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Lewis P. Checchia

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1993]

ACCOUNTANTS' LIABILITY TO THIRD PARTIES UNDER *BILY V. ARTHUR YOUNG & COMPANY*: DOES A WATCHDOG NEED PROTECTION?

I. INTRODUCTION

Today's accounting profession performs a large part of its services in the capacity of an independent auditor.<sup>1</sup> The independent auditing of both public and private businesses plays a critical role in the economic community.<sup>2</sup> As an auditor, the accountant assumes professional responsibilities not only to his or her client, but also to third parties who rely on the auditor's statements when making financial decisions.<sup>3</sup>

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1. See *Bily v. Arthur Young & Co.*, 834 P.2d 745, 749 (Cal. 1992) (recognizing that certified public accountants' primary service is financial auditing); Willis W. Hagen II, *Certified Public Accountants' Liability for Malpractice: Effect of Compliance with GAAP and GAAS*, 13 J. CONTEMP. L. 65, 66 (1987) (stating that certified public accountant's principal function is independent auditing); Samuel S. Paschall, *Liability to Non-Clients: The Accountant's Role and Responsibility*, 53 MO. L. REV. 693, 698 (1988) (asserting that majority of accountants' revenues come from auditing). The word auditor means "one who hears." HOWARD F. STETTLER, *AUDITING PRINCIPLES* 5 (4th ed. 1977). The term comes from the time when public accounts were read aloud for approval and acceptance. *Id.* The persons hearing the accounts and approving them were known as auditors. *Id.* The function of an independent audit is to verify "the financial statements of an entity through an examination of the underlying accounting records and supporting evidence." *Bily*, 834 P.2d at 749 (quoting Hagen, *supra*, at 66).

2. John A. Siliciano, *Negligent Accounting and the Limits of Instrumental Tort Reform*, 86 MICH. L. REV. 1929, 1932 (1988). On a microeconomic level, independent auditing helps insure that individual companies are running at optimum levels by disclosing to internal management any weaknesses in their internal accounting systems. *Id.* Aggregately, these individual checks help insure the health of the larger financial community. Therefore, on a macroeconomic level, independent audits of individual companies provide potential investors and creditors with reliable information that is needed for determining financial risks and optimizing capital expenditures. *Id.*

3. See *United States v. Arthur Young & Co.*, 465 U.S. 805, 817-18 (1984). The Supreme Court, in denying work-product immunity for accountants' tax accrual workpapers, stated that:

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's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust. To insulate from disclosure a certified public accountant's interpretations of the client's financial statements would be to ignore the significance of the accountant's role as a disinterested analyst charged with public obligations.

*Id.*; see also *In re Touche*, 37 S.E.C. 629, 670 (1957). The *Touche* court held that

These responsibilities create a unique relationship between the auditor, the client and interested third parties.<sup>4</sup> In light of these responsibilities and relationships, there exists a significant debate in both the courtrooms and academia concerning the legal duty of care, under a negligence action, that an auditor must exercise toward third parties who rely on the auditor's statements.<sup>5</sup>

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an auditor's responsibility is not only to the paying client but also to the creditors and investors who rely on the auditor's certification of the client's financial statements. *Id.*; see generally AICPA PROFESSIONAL STANDARDS ET § 53.01 (CCH 1988). The American Institute of Certified Public Accountants (AICPA), commenting on accountants' responsibility, stated that:

A distinguishing mark of a profession is acceptance of its responsibility to the public. The accounting profession's public consists of clients, credit grantors, governments, employers, investors, the business and financial community, and others who rely on the objectivity and integrity of certified public accountants to maintain the orderly functioning of commerce. This reliance imposes a public interest responsibility on certified public accountants.

*Id.*

4. *Rosenblum v. Adler*, 461 A.2d 138, 150 (N.J. 1983). In *Rosenblum*, the Supreme Court of New Jersey explained:

Whenever [the auditor] certifies a financial statement [he or she] is potentially, at least, rendering a service to two or more parties whose interests may come into conflict—management and stockholder, borrower and lender, purchaser and seller. He may, and often does, serve simultaneously competitors in the same line of business, without fear on the part of either client that he will favor one or the other. It is this peculiar obligation of the certified public accountant, which no other profession has to impose on its members, to maintain a wholly objective and impartial attitude toward the affairs of the client whose financial statement he certifies.

*Id.* (quoting J. CAREY, PROFESSIONAL ETHICS OF PUBLIC ACCOUNTING 13-14 (1946)); see also *Bily*, 834 P.2d at 751. The *Bily* court stated that favorable auditor opinions allow businesses to procure capital from lenders and investors. *Id.* Under these circumstances, clients have a "biased interest" in obtaining a favorable opinion. *Id.* Investors and creditors, on the other hand, require accurate and credible reports to make effective and efficient decisions for resource allocation. *Id.*; see also STETTLER, *supra* note 1, at 7-8. Stettler explains that although the auditor's opinion is typically addressed to the client, the opinion will be used by persons other than the client. *Id.* This fact embodies the unique relationship between client and auditor. *Id.* at 8. Although the auditor is compensated by the client, total independence must be sustained in all areas relating to the audit. *Id.* Such independence is necessary for the achievement of "widespread acceptance" of the auditors opinion. *Id.* For the purposes of this Note, interested third parties include investors, creditors, or any other entity or individual interacting with the client for financial purposes.

5. See, e.g., Paschall, *supra* note 1, at 719-28 (asserting that auditors should have duty to all reasonably foreseeable third parties); Howard B. Wiener, *Common Law Liability of the Certified Public Accountant for Negligent Misrepresentation*, 20 SAN DIEGO L. REV. 233, 259-60 (1983) (supporting expansion of auditors liability to all foreseeable injury in order to compensate injured parties, deter negligent conduct and apply standard of negligence liability, applicable in all other contexts). But see Thomas L. Gossman, *IMC v. Butler: A Case for Expanded Professional Liability for Negligent Misrepresentation?*, 26 AM. BUS. L.J. 101, 126-27 (1988) (asserting that adoption of foreseeability approach in determining accountant's

The California Supreme Court recently addressed this issue in *Bily v. Arthur Young & Company*.<sup>6</sup> In *Bily*, the court held that, in claims of professional negligence, an accountant's general duty of care regarding an audit extends only to the client.<sup>7</sup> The court held that an auditor may be liable under the claim of negligent misrepresentation, however, to third parties who were the intended beneficiaries of the auditor's statements and who were actually foreseen.<sup>8</sup> The California Supreme Court's decision limits the scope of an auditor's liability,<sup>9</sup> which had been significantly expanded in California only several years earlier.<sup>10</sup> This holding may be the beginning of a significant trend that could have a great impact on the economic community in California and other jurisdictions that have not resolved this issue.<sup>11</sup>

This Note first discusses the development of independent auditing

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liability is "unwarranted and unwise" because it is legally unsound and ill-advised for public policy reasons); Siliciano, *supra* note 2, at 1931 (supporting privity restrictions on auditor's liability to third parties for public policy reasons); see also Mark D. Boveri & Brent E. Marshall, Note, *The Enlarging Scope of Auditors' Liability To Relying Third Parties*, 59 NOTRE DAME L. REV. 281 (1983) (discussing privity approach to auditor's liability and emerging foreseeability approach). For a discussion of the different standards that courts use in defining an auditor's liability to third parties, see *infra* notes 22-89 and accompanying text.

6. 834 P.2d 745 (Cal. 1992).

7. *Id.* at 747. This limitation of liability is referred to as the privity standard. For a further discussion of the privity standard and how it is applied in accountant liability cases, see *infra* notes 30-61 and accompanying text.

8. *Bily*, 834 P.2d at 747. This limitation of liability is referred to as the *Restatement* approach. For a further discussion of the *Restatement* approach and how it is applied in accountant liability cases, see *infra* notes 62-72 and accompanying text. The *Bily* dissent found the application of different standards to the two negligence claims illogical. *Bily*, 834 P.2d at 776 (Kennard, J., dissenting). The dissent asserted that courts should apply the same standard of care under both theories of liability. *Id.* (Kennard, J., dissenting). It argued that the scope of an auditor's duty should not depend on "which legal theory had been pleaded." *Id.* (Kennard, J., dissenting).

9. See *Bily*, 834 P.2d at 775 (Kennard, J., dissenting). Justice Kennard believes that the majority's decision will give negligent auditors extensive immunity for negligent preparations of audit opinions. *Id.* (Kennard, J., dissenting). For a further discussion of the dissenting opinion, see *infra* notes 146-69 and accompanying text.

10. See *Int'l Mortgage Co. v. John P. Butler Accountancy Corp.*, 223 Cal. Rptr. 218 (Cal. Ct. App. 1986) (expanding auditor's liability to those reasonably foreseeable third parties who had relied on auditor's report). For a further discussion of *International Mortgage* and the history of accountant liability law in California prior to *Bily*, see *infra* notes 90-98 and accompanying text.

11. See Richard B. Schmitt, *California Court Limits Liability of Auditors*, WALL ST. J., Aug. 28, 1992, at B1. In reporting on the *Bily* case, the *Wall Street Journal (Journal)* concluded that the holding will affect the ability of capital investors, creditors and the government to recover financial damages for relying on negligently audited financial statements. *Id.* Moreover, the *Journal* stated that "[t]he decision . . . present[s] a new and difficult hurdle for potential plaintiffs in what has been one of the nation's most hostile jurisdictions for auditors." *Id.* For a further discussion on the impact of the *Bily* decision on California and other jurisdictions, see *infra* notes 201-05 and accompanying text.

and its impact on the accounting profession and the economic community. The Note then addresses an accountant's legal duty under the tort of negligent misrepresentation and the three basic liability standards adopted by most jurisdictions, including the standard utilized in California courts prior to the *Bily* decision. The Note next examines the analysis employed by the California Supreme Court in *Bily* and critically analyzes the court's rationale. The Note proposes a more equitable approach in determining auditors' liability. This approach would allow recovery for valid third party claims while still maintaining the economic viability of the accounting profession. The Note concludes by examining the impact *Bily* may have on California and other states.

## II. BACKGROUND

### A. *The Development of Auditing*

Until the early 1930s, corporations primarily used independent audits to check their internal accounting procedures for efficiency and integrity.<sup>12</sup> Demand for independent auditing grew, however, with the increasing need for companies to seek capital from outside parties and the Securities and Exchange Commission's commitment to providing accurate information to investors.<sup>13</sup> Today, most accounting firms receive

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12. See *Rosenblum v. Adler*, 461 A.2d 138, 149 (N.J. 1983) (noting that "at one time the audit was made primarily to inform management of irregularities and inefficiencies in the business."); *Ultramares Corp. v. Touche*, 174 N.E. 441, 446 (N.Y. 1931). In *Ultramares*, Justice Cardozo stated that independent audits were "a convenient instrumentality for use in the development of the business, and only incidentally or collaterally for the use of those to whom [the company] might exhibit it [there]after." *Id.*; see also Albert G. Besser, *Privity?—An Obsolete Approach to the Liability of Accountants to Third Parties*, 7 SETON HALL L. REV. 507, 531 (1976) (stating that primary use of auditing in early 20th century was for apprising client's management of inconsistencies and fraudulent activities); Wiener, *supra* note 5, at 250 (stating that "the primary responsibility of an auditor was to the owner of a business to report on the operation of that business and to detect fraud and embezzlement by the company's employees.").

13. See Paschall, *supra* note 1, at 722 (noting that federal securities regulations in 1930s and maturation of large enterprises seeking external capital greatly increased demand for independent audits); Wiener, *supra* note 5, at 250 (asserting that statutes administered by Securities and Exchange Commission reflect belief that dependable financial information is essential prerequisite for informed investment decisions). The Securities and Exchange Commission, through the Securities Act of 1933 and the Securities Exchange Act of 1934, took substantial steps in providing investors with credible and unbiased disclosure of public companies. *Rosenblum*, 461 A.2d at 149; Paschall, *supra* note 1, at 722; see also WILLIAM L. CARY & MELVIN A. EISENBERG, *CORPORATIONS* 257 (6th ed. 1988) (stating that Securities Act of 1933 and Securities Exchange Act of 1934 "were designed to facilitate informed investment analysis and decisions by the investing public, primarily by ensuring adequate disclosure of material information"). The Securities Act of 1933 requires certified financial statements for all prospectuses filed in connection with public offerings of stock. *Rosenblum*, 461 A.2d at 149 (citing 15 U.S.C.A. §§ 77g & 77aa (1981)). The Securities Exchange Act of 1934 requires companies that have assets of one million dollars or

the majority of their revenues from auditing,<sup>14</sup> and corporations primarily use independent audits to establish their financial credibility to lenders and investors.<sup>15</sup> Unfortunately, the demand for auditing has not only expanded an accounting firm's revenues, but has also increased their exposure to liability.<sup>16</sup> This exposure results when third parties rely on the representations of a company's certified financial statements.

### B. *Auditors' Duty To Third Parties*

If a third party is injured by relying on false representations negligently prepared by an independent auditor, he may bring a claim under professional negligence (malpractice), or negligent misrepresentation.<sup>17</sup> Although the *Bily* court clearly distinguishes between the two torts, most courts and commentators find no practical difference between the torts when applied to false representations.<sup>18</sup> Consequently, most courts fail to distinguish between the torts when addressing auditor liability<sup>19</sup> or focus their analysis solely on the tort of negligent misrepresentation.<sup>20</sup>

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more and over 500 shareholders to include certified financial statements in their annual reports. *Id.* (citing 15 U.S.C.A. § 78(1)(g)(1) (1981)).

14. For a discussion of the significance of independent auditing to accounting firm revenues, see *supra* note 1 and accompanying text.

15. See *Bily v. Arthur Young & Co.*, 834 P.2d 745, 751 (Cal. 1992). The *Bily* court explained:

[A]udit reports are very frequently (if not almost universally) used by businesses to establish the financial credibility of their enterprises in the perceptions of outside persons, e.g., existing and prospective investors, financial institutions, and others who extend credit to an enterprise or make risk-oriented decisions based on its economic viability.

*Id.*; see also *Rosenblum*, 461 A.2d at 149 (stating that audit opinions are created for use of investors and creditors "who have no contractual relationship with the auditor"); JOHN D. BAZLEY ET AL., *FINANCIAL ACCOUNTING: CONCEPTS AND USES* 35 (1988) (noting that numerous financial transactions by investors and creditors are based on reliance of information found in financial statements); Paschall, *supra* note 1, at 723 (stating that primary users of audit opinions are third parties that auditor's client is attempting to attract); Wiener, *supra* note 5, at 250 (stating that independent auditing of public companies is primarily for benefit of third parties).

16. See Stephen M. Lazare, Note, *H. Rosenblum, Inc. v. Adler: A Foreseeability Unreasonable Extension of an Auditor's Legal Duty*, 48 ALBANY L. REV. 876, 902-04 (1984) (asserting that increased uses for accountants' work increases accountants' liability exposure).

17. Siliciano, *supra* note 2, at 1933 & n.19.

18. *Id.* (citing *Greycas, Inc. v. Proud*, 826 F.2d 1560, 1563 (7th Cir. 1987), *cert. denied*, 484 U.S. 1043 (1988)). For a discussion of the *Bily* court's liability analysis under each tort, see *infra* notes 116-45 and accompanying text.

19. See *Bily*, 786 P.2d at 768. The *Bily* court stated that "neither the courts, the commentators, nor the authors of the Restatement Second of Torts have made clear or careful distinctions between the [two torts]." *Id.*

20. *Rosenblum v. Adler*, 461 A.2d 138, 142 (N.J. 1983). The *Rosenblum* court stated that an action against an auditor is "realistically one predicated upon his representations." *Id.* Therefore, the court concluded, claims of professional malpractice "can be viewed as grounded in negligent misrepresentation." *Id.* The *Restatement (Second) of Torts* defines negligent misrepresentation:

Typically, the majority of third party claims against independent audi-

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.

RESTATEMENT (SECOND) OF TORTS § 552(1) (1977); see also W. PAGE KEETON ET AL., PROSSER & KEETON ON THE LAW OF TORTS §§ 105-110 (5th ed. 1984 & Supp. 1988). In order to recover under negligent misrepresentation, a third party plaintiff must prove that: 1) the auditor owed the party a legal duty of care; 2) the auditor breached that duty; 3) the party justifiably relied on the representations of the auditor; 4) the party suffered injury; and 5) the auditor's misrepresentations were the cause in fact and proximate cause of the party's injury. Paschall, *supra* note 1, at 704. For a detailed discussion of these elements in the context of auditor liability cases, see IRVING KELLOGG, HOW TO FIND NEGLIGENCE AND MISREPRESENTATIONS IN FINANCIAL STATEMENTS 214-20 (3d ed. 1983). Many courts adopting the tort of negligent misrepresentation have used some variation of the *Restatement (Second) of Torts* § 552 (1977). For a discussion of the *Restatement (Second) of Torts* § 552 and its application in this area, see *infra* notes 62-72 and accompanying text. For a list of jurisdictions adopting the *Restatement* approach, see *infra* note 28.

A defendant auditor may effectively challenge a negligent misrepresentation claim by showing that the auditor exercised the reasonable care that a competent member of his or her profession would have used in the same or similar circumstances. Samuel S. Paschall, *Professional Negligence: The Accountant's Liability to Third Parties*, TRIAL, July 1989, 61-64. One resource a juror or judge can use in measuring an auditor's standard of care is the Comprehensive GAAS Guide (GAAS Guide). *Bily*, 834 P.2d at 750 (citing MARTIN A. MILLER & LARRY P. BAILEY, COMPREHENSIVE GAAS GUIDE (1991)). The GAAS Guide is a frequently used summary of generally accepted auditing standards (GAAS) *Id.* The generally accepted auditing standards, in abbreviated form, 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 principles have not been consistently observed in the current period in relation to the preceding period.

tors are based on negligent misrepresentation.<sup>21</sup>

Under either tort, the scope of an auditor's legal duty of care to persons outside the auditor-client relationship creates the principle area of dispute with respect to auditor negligence claims.<sup>22</sup> The scope of an auditor's liability toward third parties is a policy issue that every jurisdiction must confront.<sup>23</sup> Currently, there are three judicially recognized standards for determining an auditor's duty of care to third parties.<sup>24</sup> Several jurisdictions follow Justice Cardozo's holding in *Ultramares Corp. v. Touche*,<sup>25</sup> which limits an auditor's liability to those persons with whom the auditor was in privity or a relationship "akin to privity."<sup>26</sup>

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, 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.

AICPA AUDITING STANDARDS: ORIGINAL PRONOUNCEMENTS no. 1, § 150.02 (William R. Lalli ed., 1990). The adherence to generally accepted auditing principles or standards may provide evidence of due care, but it is not conclusive. Paschall, *supra* note 1, at 705 (citing *United States v. Simon*, 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970)). In *Simon*, the court held that the practice of generally accepted accounting principles will not always shield an auditor from liability, particularly where the auditor knowingly chooses not to disclose material facts. *United States v. Simon*, 425 F.2d 796, 808. For a comprehensive discussion of an auditor's standard of care in negligent misrepresentation actions, see Hagen, *supra* note 1, at 78-88.

21. Siliciano, *supra* note 2, at 1933.

22. *Thayer v. Hicks*, 793 P.2d 784, 788 (Mont. 1990) (asserting primary issue courts confront in accountant liability cases is degree of care auditor owes to third parties).

23. *Bily*, 834 P.2d at 761. The *Bily* court explained that "[d]uty is . . . only an expression of the sum total of those considerations of policy which lead the law to say that the particular plaintiff is entitled to protection." *Id.* (quoting *Dillon v. Legg*, 68 Cal. 2d 728, 734 (1968)); see also *Rosenblum v. Adler*, 461 A.2d 138, 147 (N.J. 1983). The *Rosenblum* court stated that the question of whether a duty exists involves a balancing of three elements: the relationship between the parties, the level of risk, and the "public interest" in resolving the issue in favor of a particular party. *Id.*; see also Paschall, *supra* note 1, at 707. Paschall notes that "[w]hich particular third parties are, in fact, foreseeable users of the accountant's work product is a policy decision that determines the extent of the accountant's liability." *Id.* at 707.

24. See *Bily*, 834 P.2d at 752; *Thayer*, 793 P.2d at 788; KEETON ET AL., *supra* note 20, § 107.

25. 174 N.E. 441 (N.Y. 1931).

26. *Bily*, 834 P.2d at 752. Principle cases of jurisdictions which apply Justice Cardozo's approach include the following: *Colonial Bank of Alabama v. Ridley & Schweigert*, 551 So. 2d 390 (Ala. 1989); *Idaho Bank & Trust Co. v. First Bancorp of Idaho*, 772 P.2d 720 (Idaho 1989); *Thayer v. Hicks*, 793 P.2d 784 (Mont. 1990); *Citizens Nat'l Bank v. Kennedy & Coe*, 441 N.W.2d 180 (Neb. 1989); *William Iselin & Co. v. Landau*, 522 N.E.2d 21 (N.Y. 1988); *Landell v. Lybrand*, 107 A. 783 (Pa. 1919). Several states have adopted some form of the



Three jurisdictions have expanded auditor liability to those reasonably foreseeable third parties who relied on the audit report.<sup>27</sup> The majority of jurisdictions, however, have imposed liability under some variation of section 552 of the *Restatement (Second) of Torts*, which permits third parties to recover only if they were the intended or foreseen beneficiaries of the auditor's statements.<sup>28</sup> In order to appreciate the controversy regarding the appropriate liability standard, a review and analysis of each approach is necessary.<sup>29</sup>

### C. Justice Cardozo's Privity Relationship.

The development of the privity doctrine in third party negligence claims traces back to *Winterbottom v. Wright*.<sup>30</sup> In *Winterbottom*, the driver of a mail coach brought a negligence action against the mail coach repairer for physical injuries caused by the poor condition of the coach.<sup>31</sup>

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privity doctrine through legislation. See ARK. CODE ANN. § 16-114-302 (Michie Supp. 1990); ILL. REV. STAT. ch. 111, para. 5535.1 (Supp. 1990); KAN. STAT. ANN. § 1-402(b) (1991); UTAH CODE ANN. § 58-26-12 (Supp. 1990).

27. *Bily*, 834 P.2d at 752. Included in this list are Mississippi, New Jersey and Wisconsin. See *Touche Ross & Co. v. Commercial Union Ins. Co.*, 514 So. 2d 315 (Miss. 1987); *Rosenblum, Inc. v. Adler*, 461 A.2d 138 (N.J. 1983); *Citizens State Bank v. Timm, Schmidt & Co.*, 335 N.W.2d 361 (Wis. 1983).

28. *Bily*, 834 P.2d at 752. Principle cases of numerous jurisdictions have adopted some form of the *Restatement*. See *First Nat'l Bank of Commerce v. Monco Agency Inc.*, 911 F.2d 1053 (5th Cir. 1990) (Louisiana law); *Ingram Indus., Inc. v. Nowicki*, 527 F. Supp. 683 (E.D. Ky. 1981) (Kentucky law); *Bunge v. Eide*, 372 F. Supp. 1058 (D.N.D. 1974) (North Dakota law); *Rusch Factors, Inc. v. Levin*, 284 F. Supp. 85 (D.R.I. 1968) (Rhode Island law); *First Fla. Bank N.A. v. Max Mithchell & Co.*, 558 So. 2d 9 (Fla. 1990); *Badische Corp. v. Caylor* 356 S.E.2d 198 (Ga. 1987); *Pahre v. Auditor of State* 422 N.W.2d 178 (Iowa 1988); *Law Offices of Lawrence J. Stockler, P.C. v. Rose*, 436 N.W.2d 70, (Mich. Ct. App. 1989), *leave to appeal denied*, 450 N.W.2d 270 (Mich. 1990); *Bonhiver v. Graff* 248 N.W.2d 291 (Minn. 1976); *Aluma Craft Mfg. Co. v. Elmer Fox & Co.* 493 S.W.2d 378 (Mo. Ct. App. 1973); *Spherex Inc. V. Alexander Grant & Co.*, 451 A.2d 1308 (N.H. 1982); *Raritan River Steel Co. v. Cherry*, 367 S.E.2d 609 (N.C. 1988); *Haddon View Inv. Co. v. Coopers & Lybrand*, 436 N.E.2d 212 (Ohio 1982); *Bethlehem Steel Corp. v. Ernst & Whinney* 822 S.W.2d 592 (Tenn. Ct. App. 1990) (adopting modified form of *Restatement*); *Shatterproof Glass Corp. v. James*, 466 S.W.2d 873 (Tex. Ct. App. 1971); *Haberman v. Public Power Supply Sys.*, 744 P.2d 1032 (Wash. 1987); *First Nat'l Bank v. Crawford*, 386 S.E.2d 310 (W. Va. 1989).

29. For additional background on these liability standards, see *Bily*, 834 P.2d at 752-60; Gossman, *supra* note 5, at 100-09; Paschall, *supra* note 1, at 707-21; Boveri & Marshall, Note, *supra* note 5, at 282-91; Lazare, Note, *supra* note 16, at 880-94.

30. 152 Eng. Rep. 402 (Ex. of Pleas 1842); see also Paschall, *supra* note 1, at 707 (discussing origins and development of privity doctrine); Lazare, Note, *supra* note 16, at 880 (same).

31. *Winterbottom*, 152 Eng. Rep. at 402. Defendant Wright was a repairer and manufacturer of mail coaches. *Id.* Wright contracted with the Postmaster General to maintain the coaches in a safely operating condition. *Id.* at 402-03. The Defendant breached his obligations, thereby causing injury to the coach driver, *Winterbottom*. *Id.* at 403.

The court held that the plaintiff could not recover because there was no privity of contract between the defendant and plaintiff.<sup>32</sup> This privity doctrine, barring a few exceptions,<sup>33</sup> remained intact until Justice Cardozo, in *MacPherson v. Buick*,<sup>34</sup> expanded the scope of manufacturers' liability to those parties who could foreseeably be harmed by a manufacturer's negligently made product.<sup>35</sup> In *MacPherson*, Buick Motor Company sold an automobile to a car dealership, which in turn sold it to the plaintiff.<sup>36</sup> The plaintiff was injured when one of the car's wheels crumbled and caused the car to crash.<sup>37</sup> The court, responding to social and industrial change,<sup>38</sup> disregarded the privity of contract doctrine and allowed the third party plaintiff to recover under the theory of negligence.<sup>39</sup>

Several years later, in *Glanzer v. Shephard*,<sup>40</sup> the privity doctrine was

32. *Id.* at 405. In his discussion of the consequences of recognizing third party liability in this situation, Lord Abinger stated:

[I]f the plaintiff can sue, every passenger, or even any person passing along the road, who was injured by the upsetting of the coach, might bring a similar action. Unless we confine the operation of such contracts as this to the parties who entered into them, the most absurd and outrageous consequences, to which I can see no limit, would ensue.

*Id.* The *Winterbottom* court, however, did recognize an exception where the benefit of the contract was for a particular third party. *Id.* at 405 (distinguishing *Levy v. Langridge*, 150 Eng. Rep. 1458 (Ex. Ch. 1838), in which defendant seller of defective gun was found liable for injuries of specifically known third party user).

33. See *Schemerhorn v. Vanderheyden*, 1 Johns. 138, 139 (N.Y. 1806) (holding that when contract is made for benefit of third party, third party can bring cause of action on contract). Shortly after the decision in *Winterbottom*, the New York Court of Appeals disregarded the privity doctrine for suppliers of inherently dangerous products. *Thomas v. Winchester*, 6 N.Y. 397 (1852). In *Thomas*, the court held that a dealer in poisonous drugs who negligently mislabeled his product owed a duty of care to third party users. *Id.* at 397. The court held that "death or great bodily harm of some person" was a certain consequence of mislabeling poison. *Id.* at 409. For a further discussion of the *Thomas* holding, see Lazare, Note, *supra* note 16, at 882.

34. 111 N.E. 1050, 1053 (N.Y. 1916).

35. *Id.*

36. *Id.* at 1051.

37. *Id.* The car collapsed when a defective wheel crumbled, throwing the plaintiff from the car. *Id.* The defect could have been discovered by the manufacturer through reasonable inspection. *Id.*

38. See Paschall, *supra* note 1, at 708 (asserting that "concerns for human life and public safety" played major role in *MacPherson* holding).

39. *MacPherson*, 111 N.E. at 1053. Justice Cardozo stated:

If the nature of a thing is such that it is reasonably certain to place life and limb in peril when negligently made, it is then a thing of danger. Its nature gives warning of the consequences to be expected. If to the element of danger there is added knowledge that the thing will be used by persons other than the purchaser, and used without new tests, then, irrespective of contract, the manufacturer of this thing of danger is under a duty to make it carefully.

*Id.*

40. 135 N.E. 275 (N.Y. 1922).

similarly weakened in the area of professional services. In *Glanzer*, a merchant retained the services of a public weigher for the purpose of confirming the weight of beans sold to the plaintiffs.<sup>41</sup> The defendant public weigher negligently misstated the weight of beans.<sup>42</sup> The plaintiffs relied on the public weighers misstatements, suffered financial loss, and sued the public weigher for recovery.<sup>43</sup> The court held that the public weigher had a duty of care to the third party plaintiffs because "[t]he plaintiffs' use of the certificates was not an indirect or collateral consequence of the action of the weighers . . . [but] was a consequence which, to the weighers' knowledge, was the end and aim of the transaction."<sup>44</sup>

Following *Glanzer*, the privity issue again surfaced in *Ultramares Corporation v. Touche*,<sup>45</sup> where the New York Court of Appeals determined the scope of an independent auditor's liability to third parties.<sup>46</sup> In *Ultramares*, plaintiff Ultramares Corporation (Ultramares) issued unsecured loans totalling \$165,000 to Fred Stern and Company (Stern).<sup>47</sup> Stern subsequently went bankrupt and defaulted on its loans.<sup>48</sup> Ultramares brought fraud and negligence actions against Stern's independent auditors, claiming that it had relied on the auditor's opinion to issue loans to Stern.<sup>49</sup> The auditors negligently reported that Stern had assets in ex-

41. *Id.*

42. *Id.* The plaintiff contracted to purchase 905 bags of beans from Bech, Van Sicken & Company (Bech). *Id.* The price of the beans was determined by "weight sheets," which were certified by public weighers. *Id.* Bech contracted with the defendant public weighers to weigh and certify the beans and to deliver a copy of the certified weight sheets to the plaintiffs. *Id.* The beans were sold to the plaintiffs for a price determined by the certified weigh sheets. *Id.* The plaintiff, in attempting resale, found that the weight of the beans was overestimated by nearly 12,000 pounds. *Id.*

43. *Id.* The plaintiffs lost \$1,261.26 by overpaying for the beans. *Id.*

44. *Id.* In supporting this position, the court reasoned that the defendant public weigher knew that his certificate would be relied on for the sale of beans and sent a copy of the certificate directly to the third party customer for the "purpose of inducing action." *Id.* at 275-76. The differences between the holdings in *Glanzer* and in *MacPherson*, however, are notable. In *Glanzer*, Justice Cardozo did not extend liability to all foreseeable users of the weigher's services. *Id.* Instead, Cardozo limited recovery only to those parties whom the weigher specifically intended and knew would rely on his information. *Id.* By providing examples of title searchers and attorneys, Cardozo implicitly distinguished between a provider of erroneous information and a manufacturer of negligently made products. *Id.* at 276.

45. 174 N.E. 441 (N.Y. 1931).

46. *Id.* at 442.

47. *Id.*

48. *Id.* Fred Stern & Company imported and sold rubber. *Id.* The nature of Stern's business necessitated obtaining "extensive credit" and borrowing large sums of money from lenders. *Id.*

49. *Id.* at 443. In March 1924, Stern approached the plaintiff and requested loans to finance its operations. *Id.* The plaintiff had a previous relationship with Stern and lent money to Stern on the condition that Stern provide a certified balance sheet. *Id.* It was customary practice for Fred Stern & Company to pro-

cess of one million dollars, although, in reality, the company was insolvent.<sup>50</sup> The auditor had supplied Stern with thirty-two copies of its opinion and had known that Stern would use the opinion to solicit capital from third parties.<sup>51</sup> The New York Court of Appeals held that the defendant auditor owed no duty of care to third parties.<sup>52</sup> It stated that “[i]f 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.”<sup>53</sup> The court did recognize, however, that in certain situations, the relationship between the auditor and a third party would be “so close as to approach that of privity.”<sup>54</sup>

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vide certified balance sheets to all of its potential lenders, sellers, buyers or shareholders. *Id.* at 442. The plaintiff relied on the certified balance sheet and made a series of loans to Stern. *Id.* at 443.

50. *Id.* at 442. An employee of the Stern company fraudulently posted fictitious sales, accounts payable and inflated inventory totalling over one million dollars. *Id.* The defendant's agent who was assigned to audit Stern failed to investigate these questionable postings. *Id.* The court concluded that the audit was performed negligently and stated that “[a] cautious auditor might have been dissatisfied [with the suspicious postings] and [would] have uncovered what was wrong.” *Id.* at 444.

51. *Id.* at 442. For three years, the defendants had performed similar services for Stern. *Id.* The defendant, however, had no actual knowledge of any particular user who relied on the audit. *Id.*

52. *Id.* at 444.

53. *Id.*; see also Dean Foust, *The Big Six Are In Big Trouble*, *Bus. Wk.*, April 6, 1992, at 78 (stating that accounting industry is defending legal claims totalling two billion dollars in potential damages).

54. *Ultramares Corp. v. Touche*, 174 N.E. 441, 446 (N.Y. 1931). For example, under this analysis, if Stern had specifically told the defendant that the primary use of the independent audit was for the plaintiffs and that the audit should be specifically delivered to the plaintiff, the court may have found the existing relationship sufficiently “close as to approach privity.” Paschall, *supra* note 1, at 711. Instead, the court held that the defendant's service was performed primarily for the benefit of Stern and only “incidentally and collaterally” for the plaintiffs. *Ultramares*, 174 N.E. at 446. Accordingly, the court distinguished this case from the holding in *Glanzer*, where the sale of beans to a third party was the “end and aim of the transaction” between the merchant and the weigher. *Id.* Several commentators have linked *Ultramares* with *Glanzer* and refer to the combination as the “primary benefit rule.” Lazare, Note, *supra* note 16, at 885 & n.38.

The New York Court of Appeals affirmed and clarified the restrictive *Ultramares* approach in *Credit Alliance v. Arthur Andersen & Co.*, 483 N.E.2d 110 (N.Y. 1985). The *Credit Alliance* court created a three-part test to determine an accountant's liability to a particular third party. *Id.* at 118. The court stated that a third party must prove the following in order to recover:

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

*Id.* Although this test is similar to the *Restatement* approach, the third prong (the

Commentators suggest that important economic and legal policy considerations may have motivated the court's decision in *Ultramares*.<sup>55</sup> First, because the accounting industry was still in its infancy stage, the court may have wanted to protect it from exposure to extensive financial liability.<sup>56</sup> Second, the court believed that expanding the scope of liability in this case would have a precedential effect on other professions.<sup>57</sup> Finally, the court sought to punish negligence less severely than intentional fraud.<sup>58</sup> It stated that if it expanded liability to third party negligence claims, the same penalty would result for negligence as for fraud.<sup>59</sup>

Although the *Ultramares* decision has been criticized by judges and commentators,<sup>60</sup> it remains the standard in at least nine states and has

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linking prong) of the *Credit Alliance* test requires not only that the third party be known to the auditor, but also that the auditor "either directly convey the audit report to the third person or otherwise act in some manner specifically calculated to induce reliance on the report." *Bily v. Arthur Young & Co.*, 834 P.2d 745, 755 (Cal. 1992). For a further discussion of the *Restatement* approach, see *infra* notes 62-72 and accompanying text. The *Bily* court criticized the *Credit Alliance* test because the third prong of the test, known as the linking prong, fails to illustrate what type of conduct is necessary for its satisfaction. *Bily*, 834 P.2d at 754. The *Bily* court noted, however, that the linking prong will probably be further defined as similar cases are adjudicated. *Id.* at 755.

55. Paschall, *supra* note 1, at 712-14; Boveri & Marshall, Note, *supra* note 5, at 284.

56. Boveri & Marshall, Note, *supra* note 5, at 284 (recognizing that accounting was not multi-million dollar industry but rather newly emerging profession); see also Paschall, *supra* note 1, at 713-14. Paschall states that in *Ultramares*, Cardozo was concerned with protecting the young accounting industry from the dangers of extensive liability. Paschall, *supra* note 1, at 713-14. This concern was evidenced by Cardozo's reference to *Moch Co. v. Rensselaer Water Co.*, 159 N.E. 896 (N.Y. 1928). Paschall, *supra* note 1, at 714 n.101. The *Rensselaer* case involved the "fledgling" public waterworks industry, which would have been damaged by an expansion of liability. *Id.* Paschall further notes that Justice Cardozo's policy rationales are outdated because his analysis centered around the accounting industry when it was still considered to be an unimportant practice and not the "powerful, prestigious entity that it is today." *Id.*

57. *Ultramares*, 174 N.E. at 447. Cardozo provided several examples of how the expansion of negligence in this case would affect other professions. *Id.* In the legal profession, Cardozo stated that lawyers certifying the validity of corporate or municipal bonds would be exposed to liability from investors. *Id.* Additionally, in the real estate industry, Cardozo noted that title companies insuring titles to tracts of land would be liable to third parties "who may wish the benefit of a policy without payment of a premium." *Id.*

58. *Id.* at 447. But see Boveri & Marshall, Note, *supra* note 5, at 285. Boveri and Marshall concede that punishing intentional actions more severely than negligent acts is a valid policy. *Id.* They argue, however, that imposing harsher penalties for intentional acts is preferable to denying recovery for negligent ones. *Id.*

59. *Ultramares*, 174 N.E. at 447.

60. See *Bily v. Arthur Young & Co.*, 834 P.2d 745, 774 (Cal. 1992) (Kennard, J., dissenting); *International Mortgage Co. v. John P. Butler Accountancy Corp.*, 223 Cal. Rptr. 218, 221 (1986) (outlining significant changes in role of independent auditors since *Ultramares*). In *Bily*, Justice Kennard criticized the

been incorporated into several state statutes.<sup>61</sup>

#### D. *The Restatement Approach: The Foreseen Party*

The majority of states have rejected the privity approach taken in *Ultramares* in favor of the more flexible *Restatement* approach. For example, in *Rusch Factors, Inc. v. Levin*,<sup>62</sup> the United States District Court for the District of Rhode Island discarded the privity doctrine<sup>63</sup> and instead applied section 552 of the *Restatement (Second) of Torts*.<sup>64</sup> Section 552 limits the liability of a supplier of information in a negligence action to those persons or group of persons to which the supplier 1) specifically intends to furnish the information, or 2) specifically knows will receive the information.<sup>65</sup> The defendant auditor in *Rusch* had specific knowl-

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majority's application of the privity doctrine and stated that the majority, "[r]ummaging in the archives of legal history, amidst the debris of discarded dogmas . . . retrieves and revives, as an element of a cause of action for negligence, the requirement of privity, which this court had described more than 20 years ago as 'virtually abandoned in California.'" *Bily*, 834 P.2d at 775 (Kennard, J., dissenting) (quoting *Heyer v. Flaig*, 70 Cal.2d 223, 227 (1969)); see also Paschall, *supra* note 1, at 712. Paschall believes that although Cardozo may have had legitimate policy reasons for limiting an auditor's liability in 1931, the *Ultramares* standard is not applicable to the accounting profession as it exists today. *Id.* at 712-14; see also T. J. Fiflis, *Current Problems of Accountant's Responsibilities to Third Parties*, 28 VAND. L. REV. 31, 107 (1975) (arguing that auditor's "current public service status" makes *Ultramares* decision obsolete); Wiener, *supra* note 5, at 250 (stating that auditing functions and responsibilities have significantly changed since *Ultramares*). But see Gossman, *supra* note 5, at 116-17. Gossman argues that since *Ultramares*, the role of the auditor has not changed; rather, a class of third parties relying on cost-free audits has emerged. *Id.* Gossman asserts that the real issue in determining the scope of an auditor's liability is whether "an auditor owe[s] a duty of care to this new class of freeloaders." *Id.* at 117.

61. For a listing of legislative adoption of the *Ultramares* decision, see *supra* note 26.

62. 284 F. Supp. 85 (D.R.I. 1968).

63. *Id.* at 91-93.

64. *Id.* The district court criticized the *Ultramares* approach because it failed to provide recovery for innocent third parties, failed to equitably spread the risk of loss, and failed to encourage due care in the accounting profession. *Id.* at 90.

65. The RESTATEMENT (SECOND) OF TORTS § 552 states in pertinent part:

(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

edge that the creditor plaintiff would rely on its unqualified opinion.<sup>66</sup> Thus, the court held that the limited group of investors whose reliance on the audit was actually foreseen should not be barred from recovery.<sup>67</sup>

The *Rusch* decision demonstrates how the *Restatement* approach diverges from the holdings in *Ultramares* and *Glanzer*. The latter decisions require specific identification of the intended beneficiaries before liability can be imposed. The *Restatement*, however, requires only that the beneficiaries "belong to an identifiable group for whom the information was intended to be furnished."<sup>68</sup> The *Restatement* approach, however, is

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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(1)-(3) (1977). The *Restatement* provides the following illustrations in explaining the scope of an auditor's third party liability:

5. A is negotiating with X Bank for a credit of \$50,000. The Bank requires an audit by independent public accountants. A employs B & Company, a firm of accountants, to make the audit, telling them that the purpose of the audit is to meet the requirements of X Bank in connection with a credit of \$50,000. B & Company agrees to make the audit, with the express understanding that it is for transmission to X Bank only. X Bank fails, and A, without any further communication with B & Company, submits its financial statements accompanied by B & Company's opinion to Y Bank, which in reliance upon it extends a credit of \$50,000 to A. The audit is so carelessly made as to result in an unqualified favorable opinion on financial statements that materially misstates the financial position of A, and in consequence Y Bank suffers pecuniary loss through its extension of credit. B & Company is not liable to Y Bank.

6. The same facts as in Illustration 5, except that nothing is said about supplying the information for the guidance of X Bank only, and A merely informs B & Company that he expects to negotiate a bank loan, for \$50,000, requires the audit for the purpose of the loan, and has X Bank in mind. B & Company is subject to liability to Y Bank.  
*Id.* § 552 cmt. h, illus. 5 & 6.

66. *Rusch Factors*, 284 F. Supp. at 93. Plaintiff *Rusch Factors* was a commercial banking corporation. *Id.* at 86. In 1963 and 1964, a Rhode Island company approached the plaintiff for financing. *Id.* The plaintiff requested certified financial statements from the company to review its financial condition. *Id.* The defendant auditor prepared a report that erroneously certified that the company was solvent, when in reality it was insolvent. *Id.* The plaintiff relied on this inaccurate information to its detriment and suffered losses of \$120,000. *Id.* The record indicated that the defendant knew that the certified financial statements would be utilized by and "had as its very aim and purpose, the reliance of potential financiers of the Rhode Island corporation." *Id.* at 93.

67. *Id.* at 92-93. Although the court adopted the *Restatement* approach, it did not foreclose the possibility that the Rhode Island Supreme Court might adopt the *Ultramares* approach if given the appropriate factual circumstances. *Id.* at 91. The district court, however, avoided the issue by comparing the present case to *Glanzer*, where the third party's reliance was foreseen by the defendant. *Id.*

68. *Rosenblum v. Adler*, 461 A.2d 138, 145 (N.J. 1983). The *Restatement* specifically states that "the negligent supplier of misinformation [is liable] only

similar to the privity doctrine because both standards focus on the knowledge and intent of the independent auditor for determining whether liability should be imposed.<sup>69</sup>

Although the majority of states adopt some variation of the *Restatement (Second) of Torts* section 552 when determining an accountant's third party liability,<sup>70</sup> the approach has been criticized by some commentators who contend that there is no rational reason for protecting a foreseen third party over a foreseeable one.<sup>71</sup> Moreover, the *Restatement* provides a relatively easy way for accountants to relieve themselves of third party liability by not inquiring about the use of their audits.<sup>72</sup>

#### E. *Rosenblum and the Reasonably Foreseeable Standard*

While New York continued to uphold the privity doctrine and other jurisdictions were adopting the *Restatement* approach to auditors' liability, the New Jersey Supreme Court in *Rosenblum v. Adler*<sup>73</sup> jumped to the other end of the liability spectrum. The court held that independent auditors are liable to reasonably foreseeable third parties who justifiably relied on the auditor's statements.<sup>74</sup> In *Rosenblum*, plaintiff stock purchasers brought action for negligent misrepresentation against Touche Ross & Company (Touche), who audited the financial statements of Gi-

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to those persons for whose benefit and guidance it is supplied . . . [However] it is not necessary that the maker should have any particular person in mind as the intended, or even the probable, recipient of the information." RESTATEMENT (SECOND) OF TORTS § 552 cmt. h.

69. See Paschall, *supra* note 1, at 44; see also *Rosenblum*, 461 A.2d at 145 (stating that both *Restatement* and *Ultramares* approaches require relationship between auditor and third party).

70. For a listing of jurisdictions adopting the *Restatement* approach, see *supra* note 28.

71. Wiener, *supra* note 5, at 252. Justice Wiener states that:

The placing of liability on the fortuitousness of whether the name of the bank is disclosed or whether a class of lending institutions were known to the accounting firm may be a comfortable line to be drawn by those preparing the *Restatement*, but it does not appear to rest on sound analytical considerations. If the purpose of imposing liability is to increase the flow of *accurate* information this hardly turns on the state of mind of the accountant.

*Id.*; see also Boveri & Marshall, Note, *supra* note 5, at 287 (stating that both foreseen and foreseeable parties receive audit for free and therefore should not be subject to different standards of care).

72. *Bily v. Arthur Young & Co.*, 834 P.2d 745, 784 (Cal. 1992) (Kennard, J., dissenting). Justice Kennard states that an auditor can evade liability by simply agreeing with his or her client "to remain blissfully unaware of the report's proposed distribution and the uses to which it will be put." *Id.* (Kennard, J., dissenting); see also Boveri & Marshall, Note, *supra* note 5, at 287 (arguing that "a clever accountant could circumvent the *Restatement* provision by asking his client not to reveal the intended users of the statement").

73. 461 A.2d 138, 153 (N.J. 1983).

74. *Id.* at 153.



ant Stores Corporation (Giant).<sup>75</sup> Touche failed to recognize that Giant's financial statements were fraudulent.<sup>76</sup> The plaintiff, relying on Touche's unqualified audit report, sold its operations to Giant in exchange for Giant common stock.<sup>77</sup> The stock was worthless and Giant went into bankruptcy.<sup>78</sup> The court held that, unless auditors issued a statement limiting the distribution of their opinion, their duty of care extended to those reasonably foreseeable third parties who received the auditor's statement from the audited company and who relied on the statements to make business decisions.<sup>79</sup>

The court based its holding on several policy reasons.<sup>80</sup> First, the court stated that the function of an audit has evolved from an internal management resource to an independent evaluation mechanism for interested third parties.<sup>81</sup> Second, the court believed that expanded liability would produce more careful and comprehensive auditing reviews and encourage the adoption of stricter standards, which would effectively reduce liability.<sup>82</sup> Third, the court opined that losses should be shifted to the party who is in the best position to control and manage the loss.<sup>83</sup> In this situation, the court reasoned that accountants could protect themselves from loss by acquiring insurance.<sup>84</sup> Finally, the court

75. *Id.* at 140. Giant managed retail catalog showrooms, gift shops, and discount department stores. *Id.* Defendant Touche was Giant's independent auditor from 1969 through 1972. *Id.*

76. *Id.* Giant falsified its books in 1971 and 1972 by recording non-existing assets and by omitting substantial liabilities. *Id.* at 141. The discrepancies were discovered in 1973 after Touche had issued unqualified opinions on Giant's financial statements. *Id.* The Securities and Exchange Commission reported that Touche's 1972 audit of Giant "did not meet the requirements of the accounting profession." *Id.* at 141 n.1.

77. *Id.* at 141. The report stated that "it had examined the statements of earnings and balance sheets 'in accordance with generally accepted auditing standards' and that the financial statements 'present[ed] fairly' Giant's financial position." *Id.*

78. *Id.*

79. *Id.* at 153. The court never addressed whether an auditor's duty extended to third parties such as institutional or portfolio managers receiving the statements second hand. *See id.* at 152.

80. *Id.* at 147-52.

81. *Id.*; *cf.* *Ultramares Corp. v. Touche*, 174 N.E. 441, 448 (N.Y. 1931) (doubting whether typical businessperson would place much weight on such evaluation).

82. *Rosenblum*, 461 A.2d at 152. This contention, however, is subject to criticism. *See, e.g.*, Siliciano, *supra* note 2, at 1959-60 (arguing that level of care may not increase with expansion of liability).

83. *Rosenblum*, 461 A.2d at 151.

84. *Id.* at 151 & n.11. The court noted the availability and affordability of liability insurance. *Id.* Moreover, although the defendants asserted that the cost of insurance under the foreseeability approach would be catastrophic, it provided no evidence to support its contention. *Id.* Several commentators have criticized the *Rosenblum* rationale concerning insurance. *See, e.g.*, Lazare, Note, *supra* note 16, at 910 (stating that *Rosenblum* risk of loss analysis is "oversimplified and misleading"). For a discussion of the potential negative effects the fore-

stated that accountant's liability in this situation has certain "built-in limits" and, as a result, is not limitless as stated in *Ultramares*.<sup>85</sup>

The Supreme Courts of Mississippi and Wisconsin have also adopted foreseeability standards for assessing an accountants liability to third parties.<sup>86</sup> Following *Rosenblum*, the Wisconsin Supreme Court in *Citizens State Bank v. Timm, Schmidt & Co.*<sup>87</sup> based its decision on policy considerations, including the protection of innocent third parties, risk allocation and deterrence.<sup>88</sup> The court also concluded that limiting liability would hurt the general economy: "[i]f relying [third party creditors] are not allowed to recover, the cost of credit to the general public will increase because creditors will either have to absorb the cost of bad loans . . . or hire independent accountants to verify the information received."<sup>89</sup>

#### F. *California Law Before Bily: International Mortgage and the Foreseeability Test*

In 1986, the California Court of Appeal had also adopted the foreseeability approach for accountants' liability cases. The court held in *International Mortgage v. John P. Butler Accountancy Corporation*<sup>90</sup> that an accountant was liable to those reasonably foreseeable third parties who relied on the accountant's certified financial statements.<sup>91</sup> In this case, the plaintiff mortgage company, in reliance upon certified financial statements prepared by defendant accountant, entered into loan transactions with Westside Mortgage, Inc.<sup>92</sup> The financial statements were

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seeability approach would have on auditors' ability to obtain insurance, see Siliciano, *supra* note 2, at 1950.

85. *Rosenblum*, 461 A.2d at 152.

86. See *Touche Ross & Co. v. Commercial Union Ins. Co.*, 514 So. 2d 315 (Miss. 1987); *Citizens State Bank v. Timm, Schmidt & Co.*, 335 N.W.2d 361 (Wis. 1983). In *Citizens State*, the Wisconsin Supreme Court held that an accountant is liable for all "foreseeable injuries resulting from their negligent acts," except when public policy dictates otherwise in a particular case. *Citizens State*, 335 N.W.2d at 366.

87. 335 N.W.2d 361 (Wis. 1983).

88. *Id.* at 365. The court reasoned that because third parties are generally the primary users of an auditor's report, they should be protected. *Id.* at 365 & n.10. The court also stated that if negligent accountants were not held liable to third parties, their negligent acts would continue undeterred. *Id.* at 365. The court, however, provided no support for this statement. Moreover, the court provided no information or illustrations to support their contention that accountants can spread the risk of their liability through insurance.

89. *Id.*

90. 223 Cal. Rptr. 218 (Cal. Ct. App. 1986).

91. *Id.* at 227.

92. *Id.* at 219. Westside Mortgage, Inc. (Westside) arranged loans for qualified buyers and sold these loans to other mortgage bankers. *Id.* International Mortgage Company (IMC), wanting to buy and sell loans, contacted Westside. *Id.* Westside delivered to IMC its certified financial statements that had been prepared by defendant John P. Butler Accountancy Corporation. *Id.* After

inaccurate and Westside defaulted on its loan.<sup>93</sup> The defendant had no knowledge of the plaintiff mortgage company and was unaware that it reviewed or relied upon the certified financial statements.<sup>94</sup> In determining whether defendant's legal duty extended to the third plaintiff, the court rejected the privity doctrine and the *Restatement* approach.<sup>95</sup> The court maintained that existing California civil and common laws held every person responsible for their foreseeable negligent acts and that any exceptions to this rule must be "clearly supported by public policy."<sup>96</sup> The court found no policy considerations sufficient to relieve an auditor's duty of care to foreseeable third parties.<sup>97</sup> The court concluded that society is better protected by holding auditors liable to foreseeable third parties because such liability will provide a "financial disincentive" for negligent auditing.<sup>98</sup>

Several years after *International Mortgage* was decided, the California Supreme Court in *Bily v. Arthur Young & Co.*<sup>99</sup> reviewed the issue of what liability standard should be used in professional negligence and negligent misrepresentation claims against independent auditors. The *Bily*

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reviewing the financial statements, IMC entered into an agreement with Westside to buy and sell government loans. *Id.*

93. *Id.* The financial statements in question reported Westside's net worth at \$175,036. *Id.* Westside's primary asset, a \$100,000 note receivable on real property, proved to be worthless. *Id.* The misrepresentation damaged IMC because Westside's net worth without the note failed to meet the required standards for certain governmental loans. *Id.* Consequently, Westside's inability to deliver trust deeds resulted in alleged damages of more than \$400,000 to IMC. *Id.*

94. *Id.* at 220.

95. *Id.* at 226-27. In rejecting both the *Ultramares* approach and the *Restatement* approach, the court stated that the "protectionist rule of privity" advanced in *Ultramares* can no longer be followed in light of the existing obligations an auditor has to the public. *Id.* Moreover, the court found that the *Restatement* standard fails to represent the state's "concept of tort liability for negligence." *Id.*

96. *Id.* at 227. The *International Mortgage* court cited the California Civil Code § 1714, which states that "[e]very one is responsible, not only for the result of his willful acts, but also for an injury occasioned to another by his want of ordinary care or skill in the management of his property or person. . . ." *Id.* (citing CAL. CIV. CODE § 1714 (West 1986)). The court also referred to the California Supreme Court's decision in *Heyer v. Flaig*, 449 P.2d 161 (Cal. 1969), to support its holding. *International Mortgage*, 223 Cal. Rptr. at 227. In *Heyer*, the court held that a lawyer who prepares a will owes a duty to the client's intended beneficiaries as well as to the client himself. *Heyer*, 449 P.2d at 165. The *Heyer* court concluded that "public policy requires that the attorney exercise his position of trust and superior knowledge responsibly so as not to affect adversely persons whose rights and interests are certain and foreseeable." *Id.*; see also *Rowland v. Christian*, 443 P.2d 561, 564 (Cal. 1968). The *Christian* court held that, barring a statutory provision limiting liability, a person is liable for harm caused by his or her negligent conduct unless public policy dictates otherwise. *Id.*

97. *International Mortgage*, 223 Cal. Rptr. at 226.

98. *Id.*

99. 834 P.2d 745 (Cal. 1992).

court adopted the privity standard for professional negligence claims and the *Restatement* approach for claims of negligent misrepresentation.<sup>100</sup> In reaching this decision, the court rejected the foreseeability standard adopted in *International Mortgage*.<sup>101</sup> The court, advancing various policy considerations, outlined its reasons for imposing stricter liability standards in the accounting field.<sup>102</sup>

### III. CASE DISCUSSION: *BILY V. ARTHUR YOUNG & CO.*

In *Bily*, investors in the Osborne Computer Company (Osborne) brought action against Arthur Young & Company (Arthur Young) for professional negligence, negligent misrepresentation and fraud.<sup>103</sup> Osborne hired Arthur Young to audit its 1981 and 1982 financial statements.<sup>104</sup> After review, Arthur Young issued an unqualified audit

100. *Id.* at 747.

101. *Id.* at 767.

102. For a discussion of the policy considerations outlined by the majority, see *infra* notes 118-45 and accompanying text.

103. *Bily v. Arthur Young & Co.*, 834 P.2d 745, 748-49 (Cal. 1992). Osborne developed and marketed the first portable personal computer in 1981. *Id.* at 747. By 1982, Osborne earned over \$10 million in revenues per month and became one of the fastest growing companies in American history. *Id.* At the end of 1982, Osborne initiated plans to make a public offering of its stock. *Id.* Osborne sold warrants to investors in order to meet the capital requirements necessary for a public offering. *Id.* Warrants are instruments sold in exchange for loans or for "letters of credit" used to obtain loans. *Id.* The warrants permitted investors to buy blocks of Osborne's stock at "favorable" prices which would lead to substantial profits when (or if) Osborne went "public." *Id.* The plaintiffs were individuals and pension and capital investment funds who purchased warrants and common stock from Osborne. *Id.* One of the investors, Robert Bily purchased 37,000 shares of stock from Osborne for \$1.5 million. *Id.*

104. *Id.* Arthur Young at the time was part of the "Big Eight" accounting firms. *Id.* Subsequently, Arthur Young merged with Ernst & Whinney (another "Big Eight" firm) to form Ernst & Young in 1990. *Id.* Currently, Ernst & Young is now part of the "Big Six" accounting firms. *Id.* Included in the "Big Six" are: 1) Arthur Andersen & Company; 2) Coopers & Lybrand; 3) Deloitte & Touche; 4) Ernst & Young; 5) KPMG Peat Marwick; and 6) Price Waterhouse. The "Big Six" audits nearly 90% of all publicly traded corporations with annual revenues of at least one million dollars. J. MICHAEL COOK ET AL., *THE LIABILITY CRISIS IN THE UNITED STATES: IMPACT ON THE ACCOUNTING PROFESSION, A STATEMENT OF POSITION 4* (1992) (citing *WHO AUDITS AMERICA* 393-96 (25th ed. 1991)). Moreover, the "Big Six" audit nearly all of the country's largest corporations, including the following: 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. *Id.* In its capacity as an auditor, Arthur Young was responsible for "review[ing] the annual financial statements prepared by [Osborne's] in-house accounting department, examin[ing] Osborne's] books and records . . . and issu[ing] an audit opinion on the financial records." *Bily*, 834 P.2d at 747. For auditing purposes, the client's financial statements must include the following documents: a balance sheet, an income statement, a statement showing changes in retained earnings, a statement of changes in financial position and a disclosure of changes in other categories of shareholder equity. Lazare, Note, *supra* note 16, at 877 & n.5 (citing S. DAVIDSON & R. WEIL, *HANDBOOK OF MODERN*

opinion on Osborne's financial statements.<sup>105</sup> The 1982 financial statement showed a net operating profit of \$69,000 on revenues exceeding six million dollars.<sup>106</sup> The plaintiff investors allegedly relied on Arthur Young's opinion when making investments totalling six million dollars.<sup>107</sup> In September of 1983, Osborne filed for bankruptcy and the plaintiffs lost their investments.<sup>108</sup>

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ACCOUNTING 2-2 to 2-3 (3d ed. 1983)). A balance sheet indicates the financial condition of a company by reporting the company's assets, liabilities and owner's equity. *Id.* The income statement presents the profitability of a company, over a specific time period, by reporting its gross revenues and expenses and indicating whether the company realized a profit or suffered a loss. *Id.* The statement of retained earnings reports the change in position, over a specific time period, of earnings that the company has not distributed to its shareholders. *Id.* Statements reporting changes in shareholders' equity over time may include stock dividends, splits and retirements and other transactions that affect the interests of shareholders. *Id.*

105. *Bily*, 834 P.2d at 747. After reviewing the financial statements of a client-company, an auditor issues an opinion on whether the company's financial statements accurately represent its actual financial position. Paschall, *supra* note 1, at 701. An unqualified opinion states that the audit was performed "in accordance with generally accepted accounting principles" and that the client's financial statements fairly present its financial condition. *Id.* The AICPA Audit and Accounting Manual offers the following "boiler plate" unqualified opinion:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

AICPA AUDIT & ACCOUNTING MANUAL § 10210.010, at 10211 (CCH 1990). Arthur Young printed 100 copies of the opinion for Osborne. *Bily*, 834 P.2d at 748.

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

107. *Id.* One plaintiff testified that he neither saw nor read the opinion. *Id.* at 748 n.2. The jury nonetheless issued a verdict in his and the other plaintiffs' favor. *Id.* at 749.

108. *Id.* at 748. Both internal and external factors caused the demise of Osborne. *Id.* In mid-1983, Osborne's sales fell sharply due to internal manufacturing problems. *Id.* The manufacturing problems related to Osborne's introduction of its second generation computer, the Executive. *Id.* Once on the market, the Executive cannibalized the sales of Osborne's first computer. *Id.*

At trial, the plaintiffs' expert witness identified over forty deficiencies in Arthur Young's audit that he believed constituted gross professional negligence.<sup>109</sup> The expert witness concluded that the liabilities on Osborne's 1982 statements were grossly underestimated and believed the reported \$69,000 profit was actually a three million dollar loss.<sup>110</sup> At the close of trial, the jury returned a verdict in favor of the plaintiffs for professional negligence.<sup>111</sup> The California Court of Appeal affirmed the trial court's decision.<sup>112</sup>

Although commentators believed that the California Supreme Court would eventually adopt the foreseeability approach outlined in *International Mortgage*,<sup>113</sup> the *Bily* court severely limited the scope of an auditor's liability in negligence actions.<sup>114</sup> In deciding this issue, the *Bily* court analyzed the scope of liability under two separate torts: general negligence and negligent misrepresentation.<sup>115</sup> The *Bily* court expressly distinguished negligence from negligent misrepresentation.<sup>116</sup>

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Moreover, consumer demand for the Executive outstripped supply, and Osborne's sales consequently plummeted. *Id.* Osborne finally collapsed when IBM entered the market with its own version of the personal computer. *Id.* After the plaintiffs lost their entire investments, they brought suit against Arthur Young in the Santa Clara County Superior Court. *Id.* The plaintiffs originally filed separate suits; however, these actions were consolidated for trial. *Id.*

109. *Id.* According to the expert, the majority of deficiencies came from Arthur Young's failure to uncover Osborne's internal accounting weaknesses. *Id.* Furthermore, the expert testified that Arthur Young actually discovered discrepancies, but failed to report them. *Id.* A senior auditor detected \$1.3 million in unrecorded liabilities, such as customer rebates and product returns. *Id.* The auditor recommended that Arthur Young inform Osborne's board of directors of the deficiencies in Osborne's internal accounting system; however, his supervisors at Arthur Young did not accept the recommendation, and no weaknesses were reported. *Id.*

110. *Id.*

111. *Id.* at 749. The jury, however, exonerated Arthur Young with respect to the intentional fraud and negligent misrepresentation allegations. *Id.*

112. *Bily v. Arthur Young & Co.*, 271 Cal. Rptr. 470, 472 (Cal. Ct. App. 1990).

113. See, e.g., Gossman, *supra* note 5, at 100 (asserting that *International Mortgage* holding would be affirmed by California Supreme Court, if reviewed).

114. *Bily v. Arthur Young & Co.*, 834 P.2d 745, 757 (Cal. 1992).

115. *Id.* at 760-74. The *Bily* court also addressed a claim against Arthur Young for intentional misrepresentation. See *id.* at 773-74. This Note, however, will only discuss the courts analysis under negligence and negligent misrepresentation, and will not address intentional misrepresentation.

116. *Id.* at 768. The *Bily* court noted that most jurisdictions have failed to carefully or clearly distinguish the tort of negligence from the tort of negligent misrepresentation. *Id.* The court explained that negligent misrepresentation is a distinct tort emanating from the tort of deceit. *Id.* Moreover, the court asserted that a "clear and careful" distinction is necessary for two reasons: 1) because the two torts have different statutory foundations, and 2) because the distinction has practical implications especially in complex litigation cases. *Id.* For example, in jury instructions, a general negligence claim focuses on the auditor's "level of care and compliance with professional standards." *Id.* at 772. Instructions for negligent misrepresentation, however, focus on the third party's

The following sections analyze the court's holding under both theories of negligence.

### B. *The Privity Approach for Auditor Negligence Actions*

The *Bily* court held that under the tort of negligence, an auditor owes no duty of care to persons other than the client when conducting an audit.<sup>117</sup> The *Bily* court asserted that under California common law, duty is determined by public policy, which involves the balancing of numerous factors: 1) the extent to which the conduct was intended to affect the third party; 2) the foreseeability of injury to the third party; 3) the "degree of certainty" that the third party would suffer injury; 4) the proximate connection between conduct and harm; 5) the morality of the conduct; and 6) the policy of impeding future injury.<sup>118</sup> After considering these factors, the court based its holding on three "central concerns."<sup>119</sup> First, the court concluded that under the foreseeability standard, an auditor is exposed to potential liability "far out of proportion to its fault."<sup>120</sup> Second, the court believed that due to the sophistication of third-party plaintiffs in auditor liability actions, privity is the most appropriate standard.<sup>121</sup> Finally, the court maintained that the

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justifiable reliance on an auditor's opinions. *Id.* The *Bily* dissent, however, found the application of different standards to the two negligence claims illogical. *Id.* at 775 (Kennard, J., dissenting). The dissent argued that, because the two torts in this case were factually related and applied the same standard of care to the auditor's conduct, they should not be distinguished. *Id.* (Kennard, J., dissenting). The dissent stated that it would be "anomalous to hold that the class of persons to whom the accountant owes a duty varies depending on which legal theory has been pleaded." *Id.* at 776 (Kennard, J., dissenting); *see also* *Rosenblum v. Adler*, 461 A.2d 138, 142 (N.J. 1983). In *Rosenblum*, the Supreme Court of New Jersey stated that "[a] claim against the auditor is realistically one predicated upon his representations. Though the theory advanced here by the plaintiffs is directed to the service performed by accountants and thus is in the nature of malpractice, their claim can be viewed as grounded in negligent misrepresentation." *Rosenblum*, 461 A.2d at 142.

117. *Bily*, 834 P.2d at 747.

118. *Id.* at 761 (quoting *Biakanja v. Irving*, 320 P.2d 16, 19 (Cal. 1958)); *see also* *Citizens State Bank v. Timm, Schmidt & Co.*, 335 N.W.2d 361 (Wis. 1983). In *Citizens State*, the Wisconsin Supreme Court recognized the following public policy reasons against the imposition of liability despite a finding of negligence: 1) the injury was too remote from the negligent act; 2) the injury was out of proportion to the fault of the tortfeasor; 3) in retrospect, it appeared highly extraordinary that the negligence brought about the harm; 4) the recovery would have placed an unreasonable burden on the tortfeasor; 5) the allowance of recovery would likely open the door for fraudulent claims; and 6) the allowance of recovery would enter a field that has no sensible or just stopping point. *Citizens State*, 335 N.W.2d at 366.

119. *Bily*, 834 P.2d at 761.

120. *Id.*

121. *Id.*; *see also* Siliciano, *supra* note 2, at 1955. Siliciano states that third parties in auditor negligent misrepresentation cases are mostly "sophisticated commercial creditors" who are well experienced in risk assessment financial transactions. *Id.*

foreseeability approach failed to efficiently allocate loss and promote accurate auditing.<sup>122</sup>

The *Bily* court held that endorsement of the foreseeability approach in auditor liability cases would expose the auditor to "multibillion-dollar" liability that is significantly out of proportion to the fault of the independent auditor.<sup>123</sup> The court contended that because independent audits are conducted in a "client-controlled" environment, the quality and accuracy of the audit is determined by the quality and accuracy of the information supplied.<sup>124</sup> Furthermore, after the client obtains the audit, the auditor loses control over who receives the audit.<sup>125</sup> Therefore, the court concluded that despite the auditor's efforts, the client maintains "primary control of the financial reporting process."<sup>126</sup> Under these circumstances, the court noted that potential liability to all foreseeable third parties is disproportionate to the fault of the auditor who has limited control over the accuracy and dissemination of his services.<sup>127</sup>

The court's second reason for limiting an auditor's liability focused on the sophistication and knowledge of the plaintiff in this type of action.<sup>128</sup> The court noted that investors and creditors, through training and experience, possess substantial knowledge concerning capital markets.<sup>129</sup> As a result, the court believed that these investors and creditors should realize the limitations of a "broadly-phrased professional opinion based on a necessarily confined examination."<sup>130</sup> The court distinguished the sophisticated plaintiff from the "presumptively powerless consumer" in products liability actions, where the privity barrier has been removed.<sup>131</sup> Furthermore, unlike consumers in product liability

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122. *Bily*, 834 P.2d at 761. Instead, the court argues that the foreseeability approach promotes "dislocations of resources, including increased expense and decreased availability of auditing services in some sectors of the economy." *Id.* *But see* *Rosenblum v. Adler*, 461 A.2d 138, 152-53 (N.J. 1983) (imposing liability on auditors provides for equitable distribution of loss resulting from auditor's negligent conduct).

123. *Bily*, 834 P.2d at 764.

124. *Id.* at 760.

125. *Id.* at 762. The court noted that the dissemination of the audit report was "within the exclusive province of client management." *Id.*; *see also* *Lazare*, Note, *supra* note 16, at 902-04 (discussing problems associated with uncontrolled use and distribution of audit reports and advocating judicial limitations on auditor's liability to prevent this "unique problem").

126. *Bily*, 834 P.2d at 762.

127. *Id.* at 763.

128. *Id.* at 765.

129. *Id.*

130. *Id.* The majority, however, did not take into consideration the fact that some creditors, although sophisticated, still lack the financial resources to conduct investigations outside of the independent audit. *See id.* at 785 (Kennard, J., dissenting) (differentiating between "wealthy and financial savvy" third parties and third parties with only "modest means").

131. *Id.* at 765.



cases, the court opined that the sophisticated investor or lender could reduce the risk of erroneous financial opinions by making contractual arrangements with the client, by dealing directly with the client's auditor, or by conducting its own audit.<sup>132</sup>

Finally, the court disagreed with the proposition that the foreseeability standard would ensure more careful audits and more effective risk allocation.<sup>133</sup> The court stated that the expansion of liability would not significantly increase auditing accuracy.<sup>134</sup> The court supported this contention by noting the auditor's dependence on the client for financial information and the intensive work involved in preparing such an audit.<sup>135</sup> The court concluded that expansion of an auditor's liability would instead increase the price of audits.<sup>136</sup> In addition, the court noted that the imposition of liability would decrease the availability of audits to businesses in young industries where failure rates are typically high.<sup>137</sup> Moreover, the court believed that losses from erroneous financial information are more efficiently absorbed by investors and creditors, who can diversify their investment and loan portfolios.<sup>138</sup>

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132. *Id.* In summary, the court reasoned:

As a matter of economic and social policy, third parties should be encouraged to rely on their own prudence, diligence, and contracting power, as well as other informational tools. This kind of self-reliance promotes sound investment and credit practices and discourages the careless use of monetary resources. If, instead, third parties are simply permitted to recover from the auditor for mistakes in the client's financial statements, the auditor becomes, in effect, an insurer of not only the financial statements, but of bad loans and investments in general.

*Id.*

133. *Id.* at 765-66.

134. *Id.* at 766. *But see* Rosenblum v. Adler, 461 A.2d 138, 152 (extending auditor's duty to foreseeable third parties may promote more accurate audits through stricter standards and tighter supervision); Rusch Factors, Inc. v. Levin, 284 F. Supp. 85, 91 (D.R.I. 1968) (foreseeability approach would raise cautionary procedures in accounting industry).

135. *Bily*, 834 P.2d at 766.

136. *Id.* The AICPA's code of ethics permits adjustment of price in relation to the level of an auditor's responsibility: "In determining fees, a CPA may assess the degree of responsibility assumed by undertaking an engagement as well as the time, manpower and skills required to perform the service in conformity with the standards of the profession." AICPA AUDITING STANDARDS: ORIGINAL PRONOUNCEMENTS, *supra* note 20, at § 56.06.

137. *Bily*, 834 P.2d at 766; *see also* Foust, *supra* note 53, at 78 (reporting that many accounting firms do not audit small businesses because they commonly are target of lawsuits); Zabihollan Rezaee, *Management of an Accounting Practice*, CPA J., May 1989, at 66-70. Rezaee cautions accountants to evaluate potential clients thoroughly. Rezaee, *supra*, at 63. Before retaining a client, the accountant should review the client's "integrity, ability to pay for services, management experience, and potential conflicts of interest." *Id.* The accountant should also investigate whether the client was involved in any prior litigation. *Id.*

138. *Bily*, 834 P.2d at 766. *But see* Rusch Factors v. Levin, 284 F. Supp. 85, 91 (D.R.I. 1968) (noting that "risk of loss" more easily and fairly dispersed when imposed on auditors who can, in turn, transfer cost to its customers). The *Bily* court did not consider the issue of insurance for auditors. *See Bily*, 834 P.2d at

For the preceding reasons, the California Supreme Court held that under a claim for negligence, an auditor's liability for conducting an independent audit is limited to its client.<sup>139</sup> The court, however, did offer the possibility of recovery for a limited group of third parties under the tort of negligent misrepresentation.<sup>140</sup>

#### B. *The Restatement Approach and Negligent Misrepresentation*

In determining the scope of liability under the tort of negligent misrepresentation, the court concluded that the *Restatement (Second) of Torts* section 552 was most accordant with the "elements and policy foundations" of the tort.<sup>141</sup> First, the court noted that by limiting liability only to those parties who were actually foreseen, an auditor can assess his potential liability and make rational decisions about who to audit.<sup>142</sup> Moreover, the court stated that limiting liability to those parties who the auditor actually intended to supply with information strengthens the connection between the auditor's negligent conduct and the third party's harm.<sup>143</sup> This connection, the court reasoned, prevents causation problems and makes reliance evidence more credible.<sup>144</sup> Finally, the court concluded that, other than *International Mortgage*, California courts have consistently required that the supplier of information intend to act for the benefit of a third party or limited group of third parties in a "specific and circumscribed transaction."<sup>145</sup>

#### C. *Justice Kennard's Dissent*

In a lengthy dissent, Justice Kennard stated that under California law, an individual is liable for all reasonably foreseeable harm caused by his or her negligence<sup>146</sup> and contended that any exceptions to this rule must be supported by public policy.<sup>147</sup> Justice Kennard then provided

766 & n.14. Although this issue may have strengthened its holding, the majority could not address it. *See id.* The only information supplied on the matter came from amicus curiae briefs provided by the California Society of Certified Public Accountants. *See id.* The brief included results of in-house industry surveys that pertained in part to insurance availability and use in the accounting industry. *Id.* The court declined to use the information because it found it biased. *Id.*

139. *Id.* at 767.

140. *Id.* at 768-73.

141. *Id.* at 769.

142. *Id.*

143. *Id.*

144. *Id.*

145. *Id.* at 771.

146. *Id.* at 776 (Kennard, J., dissenting). The dissent looked to California Civil Code § 1714(a) (West 1986). *Id.* (Kennard, J., dissenting). The code specifically stated that "[e]very one is responsible, not only for the result of his [or her] willful acts, but also for an injury occasioned to another by his [or her] property or person . . . ." *Id.* (Kennard, J., dissenting) (citing CAL. CIV. CODE § 1714(a) (West 1986)).

147. *Id.* (Kennard, J., dissenting); *see Christensen v. Superior Court*, 54 Cal.

several reasons why *no exception* to the existing foreseeability rule is needed in the area of accountant liability.<sup>148</sup>

In discussing the connection between an auditor's conduct and a third party's injury, Justice Kennard asserted that due to common business practices, foreseeability of harm to third parties relying on inaccurate financial reports is readily apparent.<sup>149</sup> Moreover, Justice Kennard stated that economic loss to third parties is also apparent and relatively simple to prove.<sup>150</sup> Moreover, Justice Kennard contended that once justifiable reliance is established, the connection between an auditor's conduct and the resulting third party's economic injury is sufficiently close to warrant liability.<sup>151</sup>

The dissent also responded to the majority's view that the extension of liability to third parties is unfair where the auditor's negligence is slight in comparison to the client's errors.<sup>152</sup> Justice Kennard asserted that proportionality of fault has no relevance in the determination of

3d 868, 885 (Cal. 1991) (holding every person liable for injuries caused by his or her negligent conduct except where clearly supported by public policy); *Rowland v. Christian*, 69 Cal. 2d 108, 112 (Cal. 1968) (same).

148. *Bily v. Arthur Young & Co.*, 834 P.2d 745, 776-82 (Cal. 1992) (Kennard, J., dissenting).

149. *Id.* at 777 (Kennard, J., dissenting).

150. *Id.* (Kennard, J., dissenting). The dissent distinguished economic harm from emotional distress. *Id.* It asserted that although emotional distress can be easily feigned, economic loss can be accurately measured. *Id.* (Kennard, J., dissenting). Several courts, however, have exempted a defendant from liability in cases where the only injury is economic loss. See *Robins Dry Dock & Repair Co. v. Flint*, 275 U.S. 303 (1927); *In re Kinsman Transit Co.*, 388 F.2d 821 (2d Cir. 1968). This view is referred to as the "economic loss doctrine." See Siliciano, *supra* note 2, at 1941-51. For a comprehensive discussion advocating the economic loss doctrine in the context of auditors' liability cases, see *id.* Justice Wiener asserted that the economic loss doctrine is unsound because economic loss can be just as harmful as physical harm and therefore should not be treated differently for liability purposes. Wiener, *supra* note 5, at 250. Justice Wiener argued that a negligently prepared audit can inflict "pecuniary loss more potent than the chisel or the crowbar." *Id.* (quoting *United States v. Benjamin*, 328 F.2d 854, 863 (2d Cir.), *cert. denied sub nom. Howard v. United States*, 377 U.S. 953 (1964)).

151. *Bily*, 834 P.2d at 777 (Kennard, J., dissenting). In order to recover damages against an independent auditor, a plaintiff must prove that he or she relied on the auditor's opinion and that this reliance caused his or her economic injury. *Id.* at 777-78 (Kennard, J., dissenting). To prove reliance, the plaintiff must establish that he or she reviewed the report and would not have entered into a transactional relationship with the auditor's client but for the unqualified opinion of the auditor's report. *Id.* (Kennard, J., dissenting). Moreover, the plaintiff must prove that his or her economic injury was a foreseeable outcome. *Id.* (Kennard, J., dissenting). Assuming a third party can prove causation in this manner, "the connection between the auditor's negligence and the third party's injury must be judged close by any reasonable measure." *Id.* (Kennard, J., dissenting). Although the majority did not refute the causal connection between an auditor and a third party when reliance exists, it feared that reliance could be easily fabricated and hard to disprove. *Id.* at 764.

152. *Id.* at 780 (Kennard, J., dissenting).

auditors' liability to third parties and should only be addressed in indemnity actions between the auditor and the client.<sup>153</sup>

The dissent also disagreed with the majority view that under the foreseeability approach, accountants will be exposed to nearly limitless liability.<sup>154</sup> It argued that proof of justifiable reliance, along with the relatively short time period in which business information becomes obsolete, ensures "reasonably predictable" liability limits.<sup>155</sup> Moreover, the dissent contended that there was no concrete evidence to support the claim that expanded liability would impose an undue burden on accountants.<sup>156</sup> Justice Kennard asserted that if this burden was too great in jurisdictions adopting the foreseeability standard, state legislature would have intervened.<sup>157</sup>

In discussing the auditor's work product, the dissent stated that liability will ensure more careful auditing practices and deter unlawful conduct.<sup>158</sup> The dissent highlighted that a deterrent effect is especially appropriate for the auditing function because without potential third party liability, accountants would have no motivation to act as carefully as they should.<sup>159</sup> Moreover, insofar as accountants are motivated by the desire to satisfy their clients, who need favorable audits to obtain capital, accountants would be more susceptible to client biases without the threat of third party liability.<sup>160</sup>

In addressing the majority's holding under the negligent misrepresentation claim, the dissent criticized the majority's adoption of the *Restatement* approach.<sup>161</sup> It concluded no rational basis existed for favoring

153. *Id.* (Kennard, J., dissenting).

154. *Id.* at 781 (Kennard, J., dissenting).

155. *Id.* (Kennard, J., dissenting).

156. *Id.*, at 782-83 (Kennard, J., dissenting). The dissent stated that no "competent evidence" was available to prove liability insurance was unobtainable or too expensive to acquire. *Id.* at 783 (Kennard, J., dissenting). The dissent also noted that accountants can control their potential liability by establishing agreements with their clients that limit distribution of audit reports. *Id.* at 785 (Kennard, J., dissenting).

157. *Id.* at 783 (Kennard, J., dissenting).

158. *Id.* at 781-82 (Kennard, J., dissenting).

159. *Id.* at 782 (Kennard, J., dissenting).

160. *Id.* (Kennard, J., dissenting). The dissent distinguished this case from emotional distress cases where liability to third parties has been restricted. *Id.* (Kennard, J., dissenting). In emotional distress cases, there is no need to extend liability to third parties because recovery by the person physically injured from a negligent act provides adequate deterrence against similar future conduct. *Id.* (Kennard, J., dissenting). Third party losses in an auditors' negligence claim "are not a mere ripple effect of some primary wrong to a different party." *Id.* (Kennard, J., dissenting). In most cases, the auditor's negligence does not injure the client (in reality, an auditor's negligence may help clients); rather, such negligence primarily injures a third party investor or lender who relies on the inaccurate information. *Id.* (Kennard, J., dissenting).

161. *Id.* at 784 (Kennard, J., dissenting).

foreseen users over foreseeable users.<sup>162</sup> Justice Kennard contended that the *Restatement* approach “penalizes knowledge and rewards ignorance.”<sup>163</sup> Justice Kennard theorized that, to avoid third party liability, an auditor could simply communicate to the client his or her desire to remain unaware of the audit’s intended beneficiaries.<sup>164</sup>

For the foregoing reasons, the dissent concluded that an auditor should be liable to those reasonably foreseeable third parties who rely on the auditor’s inaccurate information, regardless of the negligence theory advanced.<sup>165</sup>

In addressing the impact of the majority’s decision, the dissent concluded that the decision in *Bily* will have two major consequences.<sup>166</sup> First, the dissent opined that there would be no protection for reasonably foreseeable third parties who justifiably rely on an auditor’s inaccurate statements.<sup>167</sup> Second, because liability helps prevent inaccurate financial information from entering “the waters of commerce,” the dissent believed that the majority’s holding would have grave consequences on California’s economic community.<sup>168</sup> These consequences

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162. *Id.* (Kennard, J., dissenting). The dissent argued that there is no need to distinguish these groups because neither group pays for the audit or is owed a greater standard of care. *Id.* (Kennard, J., dissenting). Furthermore, the dissent opined that:

[t]o allow liability to turn on the fortuitous occurrence that the accountant’s client specifically mentions a person or class of persons who are to receive the reports, when the accountant may have that same knowledge as a matter of business practice, is too tenuous a distinction for us to adopt as a rule of law.

*Id.* (Kennard, J., dissenting) (quoting *Blue Bell v. Peat, Marwick, Mitchell & Co.*, 715 S.W.2d 408, 412 (Tex. Ct. App. 1986)).

163. *Id.* (Kennard, J., dissenting); cf. Sandra P. Henry & Michael R. Lane, *Legislating Accountant’s Third-Party Liability?*, CPA J., June 1989, at 49. Henry and Lane contend that because long lists of potential third parties will expand auditors’ liability under Illinois law, auditors would prefer an extremely short list or none at all. *Id.* The authors believe, however, that if the auditor is looking out for the best interest of the client, the list of third parties “should be as long and as broad as possible [to] allow the client latitude in the use of the report.” *Id.* The authors also state that auditor’s should have a “good faith” duty to be informed of interested third parties. *Id.*

164. *Bily v. Arthur Young & Co.*, 834 P.2d 745, 784 (Cal. 1992) (Kennard, J., dissenting); see also Boveri & Marshall, Note, *supra* note 5, at 287 (noting that “a clever accountant could circumvent the Restatement provision by asking his [or her] client not to reveal the intended users of the statements.”).

165. *Bily*, 834 P.2d at 784 (Kennard, J., dissenting).

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

167. *Id.* (Kennard, J., dissenting). The dissent believed that the majority’s holding provided unfair advantages to the “wealthy and financially savvy” investors and lenders who can afford to seek alternative measures in assessing the risk of a financial transaction while disadvantaging those investors and lenders with modest means whose only feasible resource is the independent audit report. *Id.* (Kennard, J., dissenting); see also Wiener, *supra* note 5, at 253 (noting that “not all lenders and investors are of an institutional species, capable financially and in terms of expertise to guard against the accountant’s negligence.”).

168. *Bily*, 834 P.2d at 786 (Kennard, J., dissenting).

will include "less careful audits, inefficient allocation of capital resources, increased transaction costs for loans and investments, and delay and disruption in the processes of lending and investing," in Justice Kennard's opinion.<sup>169</sup>

#### IV. ANALYSIS

The majority, relying on public policy considerations, concluded that an auditor's liability falls outside of California's well-established foreseeability standard.<sup>170</sup> Although the court identified valid interests in protecting accountants, it failed to adequately consider the auditor's unique relationship with third parties and responsibilities that auditors have to them.<sup>171</sup> These factors are essential to determine legal duty and should have received greater attention. Moreover, instead of arbitrarily limiting an auditor's liability to foreseen third parties, the court should have placed more faith on the existing judicial safeguards and deferred to the legislature to impose a more equitable solution.<sup>172</sup> Finally, auditors have the ability to limit their own scope of liability through various cautionary and contractual measures.<sup>173</sup> If the majority had considered these factors, its decision would have struck a more equitable balance between compensating foreseeable third parties and protecting independent auditors—a balance which *International Mortgage* achieved by adopting the foreseeability standard.

The majority disregarded the fact that an auditor has broader responsibilities to third parties than almost any other professional information supplier.<sup>174</sup> The primary purpose of an independent audit is to provide the economic community with unbiased and credible information for the execution of business decisions.<sup>175</sup> Without this function, auditing would be insignificant both for the economic community and

169. *Id.* (Kennard, J., dissenting).

170. For a discussion of California's foreseeability standard as established by common and civil law, see *supra* notes 90-98 and accompanying text.

171. For a discussion of an auditor's responsibilities and relationship to third parties, see *supra* note 4 and accompanying text.

172. For a discussion of judicial safeguards and the role of legislation in auditor liability claims, see *infra* notes 190-98 and accompanying text.

173. For a discussion of the various cautionary and contractual measures available to independent auditors, see *infra* notes 199-200 and accompanying text.

174. See Lazare, Note, *supra* note 16, at 902 (stating that auditors' scope of liability is more expansive than in other professions).

175. *Bily v. Arthur Young & Co.*, 834 P.2d 745, 749 (Cal. 1992). The majority in fact states that audits are primarily used by companies to "establish the financial credibility of their enterprises in the perceptions of [capital suppliers]." *Id.*; see also Reinier H. Kraakman, *Discussion of Auditor Liability and Information Disclosure*, 3 J. ACCT., AUDITING & FIN. 341 (1988) (noting that "[a]uditors are informational intermediaries who make representations credible by verifying their contents."); Paschall, *supra* note 1, at 723 (recognizing third parties as primary users of audits to evaluate financial position of audited company).

for the individual accounting firms.<sup>176</sup> If independent audits were not utilized in the financial community, the "Big Six" accounting firms would turn into the "Tiny Thousand" accounting firms.

The court's rationale also ignored the fact that some professions are materially and inherently more riskier than others. For example, attorneys may be subject to third party liability. Their potential liability exposure, however, is usually limited to the client or a small number of third parties.<sup>177</sup> Accountants, however, who know that their work is used by more third parties than almost any other profession, who voluntarily enter into the auditing profession, who receive premiums for their services, and whose demand is driven by these third parties should not receive protection from the courts just because their work exposes them to a variety of potential claimants.<sup>178</sup> For example, there are many sim-

176. Fiflis, *supra* note 60, at 35 (noting that "[t]he primary reason for the existence of the accounting profession . . . is the audit function and its related activities."); *see also* STETTLER, *supra* note 1, at 26. In discussing the importance of an auditor's independence, Stettler theorizes that

[n]ormally, a member of a profession is expected to be concerned solely with the interests of clients, and deference to the interests of another party would be cause for breach-of-contract action by the client. But in performing independent auditing services, the public accountant must rise above the interests of the client and be concerned with the interests of third parties, often unknown, who will be relying on the financial statements in question. Only so long as the public accountant maintains high standards of independence and impartiality will audit reports continue to be accepted by businesses, financial institutions, and investors. Should the practitioner lose the reputation for independence in auditing work, an opinion would become no more acceptable than the representations by management in statements which it has prepared.

*Id.* at 26.

177. Gary Lawson & Tamara Mattison, *A Tale of Two Professions: The Third-Party Liability of Accountants and Attorneys for Negligent Misrepresentation*, 52 OHIO ST. L.J. 1309, 1316-17 (1991). While auditors have a duty to provide unbiased information for the economic community, attorneys only have a duty to "zealously pursue" the interests of their clients. *Id.* Therefore, third parties would be less likely to rely on the representations made by an attorney. *Id.*

178. *See* Besser, *supra* note 12, at 507. Besser states that "it becomes a highly questionable practice to allow a profession to be employed and gain the benefits of a position of trust without insisting it assume the responsibilities which accompany that position." *Id.*; *see also* Henry & Lane, *supra* note 163, at 46-51. In discussing the various legislative enactments which limit an auditor's liability, Henry and Lane explain that:

Accountants . . . are in the unusual position of having potential liability to unspecified or unknown third parties; this is primarily due to the nature of the accountants' work product—the auditors report. Therefore, accountants are in a unique situation which requires them to work for a particular client and to owe a duty of due care to that client, as well as to unspecified third parties who may use and rely on the report in making business decisions.

*Id.* at 46; *see also* Wiener, *supra* note 5, at 258 (arguing that accountants "derive substantial economic benefit" from auditing and should therefore be responsible for performing these tasks in "professionally reasonable manner").

ilarities between an amateur flyer and a model car builder. Both hobbyists enjoy their activities, both invest time and resources in their activities, and both voluntarily chose to participate in their respective activities. Amateur flyers, however, know that their chances of causing injury to themselves or others is phenomenally greater than that of a model car builder. Insofar as amateur fliers acknowledge this greater risk, they concede that the risk is the "price" for playing the game. Similarly, auditors know the level of responsibility to the public that they voluntarily assume, and they should not receive liability exemption from this responsibility by the court.<sup>179</sup>

Moreover, holding accountants responsible to third parties who rely on their certified financial statements will ensure higher quality and more accurate audits.<sup>180</sup> For example, clients need favorable audits to obtain capital.<sup>181</sup> If the audit is favorable, the client may not look into the quality of the audit. Therefore, the auditor has no incentive to provide the highest quality audit but only the most favorable one.<sup>182</sup> Imposing third party liability will ensure that an audit's quality and accuracy will not be overlooked.<sup>183</sup> Moreover, imposition of third party liability not only insures that financial information entering the economic system remains credible but also increases the level of trust that investors and creditors have in audits.<sup>184</sup> This measure of trust allows them to invest in high risk, high growth companies.<sup>185</sup>

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179. See *Bily v. Arthur Young & Co.*, 834 P.2d 745, 786 (Cal. 1992) (Kennard, J., dissenting). Justice Kennard asserted that auditors should not be allowed to "profit from the value produced by anticipated third party reliance and yet escape all responsibility when their negligence results in injury to relying third parties." *Id.* (Kennard, J., dissenting).

180. *Rosenblum v. Adler*, 461 A.2d 138, 152 (N.J. 1983) (imposing duty of care to foreseeable third parties induces auditors to perform more meticulous auditing reviews); *Citizens State Bank v. Timm, Schmidt & Co.*, 335 N.W.2d 361, 365 (Wis. 1983) (imposing liability to third parties deters negligent conduct and increases due care in performance of services).

181. See *Bily*, 834 P.2d at 781 (Kennard, J., dissenting).

182. *Id.* at 781-82 (Kennard, J., dissenting).

183. See *Kraakman*, *supra* note 175, at 341. *Kraakman* argues that the imposition of duty to third party lenders and investors will compel auditors to warrant the quality of their reports. *Id.* This "warranty" will increase the credibility of information and reduce the monetary risks of third parties transacting with audited companies. *Id.*

184. *Id.* at 781 (Kennard, J., dissenting).

185. *Id.* (Kennard, J., dissenting). Justice Kennard asserts that investors who suffer losses after relying on unsound certified financial information will not have the resources to support the growth of other businesses. *Id.* (Kennard, J., dissenting). Moreover, investors, damaged by their reliance on erroneous financial information, will divert investment capital for high risk, high growth businesses and invest their funds in "well-established," stable businesses. *Id.* (Kennard, J., dissenting); *but see Siliciano*, *supra* note 2, at 1967. *Siliciano* theorizes that extension of liability to third parties will have a negative impact on "young or small or unstructured" companies. *Id.* Typically these companies have low success rates. Auditors, fearing third party liability in the event of fail-



The majority's view that third party creditors and lenders should rely on their own resources to evaluate the financial condition of a particular business<sup>186</sup> is economically inefficient considering the existing role of the independent auditor as a "public watchdog."<sup>187</sup> The court failed to consider that some creditors and investors lack the resources to conduct separate financial investigations.<sup>188</sup> Economic inefficiency is created when these creditors with limited resources perform a function that has already been completed.<sup>189</sup> Dollars wasted on performing redundant audits could be channeled into productive expenditures. Therefore, the law should not discourage investors and creditors from relying on these representations.

Although the auditing field should be held responsible for its negligent misrepresentations, the social utility of auditing suggests that auditors cannot be exposed to a level of liability so severe that it would destroy their industry.<sup>190</sup> Prior to *Bily*, the existing judicial standards in California provided the necessary safeguards against such catastrophe without resorting to the restrictive steps taken in *Bily*. For example, although the majority correctly stated that the accurateness of an auditor's work is primarily controlled by the client, it failed to recognize that an auditor's standard of care is judged in light of this condition.<sup>191</sup> An independent auditor's level of care is thus determined by what a reason-

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ure, will be unwilling to provide services to these high risk companies. *Id.* Therefore, creditors and investors involved with these particular entities will be left with no audit protection. *Id.* This consequence is far worse than the "imperfect protection" realized under the *Ultramares* approach. *Id.*

186. *Bily*, 834 P.2d at 765.

187. For a discussion of the role of an independent auditor as a "public watchdog," see notes 2-4, and accompanying text.

188. *Bily*, 834 P.2d at 785 (Kennard, J., dissenting) (noting that small creditors and investors may not be able to afford separate audit).

189. *Id.* (Kennard, J., dissenting). Justice Kennard asserted that the majority's decision will harm the small creditors and investors "whose only faults are their modest means and their willingness to place their trust in independent audit reports." *Id.* (Kennard, J., dissenting).

190. See *Raymond v. Paradise Unified Sch. Dist.*, 31 Cal. Rptr. 847, 851-52 (Cal. Ct. App. 1963). The *Raymond* court stated that the determination of duty in a negligence action takes into consideration several policy judgements, including the valuation of social utility in the activity that causes injury. *Id.* The social utility of such activity must be weighed against several factors including: 1) the risks associated with the activity; 2) the capability of each party to shoulder the financial burdens of the injury; and 3) the ability of each party to disseminate the loss. *Id.* When the social utility of the activity is greater than the risks of the activities, no duty should be enforced. RESTATEMENT (SECOND) OF TORTS §§ 291-293 (1965).

191. See AICPA AUDITING STANDARDS: ORIGINAL PRONOUNCEMENTS, *supra* note 20, at § 110.02. The AICPA Auditing Standards states that "[t]he financial statements are management's responsibility. The auditor's responsibility is to express an opinion on the financial statements. Management is responsible for adopting sound accounting policies and for establishing and maintaining an internal control structure." *Id.* The AICPA further states that "[t]he responsibility of the independent auditor for failure to detect fraud (which responsibility

ably prudent independent auditor would do in a similar situation, not by what a reasonably prudent internal accountant would do in the same situation.<sup>192</sup> Moreover, a plaintiff must prove that he justifiably relied to his or her detriment on an auditor's inaccurate statements.<sup>193</sup> This standard leads to a presumption that large sophisticated investors and lenders who have the resources to use other means to make financial decisions would not "place all their eggs in one basket" and solely rely on certified financial statements.<sup>194</sup>

Arguably, there are negative aspects of the "foreseeability approach" that judicial safeguards cannot adequately prevent. For example, commentators have suggested that the foreseeability approach prevents auditor's from obtaining adequate insurance in a "foreseeable jurisdiction"<sup>195</sup> and increases meritless claims arising from third parties

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differs as to clients and others) arises only when such failure clearly results from failure to comply with generally accepted auditing standards." *Id.* § 110.05.

192. *Bily*, 834 P.2d at 779 (Kennard, J., dissenting); see also *International Mortgage Co. v. John P. Butler Accountancy Corp.*, 223 Cal. Rptr. 218, 225 (Cal. 1986). The *International Mortgage* court stated that:

The auditor is not guaranteeing the client's records and resulting financial statements are perfect; only that any errors which might exist could not be detected by an audit conducted under GAAS and GAAP. Thus, the auditor's degree of control over the client's records is unimportant; the auditor need only control his or her abilities to apply GAAS and GAAP to a given audit situation.

*Id.*

193. Paschall, *supra* note 1, at 704.

194. The majority asserted that the final decision for a creditor or lender to issue a business capital is based on many different business factors that "have little to do with the audit report." *Bily*, 834 P.2d at 779. In this respect, a defendant auditor can attack a claim of reliance by providing expert testimony showing "that a reasonable investor or lender would not have relied on the accountant's opinion under the same circumstances . . ." *Id.* (Kennard, J., dissenting). *But see* Siliciano, *supra* note 2, at 1947. Siliciano argues that if accountant liability is extended, a third party who is injured when a company goes into financial ruin will have a vested incentive to "feign or exaggerate its reliance" on an audit in an attempt to recover from the solvent accountant. *Id.* Siliciano notes that this type of fabricated reliance is difficult to test in the court room because most evidence will come from the uncorroborated oral testimony of the plaintiff. *Id.* (citing *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 746 (1975)).

195. Siliciano, *supra* note 2, at 1949. Insurance companies fix their prices according to the level of risks encountered by the insured. *Id.* at 1950. If insurance companies are unable to ascertain the scope of an insured's losses, uncertainty will demand that insurers raise their rates significantly. *Id.* This situation directly applies to independent auditors in a "foreseeable state," because they have no way of determining approximately how much capital is "riding" on the audit. *Id.*; see also Jack P. Kramer, *Is There Trouble on the Horizon?*, CPA J., March 1992, at 67 (stating that current recession coupled with erosion of privity standard will lead to high insurance rates); Foust, *supra* note 53, at 78. The Big Six's insurance premiums have increased "tenfold" since 1985, while their maximum coverage has been halved. Foust, *supra* note 53, at 78. Typical settlements, that are between \$20 and \$30 million, are not fully covered under existing insurance policies. *Id.*

looking for a quick "out of court" settlement.<sup>196</sup> These problems, however, could be substantially reduced by legislative reform, which could impose harsh penalties on parties advancing meritless claims.<sup>197</sup> Moreover, legislation could also mandate arbitration for accountant liability cases to eliminate jury biases, reduce the price of litigation, and prevent unreasonably large damage awards.<sup>198</sup>

Individual accountants can also take precautionary measures to limit their exposure to potential liability through contractual measures.<sup>199</sup> Moreover, accountants can also limit their liability exposure by performing a careful review and evaluation of the client and his business, by limiting the distribution of the audit report, and by boosting in-house quality control.<sup>200</sup>

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196. See Siliciano, *supra* note 2, at 1947. Siliciano argued that extended liability will produce a plethora of law suits which may force accountants to settle otherwise nonmeritorious claims. *Id.* (citing *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 740 (1975)). In *Blue Chip*, the Supreme Court explained that a third party's complaint against an independent auditor may have "a settlement value to the plaintiff out of any proportion to its prospect of success at trial." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 740 (1975); see also Cook, *supra* note 8, at 1 (stating that "unwarranted litigation" and "coerced settlements" are principle causes of accountant's liability problems).

197. Cook, *supra* note 104, at 7. One act that has been proposed to reduce the volume of meritless claims in "10b-5" actions (concerning securities fraud) and negligence actions is the Securities Private Enforcement Reform Act of 1992. *Id.* at 6. Under this act, accountants liable for negligence would only be accountable for their proportionate share of the third party's injuries. *Id.* For example, if the auditor can prove that the client fraudulently tampered with the financial statements, a jury would be able to measure the amount of injury caused by the client and the injury caused by the auditor. *Id.* Moreover, losing parties would be responsible for paying the winning party's court costs and legal fees, unless the losing party can prove that the claim was substantially justified. *Id.* Adoption of these policies may discourage meritless claims and give "blameless" accountants the incentive to go to trial rather than settling outside of court. *Id.*

198. JONATHAN M. LANDERS ET AL., *CIVIL PROCEDURE* 340-41 (2d ed. 1988).

199. See Anthony J. Mancuso, *Engagement Letters*, CPA J., Dec. 1991, at 81. Mancuso believes that accountants can limit their potential liability in auditing functions by preparing an engagement letter. *Id.* An engagement letter typically outlines the scope of the audit, the responsibilities between the client and the auditor, and the limitations of the audit. *Id.*

200. Rezaee, *supra* note 137, at 66-70. Rezaee's program is divided into client-based and firm-based strategies. *Id.* Under the client-based strategy, Rezaee advocates the following preventive measures: 1) evaluate potential clients carefully by reviewing their management, general integrity, ability to pay, prior litigation history and any possible conflicts of interest; 2) exercise "professional skepticism" during the entire audit by recognizing the incentives clients may have to intentionally tamper with numbers in the financial statements; 3) avoid servicing clients outside the accounting firm's "level of expertise;" 4) develop a comprehensive knowledge of the client's business, including the client's relationship with its third party lenders and creditors, the clients prior tax returns and financial statements, and internal client developments (such as changes in management, the nature of the client's business and its litigation status); and 5) use "extreme care" in auditing high legal risk clients. *Id.* at 66-67.

The foreseeability standard set forth in *International Mortgage* provided adequate protection for auditors while redressing the valid claims of third party investors and creditors. The *Bily* court's decision, limiting the scope of an auditor's duty of care, is unwarranted under California's current public policy and judicial safeguards. This decision will have serious repercussions not only to individual investors and creditors, but also, to the general economic community.

#### IV. IMPACT OF *BILY*: TOUGH TIMES FOR SMALL CREDITORS AND INVESTORS

The decision in *Bily* will inevitably protect California's accounting industry while injuring financially limited investors and lenders who lack the resources to obtain other qualified information.<sup>201</sup> Every auditor attempts to juggle the conflicting interests of remaining unbiased and obtaining clients who desire favorable audit reports.<sup>202</sup> If liability exposure is restricted, the incentive for remaining unbiased decreases, and the balance shifts in favor of pleasing the client by providing a biased opinion.<sup>203</sup> This result would interject erroneous information into the

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Under the firm-based strategy, Rezaee suggests the following measures: 1) solve internal personnel problems by identifying drug and alcohol abuse in employees that may cause them to perform inadequately; 2) implement stringent quality control measures focusing on "compliance with GAAS, quality control policies and procedures, and professional ethics;" 3) provide an adequate number of qualified employees to conduct the audit while ensuring that they are properly trained and supervised and that they understand the necessary level of "professional care;" 4) implement peer reviews and provide continuous in-house educational training for personnel; 5) exercise due professional care at all times; 6) limit third party reliance on your reports by describing the purpose of your services, identifying the third party or class of third parties entitled to rely on the audit, disclaiming liability to all other third parties, and limiting the use of the audit report; 7) maintain adequate legal counsel and insurance coverage; 8) obtain letters of representation from clients which ensure that the client knows its responsibility for the "fair representation of financial statements" and which provides the accounting firm with evidence of contributory negligence in any potential law suits; 9) restructure the accounting firm to limit its exposure to liability; 10) review a client's internal control system as a way to identify weak or problem areas of the client; 11) adopt new standard audit report that "communicate[s] more clearly" to Congress, juries and the public the "nature of the auditor's work, what an audit entails, the responsibility assumed, as well as the auditor's conclusions about the financial statements;" and 12) exercise defensive auditing by asking at all stages of the audit, "[a]m I able to defend my work." *Id.* at 67-70.

201. *Bily*, 834 P.2d at 785 (Kennard, J., dissenting).

202. Stettler, *supra* note 1, at 26-27. Stettler theorizes that if the auditor acts with too much "zeal for independence" he or she may lose his or her client. *Id.* On the other hand, if the auditor tries too hard to please the client, the result may be approval of statements that are "misleading." *Id.*

203. *Bily v. Arthur Young & Co.*, 834 P.2d 745, 781 (Cal. 1992) (Kennard, J., dissenting). Kennard argues that auditors are highly motivated to keep their clients satisfied because the client pays for the auditing services and provides continuing business. *Id.* (Kennard, J., dissenting). This is not to say that audi-

marketplace. The resulting effect would damage individual creditors and investors who rely on the auditor's opinion and ultimately weaken the economic community that needs accurate information to function optimally.<sup>204</sup> This consequence would defeat the purpose of the Securities and Exchange Act of 1934 which mandates independent financial audits for most publicly held companies.<sup>205</sup> Moreover, the *Bily* decision may start a trend toward severely limiting an auditor's liability exposure in jurisdictions that have not yet addressed this issue.

#### V. CONCLUSION

Restricting the scope of accountants' liability under the privity approach or under the *Restatement* approach is a judicial solution that may reward unreasonable and unethical conduct and may arbitrarily deny recovery to injured third parties with valid legal claims. In the mid-1930s, the Security and Exchange Commission boosted the demand for independent audits by mandating unbiased financial disclosure. Our legal system should not allow accountants to derive all the benefits of independent auditing without assuming reciprocal responsibilities. The solution to this issue is not to deny valid claims to reasonably foreseeable third parties. Rather, the proper solution is to retain the foreseeability standard, maintain tight judicial standards and pursue legislation that reduces meritless claims and insurance costs.

*Lewis P. Checchia*

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tors will act fraudulently, but rather, that they may not commit to the same high standard of care. STETTLER, *supra* note 1, at 26-27. Moreover, Stettler argues that an auditor's desire to satisfy his or her client may result in approving misleading financial statements that results in loss of reputation. *Id.* Stettler states that once information concerning a specific accountant's failure to remain independent goes public, the economic community will become suspicious and lose faith in all public accountants. *Id.* at 26.

204. See Wiener, *supra* note 5, at 259. Justice Wiener, in discussing the important role of independent auditing in the financial community, argues that auditor misrepresentations produce "skewed investment decisions." *Id.* These decisions have a negative effect on the general economy and result in "significant financial injury" to individual investors. *Id.* But see Robert Mednick, *The War on Accountant's Legal Liability*, CPA J., Mar. 1990, at 23 (stating that expansive liability provides incentives for auditors to restrict "free flow" of financial information which is critical to our economic system).

205. For a discussion of the acts passed under the Securities and Exchange Commission, see *supra* note 13 and accompanying text.