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John A. Siliciano
Cornell Law School

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NEGLIGENT ACCOUNTING AND THE LIMITS OF INSTRUMENTAL TORT REFORM

*John A. Siliciano**

Instrumental reasoning¹ has fueled much of modern tort reform.² In justifying the expansion of liability rules, courts seldom rely primarily on the need to correct some perceived injustice visited on an individual plaintiff by the alleged tortfeasor. Reform instead is frequently defended as a means of furthering broader policy goals, such as creating incentives to encourage risk creators to take optimal levels of care or allocating the costs of accidents to parties better able to shoulder such losses.³

Using this arsenal of instrumental policy objectives, judicial tort reform has enjoyed considerable success in the field. During this century, tort reform has overwhelmed most of the barriers — such as privity, warranty disclaimer, and the absence of negligence — that traditionally shielded manufacturers from liability for defective products. The sheer relentlessness of this reform impulse, however, raises concerns about whether there may exist some inherent limits to tort's ter-

* Associate Professor of Law, Cornell Law School. B.A. 1975, Cornell University; J.D. 1979, Columbia Law School; M.P.A. 1979, Princeton University. — Ed. I thank Gregory Alexander, Jack Barceló, George Hay, James Henderson, Robert Hillman, Sheri Lynn Johnson, Jonathan Macey, Dale Oesterle, Russell Osgood, Stephen Pepper, Richard Posner, Stewart Schwab, Steven Shiffrin, Gary Simson, Robert Summers and the participants in a Cornell Law School faculty workshop for assisting me with this article.

1. As used in this article, "instrumentalism" has a dual meaning. On a broad level, it describes a willingness by some courts to use common law adjudication as a means of solving general social problems. In the tort context, this social engineering perspective is reflected in the efforts by courts, during the last half century, to reshape liability rules for the express purpose of enhancing accident deterrence, improving society's loss-spreading capacity, and compensating needy victims. But "instrumentalism" also has a narrower, consequentialist aspect: it refers to the assumption by such courts that the means selected to solve social problems — in other words, the specific design of the legal rule — will actually prove effective. As this article suggests, the second component plainly should inform the first, for if the efficacy of the means-end relationship cannot realistically be verified, the aggressiveness with which some courts approach the solution of general social problems requires rethinking. For a comprehensive treatment of instrumentalism, see R. SUMMERS, *INSTRUMENTALISM AND AMERICAN LEGAL THEORY* (1982).

2. See Stewart, *Crisis in Tort Law? The Institutional Perspective*, 54 U. CHI. L. REV. 184 (1987). Tort reform, as the term is used in this article, refers to the efforts of courts, and to a lesser extent, legislatures, during the last half-century to expand common law liability rules. It is to be distinguished from a more recent and opposing reform effort in which manufacturers, physicians, and various other defendant classes have sought legislative relief from such expansions of liability.

3. See generally Priest, *The Invention of Enterprise Liability: A Critical History of the Intellectual Foundations of Modern Tort Law*, 14 J. LEGAL STUD. 461 (1985).

ritorial imperative.⁴

To assess this issue in a specific context, this article examines a recent, pronounced shift in the standard of care owed by an accountant to third parties who rely on the accountant's audit of another party's financial statements. Traditionally, accountants could only be sued for negligence by parties with whom they were in contractual privity or its functional equivalent.⁵ In all other cases, third-party actions were restricted to claims based on fraud. A more expansive negligence rule, courts feared, would expose accountants to a degree of liability so extreme and indeterminate as to threaten their existence.⁶ In essence, public policy demanded a limit on accountant liability.

Recently, however, a number of courts have abandoned the privity defense and now hold accountants liable in negligence to third parties whose reliance on the accountant's work product was foreseeable.⁷ Such decisions justify the expansion of liability in purely instrumental terms; the costs of negligent accounting, like the costs of injuries from any other defective product, should be shifted from "innocent" third parties to the accounting profession, which through insurance can further shift such risks to the "ultimate consuming public."⁸ Moreover, by encouraging accountants "to exercise greater care leading to greater diligence in conducting audits," an expanded liability rule would serve the "public interest."⁹

The significance of this conflict over whether public policy demands a narrow or a broad definition of the accountant's duty of care ultimately depends on the success of the instrumental rationales used by the reform courts. If the privity rule is seen simply as a vestigial remnant of a bygone age, possessing neither theoretical nor practical utility, then its rejection by some courts represents a true triumph of instrumental reasoning. But if privity retains force in the age of in-

4. See, e.g., Henderson, *Expanding the Negligence Concept: Retreat from the Rule of Law*, 51 IND. L.J. 467 (1976); Priest, *The Current Insurance Crisis and Modern Tort Law*, 96 YALE L.J. 1521 (1987); Schuck, *The New Judicial Ideology of Tort Law*, in AMERICAN INSTITUTIONS AND THE LIABILITY CRISIS (W. Olson ed. forthcoming); Stewart, *supra* note 2. Some potential restraints on the utility of instrumental rationales in tort law are suggested in Siliciano, *Corporate Behavior and the Social Efficiency of Tort Law*, 85 MICH. L. REV. 1820, 1853-63 (1987).

5. See notes 25-36 *infra* and accompanying text.

6. *Ultramares Corp. v. Touche*, 255 N.Y. 170, 179-80, 174 N.E. 441, 444 (1931).

7. *International Mortgage Co. v. John P. Butler Acct. Corp.*, 177 Cal. App. 3d 806, 223 Cal. Rptr. 218 (1986); *Touche Ross & Co. v. Commercial Union Ins.*, 514 So. 2d 315 (Miss. 1987); *Rosenblum, Inc. v. Adler*, 93 N.J. 324, 461 A.2d 138 (1983); *Citizens State Bank v. Timm, Schmidt & Co.*, 113 Wis. 2d 376, 335 N.W.2d 361 (1983). This rule change was preceded in a number of jurisdictions by less drastic departures from the privity rule. See text accompanying notes 42-47 *infra*.

8. *International Mortgage Co.*, 177 Cal. App. 3d at 820, 223 Cal. Rptr. at 227.

9. *Rosenblum, Inc.*, 93 N.J. at 351-53, 461 A.2d at 152-53.

strumentalism, either as a component of contemporary tort theory or as a practical element of public policy, then the casual ease with which it has been jettisoned by the reform jurisdictions raises true concerns about the ambitions of tort law.

In addressing these issues, this article first explores the relationship between the accountant and the reliant third party, and recounts the mounting judicial hostility to the accountant's traditional privity defense. Next, the article critically examines the arguments that have supported traditional privity-based regimes. The third section turns to the reform courts¹⁰ and tests whether the rationales offered for reform justify abandoning the privity requirement.

Concluding that a convincing case for reform has yet to be made and — given the complexity of a properly executed instrumental analysis — may never be made, the article's final section reconsiders the utility of instrumental reasoning as a self-sustaining basis for tort reform. It suggests that, if the negligent accounting cases are any indication, the viability of tort reforms based on instrumental rationales may ultimately depend on how well the outcome in such cases corresponds to more traditional notions of fairness between the parties. In situations where this subtext of fairness concerns yields no obvious answer, the analysis suggests that courts armed with an instrumental agenda should proceed with considerably more caution than they currently exercise.

I. THE *ULTRAMARES* DOCTRINE AND THE REFORM COURTS

A. *The Nature of Third-Party Claims Against Accountants*

Accountants perform a variety of services for their clients, but their greatest exposure to claims by third parties arises out of their auditing function.¹¹ In an audit engagement, an accountant reviews financial statements prepared by a client and issues an opinion stating whether such statements fairly represent the financial status of the audited entity.¹² If discrepancies or deficiencies are identified, the ac-

10. The label "reform courts" is used throughout this article to refer to the jurisdictions that have embraced a full foreseeability of harm test for assessing the liability of accountants to reliant third parties. See note 7 *supra* and notes 48-60 *infra* and accompanying text. The decisions of these courts in the accounting cases are but a small part of the instrumental tort reform movement described in notes 1-2 *supra*.

11. See generally Note, *Accountants' Liability for Compilation and Review Engagements*, 60 TEXAS L. REV. 759 (1982). For companies whose stock is publicly traded, an audit is a practical, and — under the federal securities laws — a statutory necessity. Newer, smaller concerns, however, do not inevitably use audits, but instead sometimes verify their financial condition through less rigorous forms of review. See *id.*

12. In doing so, the accountant employs procedures adopted by the profession — generally accepted auditing standards [GAAS] — to verify the data supporting the statements. Addition-

countant may either insist on appropriate changes in the financial statements or qualify its opinion regarding the statements.¹³

In most cases, the end product of an audit is a short certificate, attached to the financials, stating the accountant's opinion that the audited statements "fairly present" the economic condition of the client. In the first instance, this unqualified opinion serves as an assurance to the client that its own perception of its financial health is valid and that its accounting systems are reliable. The audit, however, frequently plays a second major role: it assists the client in convincing third parties that it is safe to extend credit to or invest in the client.

Such third parties fall into several categories. They include entities, such as banks and major suppliers, that may have significant and ongoing relationships with the client. A second group, somewhat more removed from the client, might include the client's occasional creditors and suppliers as well as significant investors. Finally, if the client is a publicly traded company, individual investors who have no direct or ongoing relation with the client may rely on the integrity of the auditor's report in deciding whether to invest in the client.

For a variety of reasons, however, the audited financials may present a materially inaccurate picture of the client's financial health.¹⁴ Frequently, a financially troubled client will fraudulently alter its financial statements and underlying records in an effort to obtain further funds from creditors and investors. The accountant, in auditing these statements, may fail to detect the fraud and therefore issue an unqualified opinion. Alternatively, a poorly conducted audit may fail to detect unintended but material errors in the financial statements. In either event, third parties that relied on the misleading statements will be injured if the client's economic health deteriorates to a point where it is unable to meet its obligations.

In seeking redress, injured parties typically can state claims based on fraud or negligent misrepresentation directly against the client.¹⁵ The client's probable insolvency, however, renders such primary claims unpromising.¹⁶ The injured third party's focus therefore natu-

ally, the accountant examines the internal accounting systems and controls of the client in order to assess the client's capacity, under generally accepted accounting principles [GAAP], to produce reliable financial information. See generally PROFESSIONAL STANDARDS, AU § 110.01 (Am. Inst. of Certified Pub. Accountants 1987).

13. See generally A. ARENS & J. LOEBBECKE, *AUDITING: AN INTEGRATED APPROACH* 643-63 (1976).

14. See generally K. ST. PIERRE, *AUDITOR RISK AND LEGAL LIABILITY* (1983).

15. In addition, depending on the circumstances, such parties may have claims based on contract or on the securities laws against a defaulting client.

16. See Minow, *Accountant's Liability and the Litigation Explosion*, *J. ACCT.*, Sept. 1984, at 70, 76. If the client has entered a bankruptcy liquidation or reorganization, a tort action by an

rally shifts to the accountant, whose unqualified opinion regarding the client's financial statements may have encouraged the third party's involvement with the client, and who typically remains solvent despite the client's demise.

Third-party tort claims against the accountant generally fall into two categories. The plaintiff may seek to assert a claim based on fraud, alleging that the accountant knowingly assisted the client in concealing its true financial condition.¹⁷ Fraudulent behavior involving intentional misconduct by the accountant towards the plaintiff has never been insulated by a privity defense.¹⁸ But if the accountant was unaware of the client's perpetration of fraud or if the audit simply failed to detect nonfraudulent errors in the client's financial statements, third-party claims against the accountant typically are based on a theory of negligent misrepresentation.¹⁹

At this point, the issue of privity comes into play. In determining the scope of the duty of care running from the accountant to injured parties, courts face several options. Under a strict privity formulation, the duty of care owed by the accountant would be bounded by the reach of the formal contract with the client. As alternatives to strict privity, the duty could be extended to specific noncontracting parties, or entire categories of such parties, whose reliance on the accountant's work product was actually foreseen by the accountant. Even more broadly, the scope of duty might be defined to encompass all those whose reliance was merely foreseeable, rather than specifically foreseen. The choice among these alternatives raises important policy concerns.

B. *The Ultramares Doctrine*

The first significant judicial inquiry into the appropriate scope of the accountant's duty of care toward reliant third parties appeared in Chief Judge Cardozo's 1931 opinion for the New York Court of Ap-

injured third party will, if successful, result only in an unsecured claim against the debtor. See 11 U.S.C. § 507 (1982 & Supp. III 1985). In the context of a bankruptcy, of course, the prospects of full recovery on such a claim are very limited.

17. The exact scienter requirements for such actions vary among jurisdictions. Most traditional jurisdictions have allowed such third-party actions if either an actual intent to deceive or gross inattention sufficient to raise an inference of fraud is shown. See *Ultramares*, 255 N.Y. at 179, 174 N.E. at 444.

18. See, e.g., *Ultramares*, 225 N.Y. at 179, 174 N.E. at 444.

19. Such claims are occasionally framed in terms of professional malpractice rather than negligent misrepresentation, but there appears to be no practical difference between the two. See *Greycas, Inc. v. Proud*, 826 F.2d 1560, 1563 (7th Cir. 1987), cert. denied, 108 S. Ct. 775 (1988); *Cenco Inc. v. Seidman & Seidman*, 686 F.2d 449, 453 (7th Cir. 1982), cert. denied, 459 U.S. 880 (1982).

peals in *Ultramares Corp. v. Touche*.²⁰ The defendant accounting firm, Touche, Niven & Co., was engaged by Fred Stern & Co. to audit a yearly balance sheet. Touche was aware that Stern, a capital-intensive importing concern, would use the balance sheet in its business dealings with creditors, investors, and suppliers. To this end, Touche supplied Stern with multiple copies of the completed financial statement. Attached to the statement was Touche's certificate noting that "said statement, in our opinion, presents a true and correct view of the financial condition of Fred Stern & Co., Inc., as at December 31, 1923."²¹

While the certified balance sheet showed a healthy company, Stern was in fact insolvent. Stern's management had concealed this fact by creating fictitious assets, and Touche's rather superficial audit had failed to uncover the fraud. Using the certified balance sheet, Stern obtained numerous loans from Ultramares Corporation; many of these loans remained outstanding when Stern was ultimately declared bankrupt. Ultramares, thwarted by the bankruptcy from directly recovering its losses from Stern, turned to Touche, and asserted claims based on both fraud and negligence.

Cardozo confronted these claims during a period of profound upheaval in tort doctrine. His earlier decision in *MacPherson v. Buick Motor Co.*²² had considerably chilled tort law's brief flirtation with contractual privity as a general basis for defining duty,²³ and had in its place proposed foreseeability of harm as the chief determinant of tort liability. Yet, the transition was incomplete, for courts remained apprehensive about the vastly expanded tort liability that might flow from embracing the foreseeability norm in all contexts. Reflecting this fear, a number of doctrines worked to deny liability even in some cases where harm was plainly foreseeable. Among the most important of these doctrines was the exclusion of claims based purely on economic loss.²⁴

In *Ultramares*, these strains collided. Cardozo readily acknowledged the foreseeability of harm arising from a defective audit. "The defendants," he observed, "knew . . . that in the usual course of busi-

20. 255 N.Y. 170, 174 N.E. 441 (1931).

21. 255 N.Y. at 174, 174 N.E. at 442.

22. 217 N.Y. 382, 111 N.E. 1050 (1916).

23. See *Winterbottom v. Wright*, 10 M. & W. 109 (Ex. 1842). Although *Winterbottom's* privity rule was widely accepted in American jurisdictions, see J. HENDERSON & R. PEARSON, *THE TORTS PROCESS* 652-53 (2d ed. 1981), the New York Court of Appeals had begun, prior to *MacPherson*, to limit its scope. See, e.g., *Loop v. Litchfield*, 42 N.Y. 351 (1870); *Smith v. Devlin*, 89 N.Y. 470 (1882).

24. See generally text at notes 69-93 *infra*.

ness the balance sheet when certified would be exhibited by the Stern company to banks, creditors, stockholders, purchasers or sellers, according to the needs of the occasion, as the basis of financial dealings."²⁵ However, the very satisfaction of *MacPherson's* foreseeability criteria simply highlighted the potential that this formulation of the liability standard had for visiting extensive and purely economic losses on a negligent accountant. For if, as Cardozo observed, "[t]he range of the transactions in which a certificate of audit might be expected to play a part was as indefinite and wide as the possibilities of the business that was mirrored in the summary,"²⁶ then the nature of losses arising from a defective audit was likely to be equally diverse and far flung. In short, Cardozo confronted a critical choice between acceding to tort's expanding reliance on the foreseeability test or restricting liability by creating an exception to that general approach. He chose the latter.

With respect to the fraud claim, Cardozo recognized that tort liability might extend beyond the contractual relationship to encompass third parties where the accountant knowingly sought to deceive those injured or where the audit was conducted so poorly that the accountant could have no honest belief in the validity of its conclusions.²⁷ Where the claim was based on simple negligence, however, Cardozo reasoned that a narrower scope of duty was necessary. Conceding that Touche's audit was "so imperfect and perfunctory" as to breach a duty to the client to act "with the care and caution proper to their calling,"²⁸ the court nonetheless held that "the ensuing liability for negligence is one that is bounded by the contract, and is to be enforced between the parties by whom the contract has been made."²⁹

An opposite rule, the court feared, might "expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class," thereby creating a burden "so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences."³⁰ Nor, the court reasoned, was the implication of such a duty necessary to protect third parties. "We doubt," noted Cardozo, "whether the average business man receiving a certificate without paying for it and receiving it merely as one among a multitude of possible investors, would look for anything more [than

25. 255 N.Y. at 173-74, 174 N.E. at 442.

26. 225 N.Y. at 174, 174 N.E. at 442.

27. 225 N.Y. at 179, 174 N.E. at 444.

28. 255 N.Y. at 179, 174 N.E. at 444.

29. 255 N.Y. at 189, 174 N.E. at 448.

30. 255 N.Y. at 179-80, 174 N.E. at 444.

legal protection against outright fraud]."³¹ Finally, the court rejected an analogy between a negligent audit and a defective product. Recognizing that with respect to the latter "[t]he assault upon the citadel of privity is proceeding . . . apace,"³² the court nonetheless concluded that the differences between the harm caused by a defective product and that resulting simply from "the circulation of a thought"³³ were sufficient to justify retention of the privity doctrine in cases of negligent misrepresentation.

The privity rule of *Ultramares*, however, was not absolute. The court reaffirmed its prior decision in *Glanzer v. Shepard*,³⁴ in which a purchaser of beans was allowed to recover in negligence from the public weigher used by the seller. Recognizing a duty of care on the part of the weigher toward reliant third parties was appropriate under such circumstances because the "end and aim of the transaction" was to provide information to the purchasers, even though the weighers were reimbursed by the bean sellers.³⁵ "The bond was so close as to approach that of privity, if not completely one with it."³⁶ No equivalent relationship existed, however, between an accountant and "the indeterminate class of persons who, presently or in the future, might [rely] on the audit."³⁷ Thus, while actual foresight of reliance by a specific third party might displace privity as a trigger for liability, the mere objective foreseeability of such reliance would not suffice to establish an accountant's liability in negligence for economic losses suffered by reliant third parties.

C. *The Assault Resumes*

The *Ultramares* decision dominated judicial thinking for the next thirty years. It reflected a simple, largely intuitive judgment that the abrogation of the privity defense might easily impose costs on the pro-

31. 255 N.Y. at 189, 174 N.E. at 448. Indeed, the court feared that the abrogation of the privity doctrine would "so expand the field of liability for negligent speech as to make it nearly, if not quite, coterminous with that of liability for fraud." 255 N.Y. at 185, 174 N.E. at 447.

32. 255 N.Y. at 180, 174 N.E. at 445. Indeed, that "assault" had been launched by Cardozo fifteen years earlier in the landmark case of *MacPherson v. Buick Motor Co.*, 217 N.Y. 382, 111 N.E. 1050 (1916).

33. 255 N.Y. at 181, 174 N.E. at 445.

34. 233 N.Y. 236, 135 N.E. 275 (1922).

35. 233 N.Y. at 238-39, 135 N.E. at 275.

36. *Ultramares*, 255 N.Y. at 182-83, 174 N.E. at 446. Cardozo's reasoning on this point is quite unsatisfactory. The bean purchasers were plainly not in contractual privity with the sellers; indeed, that is why they constituted "third parties." Rather than attempt to recast the relationship as a privity-based one, the result in *Glanzer* is better defended by reference to the ease with which the defendant weighers could assess and control for the risk their conduct posed for such a specifically foreseen third party. See note 108 *infra*.

37. 255 N.Y. at 183, 174 N.E. at 446.

fession that would exceed the benefits actually realized by reliant third parties.³⁸ As time passed, however, several developments challenged the rationale of *Ultramares*. First, the privity doctrine, which New York had already rejected in *MacPherson* as a defense to negligence claims for defective products,³⁹ became extinct nationwide in product liability cases.⁴⁰ As privity disappeared in the products context, its retention in the accounting area became — by sheer force of contrast — increasingly suspect. Second, instrumental theories of tort reform emphasizing the benefits of expansive liability grew more important. This growth was reflected in the development of a rich body of scholarly literature, judicial dissatisfaction with privity defenses and warranty disclaimers in the products context, and the emergence of strict liability as the dominant regime for defective products.⁴¹

Thus, in the late 1960s, courts⁴² and commentators⁴³ began chafing at what appeared to be the increasingly outdated restraints imposed by the *Ultramares* decision.⁴⁴ This dissatisfaction initially took the form of expansive interpretations of the *Glanzer* exception to the privity requirement. Some courts, as well as the drafters of the Restatement (Second) of Torts, relaxed *Glanzer's* insistence on a specifically foreseen and identified third party and found *Ultramares* inapplicable when the plaintiff was a member of a “foreseen and limited” class of

38. In noting the negative consequences that might flow from an expanded liability rule, Cardozo plainly employed the type of consequentialist reasoning typical of instrumentalism. See note 1 *supra*. Yet, at least in *Ultramares*, Cardozo rejected the more central characteristic of instrumental tort reform: the belief that judges, through modification of liability rules, could and should address broad social problems. Instead, as discussed below, Cardozo placed substantial emphasis on the value of private ordering and, failing that, on the primacy of the legislature as the instrument of reform.

39. *MacPherson v. Buick Motor Co.*, 217 N.Y. 382, 111 N.E. 1050 (1916).

40. R. EPSTEIN, C. GREGORY & H. KALVEN, *CASES AND MATERIALS ON TORTS* 425 (1984).

41. See generally Owen, *Rethinking the Policies of Strict Products Liability*, 33 VAND. L. REV. 681 (1980); Priest, *supra* note 3.

42. See, e.g., *Rusch Factors, Inc. v. Levin*, 284 F. Supp. 85 (D.R.I. 1968); *Aluma Kraft Mfg. Co. v. Elmer Fox & Co.*, 493 S.W.2d 378, 383-85 (Mo. Ct. App. 1973).

43. See, e.g., Besser, *Privity? — An Obsolete Approach to the Liability of Accountants to Third Parties*, 7 SETON HALL L. REV. 507 (1976); Fiflis, *Current Problems of Accountants' Responsibilities to Third Parties*, 28 VAND. L. REV. 31 (1975); Solomon, *Ultramares Revisited: A Modern Study of Accountants' Liability to the Public*, 18 DE PAUL L. REV. 56 (1968); Weiner, *Common Law Liability of the Certified Public Accountant for Negligent Misrepresentation*, 20 SAN DIEGO L. REV. 223 (1983); Comment, *Auditors' Responsibility for Misrepresentation: Inadequate Protection for Users of Financial Statements*, 44 WASH. L. REV. 139 (1968).

44. Indeed, some courts and commentators have suggested that a simple “Awe for Cardozo” preserved privity in the accountants context while it crumbled elsewhere. See *International Mortgage Co. v. John P. Butler Acct. Corp.*, 177 Cal. App. 3d 806, 812, 223 Cal. Rptr. 218, 221 (1986) (“That the ‘citadel’ has not been breached, insofar as certified public accountants’ liability, may well be due to the reputation of the distinguished author of *Ultramares*.”); Shugrue, *Auditing the Auditors*, TRIAL, June 1977, at 31; Weiner, *supra* note 43, at 236 n.9.

reliant third parties.⁴⁵ Other courts amended *Glanzer's* "end and aim" restriction so that a claim could be maintained as long as the supplying of information to a third party was "one of the ends and aims" of the audit.⁴⁶ A few courts pushed further, altogether abandoning the "end and aim" restriction of *Glanzer* in favor of recognizing a duty to any actually foreseen third party.⁴⁷

None of these formulations, however, directly challenged the notion that liability was inappropriate in cases where the accountant had not actually foreseen reliance by some reasonably identifiable third party. Yet, defining duty in a way that turned simply on the presence of the defendant appeared to some commentators a hard line to hold. Why, the question seemed to be, should an accounting firm be absolved of liability simply because it was subjectively ignorant of the objectively foreseeable harm its negligence might impose on third parties? Unable to find a ready answer, tort commentators urged that the accountant's duty of care be expanded to encompass third parties whose reliance was merely foreseeable rather than actually foreseen.⁴⁸

This expansion came in the 1983 decision of the New Jersey Supreme Court in *Rosenblum, Inc. v. Adler*,⁴⁹ a case now widely hailed as the heir-apparent to *Ultramares*.⁵⁰ Touche again played the role of

45. See, e.g., *Rusch Factors, Inc. v. Levin*, 284 F. Supp. at 93. See also RESTATEMENT (SECOND) OF TORTS § 552 (1977) (limiting plaintiff class to "the person or one of a limited group of persons for whose benefit and guidance [the accountant] intends to supply the information or knows that the recipient intends to supply it").

46. *White v. Guarente*, 43 N.Y.2d 356, 362, 372 N.E.2d 315, 319 (1977) (emphasis added). See also *Ryan v. Kanne*, 170 N.W.2d 395 (Iowa 1969); *Haddon View Inv. Co. v. Coopers & Lybrand*, 70 Ohio St. 2d 154, 436 N.E.2d 212 (1982).

47. See, e.g., *Shatterproof Glass Corp. v. James*, 466 S.W.2d 873 (Tex. Civ. App. 1971).

48. See, e.g., *Weiner*, *supra* note 43, at 252 ("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 upon sound analytical considerations."). See also *Rusch Factors*, 284 F. Supp. at 91 (dicta raising the question of expansion of liability to include foreseeable parties); *Touche Ross & Co. v. Commercial Union Ins.*, 514 So. 2d 315, 321 (Miss. 1987) ("In fact, there is no reason to prefer a foreseen user over a foreseeable user. . .").

49. 93 N.J. 324, 461 A.2d 138 (1983).

50. See, e.g., Recent Developments, *Rosenblum v. Adler: CPAs Liable at Common Law to Certain Reasonably Foreseeable Third Parties Who Detrimentially Rely on Negligently Audited Financial Statements*, 70 CORNELL L. REV. 335 (1985) [hereinafter Recent Developments, CPAs]; Recent Decisions, *Tort Law — The Enlarging Scope of Auditor's Liability to Relying Third Parties*, 59 NOTRE DAME L. REV. 281 (1983); New Jersey Developments, *Rosenblum v. Adler: The New Jersey Supreme Court Expands Accountants' Liability*, 37 RUTGERS L. REV. 161 (1984); Comment, *The Citadel Falls? — Liability for Accountants in Negligence to Third Parties Absent Privity: Credit Alliance Corp. v. Arthur Andersen & Co.*, 59 ST. JOHN'S L. REV. 348 (1985); Comment, *Adjusting Accountants' Liability for Negligence: Recovery for Reasonably Foreseeable Users of Financial Statements*, 13 BALT. L. REV. 301 (1984); Recent Developments, *Torts — Accountants' Liability — An Independent Auditor Who Furnishes a Financial Statement Owes a Duty to All Those Whom the Auditor Should Reasonably Foresee as Recipients of That Opinion; One Who Is Not in Privity with the Auditor But Who Relies on Such Statements May Recover in Negligence*, 29 VILL. L. REV. 563 (1983); See also authorities cited in note 43 *supra*.

the hapless accountant, once more having failed to detect fraudulent entries in the financial statements of another fiscally moribund client, Giant Stores Corporation. When Giant's fraud was discovered and it entered bankruptcy, the plaintiffs, who had relied on the financial statements in agreeing to merge with Giant, sued Touche for negligence. On appeal, the New Jersey Supreme Court framed the issue in broad, instrumental terms: "[T]o what extent," queried the court, "does public policy justify imposition of a duty" on accountants towards third parties who foreseeably rely on the accountant's work?⁵¹

In answering this question, the court drew on themes dominant in prior judicial departures from *Ultramares*.⁵² "Why," the court began rhetorically, should privity remain a bar "when no such limit is imposed . . . on liability for defects in products . . . ?"⁵³ Concluding that the manufacturer of a defective product and the author of an unqualified auditor's opinion are both "impliedly holding out that the product is reasonably fit, suitable and safe,"⁵⁴ the court found the analogy to products liability law persuasive. Thus, through use of the products analogy, the *Rosenblum* court depicted its decision as a long overdue alignment of doctrine rather than a bold departure from tradition.

Pursuing the analogy, the court concluded that abrogation of the privity requirement would further the same instrumental policy rationales that supported the expansion of liability rules in the defective products context. First, increasing the accountant's exposure to liability might "cause accounting firms to engage in more thorough reviews."⁵⁵ Similarly, an expanded scope of duty would compensate the "innocent creditor or investor" while shifting the risk of a negligent audit "to the one responsible for the loss."⁵⁶ Such loss shifting, of course, raised the spectre of financial ruin that preoccupied Cardozo in *Ultramares*. But the *Rosenblum* court concluded that accountants could guard against such burdens simply by purchasing malpractice

But see Ebke, In Search of Alternatives: Comparative Reflections on Corporate Governance and the Independent Auditor's Responsibilities, 79 NW. U. L. REV. 663 (1984). Note, H. Rosenblum, Inc. v. Adler: *A Foreseeably Unreasonable Extension of an Auditor's Legal Duty*, 48 ALB. L. REV. 876 (1984).

After this article was accepted for publication, an excellent critique of the *Rosenblum* court's approach appeared in the literature. See Goldberg, *Accountable Accountants: Is Third-Party Liability Necessary?*, 17 J. LEGAL STUD. 295 (1988). Many elements of that analysis parallel what is offered here: readers, particularly those interested in an economic perspective on the problem, are likely to find Professor Goldberg's article valuable.

51. 93 N.J. at 329, 461 A.2d at 140.

52. See, e.g., *Rusch Factors*, 284 F. Supp. at 93.

53. 93 N.J. at 341, 461 A.2d at 147.

54. 93 N.J. at 341, 461 A.2d at 147.

55. 93 N.J. at 350, 461 A.2d at 152.

56. 93 N.J. at 351, 461 A.2d at 152.

insurance and charging its cost to the client.⁵⁷ These insurance costs, in turn, could be further dispersed by passing them on to the general consuming public. In sum, the court concluded, "[t]he public interest will be served by the rule we promulgate this day."⁵⁸

Rosenblum's challenge to *Ultramares* was applauded by most commentators,⁵⁹ and has served as the touchstone in other jurisdictions for subsequent judicial reassessments of the privity defense.⁶⁰ Thus, it was with some suspense that the New York Court of Appeals, in the 1985 case of *Credit Alliance Corp. v. Arthur Andersen & Co.*,⁶¹ undertook to examine the continued validity of its *Ultramares* doctrine. Yet, after acknowledging the growing sentiment favoring expanded liability rules, the court, with little elaboration, affirmed the continuing validity of the *Ultramares* doctrine.⁶² Following *Credit Alliance*, courts have continued to declare themselves for, or against, retention of the accountant's traditional privity defense.⁶³

Predictably, the accounting profession has reacted to all this ferment with considerable dismay.⁶⁴ But even if this reaction is dismissed as the inevitable, reflexive anger any defendant class feels about the erosion of its traditional legal protections, the split in authority is disturbing itself, for it suggests a potential looseness or indeterminacy regarding the proper role of tort law or its ability to achieve its purported policy objectives. Unfortunately, the analyses offered by courts on both sides of the issue seldom consist of more than flat assertions that privity, or its rejection, will further some important instrumental goal. The academic press, which currently favors the reform courts, offers little more substance; typically, the accountant's privity defense is simply labelled as another "citadel" to be stormed, as if that incan-

57. 93 N.J. at 350, 461 A.2d at 152.

58. 93 N.J. at 353, 461 A.2d at 153.

59. See note 50 *supra*.

60. See *International Mortgage Co. v. John P. Butler Acct. Corp.*, 177 Cal. App. 3d 806, 819, 223 Cal. Rptr. 218, 226 (1986); *Citizens State Bank v. Timm, Schmidt & Co.*, 113 Wis. 2d 376, 386, 335 N.W.2d 361, 366 (1983).

61. 65 N.Y.2d 536, 493 N.Y.S.2d 435, 483 N.E.2d 110 (1985).

62. 65 N.Y.2d at 545-55, 493 N.Y.S.2d at 439-45, 483 N.E.2d at 114-20.

63. See, e.g., *Toro Co. v. Krouse, Kern & Co.*, 827 F.2d 155 (7th Cir. 1987) (following *Ultramares* and *Credit Alliance* in diversity action under Indiana law); *Touche Ross & Co. v. Commercial Union Ins.*, 514 So. 2d 315 (Miss. 1987) (following *Rosenblum*); *Raritan River Steel Co. v. Cherry, Bekaert & Holland*, 367 S.E.2d 609 (N.C. 1988) (after considering both approaches, court adopted intermediate, Restatement-based test).

64. See, e.g., Collins, *Malpractice Prevention and Risk Management*, J. ACCT., July 1986, at 52; Collins, *Professional Liability: The Situation Worsens*, J. ACCT., Nov. 1985, at 57; Gavin, Hicks & Decosimo, *CPA's Liability to Third Parties: The Risk Is Increasing*, J. ACCT., June 1984, at 80; Minow, *supra* note 16, at 70.

tation of Prosser's classic characterization⁶⁵ ended all debate on the wisdom of marshalling another crusade.⁶⁶

What is called for, then, is a more systematic examination of the arguments driving this schism. This article proceeds with such an inquiry by exploring the considerations that restrained Cardozo and the visions that motivate the reform movement.

II. THE ARGUMENTS FOR RESTRAINT: ECONOMIC LOSS AND THE PROSPECT OF PRIVATE ORDERING

In the richly textured world of contemporary tort scholarship,⁶⁷ Cardozo's justification of a privity defense for accountants seems, at first encounter, both underdeveloped and a bit quaint. Indeed, both reform courts and commentators often seem content to treat *Ultramares* as a timepiece of no enduring significance.⁶⁸ Yet, beneath its historical patina, the opinion reflects two themes that still influence tort law today — the fear of allowing recovery for pure economic loss and the advantages of using private ordering as a supplemental means of allocating risk. The question, therefore, is to what extent these attitudes should affect the liability rules governing negligent accounting.

A. *The Economic Loss Doctrine*

Foreseeability of harm has served as the touchstone of liability throughout much of tort law.⁶⁹ Still, under some circumstances, tort law resists this instinct, and resorts to fairly categorical limitations on liability even when harm is plainly foreseeable. The common law bars

65. Prosser, *The Assault upon the Citadel (Strict Liability to the Consumer)*, 69 YALE L.J. 1099 (1960). Ironically, Prosser borrowed the metaphor from Cardozo's *Ultramares* opinion. See 225 N.Y. at 180, 174 N.E. at 445.

66. See sources cited *supra* note 50.

67. See Schwartz, *Directions in Contemporary Products Liability Scholarship*, 14 J. LEGAL STUD. 763 (1985).

68. See sources cited *supra* note 44.

69. See text at notes 22-24 *supra*. Indeed, the reform courts in the negligent accounting cases all start from the presumption that foreseeability of harm ordinarily forms the basis of tort liability. See, e.g., *International Mortgage Co. v. John P. Butler Acct. Corp.*, 177 Cal. App. 3d 806, 820, 223 Cal. Rptr. 218, 227 (1986) ("tort liability should be delimited only by the concept of foreseeability"); *Rosenblum Inc. v. Adler*, 93 N.J. 324, 339, 461 A.2d 138, 145 (1983) ("Generally, within the outer limits fixed by the court as a matter of law, the reasonably foreseeable consequences of the negligent act define the duty and should be actionable."); *Citizens State Bank v. Timm, Schmidt & Co.*, 113 Wis. 2d 376, 386 (1984) ("The fundamental principle . . . is that a tortfeasor is fully liable for all foreseeable consequences of his act except as those consequences are limited by policy factors.").

against liability for fright without impact⁷⁰ and for failure to rescue⁷¹ provide two ready examples of this curtailment of the foreseeability norm. A third example, of more direct relevance here, is tort law's enduring reluctance to allow third-party recovery for pure economic loss.⁷²

The exact parameters of the economic loss doctrine are difficult to define.⁷³ Generally stated, the doctrine absolves a tortfeasor of liability for purely economic losses suffered by noncontractual parties as a result of his negligence. Judicial application of the doctrine, however, has hardly been consistent. A string of exceptions,⁷⁴ combined with the hostility of some courts toward any restrictions on the operation of the foreseeability norm,⁷⁵ diminish the utility of abstract formulations of the economic loss doctrine. It is therefore useful to consider a paradigmatic case.⁷⁶ Suppose a driver negligently crashes into an oncoming vehicle in the middle of the only river bridge connecting two halves of a city. Resulting damage to the bridge forces its closure. Under traditional negligence rules, the driver would be liable for dam-

70. See, e.g., *Tobin v. Grossman*, 24 N.Y.2d 609, 249 N.E.2d 419 (1969); *Mitchell v. Rochester Ry.*, 151 N.Y. 107, 45 N.E. 354 (1896), *overruled*, *People v. Mussenden*, 308 N.Y. 558, 10 N.Y. 2d 239 (1955). But see *Dillon v. Legg*, 68 Cal. 2d 728, 441 P.2d 912, 69 Cal. Rptr. 72 (1968). See generally, Henderson, *supra* note 4, at 515-19.

71. See, e.g., *Buch v. Amory Mfg. Co.*, 69 N.H. 257, 44 A. 809 (1898); *Yania v. Bigan*, 397 Pa. 316, 155 A.2d 343 (1959). See generally Henderson, *Process Constraints in Tort*, 67 CORNELL L. REV. 901, 928-43 (1982); Landes & Posner, *Salvors, Finders, Good Samaritans, and Other Rescuers: An Economic Study of Law and Altruism*, 7 J. LEGAL STUD. 83 (1978); Weinrib, *The Case for a Duty To Rescue*, 90 YALE L.J. 247 (1980).

72. See, e.g., *Robins Dry Dock & Repair Co. v. Flint*, 275 U.S. 303 (1927); *In re Kinsman Transit Co.*, 388 F.2d 821 (2d Cir. 1968). See generally Edmeades, *The Citadel Stands: The Recovery of Economic Loss in American Products Liability*, 27 CASE W. RES. L. REV. 647 (1977); Rabin, *Tort Recovery for Negligently Inflicted Economic Loss: A Reassessment*, 37 STAN. L. REV. 1513 (1985); Schwartz, *Economic Loss in American Tort Law: The Examples of J'Aire and of Products Liability*, 23 SAN DIEGO L. REV. 37 (1986).

73. See, e.g., J. HENDERSON & A. TWERSKI, *PRODUCTS LIABILITY: PROBLEMS AND PROCESS* 275 (1987) ("The case law and much of the literature on economic loss are distressingly difficult to follow. . . . It often seems that courts are seeking to determine whether in the world of Platonic forms the case will be relegated to the room that houses tort cases or the one that houses contract claims."); Schwartz, *supra* note 72, at 38 (difficult to formulate general theory of economic loss because "problem . . . is multiform rather than unitary in character"). See also Atiyah, *Negligence and Economic Loss*, 83 L. Q. REV. 248, 265-76 (1967).

74. See note 82 *infra*.

75. Indeed, the California and New Jersey courts that have led the assault on the accountant's traditional privity defense have been the most vocal in criticizing the restraints placed on tort law by the economic loss doctrine. See *J'Aire Corp. v. Gregory*, 24 Cal. 3d 799, 598 P.2d 60, 157 Cal. Rptr. 407 (1979); *People Express Airlines, Inc. v. Consolidated Rail*, 100 N.J. 246, 495 A.2d 107 (1985).

76. This bridge closure example is adapted from *Dundee Cement Co. v. Chemical Labs., Inc.* 712 F.2d 1166 (7th Cir. 1983); *Leadfree Enters., Inc. v. United States Steel Corp.*, 711 F.2d 805 (7th Cir. 1983); *In re Kinsman Transit Co.*, 388 F.2d 821, 825 n.8 (2d Cir. 1968); *Nebraska Innkeepers, Inc. v. Pittsburgh-Des Moines Corp.*, 345 N.W.2d 124 (Iowa 1984); and *Rickards v. Sun Oil Co.*, 23 N.J. Misc. 89, 41 A.2d 267 (1945).

age to the bridge and the other car and for injuries sustained by persons involved in the crash. He would also be liable, in most jurisdictions, for purely economic harms such as lost wages suffered by these "direct" victims of his negligence.⁷⁷

Any analysis driven solely by the foreseeability of harm, however, would remain unsatiated. In blocking traffic on the bridge, the negligent driver has directly impaired the flow of commerce between the two halves of the city. Southside plumbers will be unable to fix Northside leaks, and Northside policemen will be forced to forgo their favorite Southside donuts. These short-run economic losses are as foreseeable, under any sensible view of that concept,⁷⁸ as the physical harm and property damage inflicted at the scene of the accident. Nonetheless, under such circumstances, tort law through the economic loss doctrine has resisted extending liability to the limits of foreseeability for a variety of reasons.

Most importantly, tort courts and scholars have been concerned that allowing recovery for such economic losses would generate excessive levels of liability.⁷⁹ To be sure, such problems can occasionally arise even when the harm in issue is the traditional grist of tort law — property damage and personal injury. Still, in most cases, this is not so; the laws of physics generally limit the degree of physical harm caused by a tortious act.⁸⁰ The momentum of an economic harm, on the other hand, is not so easily dampened. Instead, the impact of the original loss is likely to ripple outward to injure more remote parties whose economic fate is linked to the original victim.⁸¹ Thus, unless

77. See generally RESTATEMENT (SECOND) OF TORTS §§ 924, 927 (1979).

78. Rather than appear disloyal to the foreseeability norm, however, courts often justify the limitation of liability in such cases on pretextual grounds. See, e.g., *Rickards*, 23 N.J. Misc. at 95, 41 A.2d at 270 (economic impacts of negligently caused bridge closure were not "the natural and proximate result of defendant's negligence"). See generally Rabin, *supra* note 72, at 1522-24.

79. See generally Rabin, *supra* note 72.

80. See Perlman, *Interference with Contract and Other Economic Expectancies: A Clash of Tort and Contract Doctrine*, 49 U. CHI. L. REV. 61, 70-72 (1982).

81. See *id.* at 72:

Economic relationships are intertwined so intimately that disruption of one may have far-reaching consequences. Furthermore, the chain reaction of economic harm flows from one person to another without the intervention of other forces. Courts facing a case of pure economic loss thus confront the potential for liability of enormous scope, with no easily marked intermediate points and no ready recourse to traditional liability-limiting devices such as intervening cause.

(footnotes omitted); Rabin, *supra* note 72, at 1532-33:

The careless driver or land occupant can only wreak so much havoc on others; typically, the damage is limited to an unfortunate few. . . .

. . . .
 . . . By contrast, the problem of widespread economic loss is all-pervasive. The purely economic "ripple effects" of careless conduct can occur as a secondary consequence of any negligent harm. . . .

recovery for such losses is tethered to some collateral limiting factor — such as related physical harm or the presence of a special relationship between the parties⁸²—the unrestrained operation of the foreseeability norm might quickly generate extensive levels of liability.

Courts seldom fully articulate why they fear the widespread liability that would result if recovery for economic loss was allowed, but several themes appear to be at work in their decisions. As a matter of corrective justice, courts seem to view full liability for economic loss as potentially disproportionate to the tortfeasor's wrongdoing,⁸³ particularly when such wrongdoing consists solely of negligence.⁸⁴ If actually imposed, such liability could financially cripple the tortfeasor,⁸⁵ and even the prospect of its imposition might deter socially beneficial activity.⁸⁶ In addition, courts invoke a fear of the enormous administrative costs of aggregating and processing the damage claims that would result if recovery for economic loss were allowed.⁸⁷ Furthermore, courts have tended to view purely economic losses as part of the background noise of a complex and integrated economy and therefore have left the burden of insuring against such losses on the parties to whom such losses originally fall.⁸⁸

82. Both these circumstances constitute general exceptions to the bar against recovery of economic losses. *See, e.g.,* *George A. Hormel & Co. v. Dahl*, 92 Cal. App. 3d 963, 155 Cal. Rptr. 337 (1979) (recovery for lost wages allowed after damage to plaintiff's plant); *Glanzer v. Shepard*, 233 N.Y. 236, 135 N.E. 275 (1922) (third party allowed to recover economic losses from defendant because "end and aim" of defendant's contract was to benefit third party). They owe their existence not as much to any particular analytical justification as to the fact that they allow courts to address some particularly strong claims without embracing the open-ended liability that an unrestrained foreseeability test would generate. *See generally* Rabin, *supra* note 72, at 1515-16.

83. *See, e.g.,* *Dundee Cement Co. v. Chemical Labs., Inc.*, 712 F.2d 1166, 1171 (7th Cir. 1983) (fear of the "crushing, virtually open-ended liability imposed on defendants if economic claims are recognized"); *Leadfree Enters., Inc. v. United States Steel Corp.*, 711 F.2d 805, 808 (7th Cir. 1983) (tort law needs to have "a sensible stopping point in order to preclude open-ended, crushing liability on a tortfeasor"); *Rickards v. Sun Oil Co.*, 23 N.J. Misc. 89, 94, 41 A.2d 267, 269 (1945) ("The effect would be to impose a liability entirely disproportionate to the act committed or to the failure to perform the duty assumed.").

84. In contrast, when intentional misconduct is involved, the economic losses of third parties are more easily recovered. *See, e.g.,* RESTATEMENT (SECOND) OF TORTS § 533 (1979) (allowing third-party recovery based on intentional misrepresentation).

85. *See* note 83 *supra*.

86. *See, e.g.,* *Dundee Cement Co.*, 712 F.2d at 1172 n.4 (the "flood of new litigation by people trying to show that they were specially damaged . . . [would cause a] great . . . deterrent effect on desirable economic activity because of people's unwillingness to be taken to court even if they ultimately would win"); Perlman, *supra* note 80, at 70-71 (courts fear that the prospect of error in adjudication of economic loss claims "may inhibit socially useful activity").

87. *See, e.g.,* *Dundee Cement Co.*, 712 F.2d at 1172 n.4 ("the burden on the court system would be great"); *cf. Borer v. American Airlines, Inc.*, 19 Cal. 3d 441, 563 P.2d 858, 138 Cal. Rptr. 302 (1977) (rejecting loss of consortium claim because of the administrative costs of processing such claims).

88. *See, e.g.,* *Dundee Cement Co.*, 712 F.2d at 1166 ("[I]n many [cases,] the [result] would be to compel legal involvement in inconveniences that most people previously considered inevitable

The judicial fear of extensive tort liability is not the only rationale for the economic loss doctrine. One subsidiary concern is that allowing recovery for economic loss creates the potential for exaggerated — that is, inaccurate — assessments of damages. In the above illustration, for example, the negligently caused bridge closure would deprive Southside plumbers and donut shops of their Northside customers. These concerns might nonetheless enjoy a temporary increase in business from Southside consumers who otherwise prefer the services and products of Northside vendors. Even were this not so, their Northside counterparts might well profit from the accident. While these opposing economic impacts are unlikely to have the symmetry of Newton's Third Law,⁸⁹ they still pose problems for tort courts in assessing the magnitude of economic loss caused by the defendant's negligent conduct. Such courts are accustomed to viewing injury as a much less ambiguous event. The loss of an arm or a car or a life generally represents a unilateral impairment of society's wealth which is easily measured.⁹⁰ But this limited perspective, if extended to cases of pure economic loss, presents the danger that courts will overestimate the aggregate economic impact of a negligent act by ignoring collateral economic gains.

Another supplementary rationale for the doctrine stems from the fear that allowing third-party recovery for the economic losses may create moral hazards. In the above example, such problems are largely of the *ex post* variety; parties whose economic misfortunes are unrelated to the bridge closure may make fraudulent or exaggerated claims in order to recover from the defendant.⁹¹ Such moral hazards can also, under some circumstances, take on an *ex ante* character.⁹²

in a crowded world. . . . The effect . . . would be to make a tortfeasor an insurer for the economic losses suffered by the people inconvenienced by his negligent action."); *cf.* *Ryan v. New York Cent. R.R.*, 35 N.Y. 210, 216-17 (1866) ("To hold that the owner must not only meet his own loss by fire, but that he must guarantee the security of his neighbors on both sides, and to an unlimited extent, would be to create a liability which would be the destruction of all civilized society.").

89. Newton's Third Law of Motion, a formalization of earlier work by Galileo, holds that every physical action creates an equal but opposite reaction. 8 THE NEW ENCYCLOPEDIA BRITANNICA 663-64 (15th ed. 1985).

90. In addition, with respect to such losses, tort law's perspective is inherently individualistic: the plaintiff's particular claim to be made whole dominates the analysis. *See* Rabin, *supra* note 72, at 1531 n.59.

91. This seldom presents a problem with respect to personal injury tort claims, since few people would leave a preexisting ailment untreated in the hope of someday folding the costs of treatment in with those arising from a tortious injury. The same is generally true of property damage, although the proprietors of automobile body repair shops might easily provide contrary examples.

92. *See* note 101 *infra* and accompanying text. *See generally* Epstein, *Products Liability as an Insurance Market*, 14 J. LEGAL STUD. 645 (1985).

In such cases, the mere prospect of recovery from another can encourage a third party to relax the care it would otherwise take.⁹³

These factors — excessive liability, exaggerated damages, fraudulent claims, and lower standards of care — in addition to providing an underlying rationale for the economic loss doctrine, also outline the doctrine in a way that helps illuminate Cardozo's argument in *Ultramares*. His apprehension about the "hazards" of exposing the accounting profession to liability "in an indeterminate amount for an indeterminate time to an indeterminate class" can no longer easily be characterized simply as a bit of raw protectionism.⁹⁴ Rather, Cardozo's decision plainly reflects the economic loss doctrine's broader concern about the effective limits of tort law. But because Cardozo did not fully develop the analysis, we are left with the question of how fully the accounting cases fall within the parameters of the economic loss doctrine.

With respect to the doctrine's central concern about the imposition of extensive liability, the accounting cases seem to approximate the paradigmatic case sketched above. Although the first tier of victims of a defective audit — the creditors and investors involved with a defaulting client — is somewhat less diverse than the wide range of enterprises affected by a bridge closure, the level of losses certainly can be just as extensive. Moreover, the harm suffered by such parties can continue to ripple throughout the economic community as their relationships with other parties are disrupted by their disastrous entanglement with a moribund client.⁹⁵ This certainly was how Cardozo perceived the problem in 1931, and the audit plays an even more cen-

93. These *ex ante* moral hazard problems are not present in many economic loss cases, such as the bridge closure cases, because the likelihood of the loss-causing accident is too remote and random to form the basis of a strategic decision by a third party to behave in an abnormal fashion. See Rabin, *supra* note 72, at 1525.

94. See, e.g., *Rusch Factors, Inc. v. Levin*, 284 F. Supp. 85, 91 (D.R.I. 1968) ("[T]he decision in *Ultramares* constitutes an unwarranted inroad upon the [foreseeability] principle."); Seavey, *Mr. Justice Cardozo and the Law of Torts*, 52 HARV. L. REV. 372 (1939) (suggesting that privity was an example of temporary protective judicial legislation); Weiner, *supra* note 43, at 260 ("The time has come to [deprive] the negligent accountant of this anachronistic protection.")

95. To be sure, at some point, such losses are likely to be self-limiting. The client that uses the audit to secure loans from creditors and investors typically does not have an infinite ability to absorb such funds, and thus third-party exposure will eventually be limited by the client's debt-handling capacity. Moreover, the usefulness of an audit quickly fades as time passes and the client's financial situation inevitably changes. Thus, Cardozo plainly overstates the case in characterizing the losses arising from negligent accounting as "indeterminate" in amount and duration. This qualification should not be unduly emphasized, however, for courts have routinely invoked the rationales underlying the economic loss doctrine in cases where liability would ultimately be self-limiting. For example, the negligent failure of municipal water suppliers to maintain water pressure sufficient for fire-fighting purposes has routinely been held to be an insufficient basis for third party recovery despite the fact that the number of flammable properties in the area might be thought to set a natural outer limit to the resulting destruction. See, e.g., *H.R. Moch Co. v. Rensselaer Water Co.*, 247 N.Y. 160, 159 N.E. 896 (1928). In such cases,

tral role in today's economy.⁹⁶ Thus, the prime consideration behind the economic loss doctrine — the fear of excessive tort liability — appears present in the negligent accounting cases.

The second factor favoring application of the economic loss doctrine — the potential exaggeration of losses if liability is allowed — seems less relevant to the accounting cases. To be sure, the third party's ill-advised decision to commit resources to an auditor's client obviously benefits the client. But the client in such cases is usually as negligent as the accountant, if not actively involved in an effort to defraud the third party. Thus, the benefits to the client generated by negligent accounting are unlikely to be the sort of neutral, untainted gains that might properly be netted against the harm suffered by third parties in assessing the aggregate impact of the defendant's conduct.⁹⁷ The tendency of tort courts to focus their attention on the loss side of the ledger therefore presents no particular problem in the accounting context.

In contrast, the further consideration of the moral hazards raised by an expansive liability rule is particularly significant in the accounting cases. Obviously, a third party who suffers harm when an audited client becomes insolvent has a strong incentive, *ex post*, to feign or exaggerate its reliance on the audit in an effort to recover losses from the accountant. Such claims are particularly difficult to test in the adjudicative process because they often consist of nothing more than the third party's oral representation that it relied on the audit rather than other factors in deciding to deal with the client.⁹⁸ Moreover, even were the fact-finding process infallible, the sheer volume of such suits might pressure accountants to settle potentially nonmeritorious claims.⁹⁹ Precisely these concerns have led the Supreme Court to curtail the potential scope of private actions against accountants under

courts have viewed the extensive nature of the harm as sufficient to justify terminating liability well short of the limits of foreseeability.

96. Most notably, the federal securities laws require most publicly held companies to produce certified financial statements as part of their mandatory periodic disclosures to the investing public. See generally R. CLARK, *CORPORATE LAW* 723 (1986).

97. See generally Note, *Protecting the Auditor from Unwarranted Third-Party Liability: Rethinking the Indemnification Issue*, 35 SYRACUSE L. REV. 763 (1984). Moreover, by failing to prevent the dissemination of inaccurate financial information, a negligently prepared and defective audit may permit capital investment to flow to inefficient uses.

98. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 746 (1975) ("Plaintiff's entire testimony could be dependent upon uncorroborated oral evidence . . . and still be sufficient to go to the jury.").

99. See *Blue Chip Stamps* 421 U.S. at 740 (noting that a complaint alleging inaccurate financial disclosures may have "a settlement value to the plaintiff out of any proportion to its prospect of success at trial").

the securities law,¹⁰⁰ and they similarly militate for application of the economic loss doctrine in state law negligence actions.

More importantly, however, the accounting cases raise the prospect of *ex ante* moral hazards. In the above example, it is implausible to assume that Southside donut shops will relax their competitive efforts on the assumption that a bridge accident will occur sometime in the future and provide a convenient scapegoat for any losses. Such accidents are simply too random and unpredictable to form the basis of before-the-fact strategic behavior. In contrast, the third party in a triangular relationship with a client and an accountant already knows of the audit's existence and therefore may contemplate blaming the accountant for any harms suffered as a result of risks not revealed by the audit. Thus, a rule allowing third-party recovery against auditors for all foreseeable harm creates incentives for third parties to relax their independent efforts to assess and control the risks inherent in their dealings with the client.¹⁰¹

Cardozo's concern about the negative impact of a full foreseeability rule thus can be recast quite easily into arguments for limiting liability under the economic loss doctrine. Indeed, both the case law and commentary on economic loss routinely cite *Ultramares* as a cornerstone of that doctrine.¹⁰² The reform courts, however, have paid little or no attention to the economic loss doctrine and instead have focused simply on the foreseeability of harm generated by defective audits. And to the extent that such courts and their supporting commentators have acknowledged Cardozo's fear of the open-ended liability that a foreseeability rule generates, they have been content to offer the standard bromide of modern tort law: the use of insurance to offset tort

100. See, e.g., *Blue Chip Stamps* 421 U.S. at 740 (denying standing in rule 10b-5 securities actions to those plaintiffs claiming that defendant's wrongful conduct caused them *not* to purchase or sell affected securities; standing available only to actual purchasers or sellers); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 & n.33 (1976) (imposing a scienter requirement for private actions under rule 10b-5).

101. In theory, tort law could control such moral hazard problems by viewing the situation as one involving joint care and freeing the accountant of liability if the third party took inadequate care. In practice, however, the reform courts have resisted this view and have instead sought to characterize all third parties as helpless consumers of the accountant's work product. See notes 113-14 *infra* and accompanying text. While this portrayal may be apt for some third parties, most are far more capable of and actively involved in assessing client risk. See text at notes 136-41 *infra*. For such parties, a full foreseeability rule tends to transform the audit into a partial warranty of the client's economic solvency, and thus depresses incentives by such parties to take independent care. Cf. Menzel, *The Defense of Contributory Negligence in Accountant's Malpractice Actions*, 13 SETON HALL L. REV. 292 (1983) (discussing limited availability of contributory negligence defense against claims brought by client).

102. See, e.g., *Dundee Cement Co. v. Chemical Labs., Inc.*, 712 F.2d 1166, 1171 (7th Cir. 1983); Rabin, *supra* note 72, at 1527.

liability.¹⁰³ The *Rosenblum* court, for example, concluded that because accountants have been able to obtain malpractice insurance against claims made directly by their clients, there was "no reason to believe" they could not similarly insure against third-party claims.¹⁰⁴ As others have shown,¹⁰⁵ however, this judicial belief in the universal utility and availability of insurance is dangerously misguided.

Assuming it is available, insurance does little to alleviate the concerns that underlie the economic loss doctrine. The level of liability is just as extensive; only the method of payment has been changed. The defendant still faces a disproportionate and potentially crushing liability burden, and the tort system still faces the heavy costs of aggregating and processing extensive third-party claims. Nor does the use of insurance alter the moral hazards that arise when the accountant is made responsible for third-party losses. If anything, insurance tends to exacerbate this problem by mooting the third party's potential concern over the accountant's ability to pay for tort damages.

Moreover, there is little reason to assume that insurance will necessarily be available to cover extensive and highly unpredictable third-party liability claims. For insurance to operate effectively, an insurer must be able with some degree of certainty to project the level of losses that can be expected should the audit prove defective.¹⁰⁶ This calculation is relatively straightforward for third-party creditors where they are required under a privity-based rule to guard against their own losses. Knowing their precise exposure to other concerns, third-party creditors can protect against the prospect of default by reserving funds to cover bad debts. This strategy simply represents a form of self-insurance.

However, if the accountant or its insurer is forced to cover the losses suffered by third parties when a client defaults, the predictive process becomes considerably more difficult. Except in a *Glanzer* situation,¹⁰⁷ the accountant does not know the identity, number, or financial exposure of third-party creditors against whose losses, under a foreseeability regime, it must insure.¹⁰⁸ It can, of course, attempt to

103. See, e.g., *Escola v. Coca-Cola Bottling Co.*, 24 Cal. 2d 453, 462, 150 P.2d 436, 441 (1944) (Traynor, J., concurring) ("[T]he risk of injury can be insured by the manufacturer and distributed among the public as a cost of doing business."). See generally Siliciano, *supra* note 4, at 1832-33.

104. *Rosenblum, Inc. v. Adler*, 93 N.J. 324, 349, 461 A.2d 138, 151 (1983).

105. See H. STEINER, *MORAL ARGUMENT AND SOCIAL VISION IN THE COURTS* 103-04 (1987); Danzon, *Tort Reform and the Role of Government in Private Insurance Markets*, 13 J. LEGAL STUD. 517 (1984); Epstein, *supra* note 92; Priest, *supra* note 4.

106. See Priest, *supra* note 4, at 1539.

107. See note 34 *supra* and accompanying text.

108. Thus viewed, the *Glanzer* exception to *Ultramares* represents an essentially contractual

estimate such losses by analyzing its clients' business practices, debt structures, and so forth. Nonetheless, the accountant's second-hand information about potential third-party losses is almost certain to be less accurate and more costly to obtain than is each third party's precise knowledge concerning its individual financial exposure.

This kind of informational asymmetry is not only a justification for invoking the economic loss doctrine,¹⁰⁹ but it is also a basis for concern about the availability of insurance. If unable to discern the number, identity, and characteristics of reliant third parties whose losses it must cover, the accountant's insurer is likely to respond to such uncontrollable uncertainties¹¹⁰ by raising premiums dramatically. Such precipitous rate surges, in turn, may trigger the fatal "unraveling" of insurance risk pools, as those accounting firms that can best manage and regulate risk opt out in favor of self-insurance. This pattern has occurred in other situations where tort liability has expanded rapidly, and anecdotal evidence seems to confirm the beginnings of such destructive trends in the accounting area.¹¹¹

In sum, the concerns expressed in *Ultramares* over the negative impact of a foreseeability rule for negligent accounting still resonate within contemporary tort doctrine. While the rationales of the economic loss doctrine may not apply in all respects, neither can Cardozo's reasoning be dismissed simply as outdated protectionism. In any event, a reading of *Ultramares* that focused solely on the court's fear of the negative consequences of abolishing privity would be incomplete, for the opinion also offers the seeds of a positive vision of

arrangement between the parties concerning how to allocate efficiently the losses arising from the negligent audit. By requesting status as a foreseen beneficiary of the client's audit, the third party avoids the costs of conducting its own audit and obtains protection against auditor negligence. Yet the auditor is theoretically able to recapture the benefit thus bestowed by increasing its charge to the client. Similarly, its knowledge of the identity and economic exposure of the third-party beneficiary enhances the accountant's ability to insure effectively against third-party claims arising from the audit.

109. As noted above, the economic loss cases often assume a superior ability by third parties to insure against economic losses. *See, e.g.,* H.R. Moch Co. v. Rensselaer Water Co., 247 N.Y. 160, 159 N.E. 896 (1928).

110. The accountant could attempt to control its exposure by disclaiming responsibility to reliant third parties, but given the hostility such efforts have met in the defective products context, the long-run viability of such a tactic is questionable. *See* note 153 *infra* and accompanying text.

111. *See generally* Priest, *supra* note 4, at 1521-22. *See also* H. JAENICKE, THE EFFECT OF LITIGATION ON INDEPENDENT AUDITORS 4 (2d ed. 1981) (noting sharp premium rise and exit of some firms from insurance market); Collins, *Malpractice Prevention and Risk Management*, *supra* note 64, at 52 (liability payments by Big 8 accounting firms totalling \$180 million in period 1980-1986 have resulted in insurance becoming unavailable or prohibitively expensive); Berton, *Small CPA Firms' Liability Rates Soar*, Wall St. J., Nov. 19, 1985, at 6, col. 1 (noting that of the dozen insurers that traditionally offered coverage to small and middle-sized accounting firms, only three remain in face of liability crisis).

how third parties generally are able to protect their interests without the full-scale assistance of tort remedies.

B. *Private Ordering and the Products Model*

In *Ultramares*, Cardozo concluded that abrogation of privity was not only dangerous but also unnecessary. Third parties already enjoyed protection against outright fraud, and the court expressed doubt "whether the average business man receiving a certificate without paying for it, and receiving it merely as one among a multitude of possible investors, would look for anything more."¹¹² The message here was clear; tort law provided a necessary base level of protection, and any additional assurance against loss was properly left to individual efforts of the parties. In the contemporary lexicon, Cardozo professed a faith in private ordering by third parties as a viable means of controlling the risk inherent in financial transactions.

The reform courts view the situation much differently. The injured third party is routinely compared to the helpless consumer of a defective product, and from this analogy springs a conclusion that tort law should take a more aggressive role in protecting third parties from negligent accounting.¹¹³ Thus, the faith in private ordering is supplanted by a resort to foreseeability as a normative basis of tort liability. Yet, this tendency to view foreseeability as a "modern" categorical replacement for the "antiquated" contractual view embodied in the privity doctrine overlooks the fact that both concepts have long shared the domain of tort law.¹¹⁴ Indeed, Cardozo in *Ultramares* was plainly aware of the utility of foreseeability of harm as a determinant of liability, having engineered its triumph over privity in the products area fifteen years earlier in *MacPherson v. Buick Motor Co.*¹¹⁵ The question, therefore, is whether Cardozo was correct in concluding that adoption of this foreseeability-based products liability model was unnecessary in negligent accounting cases.

Cardozo's opinion in *MacPherson* provides an obvious starting

112. *Ultramares*, 255 N.Y. 170, 189, 174 N.E. 441, 448 (1931).

113. See, e.g., *International Mortgage Co. v. John P. Butler Acct. Corp.*, 177 Cal. App. 3d 806, 820, 223 Cal. Rptr. 218, 226 (1986) ("It is only reasonable that the same judicial criteria govern the imposition of negligence liability, regardless of the defendant's profession."); *Rosenblum, Inc. v. Adler*, 93 N.J. 324, 341, 461 A.2d 138, 147 (1983) ("Why [should privity remain a bar] when no such limit is imposed [for] liability for defects in products . . . ?").

114. For example, Holmes embraced both the "general principle" that "loss from accident must lie where it falls" and the prospect of liability if "a prudent man would have foreseen the possibility of harm." O.W. HOLMES, *THE COMMON LAW* 94, 96 (1881).

115. 217 N.Y. 382, 111 N.E. 1050 (1916). See also *Palsgraf v. Long Island R.R.*, 248 N.Y. 339, 344, 162 N.E. 99, 100 (1928) ("The risk reasonably to be perceived defines the duty to be obeyed . . .").

point. In that case, Cardozo held that a manufacturer owes a duty of care, with "its source in the law,"¹¹⁶ to the foreseeable consumers of its product, despite the absence of a contractual relationship between producer and consumer. In rejecting the alternative thesis that the existence of such an obligation should depend on whether the parties were in contractual privity, Cardozo assumed that the ultimate consumer of a defective product would be unable to detect product defects. The product in issue, a car with a defective wheel, was put "on the market to be used without inspection by . . . customers."¹¹⁷ Thus, even if the producer and the consumer were in privity, the *MacPherson* analysis suggests that the consumer's informational disadvantage would typically preclude him from bargaining effectively with the producer over safety concerns.¹¹⁸ Under such circumstances, courts might (and, indeed, ultimately did) justifiably conclude that, despite the *presence* of privity, the obligations generated by private ordering should still be supplemented by an independent legal duty based on one party's ability to foresee and avoid inflicting harm on another.¹¹⁹

The viability of a privately ordered solution to the problem of risk was made even more unlikely in *MacPherson* because the consumer was *not* in privity with the creator of the risk — the product manufacturer. Instead, the product was unilaterally designed and produced by the manufacturer, supplied to an intermediary for distribution, and ultimately purchased from that intermediary by the consumer. Even if the consumer was fully informed, his prospects for directly altering the level of risk were significantly limited by the distance and disparity of power between the risk producer and the consumer.

The subsequent landmark decision of *Henningsen v. Bloomfield Motors, Inc.*¹²⁰ expressly invoked this concern in concluding that an-

116. 217 N.Y. at 390, 111 N.E. at 1053.

117. 217 N.Y. at 390, 111 N.E. 1050. Indeed, Cardozo distinguished the contrary cases of *Loop v. Litchfield*, 42 N.Y. 351 (1870), and *Losee v. Clute*, 51 N.Y. 494 (1873), as representing special situations where the product supplier was aware that the product user would independently inspect that product for defects.

118. Indeed, much of modern tort theory, in its analysis of the efficiency of various liability regimes, similarly posits the existence of a consumer class that is essentially uneducable with respect to product risk. Consequently, a contractual solution to the problem of product risk is rejected in favor of a system of liability rules that incorporate consumers' unstated expectations regarding product risk. See generally Siliciano, *supra* note 4, at 1823-24.

119. In the landmark case of *Henningsen v. Bloomfield Motors, Inc.*, 32 N.J. 358, 161 A.2d 69 (1960), tort law accepted this proposition in denying manufacturers the ability to use warranty provisions to disclaim liability for negligence. There, the New Jersey Supreme Court observed that "the ordinary consumer . . . cannot be expected to have the knowledge or capacity or even the opportunity to make adequate inspection of mechanical instrumentalities, like automobiles, and to decide for himself whether they are reasonably fit for the designed purpose." 32 N.J. at 375, 161 A.2d at 78.

120. 32 N.J. 358, 161 A.2d 69 (1960).

other component of a possible contractual solution to the problem of risk — the warranty disclaimer — was ineffective in relieving manufacturers of liability arising from defective products. In the court's view, the traditional belief that such disclaimers were the result of the "free bargaining of parties who are brought together by the play of the market, and who meet each other on a footing of approximate economic equality"¹²¹ must give way to a recognition of the "strong bargaining power and position" of the producer¹²² and the "gross inequality of bargaining position occupied by the consumer."¹²³ Under such circumstances, the court felt compelled to override the outcome of private ordering and impose a duty — an implied warranty of merchantability — based in law.¹²⁴

But how well do the concerns underlying the products model and the model's rejection of a private ordering solution apply to the negligent accounting cases? Although the reform courts reflexively adopt the defective products analogy, Cardozo had a substantial basis for placing greater reliance on private ordering. At the outset, it is critical to note that accountants are already under substantial pressures to perform careful audits.¹²⁵ Even absent any liability rules, accountants would have a significant economic stake in establishing and maintaining a reputation for conducting good audits.¹²⁶ This positive incentive works on at least two levels. The typical client, for its own internal monitoring purposes, will insist on a careful audit; accountants who fail to meet this standard will not be retained. Similarly, accounting firms with a reputation for care will enhance the client's prospects of obtaining credit on reasonable terms from outside parties. These factors suggest that accounting firms with an interest in permanence and growth will audit with care.

121. 32 N.J. at 389, 161 A.2d at 86.

122. 32 N.J. at 389, 161 A.2d at 86.

123. 32 N.J. at 391, 161 A.2d at 87.

124. See generally Priest, *supra* note 3, at 508-09. See also G.E. WHITE, *TORT LAW IN AMERICA: AN INTELLECTUAL HISTORY 202-03* (1980) (concept of consumer "powerlessness" critical to success of strict liability theory).

125. To be sure, product manufacturers also face incentives apart from tort law to produce reasonably safe products. Reputational concerns and contract law requirements, for example, create incentives towards safety. See generally Siliciano, *supra* note 4, at 1838-39. This system of incentives, however, is almost certainly weaker than that which encourages accountants to act nonnegligently. Product manufacturers are not guided by a strong professional ethic and are not regulated by an internal governing body. They face no federal regulation akin to the control that the securities laws exercise over accountants. And their ability to produce new products under new names allows manufacturers to recover from reputational injury in a way that may be impossible for a profession like accounting, in which the actors ultimately have only their reputation for accuracy to sell.

126. See generally Fischel, *The Regulation of Accounting: Some Economic Issues*, 52 *BROOKLYN L. REV.* 1051 (1987).

A battery of other forces supplements this natural system of incentives.¹²⁷ Contract and tort law impose a duty of care on accountants with respect to their clients.¹²⁸ Third parties can tie into this protection by coming within the *Glanzer* exception to *Ultramares*.¹²⁹ Third parties are also independently protected against fraud by the accountant.¹³⁰ In addition, the securities laws contain an array of special duties and potential liabilities for the auditors of publicly held companies.¹³¹ Finally, the accounting profession has, since *Ultramares*, moved significantly in the direction of detailed and comprehensive self-regulation.¹³²

127. See generally K. ST. PIERRE, *supra* note 14, at 6-7 ("The auditor currently faces a complex, often hostile legal environment. . . . [T]he possibility of legal retribution appears in every audit engagement.").

128. *Ultramares Corp. v. Touche*, 255 N.Y. 170, 179, 174 N.E. 441, 444 (1931).

129. See note 34 *supra* and accompanying text. Moreover, such parties may be able to raise contract claims based on a third-party beneficiary theory. See generally E.A. FARNSWORTH, *CONTRACTS* 709-33 (1982); Waters, *The Property in the Promise: A Study of the Third Party Beneficiary Rule*, 98 HARV. L. REV. 1109 (1985). Under the Restatement approach, for example, a third party may recover if it is the "intended beneficiary" of the contract. RESTATEMENT (SECOND) OF CONTRACTS § 302 (1981). To satisfy this requirement, the third party must show, among other things, that allowing it a contract remedy will "effectuate the intention of the parties." *Id.* Although this remedy is plainly narrower than the tort remedy fashioned by the reform courts, such courts pay virtually no attention to the analysis underlying the carefully crafted limits on third-party recovery in the contract context. Yet, given the similarity between the two areas, it would seem that contract law should inform, if not completely supplant, the efforts of tort courts to protect third-party interests.

130. *Ultramares*, 255 N.Y. at 179, 174 N.E. at 444.

131. For example, under section 11 of the Securities Act of 1933, 15 U.S.C. § 77(k) (1982), accountants are liable to the purchasers of new securities for negligent material misstatements and omissions in the audited financial information contained in the registration statement. In addition, accountants may be held liable under section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1982), for fraud or gross recklessness involving securities disclosures. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). Furthermore, the Securities and Exchange Commission is empowered to suspend or bar accountants from practice before the Commission. 17 C.F.R. § 201.2(e) (1987). See generally Marsh, *Rule 2(e) Proceedings*, 35 BUS. LAW. 987 (1980). This is not to suggest that the current configuration of the securities laws provides accountants with optimal incentives for care. Such an inquiry lies beyond the scope of this article. It may be, however, that the expansive liability authorized under certain provisions of the securities laws, such as § 11 of the 1933 Act, creates problems similar to those engendered by the *Rosenblum* court's approach to the negligence standard. See note 145 *infra*. Yet, even here, the securities laws demonstrate a restraint and predictability absent from the approach of the reform courts. Under § 11, for example, the plaintiff class, the proof of violation, and the measure of damages are statutorily defined in a manner that enhances the accountants' ability to gauge, *ex ante*, its liability exposure.

132. The American Institute of Certified Public Accountants (AICPA) is the profession's general oversight body. It determines standards for accountant certification, and, through its committee system, helps formulate auditing and accounting standards. Most recently, the Auditing Standards Board of the AICPA promulgated a series of statements on auditing standards (SASs) that increased accountants' audit responsibilities. The most significant of these new standards impose on accountants an affirmative obligation to look for financial fraud during the course of audits (SAS no. 53) and require disclosure of substantial concerns over whether an audited company will remain financially solvent (SAS no. 59). See Guy & Sullivan, *The Expectation Gap Auditing Standards*, J. ACCT., Apr. 1988, at 36. Of course, one might naturally question the efficacy of professional self-regulation, but the fact remains that the accounting

Admittedly, significant debate exists over whether such existing restraints achieve an optimal level of audit care.¹³³ Yet no one, except perhaps the reform courts, assumes that the effect of these incentives is trivial.¹³⁴ Moreover, the third party is a free-riding beneficiary of the care taken by the accountant as a result of these incentives.¹³⁵ Thus, the question asked by the reform courts — whether imposing a duty of care towards reliant third parties is necessary to make accountants behave carefully — is the wrong one. The more appropriate inquiry instead would seem to be whether third parties desiring *additional* protection above this existing baseline can effectively achieve such a result without judicial imposition of a uniform foreseeability standard.¹³⁶

Cardozo's affirmative answer to this question draws support from important differences between the capacity of third parties in the negligent accounting and defective products contexts to protect their own interests. Most third parties in the accounting cases stand in sharp contrast to the hapless consumer in the *MacPherson* and *Henningsen* contexts. Despite the effort of reform courts to portray such parties as "innocent victims" of auditing mistakes, in reality these parties typically are sophisticated commercial creditors who are adept at assessing and accounting for financial risk in the transactions they enter. Indeed, virtually all of the plaintiffs in the reported negligent accounting

profession's internal oversight is far more rigorous and comprehensive than that exercised by the product manufacturing industry.

133. See generally Connor, *Enhancing Public Confidence in the Accounting Profession*, J. ACCT., July 1986, at 76; Mednick, *The Auditor's Role in Society: A New Approach to Solving the Perception Gap*, J. ACCT., Feb. 1986, at 70.

134. See, e.g., *Citizens State Bank v. Timm, Schmidt & Co.*, 113 Wis. 2d 376, 384, 335 N.W.2d 361, 365 (1984) ("Unless liability is imposed, third parties who rely upon the accuracy of the financial statements will not be protected. Unless an accountant can be held liable to a relying third party, this negligence will go undeterred.").

135. In this sense, the reliant third party is a classic free-rider. The accountant as a practical matter cannot prevent dissemination of its product to such third parties. Moreover, because the client and the reliant third party both care about precisely the same thing — the accuracy of the financial statements — the accountant cannot tailor the audit in such a way that it serves the client's need without incidentally benefitting the third party.

136. This criterion for justifying the existence or expansion of liability rules — that the parties otherwise cannot collectively optimize their preferences — explains many features of the current liability landscape. Consider, for example, the liability of manufacturers for harm arising from product defects. If consumers were able to bargain effectively and costlessly with producers over product risk, a tort rule assigning liability to manufacturers for product defects would be unnecessary. Instead, consumers and producers would negotiate over risk in the same manner that they might over factors like price and quality. But because product consumers are generally assumed to be incapable of effectively perceiving or bargaining over product risk, the tort system supplies an alternate method — a liability rule — that indirectly educates producers about the optimal level of product risk. See generally Landes & Posner, *A Positive Economic Analysis of Products Liability*, 14 J. LEGAL STUD. 535, 549-50 (1985). See also Siliciano, *supra* note 4, at 1823-26.

cases are banks, commercial creditors, or trade creditors who, as part of their normal course of business, routinely evaluate the probable risks associated with contemplated transactions.

Moreover, in contrast to the product consumer, the sophisticated third-party creditor in the accounting cases *is* in a direct bargaining relationship with the primary risk creator — the accountant's client¹³⁷ — and is far better able to protect itself against the prospect that the client will inaccurately portray its financial condition. A creditor can, of course, simply accept the client's representations as to its economic health, thus speeding and simplifying the negotiations. In such cases, it bears the entire risk that the client's representations are inaccurate and that the client's eventual insolvency might preclude any direct recovery for losses arising from such misrepresentations. Alternatively, the third party can expend resources to improve the veracity of the information. It can insist on conducting or financing its own audit, thus contractually securing from the accountant direct protection against accounting negligence.¹³⁸ Moreover, a third party can bring itself within the *Glanzer* exception to *Ultramares* by requesting that the client have an audit conducted expressly on the third party's behalf.¹³⁹ Finally, the third party can account for the risk by bargaining

137. In this context, it is critical to note that the accountant's "product" is simply an opinion about the quality of someone else's product — the client's financial statements. The third party's primary reliance is on these financial statements, since they provide the data on which the third party's decision will be based. *See, e.g., Ultramares Corp. v. Touche*, 255 N.Y. 170, 173-74, 174 N.E. 441, 442 (1931) (client's balance sheet shown to numerous third parties "as the basis of financial dealings"). Thus, the primary risk in the triangular relation between client, accountant, and third party is generated by the client, who may provide the third party with erroneous information about its financial status in order to obtain needed credit. *See In re Interstate Hosiery Mills, Inc.*, 4 S.E.C. 721 (1939) ("The fundamental and primary responsibility for the accuracy [of financial statements] rests upon management."). Therefore, if the third party can protect itself against such risks in its dealings *with the client*, then the lack of privity between the third party and the accountant becomes irrelevant in assessing the viability of private ordering as an alternative means of controlling risk. In this respect, the defective products and negligent accounting cases differ fundamentally, for only in the latter is the potential victim in a direct relationship with the primary risk creator.

138. One might argue that this option results in an unnecessary duplication of accounting services and that tort law should seek to avoid such a waste of social resources by imposing on accountants a generic duty of care on behalf of third parties. But this mischaracterizes the motivation behind independently conducted third-party audits. Such parties already free-ride on the accountant's duty of care toward clients, *see* note 128 *supra* and accompanying text, and if they wish to obtain direct protection against negligence, they can bring themselves within the *Glanzer* exception to *Ultramares*. Thus, third parties will generally seek an independent audit only if they want to improve upon or double-check the client's audit. In thereby generating additional information or reducing the risk of error associated with the first audit, third-party-instigated audits seemingly fulfill an independent, socially useful role that tort law, through an expanded liability rule, may be powerless to improve upon.

139. Of course, if an audit has just been completed, a third party may be unable to take advantage of the *Glanzer* rule without delaying its transaction with the client until a new audit is conducted or without financing its own audit. But such situations do not seem to merit sufficient sympathy to require the intervention of tort law. In essence, a third party proceeding under such

for special security or improved terms in the transaction.¹⁴⁰

All these options allow many third parties to identify and control the primary risk generated by the client. Indeed, from an efficiency perspective, it may be particularly sensible to place the burden of taking such steps on the third party, for it is unquestionably in the best position to know how it intends to use the audit and therefore how it can best protect itself against imperfect audits. Yet, in the negligent accounting cases, third parties forgo such tailored protection and choose simply to rely on the free, off-the-shelf auditor's opinions provided by the client. This is hardly a risk-free strategy, as the negligent accounting cases demonstrate, but it is a *strategy* nonetheless. The elective nature of the strategy distinguishes the typical third-party creditor in the accounting cases from the presumptively powerless consumer in the defective products context. Admittedly, such a party might prefer enhanced protection against negligence if freely provided by rule of law. But this tells us little; any rational actor prefers more security against loss over less security if the additional protection is costless. Such protection, however, usually comes at a price, and the critical inquiry therefore becomes whether, *ex ante*, the party is able to obtain the level of protection it desires. The typically sophisticated creditors in the accounting case *could* obtain such supplemental protection against client-generated risk through a variety of means other than reliance on a gratuitously provided audit. This fact supports Cardozo's implicit conclusion in *Ultramares* that their unwillingness to obtain this protection represents a choice that the law need not supplement.¹⁴¹

For most third parties, then, tort law might sensibly view private ordering as a viable alternative to a foreseeability-based negligence

circumstances has made a calculation that the benefits of dealing immediately with the client outweigh the value of the additional protection against negligence that might be obtained by delaying the transaction until a new audit can be conducted. This seemingly represents a classic business judgment about acceptable levels of risk and return that need not be skewed by the intervention of tort law.

140. See generally *Professional Liability — A New Development*, 99 N.J. L.J. 356, 356 (1976):

In the typical commercial transaction, the creditor or investor parting with his money often relies on many factors other than a financial statement or legal opinion proffered by the other side. Many investors do not bother with an audit at all, but accept contractual representations and warranties. Others bring in their own accountants and lawyers (with whom, of course, they are in direct privity) to conduct the necessary investigations on which they rely.

141. Indeed, the fact that the third-party plaintiffs in the negligent accounting cases did not avail themselves of the alternate risk-reducing strategies discussed above also supports this article's hypothesis that most third parties, when viewing a transaction with a client *ex ante*, conclude that the existing incentives for care placed on the accountant are sufficient to protect such third parties' interests, their *ex post* protestations notwithstanding. See text at notes 125-32 *supra*.

rule. However, with respect to one class of potential plaintiffs — remote, passive investors in the client's debt or equity offerings — this conclusion becomes more problematic. In speaking of “the average business man,”¹⁴² Cardozo plainly envisioned the sort of sophisticated creditor discussed above. But in today's capital markets, an audit is often part of a package of information used to attract investors. Some investors, by virtue of their size and financial sophistication, undoubtedly approximate or surpass the financial sophistication of the “average business man” of Cardozo's private ordering conception.¹⁴³ Nonetheless, others are remote, unsophisticated individuals who lack any significant capacity to bargain directly with the client over investment risk.

With respect to this subclass of third parties, the defective products model is a closer match. The question, therefore, is whether their presence as potential claimants¹⁴⁴ justifies the reform courts' rejection of privity. Arguing against such a conclusion, one might observe that the potential deficiency of private ordering in this context is at least partly offset by the substantial protection the securities laws provide to this group of audit consumers.¹⁴⁵ But this is merely an argument that foreseeability *need not* supplant privity; it does not prove that foreseeability *should not* do so. In other words, might not the approach of the reform courts be applauded simply because it is a “better” — that is, a more comprehensive, vigorous, and effective — means of controlling the risks associated with negligent auditing? Indeed, the central thesis of the reform courts is that their handiwork markedly improves upon existing doctrine. Thus, without the slightest hesitation, the court in *Rosenblum Inc. v. Adler* declares that “[t]he public interest will be served by the rule we promulgate this day.”¹⁴⁶ Others have

142. *Ultramares Corp. v. Touche*, 255 N.Y. 170, 189, 174 N.E. 441 448 (1931).

143. *Cf.* *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953) (differentiating investors' need for protection under securities laws on basis of financial sophistication and access to information); 17 C.F.R. § 230.501 (1987) (defining “accredited investors” in need of less disclosure protection under Securities Act of 1933).

144. Interestingly, such investors seldom appear as plaintiffs in state court negligent accounting actions. Most likely, such investors generally pursue claims against accountants under the federal securities laws, with any state law tort claims appended to such actions. *See, e.g., Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

145. *See* note 131 *supra*. In addition, the concerns underlying the economic loss doctrine seem particularly pressing with respect to this class of plaintiffs: their claims are likely to be extensive, widely scattered, extremely costly to aggregate, and prone to moral hazard problems. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) (such problems favor narrow scope of implied rights of action under rule 10b-5). *See generally* note 210 *infra*.

146. 93 N.J. 324, 353, 461 A.2d 138, 153. *See also International Mortgage Co. v. John P. Butler Acct. Corp.*, 177 Cal. App. 3d 806, 820, 223 Cal. Rptr. 218, 227 (1986) (“society is better served” by abrogating privity).

ably chronicled the forces behind this new aggressiveness.¹⁴⁷ The narrow question for this article's purposes, however, is whether the promise is fulfilled in the negligent accounting cases. To answer this, the focus now shifts from the considerations that restrained Cardozo to the visions that motivate the reform movement.

III. THE ARGUMENTS FOR ACTION: THE PROMISE OF INSTRUMENTAL REFORM

As noted, the reform courts pay little attention to the rationales of the economic loss doctrine or the potential viability of private ordering as an adequate supplement to the baseline protection afforded by a privity regime. Their efforts instead are devoted to showing that expanding the liability of accountants to reliant third parties will serve the instrumental goals of improved deterrence and loss spreading. Assuming for a moment that Cardozo's arguments for restraint are without substance, this article examines whether the reform movement has delivered on this pledge of furthering public policy.

A. *The Deterrence Rationale*

The dominant instrumental rationale for abandoning privity is that exposing accountants to third-party negligence actions will provide "a financial disincentive for socially unreasonable conduct."¹⁴⁸ The deterrence model invoked is both simple and classic; imposing accident costs on an actor will encourage that actor to take steps to prevent accidents that are worth preventing — that is, those accidents where damages exceed the corresponding costs of prevention.¹⁴⁹ Stated this way, the reform courts' application of this model to the accounting context seems an easy case; the accountant, if made liable for injuries sustained by third parties when they rely on negligently prepared and inaccurate financial statements, will naturally seek to reduce the levels of such injuries by auditing financial statements more carefully.

Unfortunately, the reaction of the accounting profession to the reform efforts fails to substantiate this behavioral model. Rather than simply vowing to audit more vigorously, the profession has con-

147. See Owen, *supra* note 41; Priest, *supra* note 3; Schuck, *supra* note 4.

148. Weiner, *Common Law Liability*, *supra* note 43, at 256. See *International Mortgage Co.*, 177 Cal. App. 3d at 820, 223 Cal. Rptr. at 227 ("[S]uch a rule provides a financial disincentive for negligent conduct and will heighten the profession's cautionary techniques."); *Rosenblum*, 93 N.J. at 350, 461 A.2d at 152 (new rules "may cause accounting firms to engage in more thorough reviews"); *Citizens State Bank v. Timm, Schmidt & Co.*, 113 Wis. 2d 376, 384, 335 N.W.2d 361, 365 (1984) ("Unless an accountant can be held liable to a relying third party, this negligence will go undeterred.").

149. For a more detailed discussion of this model, see Siliciano, *supra* note 4, at 1823-26.

sciously devised a number of strategies for limiting liability exposure through means other than increasing the level of care. Thus, in response to the threat of enhanced liability, accounting firms may limit their services to clients with few third-party contacts.¹⁵⁰ Accountants may also withdraw services altogether from clients in high-risk industries, such as those characterized by a high asset base in inventory or accounts receivable.¹⁵¹ Similarly, audits may become unavailable to enterprises in an early growth phase, where audit risks are generally highest.¹⁵² Another major tactic embraced by the profession, ironically, was explicitly suggested by the *Rosenblum* court; accountants concerned over open-ended third-party liability could "expressly limit in their certificates the persons or class of persons who would be entitled to rely upon the audit."¹⁵³

This apparent belief of the accounting profession that the liability threatened by the new rules is best controlled through evasive behavior¹⁵⁴ rather than increased audit care necessitates a rethinking of the reform courts' deterrence model. Two critical questions suggest themselves: why are accountants behaving in this manner, and what are the consequences of pressing ahead with an expanded liability regime in the face of such conduct?

1. *The Incentives for Liability Evasion*

As previously noted, accountants face substantial incentives for care even under a traditional privity regime.¹⁵⁵ Their apparent decision to respond to the reform courts' efforts through evasive behavior rather than through enhanced care seemingly reflects a belief that sig-

150. See Collins, *Malpractice Prevention and Risk Management*, *supra* note 64, at 54 ("clients who will distribute . . . financial statements to multiple third parties should be shunned").

151. See Collins, *id.*; Minow, *supra* note 16, at 80.

152. See Minow, *id.*

153. 93 N.J. at 351, 461 A.2d at 152. This effort by the *Rosenblum* court to suggest to accountants strategies to evade the court's own holding is perplexing in its own right. Even more baffling, however, is the court's ignorance of its own ruling in *Henningsen v. Bloomfield Motors, Inc.*, 32 N.J. 358, 161 A.2d 69 (1960), in which it disallowed a parallel effort to disclaim liability for defective products. One suspects that the accounting profession would be well advised to place little hope in the long-term viability of this particular strategy. See New Jersey Developments, *Rosenblum v. Adler: The New Jersey Supreme Court Expands Accountants' Liability*, 37 RUTGERS L. REV. 161, 189-90 (1984) (urging restrictive reading of *Rosenblum*'s disclaimer language). In the short run, however, the profession has latched onto the strategy of responsibility disclaimers with relish. See Collins, *Malpractice Prevention and Risk Management*, *supra* note 64, at 64.

154. The term "evasive behavior" is used here to describe actions which seek to limit liability in a manner other than through increased investments in care. It does not imply that such behaviors are illegal. Cf. Siliciano, *supra* note 4, at 1835-40.

155. See text accompanying notes 125-32 *supra*.

nificant limits exist to the effectiveness of further investments in care. These limits may come from several sources.

First, the accountant's necessary reliance on client input makes risk control more difficult than it is in the defective products context. Unlike a product manufacturer that designs and manages its own production processes, the accountant serves simply as a reviewer of the product of another. If the accountant audits more thoroughly, the client who innocently errs may be corrected, but will a client tempted by fraud be restrained? To some extent, the fear of an extensive audit might make such clients more cautious *ex ante*, but there appear to be significant limits to the efficacy of this incentive. The client who falsifies financial information is often driven by fiscal desperation; if its financial disclosures are accurate, the third-party credit necessary to save the business from failure will not be forthcoming. Faced with an overly energetic auditor, the client itself is likely to engage in evasive behavior. It may switch auditors, redouble its efforts to fool the audit staff, or pursue third-party financing that does not require an audit. But it is unlikely to pursue the option, anticipated by the reform courts, of telling the truth.¹⁵⁶ Therefore, even if the accounting profession willingly shouldered its new responsibilities, reform might be ineffective.¹⁵⁷

Second, the labor-intensive nature of auditing may set natural limits on the efficacy of further expenditures on care, even in situations where the client is not actively seeking to produce fraudulent financial statements. Unlike product manufacturing, where design and manufacturing defects are typically remedied through "technological fixes," the central device for reducing risk in the accounting context is to increase the workhours devoted to the audit. Yet, either method of

156. See generally Levy, *Financial Fraud: Schemes and Indicia*, J. ACCT., Aug. 1985, at 78.

157. Indeed, the client's treachery may bestow on the accountant a defense of contributory negligence against the actions brought directly by the client against the accountant. See Menzel, *supra* note 101. The implicit economic assumption underlying this defense is that the standard of care applied to a tortfeasor (here, the accountant) should be set on the assumption that the "victim" (here, the client) is exercising due care. W. LANDES & R. POSNER, *THE ECONOMIC STRUCTURE OF TORT LAW* 88 (1987). But when the claim against the accountant is brought by a third party, the reform courts completely ignore the potential for client misconduct, and view the situation as one in which the accountant alone has control over the probability of accounting accidents. If the goal of the deterrence rationale is to encourage efficient investments in care by all parties, tort law cannot tolerate this binary view of the accountant-client relationship. The audit, although consumed by both client-victims and third-party-victims, is a single, indivisible process that cannot be conducted differently for different potential victim classes. Therefore, to establish a standard of care for the accountant in carrying out this process, tort law must settle on a single view of the caretaking capacity of clients and third parties. In the accounting cases, there are strong arguments for adopting a joint care model, for otherwise accountants will overinvest in care while clients and third parties will have little incentive to make efficient investments in care. See *id.* at 88-89.

doing so — increasing the personnel or increasing the hours devoted to an audit — is likely at some point to increase, or at least fail to further decrease, audit risk. If more personnel are deployed on an audit, the risk of error may eventually begin to rise due to increased problems of supervision.¹⁵⁸ Alternatively, if staffing remains unchanged while more time is devoted to an audit, a similar increase in audit risk will eventually occur as the informational basis of the audit becomes stale.¹⁵⁹

A perfectly functioning tort system should, of course, be able to adjust for these problems by holding accountants harmless when the efficacy of further investments in care is undermined by client misconduct or technological limitation. Yet, this is not the system we have. Thus, even if accountants were able to “get it right” in deciding against further investments in care, they might legitimately be concerned about whether the adjudicative process would necessarily conclude that they had done so. The determination of negligence is often dangerously open-ended and subjective.¹⁶⁰ These problems are exacerbated when the subject of the negligence determination — the auditing process — itself involves numerous discretionary judgments.¹⁶¹ This concern has led the profession’s defenders to complain bitterly that courts and juries frequently hold accountants to unrealistic and unattainable standards that effectively force them to act as insurers of the businesses they audit.¹⁶²

In light of the above factors, the evasive behavior of accountants is hardly surprising. Faced with the prospect of a reckless client, a limited technology, and an error-prone adjudicative process, the profession might reasonably view the enhanced liability imposed by the

158. As anyone acquainted with auditing knows, the process is far from mechanical. Instead, modern audits of complex enterprises require accountants to make numerous judgments about the proper characterizations of the data and the reliability of the client’s accounting systems. Although the GAAS and GAAP standards channel the inquiry somewhat, a large subjective element inevitably remains. *See* Connor, *supra* note 133; Mednick, *supra* note 133. Moreover, such discretionary judgments are often made, in the first instance, by relatively junior members of the accountant’s field staff. Effective supervision of their work therefore becomes a critical part of maintaining audit integrity, *see* K. ST. PIERRE, *supra* note 14, and this oversight function obviously becomes more difficult as staffing is increased.

159. The principal component of audited financial statements is a balance sheet, which constitutes an economic snapshot of an entity’s assets, liabilities and net worth as of a given day. *See, e.g.*, text accompanying note 21 *supra*. These components are in constant flux, and thus the value of a balance sheet as a reliable indicator of economic health declines as the time between the completion of the fiscal period upon which the audit is based and the completion of the audit itself is extended.

160. *See, e.g.*, Henderson, *supra* note 71.

161. *See* Connor, *supra* note 133; Mednick, *supra* note 133.

162. *See, e.g.*, Minow, *supra* note 16, at 77 (noting “the failure of courts and juries to distinguish between an audit failure and a business failure”).

reform courts simply as a tax on the activity of accounting. Worse yet, it is a tax that to a significant extent appears to operate independently of the accountant's level of care. Under such circumstances, the accountant's best practical option — its cheapest means — for controlling liability is to curtail operations in areas where the risk of third-party claims is greatest or where the audit involved poses the greatest likelihood of unavoidable errors or client deception. Significantly, this is precisely what the profession has set out to do.

2. *The Consequences of Expanded Liability*

Assuming for a moment that the profession's resort to evasive behavior is incomplete and that accountants therefore make some increased investments in care, important questions remain over whether the reform effort actually promotes the public welfare; for if replacing *Ultramares* with a foreseeability-based liability rule produces safer audits, such a change is also certain to make such audits more costly,¹⁶³ more time-consuming,¹⁶⁴ and less universally available.¹⁶⁵

If an audit were truly like any other product — a lawnmower, for example — these collateral effects of improving safety might not be troubling. Because nearly all the benefits¹⁶⁶ of a lawnmower are conferred on the owner of the machine,¹⁶⁷ a liability rule imposing on manufacturers all foreseeable accident costs caused by the lawnmower would, in theory, drive producers toward an efficient level of product safety and an efficient level of production.¹⁶⁸ A manufacturer would

163. These increased costs come from at least three sources: (a) the increased costs of committing additional time and personnel to an audit; (b) the increased costs of insuring against potential losses to third parties; and (c) the increased dead-weight costs of creating a "paper trail" sufficient to demonstrate audit care in subsequent third-party litigation. See Fischel, *supra* note 126, at 1055. Marginal accounting firms may not be able to bear such added cost; their demise in turn decreases the availability of accounting services. See text accompanying note 199 *infra*. See also Ebke, *supra* note 50, at 690-91.

164. See generally Note, Rosenblum v. Adler: *Auditors' Liability for Negligent Misrepresentation — the Explosive Power Resident in Words*, 38 U. MIAMI L. REV. 939, 957 (1984).

165. See text accompanying notes 150-53 *supra*.

166. The benefits referred to here are of at least two types. One "benefit" is simply the value of the manufacturer's investment in safety, which the tort system perceives as lowered accident costs. This benefit (*i.e.*, cost avoided) can presumably be fully captured by the tort system, since it represents a reduction in the tort liability the producer must initially bear and ultimately pass on to the consumer. Another benefit, of central importance here, is the value, apart from safety concerns, that the use of the product bestows on the consumer and others in society. As discussed below, this type of benefit may not be fully captured and weighed against product-related costs if the consumer does not value the benefit that the product bestows on third parties.

167. To be sure, the owner's neighbors might benefit from the sight of his well-trimmed lawn, but the owner recaptures these benefits in terms of increased status and civic pride. Otherwise, some rational homeowners, this author included, might forgo the pleasure of lawncare.

168. This effect on levels of production assumes a strict liability regime for defective products, as a negligence standard does not in theory affect activity levels. See LANDES & POSNER, *supra* note 136, at 543; Shavell, *Strict Liability Versus Negligence*, 9 J. LEGAL STUD. 1 (1980).

incorporate such accident costs, along with related safety costs, into the lawnmower's price, and consumers would purchase the lawnmowers so priced as long as they expected a stream of benefits from owning a lawnmower that exceeded its costs. In such cases, the fact that an expansion of liability rules — for example, a shift from privity to foreseeability of harm as the basis of liability — might decrease the number of lawnmowers produced is of no real consequence, for it merely indicates that the social benefits of lawnmowers — as reflected in what consumers are willing to pay — are insufficient to command greater production in the face of fully incorporated social costs.

However, not all risk-creating activities take place in closed systems where all social benefits and costs can be captured and balanced in discrete purchasing decisions. A psychiatrist, for example, who successfully treats a potentially dangerous patient bestows a benefit not only on the patient but on society at large.¹⁶⁹ Such third-party benefits are very unlikely to be fully captured by the psychiatrist in his fee to the patient.¹⁷⁰ If, on other hand, his treatment of the patient is negligent, third parties may be harmed. In such an event, tort law might, under a foreseeability of harm rule, impose third-party losses on the psychiatrist. Yet, such a rule might distort, rather than optimize, the delivery of the psychiatrist's services. Faced with the full cost of his activity, but unable to capture the full benefit, the psychiatrist might simply refuse treatment to patients most likely to endanger third parties. Such a result is obviously hard to square with society's general interests.¹⁷¹

The negligent accounting cases appear to represent a parallel situation.¹⁷² The information embodied in the auditor's report initially

Indeed, if consumers were perfectly informed regarding product risk, the same efficient result would theoretically occur under an opposite, no-liability rule. See Siliciano, *supra* note 4, at 1823-25.

169. The example is from *Tarasoff v. Regents of University of California*, 17 Cal. 3d 425, 551 P.2d 334, 131 Cal. Rptr. 14 (1976) (holding psychiatrist liable in negligence to third party killed by patient).

170. Difficulty in assessing the degree of danger the patient poses to third parties impairs the psychiatrist's ability to estimate the social benefit created by successful treatment. Moreover, the socially dangerous patient, unlike the status-conscious homeowner in the lawnmower example, is unlikely to care or be willing to pay for the benefits successful treatment might bestow on his potential victims. If the psychiatrist is forced to increase the cost of his services in order to cover third-party accident costs, some patients at the margin will forgo the psychiatrist's services.

171. For criticism of the negative social impact of the *Tarasoff* decision, see Stone, *The Tarasoff Decisions: Suing Psychotherapists To Safeguard Society*, 90 HARV. L. REV. 358 (1976); Note, *Where the Public Peril Begins: A Survey of Psychotherapists To Determine the Effects of Tarasoff*, 31 STAN. L. REV. 165 (1978).

172. The problem of encouraging voluntary rescue provides another example of a circumstance in which imposing the full social cost of an activity on an actor may discourage socially

confers a benefit on the client; the value of this benefit is captured in the accountant's fee. But the audit also aids a potentially wide array of third parties considering financial transactions with the client. Even parties that ultimately decline such involvement profit from the audit to the extent that it reduces the uncertainty of their deliberations. In many cases, however, the accountant's ability to charge for these third-party benefits is limited. By definition, such parties are not in a bargaining arrangement with the accountant and therefore cannot be assessed directly for their use of the audit. Hence, the accountant, if it is to recapture this benefit, must do so through its charge to the client.

Several factors undercut this strategy. First, except in the *Glanzer* situation, where the audit is commissioned for the direct benefit of a specific third party, the accountant often does not know the extent to which the client will circulate the audit to third parties. Moreover, the client has little incentive to be forthcoming on this score, for it can typically reproduce the information contained in the audit at a trivial cost, without limit, and without any further assistance by the accountant.¹⁷³ Finally, even if the accountant merely estimates the value its services provide to third parties, it may be unable to charge its clients for such benefits without pricing the audit out of the reach of some of these clients.¹⁷⁴

Under a privity-based liability rule, these recapture problems are of little real significance to an accounting firm. It may not be able to charge third parties for the benefit they receive for an accurate audit, but it is not responsible for the losses they suffer when the audit is inaccurate due to the accountant's negligence. But if the accountant *is* charged with the costs that befall such free-riding third parties, as the reform courts propose, the accountant's inability to capture the full social benefit of its information-producing activities may force it simply to curtail the production of information in order to bring costs in line with revenues. Worse yet, this contraction of auditing services is likely to occur, as it does in the psychiatrist example above, with respect to those clients who pose the greatest risk of harm to, or have the most extensive dealings with, third parties.¹⁷⁵

useful activity. See R. COOTER & T. ULEN, *LAW AND ECONOMICS* 410-13 (1988); Landes & Posner, *supra* note 71.

173. See, e.g., *Ultramares Corp. v. Touche*, 255 N.Y. 170, 173-74, 174 N.E. 441, 442 (1931); RESTATEMENT (SECOND) OF TORTS § 552 comment a (1977) (emphasizing the extent to which information contained in the audit may be expected to be circulated).

174. This depends on the elasticity of demand for accounting services. See text at notes 197-99 *infra*.

175. This might be a positive development if the absence of an audit flatly precluded such

In short, given the nonappropriable benefits of the auditing process, the level of information produced under a liability rule based on foreseeability of harm may be less than a socially optimal level.¹⁷⁶ Thus viewed, Cardozo's fear in *Ultramares* of creating liability "in an indeterminate amount for an indeterminate time to an indeterminate class"¹⁷⁷ can be recast as a concern over the negative impact that enhanced liability might have on the market for information. This is not to suggest that the *Ultramares* rule generates optimal levels of information of an optimal quality. Negligent errors in audits occur, and when they do, reliant third parties bear the costs.¹⁷⁸ Given the imperfections in the market for information noted above, however, an optimal solution may be elusive, if not impossible. Instead, the choice may be between a broad liability rule that emphasizes informational quality and a restrained liability rule that emphasizes information production. Jurisprudence in the first amendment area has long struggled with similar tradeoffs between quality and output;¹⁷⁹ it may well be that in a situation where the potential victims of inaccurate information are equipped to guard against injury, the law should opt for the robust, though potentially flawed, production of information.¹⁸⁰

parties from attracting credit or investment *and* if society could be certain that consequent exit of this class of clients from the market was a net social benefit. Neither condition, however, is satisfied. While the absence of an audit may raise the client's cost of credit, such parties often can obtain funds without an audit. In such cases, the categorical withholding of auditing services from high-risk clients simply decreases third-party information with respect to such transactions. In addition, the strategic withdrawal of accounting services in response to the reform courts' expanded liability regime does not represent a conclusion that high-risk clients, as a class, create social costs that exceed the benefits they generate. Rather, it reflects a simple and less telling judgment that the aggregate costs of the accountant's involvement with such parties are likely to exceed the benefits the accountant is able to capture in audit fees.

176. See generally, *Greycas, Inc. v. Proud*, 826 F.2d 1560 (7th Cir. 1987) (Posner, J.), *cert. denied*, 108 S. Ct. 775 (1988); K. ARROW, *ESSAYS IN THE THEORY OF RISK-BEARING* 151, 183 (1971); Bishop, *Negligent Misrepresentation Through Economists' Eyes*, 96 L.Q. REV. 360, 364-66 (1980).

177. 255 N.Y. at 179, 174 N.E. at 444.

178. Some such errors, of course, might occur even in an optimal regime. Nonetheless, the risk-utility calculus of a privity regime, because it excludes consideration of both the risks and the benefits to third parties, is unlikely to reach the same equilibrium as would a regime capable of weighing all such benefits and costs.

179. See, e.g., *N.Y. Times v. Sullivan*, 376 U.S. 254 (1964). The first amendment implications of judicial regulation of the accountant's work product are beyond the scope of this article. For an insightful introduction to the general area, see Shiffrin, *The First Amendment and Economic Regulation: Away from a General Theory of the First Amendment*, 78 NW. U. L. REV. 1212 (1983).

180. See Perlman, *supra* note 80, at 74 ("[T]he need for limits [on tort liability] is acute when tortious behavior consists of utterances, because society places a high value on free speech. To the extent that uncertain or overbroad liability causes a speaker to take precautionary steps to avoid liability, the establishment of some limits is imperative."); RESTATEMENT (SECOND) OF TORTS § 552 comment a (1977) (restrictions on accountant liability necessary to promote "the important social policy of encouraging the flow of commercial information upon which the operation of the economy rests").

Indeed, the reform courts' preference for information quality over information quantity may be of little value to the third-party creditors and investors the reform effort is intended to protect. Given that the promised response of the accounting profession to third-party liability exposure will be to limit their auditing function to "safe" companies,¹⁸¹ rather than to audit all companies more thoroughly, overall third-party protection may decline rather than improve. Firms that would benefit most from an independent audit — because they are young or small or unstructured — may be denied such services on the ground that they pose excessive audit risks.¹⁸² The traditional creditors and investors involved with such enterprises are therefore left with no audit protection, rather than the admittedly imperfect protection they enjoyed under the traditional privity rule. At the same time, the more thorough audits conducted on the remaining auditable companies may afford little additional protection to third parties, since such firms qualified for audits by virtue of their already lower audit risk.

Furthermore, to the extent that the audit plays an important role in commerce, and particularly in the access of firms to the capital markets,¹⁸³ increasing audit cost or decreasing audit availability may produce substantial barriers to the growth of firms that can no longer afford or qualify for accounting services. Just as the extensive disclosure requirements of the federal securities laws have been criticized as an unnecessarily burdensome restriction on the ability of emerging firms to enter the capital markets,¹⁸⁴ the "improved" audit envisioned by the reform courts may be an entry ticket that too few can afford. Thus, even if the enhanced liability imposed by the reform courts does improve audit safety, it does so at a potentially significant cost to new business growth.

In sum, despite the reform courts' unquestioning faith in the utility of enhanced deterrence, it is far from clear that the benefits of abandoning the privity defense exceed the costs. The question is both ex-

181. See text accompanying notes 150-53 *supra*. Of course, the profession's reaction is unlikely to be monolithic. Some accounting firms will doubtless be willing to provide auditing services to high-risk clients in return for enhanced compensation. And such clients to some extent may be able to recapture the benefits of such audits in the form of lower costs of raising capital. But, given the imperfections of the market for auditing services suggested above, it remains unclear whether the net changes in the cost and availability of audit services enhance social welfare.

182. See Minow, *supra* note 16, at 80.

183. See Fischel, *supra* note 126.

184. See, e.g., Manne, *Economic Aspects of Required Disclosure Under Federal Securities Laws*, in *WALL STREET IN TRANSITION* 23 (H. Manne & E. Solomon eds. 1974); Easterbrook & Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 671 (1984).

ceedingly complex and largely empirical. In many ways, the necessary inquiry regarding the value of proposed reforms appears to parallel that which a court makes in assessing the reasonableness of a product design in the face of a claim that the design is defective. Here, the "product" is a liability rule itself — privity-based negligence — and before a court concludes that the rule is defective, it should determine with some confidence that a proposed design change — abrogating privity — will yield social benefits that exceed the rule's costs. Others have expressed profound skepticism about the rationality of such inquiries even when the product is simply a product,¹⁸⁵ but when the product under design scrutiny is an entire liability regime, the correct resolution of the calculus may be well beyond the law's information-gathering and problem-solving abilities.¹⁸⁶ At the very least, the net value of enhanced deterrence in the accounting cases is a dangerous issue to eyeball, or, even worse, to assume as given.

Of course, a proponent of the reforms might respond that the same uncertainties also plague the type of reform Cardozo sanctioned in *MacPherson*. This is true, but it overlooks a critical distinction between what the law must do and what the law might do. In cases like *MacPherson* and *Henningsen*, tort law perceived a failure of private arrangements regarding product risk. Against this backdrop of default, the "needs of life in a developing civilization" compelled the intervention of law.¹⁸⁷ The exact extent and configuration of the intervention may not have been perfect, but few questioned its necessity.¹⁸⁸ The reform efforts in the accounting cases, in contrast, are based not on the failure of private arrangements but on the raw promise of instrumentalism. Enhanced deterrence is no longer an outcome of the rule change, but instead is the reason for the change. Bravado replaces caution, but with it comes the right to insist on a better quality of proof. In the negligent accounting cases, that proof is simply lacking. In the resulting silence of questions unanswered, tort law stands embarrassed.

B. *The Loss-Bearing Rationale*

In addition to increasing the incentives to take care, the reform courts assume that shifting the risk of loss from the third parties to

185. See, e.g., Henderson, *Judicial Review of Manufacturers' Conscious Design Choices: The Limits of Adjudication*, 73 COLUM. L. REV. 1531 (1971).

186. See Siliciano, *supra* note 4, at 1860-63.

187. *MacPherson v. Buick Motor Co.*, 217 N.Y. 382, 391, 111 N.E. 1050, 1053 (1916).

188. See, e.g., Priest, *supra* note 3 (discussing widespread support for an expanded products liability regime).

accountants will serve a second major element of instrumental tort theory: improving society's loss-bearing capacity. Accepting a certain level of loss as inevitable,¹⁸⁹ the underlying goal of this strand of instrumental theory is to identify the actors in the risk-producing transaction who, regardless of fault, are best suited institutionally to manage the loss.¹⁹⁰ As one reform court asked, "Isn't the risk of loss more easily distributed and fairly spread by imposing it on the accounting profession, which can pass the cost of insuring against the risk onto its customers, who can in turn pass the cost onto the entire consuming public?"¹⁹¹ Such rhetorical questions tend to prompt quick and affirmative replies, and hence most commentators have easily accepted the loss-spreading justification for reform.¹⁹² Some hesitation is appropriate, however, for the decision to embrace loss-bearing as a rationale raises important theoretical and practical concerns.

1. *Theoretical Concerns*

On an abstract level, one might question why the instrumental goal of efficient loss-bearing has any place in a debate where negligence seemingly is assumed by both the privity and nonprivity jurisdictions to be the basis for liability. The loss-bearing rationale has traditionally been associated almost exclusively with strict liability, and for good reason; under a negligence regime, the accountant should be free from liability for residual losses once it has taken reasonable care.¹⁹³ To impose liability after this point would require accepting that the risk

189. As discussed below, the reform courts are quite imprecise in discussing this rationale. Terms such as "risks," "costs" and "losses" are used interchangeably, and with little explanation. This article assumes that the reform courts mean this instrumental justification for reform to be independent of the deterrence rationale in which accident losses are shifted to the accountant (*i.e.*, internalized) in order to create economic incentives for care. It may well be, however, that the reform courts are simply parroting rhetoric common in the defective products context, an area to which they draw strong parallels, without truly distinguishing between deterrence and loss-bearing rationales.

190. Hence, a traditional justification for preferring strict liability over negligence, despite the theoretical capacity of both regimes to generate the same optimal level of care, is the greater capacity of producers relative to consumers to manage the residual accident costs that would occur despite optimal care. *See generally* Priest, *supra* note 3.

191. *Rusch Factors, Inc. v. Levin*, 284 F. Supp. 85, 91 (D.R.I. 1968). *See also* *International Mortgage Co. v. John P. Butler Acct. Corp.*, 177 Cal. App. 3d 806, 820, 227 Cal. Rptr. 218, 227 (1986) ("The risk of such loss is more appropriately placed on the accounting profession which is better able to pass such risk to its customers and the ultimate consuming public."); *Rosenblum, Inc. v. Adler*, 93 N.J. 324, 350, 461 A.2d 138, 152 (1983) (costs of third-party claims should be "borne by the business entity and its stockholders or its customers"); *Citizens State Bank v. Timm, Schmidt & Co.*, 113 Wis. 2d 376, 384, 335 N.W.2d 361, 365 (1984) ("Accountants may spread the risk through the use of liability insurance.").

192. *See* pro-reform authorities cited in notes 43 and 50 *supra*.

193. *See* Landes & Posner, *supra* note 136, at 541-43.

producer was both non-negligent and still liable. Of course, in the products area, this is precisely what has occurred; instrumental theories of efficient loss-spreading have been used to justify shifting responsibility for such residual losses to the producer despite its optimal investment in care. In so doing, however, courts were required to substitute strict liability for negligence.¹⁹⁴ But if negligence is to remain the standard in the accounting area, and no court has seriously suggested otherwise,¹⁹⁵ it is hard to identify precisely the losses to which the loss-spreading rationale attaches. To be sure, there may be losses that occur when the accountant fails to invest optimally in care, but these are obviously more appropriately treated under a deterrence rationale.¹⁹⁶

Thus, the reform goal of efficient loss spreading may be senseless redundancy that collapses back into the deterrence-based issue of whether accountants under a privity regime produce excessive, and avoidable, accident costs. But if the reform courts mean to do more than this — and their analyses are simply too cursory to tell — then they are embarked on a remarkable transformation of this area of tort law. Not only is foreseeability replacing privity as the basis of liability, but the foundations are being built for a supplanting of negligence by strict liability. If these courts have indeed determined that accountants, not for any fault-based reasons but simply because of their institutional competence and placement, can be called upon to serve the collective whole by managing the losses that would otherwise fall elsewhere, such a conclusion needs both to be made explicit and to be squared against the arguments that have traditionally insulated the professions from the increasing dominance of strict liability.

2. *Practical Concerns*

The reform courts' loss-spreading rationale also raises practical concerns on several levels. First, the rationale is predicated on an empirical assumption the reform courts never substantiate — the accountant's actual ability to pass its third-party liability costs on to its clients. The structure of the accounting profession and the market for accounting services, however, may well interact in a manner that debilitates effective loss spreading.

194. See *id.* at 549-50; Shavell, *supra* note 168, at 2-3.

195. Indeed, even academics have been reluctant to propose strict liability for professionals. But see Vandall, *Applying Strict Liability to Professionals: Economic and Legal Analysis*, 59 *IND. L.J.* 25 (1983).

196. There also may be "losses" which occur when errors in the adjudicatory process cause non-negligent conduct to be labelled as negligent. Such liabilities, however, do not constitute the kind of exogenous loss that is the focus of risk-spreading rationales.

The losses to third parties that the reform courts seek to redistribute through the expanded liability regime initially appear as an additional cost of business to the accountant. The accountant's effort to recoup such costs through higher service charges to clients, however, naturally creates incentives at the margin for such clients to substitute away from such services. This substitution effect is likely to be relatively trivial with respect to the limited number of accounting firms that specialize in auditing large, publicly held companies. Because the securities laws effectively mandate that such businesses obtain audited financial statements, the ability of such businesses to decline auditing services in light of higher accountant fees is severely limited.

But for the numerically larger group of smaller, younger, and less public enterprises — which objectively might benefit most from audit services — the tendency to forgo such services rather than pay higher fees is likely to be more pronounced. In order to preserve their consumer base, accounting firms may seek to absorb a portion of the increased costs.¹⁹⁷ Unfortunately, the segment of the accounting profession that services this subgroup of consumers is itself dominated by smaller, less established firms that, on the whole, are probably less capable of handling such cost increases than the firms that audit large public enterprises.¹⁹⁸ As a consequence, some marginal accounting firms may be eliminated from the market as the demand for auditing services contracts.¹⁹⁹

True loss spreading, therefore, may occur only with part of the profession and its client base. The social benefits of loss spreading, however, may be more than offset by the decreased consumption of audit services by those clients that might benefit most from such services and by the elimination of some accounting firms that might otherwise service this segment of the market. While these questions, of course, are ultimately empirical, there is little basis for the reform courts' simplistic, trouble-free model of loss spreading.

Moreover, even if effective loss spreading is assumed, the need to

197. See generally Comment, 70 CORNELL L. REV. 335, 350-52 (1985). If this effect is sufficiently pronounced, the loss-spreading rationale is defeated; third-party losses are concentrated on a segment of the accounting profession rather than dispersed through its consumer base. Indeed, under such circumstances, a pure loss-spreading rationale might argue in favor of leaving losses on the more numerous class of third-party audit consumers.

198. In economic terms, the numerous individuals and small firms that populate this segment of the accounting profession are likely to make this portion of the market more competitive than is the relatively concentrated segment that services large, publicly held companies. Consequently, most firms will be earning only normal profits and will be unable to absorb the additional liability costs of a foreseeability-based rule.

199. See Note, *Protecting the Auditor from Unwarranted Third-Party Liability: Rethinking the Indemnification Issue*, 35 SYRACUSE L. REV. 763, 764 n.7 (1984) (reporting that some accounting firms are forced out of the market due to increased third-party liability costs).

use the accountant for such purposes is debatable. In importing the loss-spreading rationale into the domain of negligent accounting, the reform courts attempt to invoke instrumentalism's vision of the single injured consumer, who is unable to bear the potentially staggering costs of a product-related injury, and the large product manufacturer, who can easily cover such costs through insurance and incremental increases in product prices. Although this powerful image fueled the development of strict liability regimes for defective products,²⁰⁰ the effort of the reform courts to transpose it to the accounting context again ignores the third party's true nature. Like the accountant, the typical third party in the accounting cases is a commercial concern with multiple business relationships.²⁰¹ Thus, to some extent, it shares the accountant's ability to spread, throughout its consumer base, the costs it incurs when one of its customers defaults on a loan obtained with the use of a defective audit.

If losses can be spread widely in either direction, the products liability analogy once again collapses. Why, then, should the reform courts, in the absence of overriding fault-based reasons, place the loss-spreading function on the accountant rather than on the third party, where the loss would otherwise naturally fall? The only answer provided is the fear that under the latter loss-spreading mechanism, "the cost of credit to the general public will increase because creditors will either have to absorb the costs of bad loans made in reliance on faulty information or hire independent accountants to verify the information received."²⁰²

Yet, this answer, if anything, only emphasizes the parallelism of the alternative means of spreading the losses caused by the client's circulation of inaccurate information. Both potential loss spreaders — the accountant and the third party — can expend resources to minimize the losses incurred; the accountant can attempt to audit more thoroughly, while the third party can audit the client independently or bear the investment risks. Both actors can theoretically pass on such costs,²⁰³ plus any residual losses, to the public: the accountant, through increases in the cost of its services; and the third party, through increases in the cost of its credit. Either way, the increased costs initially are imposed on the client class, which in turn passes it

200. See Priest, *supra* note 3.

201. See text at notes 137-40 *supra*.

202. Citizens State Bank v. Timm, Schmidt & Co., 113 Wis. 2d 376, 384, 335 N.W.2d 361, 365 (1984).

203. As previously noted, the actual ability of an actor to pass on cost increases will depend on the elasticity of demand for the actor's product and the competitiveness of the market in which the actor operates. See note 198 and accompanying text *supra*.

on to the public in the form of price increases. Inexplicably, the reform courts view one path as good and one as bad. Using the accountant as a vehicle to impose the costs on the "entire consuming public" is apparently sound policy,²⁰⁴ while imposing the same costs on "the general public" through increases in the price of third-party credit is not.²⁰⁵ The logic of this dichotomy is, to say the least, not readily apparent.²⁰⁶

Of course, not all third parties are positioned to spread such losses. In particular, individual investors who rely on a defective audit have no real ability to redistribute the loss widely across society. For several reasons, however, enlisting the accountant to redistribute such losses may be unwise. First, as noted above, such investors may suffer rather than benefit if accountants constrict their activity in response to enhanced liability.²⁰⁷ Second, such investors can limit the impact of such losses simply by diversifying their range of investments.²⁰⁸ Finally, such investors, as a class, represent a broad social base upon which the costs of accounting errors can be spread. The question therefore becomes why this portion of the populace — the "investing public" — is entitled, absent fault-based reasons, to have its losses lifted, aggregated, and transferred by the tort system to the "general public" that consumes the products and services of the accountant's clients. This is a troubling question, and one the reform courts never address.²⁰⁹

IV. WHITHER TORT?

The above analysis does not demonstrate that Cardozo was right and the reform courts are wrong. That is not its goal. Instead, the effort here is a more modest one: to show that the case for abandoning *Ultramares* and embracing a foreseeability-based concept of liability has not yet been made, and that caution therefore is in order. One

204. *Rusch Factors, Inc. v. Levin*, 284 F. Supp. 85, 91 (D.R.I. 1986).

205. *Citizens State Bank*, 113 Wis. 2d at 384, 335 N.W.2d at 365.

206. Indeed, since the costs under either scenario ultimately pass on to the client population that consumes accounting services and third-party credit, the most significant difference between the two loss-spreading models may be the higher litigation costs that occur when the third party is allowed to transfer its losses to the accountant under the *Rosenblum* approach.

207. See text at notes 181-82 *supra*.

208. See generally R. HAUGEN, *MODERN INVESTMENT THEORY* 52-74 (1986). Indeed, many such investors use mutual funds, which effectively diversify their investment risk.

209. Indeed, the transfer of residual losses from the class of investors and creditors upon which such losses initially fall to the "general consuming public" might usefully be analyzed in economic terms as an instance of rent-seeking behavior. See, e.g., Macey, *Transaction Costs and the Normative Elements of the Public Choice Model: An Application to Constitutional Theory*, 74 VA. L. REV. 471 (1988).

might naturally have hoped for a firmer conclusion — one asserting that privity, or its antithesis, is clearly preferable. But a fundamental sub-theme of this article — that an instrumental analysis, properly executed, involves a complex, heavily empirical, and potentially open-ended inquiry — humbles any quest for definitive answers.

Perhaps the best solution, if such a thing exists, lies somewhere in the uncomfortable terrain between a flat privity rule and a full-blown foreseeability test for liability. The *Glanzer* rule, or some derivation of it, may strike a crude but workable accommodation between these poles. Although the reform courts find rules based on actual foresight rather than reasonable foreseeability of harm to be indefensible, such rules address some of the major substantive issues discussed above. They give tort law a greater role in policing the conduct of accountants than would a pure privity requirement, but nonetheless contain liability in a manner consistent with the economic loss doctrine. Moreover, they partially shift the losses generated by negligent accounting, but — because they allow the accountant to gauge its exposure accurately in advance — such rules do not seriously impair the insurance function.

Such a conclusion is only offered tentatively, for it may be too difficult and too costly, from a purely process perspective, to maintain a line in this interstitial area. The precise formulation of the original *Glanzer* exception — that *the* end and aim of the transaction was to benefit *a* specifically *foreseen* third party — is indefensible on substantive grounds. Why must there be only *one* end and aim of the transaction? Why can't the rule protect a *class* of foreseen third parties? And since the identity of some members of such a class is unknown to the accountant, isn't the actual rule really one of foreseeability? There are no obvious answers to these questions; if they are taken seriously and addressed in substantive terms, the drift from *Ultramares* to *Rosenblum* may be inevitable. Only if tort law refuses to address such inquiries, and accepts the arbitrariness of the exact placement of the line, can this substantively useful middle ground be held.²¹⁰

210. Alternatively, one might consider a stratified negligence rule that accounts for the varying ability of third parties to implement their preferences through private ordering. Thus, sophisticated investors and creditors might be required to fend for themselves, perhaps even to the extent of retracting the protection they traditionally enjoyed under the various formulations of the *Glanzer* rule. See generally Goldberg, *supra* note 50, at 302. Remote, unsophisticated investors, on the other hand, might receive the rigorous protection of a pure foreseeability rule. Cf. note 143 *supra* (noting similar stratified approach to investor protection under securities laws).

The advantage of such an approach is that it targets tort law on situations where its intervention is most useful. The disadvantages of a stratified rule, however, are considerable. It threatens considerable litigation costs, since parties who do not qualify for protection presumably will remain free to claim that they do and have the issue adjudicated. Moreover, if the steady expansion of the *Glanzer* exception to *Ultramares* is any indication, it is doubtful whether common law

Thus deflected from any firm conclusion, the focus of this article shifts from the failure of the reform courts to improve upon Cardozo's handiwork to the reasons for this shortcoming. This inquiry is worth pursuing, for the analysis offered by the reform courts seems not only to miss the mark, but to do so by a considerable distance. Of course, there are obvious dangers in drawing broad conclusions about the direction of instrumental tort reform from an examination of a single line of cases. Yet, the absolute identity of reasoning in all the negligent accounting cases — the recurring reference to the products analogy, the ready resort to deterrence and loss-spreading rationales, and the clear preference for a collectivist view of social obligation over one based in part upon private ordering — undercuts any contrary claim that such decisions are aberrational and unrepresentative. Indeed, the same patterns of argument replicate themselves throughout much of modern tort law.²¹¹ On the reasonable assumption, then, that the accounting cases do in fact reflect major currents within tort law, what can be learned from the ongoing dismantling of the accountant's traditional privity defense?

The central lesson seems apparent. Despite the laudable intentions of the reform courts, their efforts to use instrumental reasoning in assessing the merits of proposed rule changes have remained painfully superficial. This is not to suggest that instrumental tort theory itself is simplistic, for much of it is plainly quite the opposite.²¹² But if the accounting cases are any indication, the practical ability of courts to grasp and work with the nuances and limits of academic theory is limited.

This institutional incompetence manifests itself in a variety of ways. To begin with, a fixation with easy analogies and reflexive parallelism has taken the place of a careful consideration of how the unique attributes and interrelations of parties might affect the choice of liability rules. The accountant is equated with the product manufacturer, the third party with the "innocent victim" of the defective product context, and the audit with a defective product. With the roles thus cast, the answer comes easily; indeed, it appears compelled

courts are capable of resisting piecemeal redefinition of the potential plaintiff class. Finally, the resulting complication of the negligence standard may be unwarranted in light of the protection most such investors enjoy under the securities laws and are able to supplement through diversification of their investment strategies.

211. See H. STEINER, *supra* note 105; Schuck, *supra* note 4.

212. See, e.g., W. LANDES & R. POSNER, *THE ECONOMIC STRUCTURE OF TORT LAW* (1987); Calabresi & Hirschoff, *Toward a Test for Strict Liability in Torts*, 81 *YALE L.J.* 1055 (1972); Calabresi & Klevorick, *Four Tests for Liability in Torts*, 14 *J. LEGAL STUD.* 585 (1985); Schwartz, *Products Liability, Corporate Structure, and Bankruptcy: Toxic Substances and the Remote Risk Relationship*, 14 *J. LEGAL STUD.* 689 (1985); Shavell, *supra* note 168.

by the weight of well-accepted precedents in the products liability area. This result further satisfies the reform courts because it tidies the law and relieves courts of the doctrinally challenging task of gatekeeping for the citadel of privity. By simply withholding the defense for one and all, the law is, in the courts' view, made simple, clear, and modern.²¹³ But, as noted above, this effort to remake the accountant in the image of the product manufacturer obscures the true characteristics of the parties and unfairly devalues the potential utility of a privity-linked defense in the accounting cases.

Moreover, the deterrence and loss-bearing rationales that dominate instrumental tort reform have come loose from their historical moorings and now drift about in a way that ultimately embarrasses the law. Rather than viewing foreseeability as but one of a number of potential foundations for a liability rule, the reform courts consider it to be a categorical imperative. This leads such courts to promise far more than they seem able, as a practical matter, to deliver. For, while it is quite easy to say that we are all each other's keeper, it is considerably harder to show that the overall social welfare is advanced by always defining legal obligation so broadly. That the reform courts have not even attempted such a showing, but have instead simply assumed the value of enhanced accountant liability, is therefore particularly troubling.

Similarly, the loss-bearing rationale seems completely out of place in a negligence regime where all the actors are well integrated into the web of commerce. Negligence, by definition, leaves residual losses where they fall. But even if there were losses in the accounting cases in need of spreading, a dispassionate analysis might easily conclude that third parties generally are in the best position to manage and spread such losses. Yet, once again, the blind force of the products analogy preempts such a conclusion.

Finally, instrumental tort reform has developed an unhealthy and unrealistic dependence on the mythical powers of insurance. Not only does this faith in insurance undergird the courts' loss-bearing rationale, but it also serves as a universal apologia for any adverse consequences that might flow from the reform effort. *Rosenblum*, for example, scoffs at *Ultramares'* concern over the financial viability of accountants in a world without privity, noting that there is "no reason to believe" that insurance would not alleviate the burden of increased third-party liability.²¹⁴ At the same time, the court declined to enter-

213. See note 113 *supra* and accompanying text.

214. *Rosenblum, Inc. v. Adler*, 93 N.J. 324, 349, 461 A.2d 138, 151.

tain seriously the defendant accountants' argument that, given the dynamics of insurance, broad coverage for third-party claims might be unavailable or prohibitively expensive.²¹⁵ But such concerns are real and deserve to be addressed by any court that sets itself the task of determining "what duty the auditor should bear to best serve the public interest."²¹⁶

These related qualms about the direction of modern tort law raise a broader concern about the viability of instrumental reasoning as an independent, self-sustaining basis for reform. Although most formal instrumental theory eschews dependence on vague notions of fairness,²¹⁷ the accounting cases suggest that the successful application of these complex concepts may depend heavily on how their outcome correlates with rough perceptions of what is just or fair.²¹⁸ Contrast, for a moment, the accounting cases with products liability — the area where instrumental tort theory is generally considered to have enjoyed its greatest success.

In the products area, few question the utility of instrumental theories of deterrence and loss spreading. Imposing accident costs on producers should, at least in theory, encourage optimal levels of care and production.²¹⁹ And, to the extent that loss spreading is accepted as a rationale,²²⁰ the product manufacturer is generally considered to be better equipped than the individual consumer to manage and spread accident costs. Yet, in cases like *MacPherson*, *Henningsen*, and *Green-*

215. In response to the defendants' claim, the court observed: "Suffice it to say that defendants have not alerted us to data either within or outside the record to support this position." *Rosenblum*, 93 N.J. at 349 n.11, 461 A.2d at 151 n.11. This answer, however, is not sufficient. *Rosenblum* dramatically expanded the potential liability of accountants, so at the time of the decision there could be no "data" establishing the impact of the decision on the insurance markets. By the same token, existing data showing the availability of insurance under privity-based regimes were rendered irrelevant by the decision.

216. 93 N.J. at 334, 461 A.2d at 142.

217. *But see* Epstein, *A Theory of Strict Liability*, 2 J. LEGAL STUD. 151 (1973); Fletcher, *Fairness and Utility in Tort Theory*, 85 HARV. L. REV. 537 (1972).

218. No attempt is made here to tackle the daunting task of outlining a non-instrumental, fairness-based component of tort law. Some efforts have been made in this direction, see, e.g., Fletcher, *supra* note 217, but considerable debate continues on the scope and utility of this alternative, normative approach to tort law. *See generally* Weinrib, *The Insurance Justification and Private Law*, 14 J. LEGAL STUD. 681 (1985). The point here is a simpler, more descriptive one: courts, in attempting to justify the expansion of liability rules on instrumental grounds, often seek to bolster their argument through use of a subtext based on fairness concerns. And, if the negligent accounting cases are representative, the success of instrumentalist argument and its fairness counterpart may stand or fall together. For a detailed and thoughtful argument along similar lines, see H. STEINER, *supra* note 105 (arguing that courts' "social vision" concerning the actors in the tort system undergirds and supplements their use of doctrine and justificatory argument).

219. *See* Landes & Posner, *supra* note 136.

220. Recent scholarship has raised significant questions about the utility of this rationale in promoting social welfare. *See* Priest, *supra* note 4.

man, these instrumental themes do not stand alone. Instead, they are accompanied by strands of argument based on notions of fairness. The producer is cast as powerful and responsible, while the consumer is characterized as innocent and largely helpless. For most, these portrayals seem appropriate, and thus instrumental theory works in harmony with intuitive notions of the just outcome.

In the accounting cases, both lines of argument are again present. But interestingly, when one pushes the analysis, both the instrumental and the fairness arguments seem more strained. The instrumental justifications for reform offered by the courts are in reality little more than ritualistic incantations of the concepts of deterrence and loss bearing, with little or no substance to their application. Perhaps to redress this deficiency, the courts repeatedly invoke the fairness metaphor of the products context, but their effort to paint the third party as a sympathetic victim and the accountant as a heedless risk-taker simply rings false. Viewing the complex interrelation between accountant, client, and third party objectively, one is almost always hard pressed to find the underdog. Thus, the concept of fairness, even though unquestionably vague and frustratingly subjective, may be a crude but useful proxy for identifying situations where reform of tort law is appropriate.²²¹

Admittedly, the suggested correlation in these two contexts between the success of instrumental tort reasoning and the presence of intuitive notions of fairness may be spurious. A broader sampling is obviously required. But such a relationship, if established, would suggest a much more modest role for instrumental tort reform. Specifically, absent strong concerns about the unfairness of existing rules and the nonviability of private ordering solutions, tort courts should hesitate to expand liability rules on instrumental grounds alone. In such cases, the absence of clear villains and victims may signal a complexity of social interaction that does not yield easily to the relatively crude instrumental reasoning that unfortunately characterizes much of modern tort reform.

Finally, one might question whether the reform courts can now learn to stay their hand. The instrumental ideology of modern tort law is clearly empowering. Gone is the reticence of Cardozo, and with it the process-based notion that major alterations of liability rules, "if expedient, must be wrought by legislation."²²² In its place is a confi-

221. Cf. H. STEINER, *supra* note 105, at 93 ("it is the fusion of some vision of society with some ideal of right or fairness or welfare that enables us to describe in any detail any one justificatory theory").

222. *Ultramares Corp. v. Touche*, 255 N.Y. 170, 187, 174 N.E. 441, 447 (1931).

dence and sense of mission that compels each of the reform courts, in concluding its analysis of the privity issue, to pronounce that the "public interest" has been well served by the work it has done that day.²²³ To be sure, several of these courts formally recognize in passing that "policy factors" might, at some point, curtail the expansion of liability that is compelled by the choice of foreseeability as a proxy for duty.²²⁴ Yet no real effort to explore such constraints has yet occurred in the accounting cases,²²⁵ suggesting that any limitations on instrumental tort reform perceived by such courts are few and still far off.

This judicial confidence is hardly surprising. Most of the concepts of enhanced deterrence and improved risk spreading that underlie instrumental tort reform first appeared in tort scholarship,²²⁶ and thus the academy has been both quick to applaud judicial efforts to implement such theories and quick to suggest further directions for reform. Indeed, like veterans recalling past campaigns, the scholarship supporting the reform courts' abolition of the accountant's privity defense uniformly likens such efforts to the bold inroads cases like *MacPherson*, *Henningsen*, and *Greenman v. Yuba Prods. Inc.* made against the traditional defenses of product manufacturers.²²⁷

Amidst this mutual admiration among the courts and some of the scholars that comprise the instrumental reform movement in tort law, the superficial character of the arguments supporting specific reforms continues to go unnoticed. Opposing cases are seldom discussed, scholarly authority is tapped selectively, and the legitimate policy ar-

223. See, e.g., text at note 58 *supra*.

224. For example, the Wisconsin court in *Citizens State Bank v. Timm, Schmidt & Co.* concluded that privity was no longer available to accountants as a defense to third-party negligence actions "unless, under the facts of this particular case, as a matter of policy to be decided by the court, recovery is denied." 113 Wis. 2d 376, 386, 335 N.W.2d 361, 366 (1984). The court suggested that this inquiry might include (1) whether the injury is too remote from the negligence, (2) whether liability is wholly out of proportion to the accountant's culpability, (3) whether in retrospect it appears "too highly extraordinary" that the accountant's negligence should have caused the plaintiff's harm, (4) whether recovery might place an excessive burden on the accountant, (5) whether recovery might encourage fraudulent claims, or (6) whether allowing recovery might have "no sensible or just stopping point." 113 Wis. 2d at 387, 335 N.W.2d at 366. The court, however, declined to explain or apply any of these criteria, noting instead that a determination specific to the individual defendant in the case could best be made "after the facts of [the] case have been fully explored at trial." 113 Wis. 2d at 387, 335 N.W.2d at 366.

225. For example, although the Wisconsin court in *Citizens State Bank* suggests some policy reasons for protecting accountants against third-party liability, it concludes that any such claims can be raised at trial by defendants. 113 Wis. 2d at 387, 335 N.W.2d at 366. The court's refusal to discuss or apply such constraints except on a case-by-case basis, however, essentially compels accountants to assume *ex ante* the existence of a nonprivity regime. Thus, all the potential negative consequences of the rule change discussed above flow from the decision, despite the court's apparent acknowledgment that some policy factors may militate against the rule in specific cases.

226. See Priest, *supra* note 3.

227. See note 50 *supra*.

guments of those subject to the new rules are treated with derision. In essence, a new citadel has been raised by the would-be heirs of those who long ago successfully stormed the privy defense for defective products. Like its antithesis, however, this citadel of modern tort reform seemingly seeks to lay claim to more of tort law than it can successfully defend. One can hope that it too will find its hegemony challenged.