on behalf of his client to benefit or influence a third-party"). In order to recover, the court noted, the plaintiff should allege that the auditor knew of the plaintiff and the purpose of the report and that the auditor completed their report with that purpose in mind. Bonhiver v. Graff, 248 N.W.2d 291 (Minn. 1976); Hadden View Investment Co. v. Coopers & Lybrand, 70 Ohio St. 2d 154, 436 N.E.2d 212 (1982).

42. The full text of the Restatement appears as follows:

> § 552. Information Negligently Supplied for the Guidance of Others.
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> (1) One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.
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> (2) Except as stated in Subsection (3), the liability stated in Subsection (1) is limited to loss suffered;
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> (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
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> (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

jurisdictions that do not follow *Ultramares*, however, only one court has extended liability beyond that defined by the Restatement; it imposed a standard that balances several factors to determine liability.[43] Overall, the courts continue to protect the auditor and to apply the *Ultramares* standard, the Restatement position, or some hybrid of the two.[44]

In *Rosenblum*, the court intended finally to abandon the privity bar for negligence actions against auditors. It recognized various public policy concerns and redefined the auditors' legal duty to reflect changes in the modern business environment. This note considers the court's perspective in order to determine whether its

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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).

The comments to the Restatement seem to mirror the concerns of the *Ultramares* opinion and indicate that the reason for the more restrictive rule is that where only pecuniary loss is involved, a rule of this nature promotes the operational efficiency of commercial transactions. *Id.* at comment a. Compare this reasoning with that used by Judge Scheiber in the *Rosenblum* opinion, *infra* notes 79-81 and accompanying text (extended liability will not unduly burden the accounting profession because of the availabity of liability insurance coverage).

43. *See* Aluma Craft Manufacturing Co. v. Elmer Fox & Co., 493 S.W.2d 378 (Mo. Ct. App. 1973). These factors are: "(1) The extent to which the transaction was intended to affect the plaintiff; (2) the foreseeability of harm to him; (3) the degree of certainty that the plaintiff suffered injury; and (4) the closeness of the connection between the defendant's conduct and the injury suffered." *Id.* at 383 (citing Westerhold v. Carroll, 419 S.W.2d 73 (Mo. 1967)). Even this limited extension of the rule of liability was unnecessary in light of the allegations in the complaint that the auditors knew that the plaintiff would use and rely upon the audit report—a situation that could be decided within the framework of the Restatement rule.

44. A third group of courts apparently adopt a position similar to *Glanzer*—the parties bringing suit are specifically foreseen to rely on the audit. In order to equate this with the modern trend, however, these courts cite the specific person language of the Restatement Second to support their conclusion. *See* Bunge Corp. v. Eide, 372 F. Supp. 1058 (D.N.D. 1974) (the court was not persuaded that the North Dakota Supreme Court would adopt a negligence standard except where the audit was for the primary benefit of a third party and the auditor had knowledge of the fact); Rusch Factors, Inc. v. Levin, 284 F. Supp. 85 (D.R.I. 1968); Rhode Island Hosp. Trust Nat'l Bank v. Swartz, Bresenoff, Yavner & Jacobs, 455 F.2d 847 (4th Cir. 1972); Ryan v. Kanne, 170 N.W.2d 395 (Iowa 1969) *acq.* Larsen v. United Fed. Sav. & Loan Ass'n, 300 N.W.2d 281 (Iowa 1981)); Aluma Kraft Mfg. Co. v. Elmer Fox & Co., 493 S.W.2d 378 (Mo. Ct. App. 1973) *explained in* Tiffany Indus. v. Alexander Grant & Co., 536 F. Supp. 432 (W.D. Mo. 1982); Spherex v. Alexander Grant & Co., 122 N.H. 898, 451 A.2d 1308 (1982); Shatterproof Glass Corp. v. James, 466 S.W.2d 873 (Tex. Civ. App. 1971); Milliner v. Elmer Fox and Co., 529 P.2d 806 (Utah 1974). These cases, although seemingly applying a primary benefit test, extend the principle beyond that addressed in *Glanzer* or *Ultramares* and evidence the confusion prevalent in the court's discussion of the issue of auditors' liability. For a more in-depth analysis of these opinions and a discussion of the apparent inconsistencies in the current doctrine, see Gormley, *supra* note 14.

approach to the issue was sound. The sections that follow will analyze the court's language, discuss the correctness and necessity of its holding, and present a conclusion as to the future effect of the opinion on auditors' liability.

IV. ANALYSIS OF THE COURT

The *Rosenblum* court perceived the liability issue as twofold. First, it considered whether, absent privity, a party can bring a negligent misrepresentation action against the provider of a service in order to recover for a purely economic loss. Second, the court considered the type of legal duty that should be imposed on auditors in order to best serve the public interest. The *Rosenblum* court balanced the factors for and against recovery in light of the auditor's role in the present financial environment.[45]

The Supreme Court of New Jersey noted that, absent a privity-like relationship, accountants generally are not held liable to third party users of financial statements. Because this was a case of first impression in New Jersey, the court had to decide whether it would adopt this general rule.

The court first examined authority that allowed tort recovery for the negligent representations of experts that resulted in both physical injury and property damage.[46] Next, it looked at cases that permitted recovery for economic losses resulting from misrepresentation in the performance of a service where the contractor actually knew the beneficiary of his undertaking.[47]

Where the supplier of a service is not in a privity-like relationship with the injured party the New Jersey case law is split as to whether the injured party can sue the negligent supplier. The court noted, however, that two recent decisions discard the privity re-

45. 93 N.J. at 333-34, 461 A.2d at 142.

46. *Id.* at 334, 461 A.2d at 143 (quoting Pabon v. Hackensack Auto Sales, Inc., 63 N.J. Super. 476, 164 A.2d 773 (App. Div. 1960)). It is interesting that the court cites *Pabon* for the proposition that recovery for economic injury is allowed in suits for negligent misrepresentation. The suit in *Pabon* was brought to recover damages for personal injuries and for property damage to the plaintiff's automobile due to faults in the car's steering mechanism, which defendant's employee assured plaintiff was normal. The action did not deal with the type of injury that occurred in *Rosenblum* and was predicated on an express warranty on the car.

47. The court cited Economy B. & L. Ass'n v. West Jersey Title Co., 64 N.J.L. 27, 44 A. 854 (Sup. Ct. 1899) as support for the proposition that recovery of economic loss due to misrepresentation in the performance of a service is allowed when the contractor knows the beneficiary. The action, however, unlike *Rosenblum*, was based not on negligence, but on theories of contract and third party beneficiary status. *But see infra* text accompanying note 64.

quirement in negligent misrepresentation suits against the provider of a service.[48]

The first of the two cases, *Immerman v. Ostertag*,[49] dealt with the duty of notary publics to refrain from acts of negligence with regard to third parties who rely on their acknowledgements. The *Rosenblum* court apparently believed that the function of a notary is analogous to that of an auditor. The court, however, ignored the differences between the two services. *Immerman* involved a "public officer," who knew what notarized documents were and knew that the acknowledgment-taking service was for the primary benefit of a particular person. Even if a notary does not know the identity of the person requesting the acknowledgment, at a minimum he is aware that some person or entity will rely upon his acts. The auditor also performs a service for the benefit of other parties, especially when the audit is performed in order to meet the requirements of lenders, shareholders, or regulatory agencies. What distinguishes the audit, however, is that the auditor does more than acknowledge that the management's representations, in fact, are made by the company; rather, the auditor certifies that the procedures used by the management are correct and that the statements are fairly presented in accordance with GAAP—a procedure much more involved than the mere notarization of a document. The *Immerman* court further held that the notary's duty included only ordinary and reasonable care to satisfy his "own conscience" as to the truth of his representation.[50] Thus, the *Immerman* standard of care for a notary is much lower than that of an auditor under *Rosenblum*.[51]

The *Rosenblum* court also examined *Gold Mills, Inc. v. Orbit Processing Corp.*[52] In *Gold Mills*, a purchaser of goods brought suit against a security service to recover for the value of goods stolen from a transit company's premises. The security service had con-

48. *Rosenblum*, 93 N.J. at 335, 461 A.2d at 143.

49. 83 N.J. Super. 364, 199 A.2d 869 (Law Div. 1964).

50. *Id.* at 369-70, 199 A.2d at 872-73.

51. The *Immerman* case dealt with the notarization of documents signed by persons who fraudulently represented themselves as those persons who were expected to sign the documents. The court found that the notary's duty was no more than that of an ordinary man under the circumstances. In *Rosenblum*, the lack of knowledge complained of also concerned the accuracy of the certification of a fraudulent representation by another. Nevertheless, applying the *Immerman* principles to the auditors in *Rosenblum* would certainly not support the *Rosenblum* court's broad imposition of liability upon the auditor. See *infra* note 76 and accompanying text for a discussion of accountants' professional standards concerning the discovery of fraud.

52. 121 N.J. Super. 370, 297 A.2d 203 (Law Div. 1972).

tracted with the shipper to guard the lots. The case did not deal with negligent misrepresentations and, like *Immerman*, was a situation in which the service performed by the contractor benefited a limited class of persons. Also, there were "[reasonably] foreseeable consequences . . . if . . . [the defendant] failed to exercise due care."[53] The effects of a negligent audit are not as readily predictable.[54]

The *Rosenblum* court supported its opinion with New Jersey authority on the issues of negligent misrepresentation and privity. The court, however, failed to uncover any New Jersey case involving auditors' liability to third parties who relied on a negligent audit to their economic detriment.[55] The apparent lack of direct authority forced the court to look to other jurisdictions for guidance. It discovered that all of the other jurisdictions that had faced the issue applied either *Ultramares*, *Glanzer*, or the Restatement. Nevertheless, the court concluded that these decisions lacked persuasiveness. The court believed that, unless other policy considerations existed, actions against negligent auditors were maintainable irrespective of privity. Furthermore, the auditor's duty was defined by the reasonably foreseeable consequences of his actions; the *Rosenblum* court set the outer limits of the duty as a matter of law.[56]

The court's determination that the better method of defining an auditor's duty is to examine the reasonably foreseeable consequences of the party's actions does not retreat from precedent. All courts that address the issue utilize a foreseeability test. The courts differ, however, as to the results that they characterize as legally foreseeable. The courts that stand on precedent perceive the risk of harm to primary beneficiaries as the only foreseeable consequence.[57] Those that follow the Restatement[58] believe that

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53. *Id.* at 377, 297 A.2d at 207.

54. For example, the claims against Touche that arose out of the Giant audit totaled one hundred million dollars in eight lawsuits. Gormley, *supra* note 14, at 549 n.117. Gormley suggests that the *Rosenblum* court's attempt to limit his duty to a limited group does not take into account the ingenuity of counsel in obtaining sufficient documentation to prove that a number of clients not covered by the *Rosenblum* rule—*i.e.* shareholders, bondholders, institutional investors, and government agencies—fall within its protection. *Id.* at 555. The extent of these possible claims may, in fact, be "indeterminate."

55. *Rosenblum*, 93 N.J. at 336-37, 461 A.2d at 144. The only case that the court found was Coleco Industries v. Berman, 423 F. Supp. 275 (E.D. Pa. 1976) (applying New Jersey law).

56. *Rosenblum*, 93 N.J. at 338-39, 461 A.2d at 145.

57. The courts that have adopted the *Ultramares* rule have interpreted the decision to mean that there is no duty of care to third parties in cases of negligent misrepresentation; they completely bar the plaintiff's recovery. Up until the 1960's, courts even ignored the

the "zone of danger" encompasses known recipients, or a known class of recipients, exclusively. In either case, all of the courts express the fear of runaway liability and state that public policy considerations demand that they fix the outer limits of the auditor's duty within a narrowly proscribed framework.[59]

The *Rosenblum* court presented various arguments against the decisions that favor limited liability for auditors. It indicated that negligent misrepresentation actions are analogous to products liability actions,[60] which are maintainable without privity.[61] Therefore, the court proposed that auditors' "[n]egligent misrepresentations . . . may be the basis of liability irrespective of privity."[62] The court used two New Jersey products liability cases to support its argument.

Martin v. Bengue, Inc.[63] dealt with the flammable vapors emitted by a medicinal product, Ben-Gay. The court reasoned that a manufacturer knows, or should know, about such latent dangers, and must warn the public of the risks involved in the product's use. The product's directions failed to warn against those risks or even to mention them. Therefore, the court held that the user of the product presented a valid claim against the manufacturer for injuries suffered when the product caught fire, ignited his clothing, and caused serious burns.

O'Donnell v. Asplundh Tree Expert Co.[64] involved the purchase of a "safety hook" that was used to support a man's weight while trimming the upper part of a tree. When the hook failed, the man fell, sustaining serious injuries. The manufacturer gave the vendor explicit instructions regarding the hook's qualities and recommended uses. Nevertheless, the vendor made representations about the hook that directly contradicted the manufacturer's statements concerning the hook's composition and its suitability for the purchaser's required use. The court held the vendor liable. The *Rosenblum* court based its argument on the *O'Donnell* court's

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third party-direct beneficiary test of *Glanzer*. *See generally* Besser, *supra* note 33 at 516-22; Levitin, *Accountants' Scope of Liability for Defective Financial Reports*, 15 HASTINGS L.J. 436, 447-50 (1964); Marinelli, *The Expanding Scope of Accountants' Liability to Third Parties*, 23 CASE W. RES. L. REV. 113, 117-22 (1971).

58. *See supra* note 41.

59. *See generally* RESTATEMENT (SECOND) OF TORTS § 552, comment a (1977) (reasons for the limited liability).

60. *Rosenblum*, 93 N.J. at 339, 461 A.2d at 146.

61. *Id.*

62. *Id.* at 340, 461 A.2d at 146.

63. 25 N.J. 359, 136 A.2d 626 (1957).

64. 13 N.J. 319, 99 A.2d 577 (1953).

conclusion that the defendant's representations were a factor in his negligence.[65]

The *Rosenblum* court's product analogy is tenuous, yet interesting. When *Rosenblum* is analyzed in light of *Martin* and *O'Donnell*, two differing conclusions emerge. Viewed against the background of *Martin*, the audit report is a product, manufactured by the accountant, that has a latent defect that the user cannot discover. Alternatively, if the reasoning of *O'Donnel* is applied, the underlying financial statements are the "product" and the audit report is a representation concerning the adequacy and fitness of the product for its intended use. The court, however, discussed neither interpretation. It merely stated the proposition, leaving the reader to determine upon which theory its holding relied. Closer scrutiny of each alternative, however, gives insight into the court's perception and reveals the weaknesses in its analysis.

The court's recital of *O'Donnell* implies that it believed that the auditor guaranteed the statement's reliability. Nevertheless, an audit report is not designed to fulfill a guaranteeing function. The auditor attests to the fairness of the statement's presentation but cannot guarantee that it is totally accurate or that the company will remain in business. Unfortunately, financial statements are the primary vehicle for obtaining the information necessary to business decisions and the audit is a method of removing uncertainty from the transaction. Because the audit report increases reliance on the statements, it is usually perceived as guaranteeing the data.[66]

If the *Martin* analogy is followed to its logical conclusion, the audit report is inherently dangerous and needs special attention if it is to be used safely. In order to avoid liability, therefore, the auditor must warn of the risks. The only way to accomplish this is through some type of disclaimer that reveals the scope of the audit examination and the limitation inherent in the opinion. Such a disclaimer limits the reliance placed on the opinion and removes the perception that the auditor guarantees the statement's accuracy. If the auditor does not fully perform necessary audit procedures, however, the product—the report—is not safe or suitable, and the disclaimer ineffective. Moreover, as a practical matter, the ac-

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65. *Rosenblum*, 93 N.J. at 340, 461 A.2d at 146. The actual language of the *O'Donnell* opinion, relied on by the *Rosenblum* court, states that "such representations, although not constituting a warranty, are a factor . . . ." *O'Donnell*, 13 N.J. at 339, 99 A.2d at 588.

66. *See generally infra* note 89 (discussion of the meaning of an audit opinion, and of the methods with which the profession should respond to public perception of the audit function).

counting profession may be reluctant to implement the disclaimer approach. Nevertheless, the court seemed to perceive the disclaimer as an effective method for limiting the auditor's liability to third parties.[67]

After discussing both cases, the court incorporated the third part of its syllogism; it queried why, if recovery for economic injury may be awarded for defective products, such a loss should not be compensable if caused by a negligent misrepresentation. The court further stated that "[t]he maker of a 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 and *that the representation is reasonably sufficient, suitable and accurate.*"[68] This language sounds like a warranty theory, which arises out of contract and is implied in law. The court, however, never discussed the warranty issue or the issue of whether the plaintiffs were, or could be, third party beneficiaries of the underlying contract. The court's next sentence was even more confusing. It framed the issue as whether a party *not in privity with the declarant, nor intended by the declarant to be a user of the statement or opinion,* should benefit from a duty of the declarant to respond in damages for economic losses resulting from such representations. The court spoke in terms of duty and foreseeability of use, but instead of treating the foreseeability of harm to establish such a duty, it dealt with allusions to implied warranties of fitness and with even more vague analogies to products liability concepts.

Apparently, the court was searching for a method to justify its conclusion that, regardless of whether the statements are a product, the opinion is a product, or both combined are a product, "[A product-like] liability attaches to the circulation of a thought or a release of the explosive power resident in words."[69] Nevertheless, there are inherent problems in this type of analysis because recent opinions blur the distinction between actions in contract and actions in tort, especially in the products liability field. Furthermore, courts often find it difficult to differentiate between a supplier of a

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67. *See infra* note 93 and accompanying text. For further discussion on the unacceptability of disclaimers, see *Gormley, supra* note 14, at 554; Recent Decisions, *The Enlarging Scope of Auditors' Liability to Relying Third Parties,* 59 NOTRE DAME L. REV. 281, 289 n.56 (1983).

68. *Rosenblum,* 93 N.J. at 341, 461 A.2d at 147 (emphasis added).

69. *Ultramares,* 255 N.Y. at 181, 174 N.E. at 445.

service and a supplier of a product.[70] The *Rosenblum* court classified the audit as a product, thereby avoiding the analytical problems that arise when an action is based on a negligently provided service.[71]

The court's proposal that negligent misrepresentation actions are analogous to products liability actions is an attractive one, but it does not dispose of the issue of auditors' liability. The Rosenblums complained of purely economic injuries, and many jurisdictions do not allow products liability actions in the absence of physical harm. The court indicated, however, that the New Jersey case of *Santor v. A. & M. Karagheusian, Inc.*[72] allowed product liability suits for economic damage.

In *Santor*, a purchaser brought suit against a carpet manufacturer, alleging that defects in the carpet made it virtually unusable. The purchaser bought the carpet from a dealer, not the manufacturer. The Supreme Court of New Jersey reversed the court of appeals and reinstated the trial court's finding of liability, but it remanded on the issue of damages. It stated that the purchaser could recover the difference between the price paid for the carpet and its salvage value. *Santor* is a minority approach, but it is the leading authority for the states that adopt its principle.[73]

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70. *See infra* note 71. For a brief and interesting discussion on what the author believes to be the inevitable remerger of contract actions and tort actions, see G. GILMORE, THE DEATH OF CONTRACT (1974).

71. Courts are very reluctant to impose strict tort liability on suppliers of services, as opposed to products. The reason for this may be that in the case of services, the problem of mass production and mass distribution are not present. The plaintiff generally has personal contact with the defendant and knows, or can easily determine, who performed the service and how it was done. *See* Hoffman v. Simplot Aviation, Inc., 97 Idaho 32, 539 P.2d 584 (1975). An audit opinion contains elements of both manufacturing and services. It involves a production on a large scale due to the inclusion of the report in the financial statements, but there is also readily available knowledge of who performed the audit and how it was performed. Even when the service includes supplying a product, strict liability is often denied, especially for "professional services." Although the suit against the accountant sounds in negligence, these principles bear directly on the analogy made by the *Rosenblum* court. Because it did not even address the service aspect, the court may have been trying to avoid precisely these problems. If the audit is a service and the report is a product, then the performance of the audit is analogous to the manufacture of a product in a product liability case. Unfortunately, these types of hypertechnical distinctions and fictions lead to the type of clouded reasoning that has protected the auditor for so long. The true test should be one of duty and foreseeability of harm, which the *Rosenblum* court does not address. Nevertheless, courts often find it necessary to "hang their hats" on these vague principles to support their ultimate holdings. *See* Lehr, *The Application of Products Liability Principles to Professional Services*, 48 INS. COUNSEL J. 434 (1981).

72. 44 N.J. 52, 207 A.2d 305 (1965).

73. Most jurisdictions follow the approach of Seely v. White Motor Co., 63 Cal. 2d 9, 45 Cal. Rptr. 17, 403 P.2d 145 (1965), which held that economic loss was not recoverable. For

The *Rosenblum* court analyzed the auditor's role and held the accountant liable to foreseeable users of the statements.[74] The court pointed out that the company initially prepares the financial statements—the auditor only examines them.[75] Therefore, reliability of the statements depends upon the accuracy of the company's underlying accounting data. The auditor bases his evaluation of the statements on the accounting records and determines whether they fairly reflect the company's operations. The court noted that the auditor is neither required to investigate every document nor expected to have the skills of a criminal investigator.[76] Nevertheless, the court determined that accountants who use due care and professional methods may discover suspicious circumstances pointing to fraud. The court believed that the auditor who uncovers wrongdoing in such a manner serves an undeniably beneficial public purpose.

The *Rosenblum* court further discussed the expanding role of the audit function and recognized that an accepted use of audited statements is to provide them to third parties.[77] The court found that these "proper business purposes" include such uses as submission of the statements to banks and other lending institutions that

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the cases that follow the rule of *Santor*, see the cases cited in Pennsylvania Glass Sand v. Caterpillar Tractor Co., 652 F.2d 1165, 1171 n.17 (3d Cir. 1981).

74. *Rosenblum*, 93 N.J. at 341, 461 A.2d at 147. The court discussed a number of factors to be considered in determining whether a duty exists, including the burden that such a duty would place on the defendant compared with the risk and burden to the plaintiff, the availability and cost of either party insuring against the risk, and the effectiveness of placing the burden on one rather than the other. *Id.* at 342, 461 A.2d at 147 (quoting 2 F. HARPER & F. JAMES, LAW OF TORTS, § 18.6, at 1052 (1956)). Compare this with the standards used by the court in *Aluma Craft*, *supra* note 43 (the *Aluma Craft* factors deal with issues of foreseeability of harm and causation; the *Rosenblum* court's test is more policy oriented).

75. *Rosenblum*, 93 N.J. at 343, 461 A.2d at 148 (citing Commission on Auditors' Responsibilities, American Institute of Certified Public Accountants, *Report, Conclusions and Recommendations* 1 (1978)). *See also* AICPA, *supra* note 7, AU § 327. According to the AICPA, before performing an audit, the accountant should procure a management representation letter that includes management's acknowledgement of its responsibility for the fairness of the financial statements, and the absence of errors and unrecorded transactions. *See id.* AU § 333.04.

76. *Rosenblum*, 93 N.J. at 344, 461 A.2d at 148 (citing Commission on Auditors' Responsibilities, *supra* note 75, at 45). *But cf.* Foreign Corrupt Practices Act of 1977, 15 U.S.C. § 78m(b) (Supp. V 1981) (amending § 13(b) of the Securities Exchange Act of 1934). The Foreign Corrupt Practices Act, a response to Watergate, imposes certain accounting controls concerning recording and safeguarding of assets, prohibits bribes by public and nonpublic companies and mandates both civil and criminal penalties for violations of these provisions. The Generally Accepted Auditing Standards of the AICPA instruct the accountant to prepare internal accounting control reports and to present them to management in order to satisfy the Act.

77. *Rosenblum*, 93 N.J. at 345, 461 A.2d at 149.

might advance funds, and to suppliers of goods and services that might advance credit.[78] The court also questioned the argument that the imposition of a duty on accountants to third party users would bring financial catastrophe to the profession.[79] Accountants are already subject to extensive liability under the Securities Act of 1933 and the Securities Exchange Act of 1934, as well as to liability for fraud under *Ultramares*. Nevertheless, accountants have procured insurance coverage against these risks.[80] Therefore, the court found no reason to believe that added liability would prove unduly burdensome to the profession.[81]

Rosenblum offered as a further justification the possibility that the imposition of such a duty could be beneficial to the public. A duty to third parties would force accountants to apply stricter standards and closer supervision. The court believed that the business entity could absorb the extra cost and pass it through to clients, stockholders, or customers.[82]

The *Rosenblum* court's perception that its holding would increase accounting standards, and therefore benefit the public, displays a misunderstanding of the audit process. The court's argument is convincing, but it loses credibility when scrutinized against the background of auditing principles. The court addressed the role of the auditor, but it failed to discuss the role of the audit itself as well as the factors that an auditor analyzes during the engagement. The court ignored its previous assertions that auditors already face substantial liability under the securities laws and under common law fraud. Most audits are prepared for inclusion in prospectuses, 10-K reports, and in the financial statements of companies. Therefore, it is unlikely that the auditors would increase their review procedures because of an additional risk of liability. Even if the audit is performed solely for the benefit of lenders or creditors, with no liability under the securities laws, liability to these known users would still attach under the traditional rules of

78. *Id.* Under the federal securities laws these groups would only be protected if they purchased securities registered with the SEC. For a discussion of federal law liability, see *Rosenblum*, 93 N.J. at 348-49, 461 A.2d at 151. *See also* Weiner, *supra* note 32, at 240 n.22 (discussion of liability under the Federal Securities Acts).

79. *Rosenblum*, 93 N.J. at 348, 461 A.2d at 151.

80. *Id.* at 349, 461 A.2d at 151.

81. *Id.* at 348-49 n.11, 461 A.2d at 151-52 n.11 (discussion of a number of insurance plans presently available to accountants for liability imposed under the securities laws). One commentator suggests that the court's "casual attitude" concerning accounts' liability insurance is not supported by any factual basis regarding the actual availability of insurance coverage. Gormley, *supra* note 14, at 571 & n.222.

82. *Rosenblum*, 93 N.J. at 350, 461 A.2d at 152.

Glanzer and the Restatement.

The court also ignored the added time that is involved in applying more thorough review techniques. Presently, an average audit takes anywhere from 4-6 months. This period is critical because a primary element in the relevance of financial data is timeliness.[83] Without current data, the users of financial statements cannot adequately evaluate a company's current position. Furthermore, the longer the audit takes to complete, the longer the auditor is responsible for events that occur subsequent to the balance sheet date.[84] Due to their nature, subsequent events are not always capable of complete evaluation. Therefore, the increased time period may create a greater risk of error than would exist without stricter standards. Finally, the pervasive constraint on all auditing procedures is that of the benefits of the procedure in relation to the cost.[85] The imposition of additional liability in order to assure that greater care is exercised in the performance of the audit may raise standards, but at increased costs. This approach ignores the economic realities inherent in the audit process. If more extensive reviews are too costly or impractical, many firms may forego them. Furthermore, if the risk of liability is no greater than that already present, or if the added procedures do not materially increase the chance for error detection, then it is to no avail to insure against increased liability. Therefore, the reasons for the rule may be of little practical significance.

The court responded to the runaway liability argument with a statement that under the announced rule there are "built in limits" to the extent of financial exposure.[86] In order to recover, the plaintiff must establish that it received the audited statements for a proper business purpose,[87] that it relied on the statements, that any misstatements were due to the auditor's negligence, and that the negligence was the proximate cause of the plaintiff's damage.[88] The defendant can avoid liability by refuting any of these elements. Nevertheless, the reliance requirement is the most difficult to refute and may often be resolved in the plaintiff's favor. The

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83. AICPA, *Statements of Financial Accounting Concepts* (FAC) #2.

84. AICPA, *supra* note 7, AU § 560.

85. AICPA, *supra* note 83.

86. *Rosenblum*, 93 N.J. at 350, 461 A.2d at 152.

87. *See supra* text accompanying note 78.

88. *Rosenblum*, 93 N.J. at 350, 461 A.2d at 152. Compare this general tort burden for negligent misrepresentation with the plaintiff's burden under the securities laws. *Id.* at 349, 461 A.2d at 151 & n.10 (plaintiff must only show a material misrepresentation).

overall public perception of the statement's purpose[89] lends itself to a finding of reasonable reliance on the part of the user. When combined with other factors such as the nature of the financial reports, the importance of correct data, and the lack of competent data outside the statements, these conclusions suggest that the court's "limits" may be inconsequential.

The court also revealed a second limiting factor—that recovery may be limited or barred under comparative or contributory negligence laws.[90] The court did not address the form that this negligence might take, however, and from a practical standpoint, it is unlikely that the plaintiff's negligence will be a major factor in this type of suit.[91]

Rosenblum further proposed that the negligent accounting firm could limit its financial exposure by seeking "indemnification or contribution from the company and those blameworthy officers or employees."[92] This relief, although practical in theory, is of little comfort where, as will often be the case when a suit of this nature is brought, the audited company is bankrupt or judgment-proof.[93]

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89. See discussion on this purpose, *supra* note 32. *See also* Rosenfield & Lorensen, *Auditors' Responsibilities and the Audit Report*, J. ACCT., Sept. 1974, at 73-74 (the author discusses the accounting profession's views on the auditor's role, as well as the differing interpretations of the meaning of the unqualified auditor's opinion within the AICPA. The interpretations suggested are that the unqualified opinion (*see* AICPA, *supra* note 7) consists of two parts. First, that the presentation is in conformity with GAAP and second, that one of the following is true: (a) conformity with GAAP results in fair presentation, (b) the presentation is fair, or (c) GAAP have been fairly applied).

90. *Rosenblum*, 93 N.J. at 350-51, 461 A.2d at 152.

91. In *Ultramares*, the plaintiff made several unsecured loans to Stern Company. This may be negligence when one considers the problems often encountered with competing security interests, the need for perfection and priority, and the powers of a trustee in bankruptcy. For an entertaining and informative discussion of the law of security interests and priority, see R. LEVINE, THE UNIFORM COMMERCIAL CODE: AN OPERATIONAL TRANSLATION (1980). The failure of Ultramares Corporation to adequately secure a number of its loans may have been a factor in Cardozo's decision, because at the time there was no comparative negligence and the plaintiffs' negligence acted as a complete bar to recovery. For a discussion of the role that comparative negligence might play in a common law suit against the auditor by the audited company for failure to detect errors and irregularities, see Menzel, *The Defense of Contributory Negligence in Accountant's Malpractice Actions*, 13 SETON HALL L. REV. 292 (1983).

92. *Rosenblum*, 93 N.J. at 351, 461 A.2d at 152. One commentator noted that the court was unaware "that negotiation by an auditor of a contractual right of indemnification by or on behalf of the client would disqualify the auditor from serving as *independent* auditor of the client." Gormley, *supra* note 14, at 554 & n.139 (emphasis in original).

93. The court also pointed out that the auditor may limit reliance on the audit by disclaiming or limiting responsibility in certain circumstances. *Rosenblum*, 93 N.J. at 351, 461 A.2d at 152 (quoting Stanton & Dugdale, *Recent Developments in Professional Negligence-II: Accountant's Liability to Third Parties*, 132 NEW L.J. 5 (1982)). However, the problem with such an approach is that audited companies may not well receive a move of such mag-

Finally, the *Rosenblum* court limited its holding to situations where foreseeable users receive the audited statements from the business entity. The company must issue the statements for a proper business reason to influence a business decision of the user.[94] This includes lenders and suppliers, but not portfolio managers, who do not receive the statements from the company. The principle does not include shareholders who do not meet these necessary conditions—the court stressed that it expressed no opinion on these and similar situations.[95]

The court next applied the newly promulgated rule to the facts of the case. With regard to the 1971 audit, the court expressed its awareness that the traditional rationales of *Ultramares* and of the Restatement did not apply. Because Touche completed the audit in April and the merger negotiations began in September, the defendants prepared the audit report without knowledge of the plaintiff's existence.[96] Although the court considered the argument that the defendants authorized the plaintiff's use of the statements and implicitly represented that they fairly presented Giant's position, it concluded that liability was sustainable under *Glanzer*[97] or *Economy B. & L. Association v. West Jersey Title Co.*[98] Nevertheless, the court applied a broader principle in order to avoid the confusion that the somewhat attenuated fact pattern could cause at trial.[99]

The court concluded that it was "clearly foreseeable" at the time that the audited statements were prepared, that the report could be used for many proper business purposes.[100] These business purposes included incorporation into Giant's annual report given to its shareholders and the SEC, along with the proxy materials for the annual shareholders' meeting, public offerings of securi-

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nitude because of the shadow that such a disclaimer may cast on the financial statements. From a practical standpoint, the accounting profession as a whole would need to adopt disclaimers of this type, because any firm that acts unilaterally may risk losing business to those who do not disclaim responsibility. *See generally* Rosenfield & Lorensen, *supra* note 89, at 82-83 (discussing the dangers inherent in allowing individual auditors to express personal opinions outside the framework of GAAP).

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

95. *Id.* at 352-53, 461 A.2d at 153. For a discussion of how far the opinion may be extended, see *infra* text accompanying notes 109-15.

96. *Rosenblum*, 93 N.J. at 353, 461 A.2d at 154. *Cf. supra* text accompanying notes 7-11 (the facts imply a different conclusion).

97. 233 N.Y. 236, 135 N.E. 275 (1922).

98. 64 N.J.L. 27, 44 A. 854 (1899).

99. *Rosenblum*, 93 N.J. at 354, 461 A.2d at 154.

100. *Id.* at 355, 461 A.2d at 154.

ties, credit, and corporate acquisitions.[101] The court further determined that the auditor's obligation for their representations continued[102] until the release of the next set of audited financial statements: "[h]aving inserted the audit in that economic stream, the defendants should be responsible for their careless misrepresentations to parties who justifiably relied on their expert opinions."[103] The court viewed the facts in the light most favorable to the plaintiff's position and assumed that the defendants negligently prepared the 1971 audit. It found that Giant subsequently delivered the statements to the plaintiffs in furtherance of their business, *i.e.*, merger negotiations (of which defendants had become aware), and that the plaintiffs relied upon these statements when they closed the merger transaction. Therefore, the court held that the lower court erred in striking the cause of action that was predicated on the 1971 audit.[104]

With regard to the 1972 audit, the court found that the plaintiff might have refused to consummate the deal had the statements provided them with the proper data. The court believed that the facts supported the proposition because the merger agreement represented that no materially adverse changes would occur in the company's financial statements, and because Touche had prepared the audit for the express purpose of the merger. Therefore, the court rejected the defendant's argument that the audit did not cause the plaintiff's damage. The court affirmed the trial court's denial of the defendant's motion to dismiss the claims against the 1972 audit.

V. CONCLUSION

Litigation against accountants is increasing.[105] In this setting, defrauded investors, lenders, and creditors will herald the *Rosenblum* rule as a major tool in the search for the "deep pocket" de-

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101. *Id.* Presumably the *Rosenblum* fact pattern would fall within corporate acquisitions.

102. *Id.* at 355, 461 A.2d at 154-55 (citing Fischer v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1967)). This analysis, however, is incorrect. Although auditors are under a duty to disclose after-acquired information, they have no duty to actively seek such information after the date of the audit report. AICPA, *supra* note 7, AU § 561.

103. *Rosenblum*, 93 N.J. at 356, 461 A.2d at 155. This broad language sounds much like language used in cases dealing with the Commerce Clause and with the power of Congress to legislate in certain areas; it may indicate that the court extended the duty in an area that Cardozo felt should be left to the legislature. *Ultramares*, 255 N.Y. at 187, 174 N.E. at 447.

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

105. *See* Weiner, *supra* note 32, at 234-35 n.3.

fendant.[106] The decision professes to remove the privity bar of *Ultramares*, which for over half a century has insulated the errant accountant from liability for negligence to third parties. Unfortunately, the court's extension of the auditors' duty occurred in a case that did not require such overbreadth. The facts could sustain liability under the traditional rules of *Glanzer* and of the Restatement. Furthermore, because only a minority of the courts allow recovery for negligent misrepresentation when the injury is purely economic,[107] the *Rosenblum* opinion may have limited application.

The court propounded a convincing analysis of the issue, but ignored many problems that the situation presented. In its attempt to address the concerns that caused courts to limit auditors' liability, the court dealt only with the language of prior opinions and not with the reality of the accounting profession. Nevertheless, the court's instincts were correct. Its holding follows changes in the modern legal environment. Other jurisdictions may not adopt the *Rosenblum* court's reasoning, but they will certainly take notice of the rule. Accountants provide a valuable service on which users of financial statements greatly rely. It is easy to dismiss the argument that imposing a duty on accountants to third parties creates an extensive and costly burden for the profession and that it strangles the flow of commercial information.[108] The *Rosenblum* decision protects lenders and suppliers, who are necessary to the efficient operation of the commercial world. To impose on these parties, who must rely on financial statement data for their business decisions, the burden of absorbing losses due to false or misleading financial statements, seriously undermines trust in financial information. Conceivably, it could also lessen the availability of essential commercial services.[109]

The accounting profession is self-regulating. It makes every effort to keep procedures and practices at a level necessary for the

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106. The accounting profession is a prime target in the search for a "deep pocket." "By 1981, gross revenues for the top eight firms had increased to well over $6 billion." Weiner, *supra* note 32, at 236 n.10 (citing Wayne, *The Year of the Accountant*, N.Y. Times, Jan. 3, 1982, § 3, at 1).

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

108. *See* RESTATEMENT (SECOND) OF TORTS § 552, comment a (1977); *supra* notes 79-82 and accompanying text.

109. *See generally supra* note 32, for a discussion of the need of these parties to rely on accountants for necessary financial information. As stated by "Frank C. Rozzono, a securities lawyer in the Washington, D.C., office of New York's Shea & Gould. 'If we cannot rely on the public information put into the marketplace, then the financial institutions in this country will collapse.'" Middleton, *supra* note 14, at 24.

continuous and efficient performance of the accounting function.[110] Unfortunately, accountants are often so engrossed in their creation, GAAP, that they are not cognizant of the vagaries of public opinion reflected in the legislatures and in the courts.[111] The profession often responds only after a major case or a piece of legislation reveals the flaws in GAAP.[112] Whether the *Rosenblum* opinion is such a case remains to be seen. The opinion is weak in places and may not directly affect the profession in the immediate future. Nevertheless, the rationale will most certainly be used as leverage in the growing battle to tip the rules of liability in favor of placing a greater duty upon the negligent auditor. If the *Rosenblum* court's perceptions are valid, the opinion will cause a domino effect in other jurisdictions.[113] If its assumptions are incorrect, other courts will ignore it. Because future plaintiffs' attorneys will definitely be drawing on *Rosenblum* in an attempt to recover some, if not all, of their clients' losses, the accounting profession and its counsel should carefully consider the implications of the *Rosenblum* opinion. If *Rosenblum* is, as this author believes, the first of a deluge of auditors' negligence cases, accountants should attempt to re-

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110. "The profession as a whole and authoritative bodies have the responsibility to establish the framework within which individual auditors should work. . . . If the profession and authoritative bodies fail in that responsibility, everyone will suffer, including individual auditors, the profession and the public." Rosenfield & Lorensen, *supra* note 89, at 82.

111. Although Cardozo left the decision as to whether or not to allow liability for accountants without privity to the legislature, *supra* note 103, "no state legislature has done so." Weiner, *supra* note 32, at 236 n.10. Nevertheless, "in the light of the economic maturation of the independent accounting profession, . . . dependence on . . . judicial solitude seems ill-advised." Bradley, *Auditor's Liability and the Need for Increased Accounting Uniformity*, 30 LAW & CONTEMP. PROBS. 898, 921 (1965), *quoted in* Weiner, *supra*.

112. *See, e.g.*, SEC Accounting Series Release No. 19, *In re* McKesson & Robbins (1940); *In re* Equity Funding Corp., 416 F. Supp. 161 (C.D. Cal. 1976). *See generally* J. CAREY, THE RISE OF THE ACCOUNTING PROFESSION (1969) (discussion of federal law liability).

113. In a discussion concerning the *U.S. Financial* case, a suit in which twenty-three plaintiffs successfully sued Touche Ross for negligent misrepresentation, Associate Justice Weiner of the Fourth District Court of Appeal in California stated that similar scenarios would play "to packed houses across the country." Weiner, *supra* note 32, at 234. His article advocates extended liability for auditors. The article appeared five months prior to the *Rosenblum* opinion and outlined arguments adopted by the *Rosenblum* court. Furthermore, less than a month subsequent to *Rosenblum*, the Wisconsin Supreme Court denied summary judgment to a defendant-auditor on a negligence action and discarded section 552 as too restrictive in light of Wisconsin's general rule that "a tortfeasor is fully liable for all foreseeable consequence of his act except as those consequences are limited by policy factors." Citizens State Bank v. Timm, Schmidt & Co., 113 Wis. 2d 376, 383-84, 335 N.W. 2d at 361, 364-65 (1983). If the trend continues in this manner, *Rosenblum* may be a major decision in the future. For a discussion of *Citizens State Bank*, see Gormley, *supra* note 14, at 357-58; Recent Developments, *supra* note 67.

spond[114] through the formulation of new auditing procedures, through the reevaluation of the auditor's actual and perceived responsibility, and, perhaps, through future changes in legal strategy when faced with this type of litigation.[115]

STEVEN E. STARK

114. One commentator stated, "In the absence of clear statements by the profession of independent auditors' responsibilities and unambiquous reflection of those responsibilities in the auditor's report, governmental bodies may impose responsibilities that are not contemplated by auditors or that are not warranted." Rosenfield & Lorensen, *supra* note 89, at 78-79.

115. Although compliance with GAAP will not always protect the auditor, *see* Weiner, *supra* note 32, at 239 n.19, good trial strategy might. For example, in a case in Dade County, Florida, a jury found Touche Ross & Co. not liable for a failure to detect an embezzlement by administrators of Cedars of Lebanon Hospital. Touche Ross's inside counsel stated that "the jury's ability to grasp the technical issues in the case was impressive. 'Until recently . . . the tendency . . . has been to shy away from a jury trial. But our case showed that a jury isn't automatically the enemy of the CPA.' " J. ACCT., May 1982, at 12. *Rosenblum* and other opinions may have opened the door even wider for auditor's liability, but preventative measures from the profession and well planned litigation by its counsel may be an effective method to compensate for it.