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Thomas J. Shroyer

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ACCOUNTANTS AND THE DYNAMICS OF DUTY*

THOMAS J. SHROYER†

The area of accountant's liability is experiencing many complex changes. Questions concerning the standard of performance required of the accounting profession have necessitated a thorough digest analyzing established standards as well as standards recently set forward by the courts. Mr. Shroyer surveys the common law basis for claims against accountants in their ever-increasing role in substantial financial transactions. Of special significance is the abrogation of the accountant's privity defense in a growing minority of jurisdictions.

INTRODUCTION	78
I. BREACH OF CONTRACT	79
II. NEGLIGENCE	82
A. <i>General Elements</i>	82
B. <i>Breach of Duty</i>	82
C. <i>Causation or Reliance</i>	84
D. <i>Damages</i>	86
III. NEGLIGENT MISREPRESENTATION	88
A. <i>Essential Elements</i>	88
B. <i>Comparative Fault</i>	88
C. <i>Reliance</i>	89
D. <i>Damages</i>	89
IV. FRAUDULENT MISREPRESENTATION	90
A. <i>Essential Elements</i>	90
B. <i>Scienter</i>	90
C. <i>Future Events</i>	91
V. POTPOURRI	92
A. <i>Workpapers</i>	92
B. <i>Confidentiality</i>	92

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VI. THE ACCOUNTANT'S PRIVACY DEFENSE.....	93
A. <i>Introduction</i>	93
B. <i>Effect of Fraudulent Misrepresentation</i>	94
C. <i>Liability to Third Parties for Negligence</i>	94
D. <i>Traditional Rule</i>	95
E. <i>Restatement (Second) of Torts, Section 552</i>	96
F. <i>Rule of Reasonable Foreseeability</i>	97
G. <i>Bonhiver v. Graff</i>	100
CONCLUSION	102

INTRODUCTION

Fostered by an explosion in adverse litigation, the profession of accounting has recently been the subject of increased judicial scrutiny. This development is largely reflective of the central role the profession has assumed in commerce and finance. As a result, the profession faces heightened exposure to the claims of non-clients. Indeed, jurisprudential views toward the profession, newly adopted in a minority of states, stress the profession's assumed role in safeguarding the integrity of financial information in holding accountants liable to every "reasonably foreseeable" user of financial statements. This represents an important break from the immunity accountants have traditionally enjoyed from the claims of non-clients. In the view of accountants, these recent inroads on the privity defense are unfairly based on erroneous beliefs about the functions of the profession.

This Article will survey the common law basis for claims against accountants and the abrogation of the accountants' privity defense in a minority of jurisdictions.¹ The limitations on breach of contract claims against professionals in Minnesota, the elements of negligence and misrepresentation cases, and the applicability of comparative fault principles will be discussed. Specific consideration will also be given to the measure of damages and application of the "economic loss" doctrine in claims against accountants. The ferment surround-

1. This article will not deal with the numerous federal and state statutory bases for claims against accountants. For an introduction to statutory claims commonly raised against accountants, see generally R. GORMLEY, *THE LAW OF ACCOUNTANTS AND AUDITORS: RIGHTS, DUTIES AND LIABILITIES* §§ 7.1-17.08 (1981); MILLER & BRADY, *CPA LIABILITY: MEETING THE CHALLENGE* (1986); Gruenbaum and Steinberg, *Accountants' Liability and Responsibility: Securities, Criminal and Common Law*, 13 *LOY. L.A.L. REV.* 247 (1980).

ing the privity defense will then be analyzed in the context of the Minnesota decision of *Bonhiver v. Graff*.²

I. BREACH OF CONTRACT

The general rule in Minnesota is that a professional is not liable, *ex contractu*, for breach of performance warranties or for breach of contract, even to his clients.³ This prohibition is long-standing and is the majority rule.⁴ The rationale for the rule is:

Architects, doctors, engineers, attorneys and others deal in somewhat inexact sciences and are continually called upon to exercise their skilled judgment in order to anticipate and provide for random factors which are incapable of precise measurement. The indeterminate nature of these factors makes it impossible for professional service people to gauge them with complete accuracy in every instance. Thus, doctors cannot promise that every operation will be successful; a lawyer can never be certain that a contract he drafts is without latent ambiguity; and an architect cannot be certain that a structural design will interact with natural forces as anticipated. Because of the inescapable possibility of error which inheres in these services, the law has traditionally required, not perfect results, but rather the exercise of that skill and judgment which can be reasonably expected from similarly situated professionals.⁵

Although accountants have not been specifically included in the list of professionals protected by the rule, they have been characterized as professionals in other decisions.⁶ Since accountants are held to the "same standard" of care as doctors and lawyers,⁷ there is no logical basis upon which to deny ac-

2. 311 Minn. 111, 248 N.W.2d 291 (1976).

3. See *City of Moundsview v. Walijarvi*, 263 N.W.2d 420 (Minn. 1978) (cited with approval in *Waldor Pump & Equip. Co. v. Orr-Schelen-Mayeron & Assoc., Inc.*, 386 N.W.2d 375 (Minn. Ct. App. 1986)).

4. See *Walijarvi*, 263 N.W.2d at 423; *Waldor Pump*, 386 N.W.2d at 376-77.

5. See *Waldor Pump*, 386 N.W.2d at 376-77 (quoting *Walijarvi*, 263 N.W.2d at 424).

6. See, e.g., *Vernon J. Rockler & Co. v. Glickman, Isenberg, Lurie & Co.*, 273 N.W.2d 647 (Minn. 1978).

7. *Id.* at 650. "Accountants owe their clients a duty of reasonable care; they must exercise the average ability and skill of those engaged in the profession." *Id.* (citations omitted). Breach of that duty is defined as the failure of the accountants to discharge that duty with reasonable care. *Id.* "Plaintiff in an accounting malpractice action must prove the elements delineated in *Christy v. Saliterman*, 288 Minn. 144, 150, 179 N.W.2d 288, 293 (1970)." *Id.*

countants the protection of the rule. Accordingly, accountants should not normally be subject to liability, under contract principles, for breach of contract under Minnesota law.

However, where a professional gives an express warranty concerning the results of his efforts, a breach of contract action will lie.⁸ For example, an accountant who expressly represented that he would detect "any irregularities" was held liable to his audit client, on breach of contract, for failure to detect employee defalcation.⁹ Therefore, where an accountant expressly warrants a particular result, he can be sued for breach of contract.

This raises the question of whether a written engagement agreement between an accountant and client gives rise to an actionable express warranty. Typically, engagement agreements require the accountant to perform his duties in compliance with generally accepted professional standards.¹⁰ May an accountant be sued for breach of contract on a showing of deviation from those standards? There are no Minnesota cases on point, but it has been held at common law that a promise to perform services with due professional care is not an express warranty of a "specific result."¹¹

There are important reasons for plaintiffs to assert an action *ex contractu* against an accountant. These include the possible elimination of the need for expert witness testimony,¹² avoid-

8. *Waljarvi*, 263 N.W.2d at 422-23 (architect guaranteed "water tightness" of basement).

9. *City of East Grand Forks v. Steele*, 121 Minn. 296, 297-99, 141 N.W. 181, 181-82 (1913).

10. An audit engagement letter typically states as follows:

Our examination will be made in accordance with generally accepted auditing standards, and will include tests of the accounting records and such other audit procedures as we consider necessary to enable us to render an opinion on the fairness of your financial statements. It is not contemplated that we will make a detailed examination of all transactions such as would be necessary to disclose any defalcations or irregularities which may have occurred. We will, however, advise you of any findings which appear unusual or abnormal, and we will also review your system of internal controls.

J. BURTON, R. PALMER & R. KAY, *HANDBOOK OF ACCOUNTING AND AUDITING* ¶ 16-4 (1981).

11. *In re Investors Funding Corp.*, 523 F. Supp. 533, 546 (S.D.N.Y. 1980). The court applied New York common law which holds that even an express promise to follow generally accepted accounting principles [GAAP] is not a guarantee of a "specific result." *Id.*

12. *See L.B. Laboratories, Inc. v. Mitchell*, 39 Cal. 2d 56, 59, 244 P.2d 385, 386 (1952) (expert testimony to prove negligence as for an action for malpractice is unnecessary in action for breach of contract).

ance of the comparative fault statute,¹³ and the possible circumvention of the privity defense on a claim of third party beneficiary status.¹⁴ On the other hand, the contract measure of damages might be more restrictive than the measure of tort damages, since Minnesota does follow the rule of *Hadley v. Baxendale*.¹⁵

13. See *Lesmeister v. Dilly*, 330 N.W.2d 95, 101-02 (Minn. 1983). The court noted that although the comparative fault statute expressly includes negligence and breach of warranty, MINN. STAT. § 604.01, subd. 1(a) (1980), it appears that the statute was not intended to apply to contract cases. First, contract law has never spoken in terms of fault but rather recovery of the expectancy or benefit of the bargain. Second, the statute is derived from the Uniform Comparative Fault Act. See also *Mike's Fixtures, Inc. v. Bombard's Access Floor Systems, Inc.*, 354 N.W.2d 837, 839-40 (Minn. Ct. App. 1984) (which quotes *Lesmeister*, 330 N.W.2d at 101-02). The comparative fault statute continues to expressly include breach of warranty. MINN. STAT. § 604.01, subd. 1a (1986); Steenson, *The Anatomy of Products Liability in Minnesota: Principles of Loss Allocation*, 6 WM. MITCHELL L. REV. 243, 334 (1980).

14. See *Cretex Cos., Inc. v. Construction Leaders, Inc.*, 342 N.W.2d 135, 139 (Minn. 1984) (a third party beneficiary can only recover if shown to be an "intended beneficiary" under an "intent to benefit" or "duty owed" test); *Marker v. Greenberg*, 313 N.W.2d 4, 5 (Minn. 1981). The court stated: "The general rule in legal malpractice is that an attorney is liable for professional negligence only to the person with whom the attorney has an attorney-client relationship and not, in the absence of special circumstances such as fraud or improper motive, to anyone else." *Id.* See also RESTATEMENT (SECOND) OF CONTRACTS § 302 (1979):

Intended and Incidental Beneficiaries

(1) Unless otherwise agreed between promisor and promisee, a beneficiary of a promise is an intended beneficiary if recognition of a right to performance in the beneficiary is appropriate to effectuate the intention of the parties and either

(a) the performance of the promise will satisfy an obligation of the promisee to pay money to the beneficiary; or

(b) the circumstances indicate that the promisee intends to give the beneficiary the benefit of the promised performance.

(2) An incidental beneficiary is a beneficiary who is not an intended beneficiary.

Cf. Buchman Plumbing Co. v. Regents of University of Minnesota, 298 Minn. 328, 333, 215 N.W.2d 479, 483 (1974) (a third party may sue on a contract made for his direct benefit). *Contra Raritan River Steel Co. v. Cherry, Bekaert & Holland*, 79 N.C. App. 81, 88, 339 S.E.2d 62, 67 (1986). The court stated: "We find no compelling basis for distinguishing accountants from other professionals in this regard. . . . [W]e thus hold that lack of privity of contract is not a bar to actions by third parties against certified public accountants for negligent misrepresentation [of a client's financial condition]."

15. 9 Ex. 341, 156 Eng. Rep. 145 (1954); see *Lesmeister*, 330 N.W.2d at 103. The court stated: "In addition, non-breaching parties should recover damages sustained by reason of the breach which arose naturally from the breach or could reasonably be supposed to have been contemplated by the parties when making the contract as the probable result of the breach." *Id.*; see also *Frank v. Jansen*, 303 Minn. 86, 95-96, 226 N.W.2d 739, 745 (1975) (*Hadley v. Baxendale* is still followed in this state).

II. NEGLIGENCE

A. General Elements

The accounting profession is held to the "same standard of reasonable care as lawyers, doctors, architects, and other professional people engaged in furnishing skilled services for compensation."¹⁶

B. Breach of Duty

It is well established that an accountant has a duty to use due professional care in providing services to a client.¹⁷ "Reasonable care" requires that an accountant "exercise the average ability and skill of those engaged in that profession."¹⁸

The question of whether an accountant owes the plaintiff the duty of due care is generally resolved by looking no further than to see whether plaintiff is the client of the accountant.¹⁹ That is, an accountant owes the duty to his client. The matter is considerably more complicated, however, where non-clients are involved and the nature and scope of the duty owed to such third parties is discussed below.²⁰

The establishment of the standard of due professional care and its breach is ordinarily a matter for expert testimony.²¹ This is equally true in cases brought against accountants since the arcane learning of the profession is beyond the ken of most lay persons.²²

The main sources of professional standards for accountants are the American Institute of Certified Public Accountants and the Financial Accounting Standards Board. Accountants refer collectively to the standards these bodies publish as "generally accepted accounting principles" (GAAP) and "generally accepted auditing standards" (GAAS).²³ Another source of the

16. *Rockler*, 273 N.W.2d at 650.

17. *Id.*

18. *Id.*

19. *Id.*

20. See *infra* notes 108-11 and accompanying text.

21. See *City of Eveleth v. Ruble*, 302 Minn. 249, 254-55 & n.4, 225 N.W.2d 521, 525 & n.4 (1974).

22. See *City of East Grand Forks v. Steele*, 121 Minn. 296, 300-01, 141 N.W. 181, 183 (1913).

23. GAAP and GAAS are treated exhaustively in the following treatises: A. AFT-ERMAN, ACCOUNTING AND AUDITING DISCLOSURE MANUAL (1987); A. AFT-ERMAN, COM-PILATION AND REVIEW PRACTICE MANUAL (1985); BURTON & PALMER, HANDBOOK OF

standard of care, often neglected, is the Code of Professional Conduct.²⁴ The Code imposes affirmative duties on accountants to supervise associates,²⁵ maintain independence,²⁶ take reasonable tax positions,²⁷ and to generally comply with GAAP and GAAS.²⁸ Finally, an accountant's formal engagement with a client may establish the required standard of care for that particular relationship.²⁹

Many courts have held that the standard of care which an accountant owes is coterminous with GAAP and GAAS.³⁰ However, the courts have not immunized accountants from liability, despite literal compliance with GAAP or GAAS, where compliance is overly formal and ignores practicalities.³¹ Indeed, criminal convictions of accountants under the federal securities laws have been upheld without evidence of deviation from the letter of GAAP or GAAS.³² In Minnesota, expert tes-

ACCOUNTING & AUDITING (1981); D. CAUSEY, DUTIES AND LIABILITIES OF PUBLIC ACCOUNTANTS (1979); D. CAUSEY, THE TAX PRACTITIONER (1984); DYKEMAN, FORENSIC ACCOUNTING, THE ACCOUNTANT AS EXPERT WITNESS (1982); R. GORMLEY, THE LAW OF ACCOUNTANTS AND AUDITORS: RIGHTS, DUTIES AND LIABILITIES (1981); KELLOGG, HOW TO FIND NEGLIGENCE AND MISREPRESENTATIONS IN FINANCIAL STATEMENTS (1983); MAUTZ, FUNDAMENTALS OF AUDITING (UMI 2d ed.); SULLIVAN, MONTGOMERY'S AUDITING (1985).

24. MINN. R. 1100.3800 to .8000 (1987); Eizenstat & Speer, *Accountants Professional Liability: Expanding Exposure*, 1972 Fed'n of Ins. Couns. J. 7. *Contra* Wagenheim v. Alexander Grant & Co., 19 Ohio App. 3d 7, 482 N.E.2d 955 (1983) (using Ohio Administrative Code as evidence of an accountant's duty of confidentiality).

25. MINN. R. 1100.4200, subp. 2.

26. *Id.* 1100.4400.

27. *Id.* 1100, 4600.

28. *Id.* 1100.4800 & 1100.4900.

29. *See* Ryan v. Kanne, 170 N.W.2d 395, 404 (Iowa 1969).

30. *See* Isbell, *An Overview of Accountants' Duties and Liabilities Under the Federal Securities Laws and a Closer Look at Whistle-Blowing*, 35 OHIO ST. L.J. 261, 270-73 (1974); *see also* Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 703 (S.D.N.Y. 1968) (considering both S.E.C. requirements and accounting standards together); Shahmoon v. General Dev. Corp., Fed. Sec. L. Rep. (CCH) ¶ 94,308 (S.D.N.Y. 1973) (considering S.E.C. rules and accounting together).

31. *See* Hochfelder v. Ernst & Ernst, 503 F.2d 1100, 1113-14 (7th Cir. 1974), *rev'd on other grounds*, 425 U.S. 185 (1976); Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, 378 F. Supp. 112, 121-22 (S.D.N.Y. 1974), *aff'd in part, rev'd in part*, 540 F.2d 27 (2d Cir. 1976); D. CAUSEY, DUTIES AND LIABILITIES, *supra* note 23, at 2-5 (discussion of § 10(b) liability).

32. *See* United States v. Simon, 425 F.2d 796, 805-06 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970); United States v. Natelli, 527 F.2d 311, 320-26 (2d Cir. 1975). In both cases, accountants were held to the performance of non-audit duties beyond standards set by the AICPA where violations of the securities laws by their clients was known or suspected. *See also* Note, United States v. Natelli: *Extension of the Suspicious Inquiry Rule to Unaudited Financial Statements*, 1 J. CORP. L. 519, 539 (1976) (*Natelli*

timony standing alone, without any formal regulation by GAAP, has been found sufficient to establish the required level of professional care and resulting liability.³³

Accountants often use disclaimers or limited certifications in their engagement and opinion letters. This is viewed by accountants as a clear way to alert clients and third parties to the scope and nature of the services rendered and the limited nature of the accountant's opinion.³⁴

Some courts have viewed accountants' disclaimers with disfavor. In *Ryan v. Kanne*,³⁵ the accountants' disclaimer that the company's financial reports were "unaudited" was not sufficient to protect the accountant from negligence in the preparation of the report.³⁶ Similarly, in *Rhode Island Hospital Trust National Bank v. Swartz*,³⁷ it was held that the expression of qualifications on an audit opinion letter was wholly inadequate and misleading, because the qualifications failed to indicate the true extent of knowledge and investigation conducted by the accountant.³⁸

Like other professionals, accountants are not liable for an honest error in judgment in choosing between accepted methods of practice.³⁹ One court even went so far as to hold that the good faith misinterpretation of a complex area of tax law was not malpractice.⁴⁰

C. Causation or Reliance

Accounting negligence cases often turn on the issue of whether the plaintiff suffered loss as a result of malpractice. Generally, the plaintiff has the burden of proving that he reasonably relied upon the accountant's work product.⁴¹ Simply

adopted a legal duty for accountants associated with unaudited financial statements more stringent than the duty prescribed by the accounting profession).

33. See *Bonhiver*, 311 Minn. at 119, 248 N.W.2d at 297.

34. AICPA Professional Standards (CCH) § 509.45 (1982).

35. 170 N.W.2d 395 (Iowa 1969).

36. *Id.* at 404.

37. 455 F.2d 847 (4th Cir. 1972).

38. *Id.* at 851-52.

39. See *Ouelette v. Subak*, 391 N.W.2d 810, 815-16 (Minn. 1986); *Cook v. Connolly*, 366 N.W.2d 287, 290-91 (Minn. 1985); *Gammel v. Ernst & Ernst*, 245 Minn. 249, 253-55, 72 N.W.2d 364, 368-71 (1955).

40. See *Smith v. St. Paul Fire & Marine*, 344 F. Supp. 555, 558-59 (M.D. La.), *rev'd*, 471 F.2d 840 (5th Cir. 1972), *on remand*, 366 F. Supp. 1283, 1290 (M.D. La. 1973), *aff'd*, 500 F.2d 1131, 1131 (5th Cir. 1974).

41. See *Rockler*, 273 N.W.2d at 650.

put, this means that "but for" the accountant's advice or work, the plaintiff would not have acted as he did.⁴²

In regard to this element, it is proper to consider the plaintiff's business expertise and the possibility that the plaintiff would have acted as he did for some reason other than reliance upon the accountant's advice.⁴³ For example, in *Bunge Corp. v. Eide*,⁴⁴ a creditor sued an accountant for the overvaluation of a client's inventory.⁴⁵ The creditor alleged that it relied on the inflated inventory valuation in lending money to the borrower.⁴⁶ The court ruled that the creditor was not entitled to recovery, in part, because the creditor failed to follow prudent lending policies and extended credit in order to avoid a loan loss after it had learned that the borrower was in trouble.⁴⁷

Closely related to the "reasonable reliance" element is the question of whether the Minnesota Comparative Fault Act⁴⁸ applies in an accounting malpractice action. The courts are split on whether an accountant can raise his client's own negligence or fault as a defense.⁴⁹ There are no Minnesota cases on point, but it seems reasonable to predict that comparative fault principles will be applied in almost all Minnesota cases in view of the broad scope of the statute and its liberal application by the courts.⁵⁰

42. *Id.*

43. *Id.* at 651-52.

44. 372 F. Supp. 1058 (D.N.D. 1974).

45. *Id.* at 1063.

46. *Id.* at 1064.

47. *Id.*

48. MINN. STAT. § 604.01 (1986).

49. See Menzel, *The Defense of Contributory Negligence in Accountant's Malpractice Actions*, 13 SETON HALL 292, 292 (1983); see also Hawkins, *Professional Negligence Liability of Public Accountants*, 12 VAND. L. REV. 797, 809-11 (1959) (discussing types of cases in which defense is raised).

Several courts permit application of comparative fault precepts. See, e.g., *Cenco, Inc. v. Seidman & Seidman*, 686 F.2d 449, 456-57 (7th Cir. 1982), cert. denied, 459 U.S. 880, 103 S.Ct. 177 (1982); *Devco Premium Fin. Co. v. North River Ins. Co.*, 450 So. 2d 1216, 1220 (Fla. Dist. Ct. App. 1984); *Capitol Mortgage Corp. v. Coopers & Lybrand*, 142 Mich. App. 531, 537, 369 N.W.2d 922, 925 (1985); *Delmar Vineyard v. Timmons*, 486 S.W.2d 914, 921 (Tenn. Ct. App. 1972).

In other jurisdictions, the client's own fault is considered only where it contributed to the accountant's own error. See, e.g., *Shapiro v. Glekel*, 380 F. Supp. 1053, 1058 (S.D.N.Y. 1974); *Lincoln Grain, Inc. v. Coopers & Lybrand*, 216 Neb. 433, 441, 345 N.W.2d 300, 306 (1984); *National Sur. Corp. v. Lybrand*, 256 A.D. 226, 236, 9 N.Y.S.2d 554, 563 (N.Y. App. Div. 1939).

50. Minnesota Statutes section 604.01, subdivision 1a, defines "fault" to include assumption of risk, failure to avoid injury, and failure to mitigate damages. See

D. Damages

The damages recoverable in tort are those which are the natural and proximate result of the defendant's misconduct.⁵¹ A matter of particular moment in accountant's tort cases is whether an accountant can be held liable for "economic loss."

In Minnesota, limitations on the recoverability of economic loss in tort actions have been considered in *Superwood Corp. v. Siemplekamp Corp.*⁵² "Economic loss" has been defined as damages claims for inadequate value, cost of repair, and loss of profits.⁵³ In an accounting malpractice action, consequential economic loss might include profits lost by a business seller on a sale avoided by the buyer due to an accountant's negligence, losses incurred by a taxpayer forced to liquidate assets at an improvident price to pay back taxes, or "prime rate" interest income lost by a creditor on loans based on negligently prepared financial statements. The primary purpose of the limitations on the recoverability of economic loss is to shield a defendant from unlimited liability for all economic consequences of a negligent act, at least in a commercial or professional setting.⁵⁴

No Minnesota decisions have applied the *Superwood* doctrine in an accounting negligence case. The doctrine has been considered in the context of negligence claims involving other professions, with mixed results. In *D & A Development Co. v. Butler*,⁵⁵ the plaintiff brought a negligence action against two architects for failure to complete a warehouse on time. The plaintiff sought to recover profits lost as a result of late performance.⁵⁶ In rejecting the claim for lost profits, the intermediate appellate court stated that "purely economic losses that arise out of commercial transactions are not recoverable in

Florenzano v. Olson, 387 N.W.2d 168, 176 (Minn. 1986) (applying defense to negligent misrepresentation cases); Radiske v. Minnesota Valley Breeder's Ass'n, 374 N.W.2d 745 (Minn. Ct. App. 1985) (defense applies to negligence and fraud claims but not contract claims).

51. Johnson v. Gustafson, 201 Minn. 629, 634-35, 277 N.W. 252, 255 (1938).

52. 311 N.W.2d 159, 162-63 (Minn. 1982).

53. See Moorman Mfg. Co. v. National Tank Co., 91 Ill. 2d 69, 83, 435 N.E.2d 443, 449 (1982).

54. See Local Joint Executive Board v. Stern, 98 Nev. 409, 411, 651 P.2d 637, 638 (1982).

55. 357 N.W.2d 156 (Minn. Ct. App. 1984).

56. *Id.* at 157.

negligence.”⁵⁷ The court did not explain its ruling, which clearly applied *Superwood* in an action for professional negligence, and on a transaction *not* subject to the Uniform Commercial Code.⁵⁸

Recently, the potential value of *D & A Development* in limiting recovery of economic losses in professional negligence cases has been undermined by decisions of the Minnesota Court of Appeals.⁵⁹ In *Valley Farmers' Elevator v. Lindsay Bros.*,⁶⁰ the court stated that Minnesota “has long allowed negligence actions for the recovery of economic losses resulting from the negligent performance of professional services.”⁶¹ The court reasoned that *Superwood* does not protect professional malpractice actions because the Uniform Commercial Code does not govern the rendering of professional services.⁶² Since persons injured as a result of professional negligence therefore lack an implied warranty remedy for resulting economic loss, they are allowed to recover economic loss in tort actions against professionals.⁶³ In a later case, the court further undermined *D & A Development* by characterizing the application of *Superwood* as *dictum*.⁶⁴ Thus, under current interpretations of *Superwood* by the Minnesota Court of Appeals, accountants face exposure in damages for pure “economic loss” in tort actions.

57. *Id.* at 158 (citing Minneapolis Soc’y of Fine Arts v. Parker-Klein Assocs. Architects, Inc., 354 N.W.2d 816, 821 (Minn. 1984)); *Superwood*, 311 N.W.2d at 161 & n.6.

58. See MINN. STAT. §§ 336.2-101 to .2-725 (1986).

59. See *McCarthy Well Co. v. St. Peter Creamery, Inc.*, 389 N.W.2d 514 (Minn. Ct. App. 1986) (economic damages recoverable on claim for negligent performance of professional services); *Waldor Pump*, 386 N.W.2d at 377; *Valley Farmers' Elevator v. Lindsay Bros. Co.*, 380 N.W.2d 874 (Minn. Ct. App. 1986).

60. 380 N.W.2d 874 (citing *City of Eveleth v. Ruble*, 302 Minn. 249, 225 N.W.2d 521 (1974); *Northern Petrochemical Co. v. Thorsen & Thorshov, Inc.*, 297 Minn. 118, 211 N.W.2d 159 (1973)).

61. *Valley Farmers' Elevator*, 380 N.W.2d at 877-78.

62. *Id.*

63. *Id.*

64. See *Waldor Pump*, 386 N.W.2d at 377. However, this reasoning seems to ignore the ability of commercially sophisticated clients to negotiate a contract with professionals containing an express warranty of a specific result. See, e.g., *Waljarvi*, 263 N.W.2d at 423; *Steele*, 121 Minn. at 300, 141 N.W. at 182. Since *Superwood* expressly does not apply to transactions involving mere “consumers,” 311 N.W.2d at 162, the concern articulated by the court of appeals about the inability of those with weak bargaining power to negotiate the requisite warranty with a professional seems misplaced. *Valley Farmers' Elevator*, 380 N.W.2d at 877-78.

III. NEGLIGENT MISREPRESENTATION

A. Essential Elements

As purveyors of representations of fact, accountants are uniquely vulnerable to claims of misrepresentation. The first element of a negligent misrepresentation claim against an accountant is the furnishing of false information by the accountant during the course of his business, profession, or employment. To be actionable, the information must also have been supplied for the guidance of others in their business and the accountant must have failed to exercise reasonable care or competence in obtaining or communicating the information. Of course, the plaintiff's reliance upon the information must have been justified and that reliance had to have been a direct cause of plaintiff's damage, consisting of actual monetary loss.⁶⁵

The gravamen of a claim in negligent misrepresentation is whether the accountant asserted a fact "of his own knowledge without knowing whether it is true or false."⁶⁶ As explained in the leading case of *Florenzano v. Olson*:

A misrepresentation is made negligently when the misrepresenter has not discovered or communicated certain information that the ordinary person in his or her position would have discovered or communicated. Proof of the subjective state of the misrepresenter's mind, whether by direct evidence or by inference, is not needed to prove negligence. Negligence is proved by measuring one's conduct against an objective standard of reasonable care or competence.⁶⁷

At the same time, no one is held to warrant the truth of all statements made and a good faith, non-negligent mistake will not establish misrepresentation under either a claim of fraudulent or negligent misrepresentation.⁶⁸

B. Comparative Fault

The Minnesota Comparative Fault Act is applied in cases of negligent misrepresentation, though it is not available to a de-

65. See *Bonhiver*, 311 Minn. at 121-22, 248 N.W.2d at 298-99; RESTATEMENT (SECOND) OF TORTS § 552 (1977).

66. *Florenzano*, 387 N.W.2d at 174.

67. *Id.*

68. *Id.*

fendant charged with fraudulent misrepresentation.⁶⁹

C. *Reliance*

To satisfy the reliance element of a negligent misrepresentation case, the plaintiff must establish that his reliance was reasonable.⁷⁰ The reasonableness of this reliance is measured with reference to the "specific intelligence and experience" of the plaintiff.⁷¹ This principle is important in accounting malpractice cases, since claims against accountants frequently involve plaintiffs who are educated, sophisticated, and experienced in business and finance.

D. *Damages*

As a general rule, a plaintiff suing in Minnesota for misrepresentation is only entitled to out-of-pocket damages, any other losses proximately caused by the deception before it was discovered, plus expenses incurred in mitigation.⁷² Out-of-pocket damages are measured as the "difference between what the plaintiff parted with and what he got. It is therefore not a question of what the plaintiff might have gained through the transaction, but what he lost by reason of defendant's deception."⁷³

There are exceptions to application of the out-of-pocket damage measure in misrepresentation cases.⁷⁴ For example, where no consideration is exchanged between the accountant and plaintiff, the out-of-pocket rule may not be applicable.⁷⁵ The out-of-pocket rule is also not followed where it fails to provide compensation for damages caused by misrepre-

69. *Id.* at 173, 178. For a thorough analysis of the court's holding in *Florenzano*, see Note, *Minnesota Applies Comparative Fault to Negligent Misrepresentation*, 13 Wm. MITCHELL L. REV. 633 (1987).

70. *Florenzano*, 387 N.W.2d at 175-76, 178.

71. *Midland Nat'l Bank of Minneapolis v. Perranoski*, 299 N.W.2d 404, 411 (Minn. 1980) (citing *Murphy v. Country House, Inc.*, 307 Minn. 344, 351, 240 N.W.2d 507, 512 (1976)).

72. See *Strouth v. Wilkinson*, 302 Minn. 297, 300, 224 N.W.2d 511, 514 (Minn. 1974).

73. *Lehman v. Hansord Pontiac Co.*, 246 Minn. 1, 10, 74 N.W.2d 305, 311 (1955); RESTATEMENT (SECOND) OF TORTS § 552B.

74. See *Raach v. Haverly*, 269 N.W.2d 877, 882 (Minn. 1978) (allowing the value of plaintiff's labor to be taken into account as consequential damages which were not contemplated by the parties at the time of the sale).

75. See *Lack Indus., Inc. v. Ralston Purina Co.*, 327 F.2d 266 (8th Cir. 1964).

sentation.⁷⁶

Litigants contesting cases of accountants' misconduct should keep this possible difference in the measure of damages in mind when considering the merits of proceeding on theories of misrepresentation or negligence.⁷⁷

IV. FRAUDULENT MISREPRESENTATION

A. *Essential Elements*

The essential elements of a claim of fraudulent misrepresentation are well-established.⁷⁸ This Article will address those elements of the tort of deceit which are of significance to litigants in accounting cases. Of course, all elements of the tort must be established by "clear and convincing" evidence — a higher standard than the normal "preponderance" burden.⁷⁹

B. *Scienter*

The chief distinction between fraudulent misrepresentation

76. *Whitney v. Buttrick*, 376 N.W.2d 274, 279-81 (Minn. Ct. App. 1985).

77. As noted below, however, third party claimants may have no choice about limiting their theory of recovery to misrepresentation in view of the possibility that the privity defense is fully available to accountants charged with mere negligence. *See infra* notes 108-111 and accompanying text.

78. The elements are:

1. there must have been a representation;
2. the representation must have been false;
3. the representation must have concerned a past or present fact;
4. the fact must have been material;
5. it must have been susceptible of knowledge;
6. the representer must have known it was false or, in the alternative, must have asserted it as being true of his own knowledge — without knowing whether it was true or false;
7. the representer must have intended to have the plaintiff act in reliance upon his representation;
8. the plaintiff must have been induced to act;
9. the plaintiff's reliance must have been justifiable and reasonable;
10. the plaintiff must suffer damages; and
11. the damage must be the proximate result of the misrepresentation.

Weise v. Red Owl Stores, Inc., 286 Minn. 199, 202-03, 175 N.W.2d 184, 187 (1970); *Davis v. Re-Trac Mfg.*, 276 Minn. 116, 117, 149 N.W.2d 37, 38-39 (1967). In addition, to prove the elements of fraudulent misrepresentation, plaintiffs with fraudulent misrepresentation claims can consider seeking relief under the Minnesota Consumer Fraud Act, MINN. STAT. § 325F.68 to .70 (1986), which can be asserted against accountants in some circumstances. *Jenson v. Touche Ross & Co.*, 335 N.W.2d 720, 727-28 (Minn. 1983). One significant advantage of this remedy is the availability of attorney's fees. *See* MINN. STAT. § 8.31, subd. 3(a) (1986).

79. *Weise*, 286 Minn. at 203, 175 N.W.2d at 187.

and negligent misrepresentation lies in the element of intent.⁸⁰ To establish a claim of fraudulent misrepresentation, plaintiff is required to show that the misrepresentation was made with "fraudulent intent," or in other words, with "dishonesty or bad faith."⁸¹ As explained in *Florenzano*:

What the misrepresenter knows or believes is the key to proof of intent. Wrongful intent, as a state of mind, is rarely proved directly, e.g., by an admission of bad faith, but is normally established through circumstantial evidence. There is no doubt of fraudulent intent where the misrepresenter knows or believes the matter is not as he or she represents it to be. Fraudulent intent is also present when a misrepresenter speaks positively and without qualification, but either is conscious of ignorance of the truth, or realizes that the information on which he or she relies is not adequate or dependable enough to support such a positive, unqualified assertion.⁸²

C. *Future Events*

As a general matter, a claim of fraud can only be based upon representations of past or existing facts.⁸³ Representations about the future are usually not sufficient bases for fraud actions.⁸⁴ This is because representations concerning the future are treated as nothing more than conjecture and opinion.⁸⁵ Despite this general rule, an accountant can be found liable for the expression of opinion concerning future events where the accountant is relied upon for his expertise concerning the sub-

80. *Florenzano*, 387 N.W.2d at 173.

81. *Id.*

82. *Id.* (citation omitted). The classic and elegant formulation for attributing an accountant with fraudulent intent is found in *State St. Trust Co. v. Ernst*, 278 N.Y. 104, 15 N.E.2d 416, 419 (1938). The court stated:

A representation certified as true to the knowledge of the accountants when knowledge there is none, a reckless misstatement, or an opinion based on grounds so flimsy as to lead to the conclusion that there was no genuine belief in its truth, are all sufficient upon which to base liability. A refusal to see the obvious, failure to investigate the doubtful, if sufficiently gross, may furnish evidence leading to an inference of fraud so as to impose liability for losses suffered by those who rely on the balance sheet. In other words, heedlessness and reckless disregard of consequence may take the place of deliberate intention.

Id.

83. *See Cady v. Bush*, 283 Minn. 105, 109, 166 N.W.2d 358, 361 (1969).

84. *See id.*

85. *See id.*

ject of the statement.⁸⁶ An accountant can also be liable for misrepresentations about present or past facts contained in a pro forma projection about future events.⁸⁷

V. POTPOURRI

A. *Work Papers*

One issue that frequently surfaces during discovery in accounting malpractice cases is whether the accountant or the client owns financial work papers prepared by the accountant in the performance of an engagement. Under Minnesota law, the accountant owns the work papers.⁸⁸ Even so, an accountant's client is entitled to copy an accountant's work papers to the extent that they "ordinarily constitute part of the client's books and records and are not otherwise available to the client."⁸⁹

B. *Confidentiality*

Although no privilege attaches to communications between an accountant and a client, an accountant cannot disclose "any confidential information" obtained in the course of a professional engagement, except with the consent of the client.⁹⁰ Disclosure of client confidences may subject an accountant to liability to his client.⁹¹ This rule does not relieve an accountant of his obligation to comply with judicially required disclosure.⁹² An accountant may even have an affirmative obligation to disclose confidential information adverse to a client to certain regulatory authorities.⁹³

86. *Kennedy v. Flo-Tronics, Inc.*, 274 Minn. 327, 334, 143 N.W.2d 827, 831 (1966); see *Perranoski*, 299 N.W.2d at 412-13 (the court stated an accountant could be liable for a statement of opinion of future value if such statement is relied upon for his expertise on the subject, but held that the third party defendant accountant could not be held to such expertise).

87. *Berg v. Xerxes-Southdale Office Bldg. Co.*, 290 N.W.2d 612, 615 (Minn. 1980). Consideration here should also be given to the accountants' Code of Professional Conduct, which prohibits a CPA from permitting his name to be used in connection with a future forecast "which may lead to the belief that the [accountant] vouches for the achievability of the forecast." Minn. R. 1100.5000.

88. *Bonhiver*, 311 Minn. at 123, 248 N.W.2d at 299.

89. Minn. R. 1100.5300.

90. *Id.* 1100.5100.

91. *Wagenheim v. Alexander Grant & Co.*, 190 Ohio App.3d 7, 12, 482 N.E.2d 955, 961 (1983).

92. Minn. R. 1100-5100.

93. See *United States v. Authur Young & Co.*, 465 U.S. 805, 820-21 (1984) (upon

VI. THE ACCOUNTANT'S PRIVACY DEFENSE

A. Introduction

The liability of accountants to third parties⁹⁴ is an issue of moment to the profession and to the typical constituents of the class of persons denoted as third parties, such as creditors and equity investors. The topic has been the subject of a plethora of comment.⁹⁵

Accountants find the erosion of their immunity from third party claims especially threatening, due to concern about the risk of being held liable for damages "in an indeterminate amount for an indeterminate time to an indeterminate class."⁹⁶ On the other hand, lenders and investors who base financial decisions upon accountants' opinions are interested in shifting their risk of loss onto accountants who are likely to have survived the financial collapse of their client.⁹⁷ The upheaval in this area wrought by recent decisions in New Jersey,⁹⁸ Wisconsin,⁹⁹ and California¹⁰⁰ is particularly significant to Minnesota litigants in light of anomalies in the leading Minnesota case on point.¹⁰¹ The courts have articulated three distinct rules for third party claims: the most restrictive traditional rule,¹⁰² the intermediate rule of Section 552 of the *Restatement (Second) of*

service by the Internal Revenue Service); *Natelli*, 527 F.2d at 319 (Securities and Exchange Commission); *Fischer v. Kletz*, 266 F. Supp. 180, 183-84 (S.D.N.Y. 1967) (Securities and Exchange Commission); *Bonhiver*, 311 Minn. at 129, 248 N.W.2d at 302 (insurance commissioner).

94. The term "third party" is used here to refer to those who do not have contractual privity with the accountant being sued, i.e., non-clients.

95. Exhaustive bibliographies of articles concerning third party liability are contained in: Comment, *Extensions of Accountants' Liability for Negligence: One Step Closer to a New Implied Warranty of Results*, 56 U. COLO. L. REV. 265, 265 n.5 (1985); Comment, *Auditors' Liability — Adoption of a Reasonable Foreseeability Standard*, 18 U. RICH. L. REV. 221, 221 n.1 (1983).

96. *Ultramares Corp. v. Touche*, 255 N.Y. 170, 179, 174 N.E. 441, 444 (1931); see also MILLER AND BRADY, *supra* note 1, at ¶ 1.02.

97. N. MINOW, SPECIAL REPORT: ACCOUNTANTS' LIABILITY 2 (1984); Wiener, *Common Law Liability of the Certified Public Accountant for Negligent Misrepresentation*, 20 SAN DIEGO L. REV. 233 (1983).

98. See *H. Rosenblum, Inc. v. Adler*, 93 N.J. 324, 461 A.2d 138 (1983).

99. See *Citizens State Bank v. Timm, Schmidt & Co.*, 113 Wis. 2d 376, 335 N.W.2d 361 (1983).

100. See *International Mortgage Co. v. John P. Butler Accountancy*, 177 Cal. App. 3d 806, 223 Cal. Rptr. 218 (1986).

101. See *Bonhiver*, 311 Minn. at 111, 248 N.W.2d at 291, as discussed in text accompanying notes *infra* 146-63.

102. See *infra* notes 112-22 and accompanying text.

Torts,¹⁰³ and the expansive rule (or non-rule) of "reasonable foreseeability."¹⁰⁴

B. *Effect of Fraudulent Misrepresentation*

It is important to note that accountants have no immunity from reasonably foreseeable third party claims where they have committed fraudulent misrepresentation, under either the traditional¹⁰⁵ or *Restatement*¹⁰⁶ positions. This is because a morally culpable accountant, one who has acted with dishonesty or bad faith, is not entitled to special protection from the tort claims of third parties.¹⁰⁷

C. *Liability to Third Parties for Negligence*

Although no Minnesota cases have held an accountant liable to a non-client on a theory of simple negligence, other jurisdictions have allowed third parties¹⁰⁸ to maintain negligence claims.¹⁰⁹ Further, Minnesota has allowed third parties to sue other professionals on negligence theories.¹¹⁰ The practical significance of the distinction between negligence and misrepresentation theories is now uncertain, in view of the recent recognition in Minnesota of the tort of negligent misrepresentation.¹¹¹

103. See *infra* notes 123-30 and accompanying text.

104. See *infra* notes 131-45. Another standard was recently posited in *Raritan River Steel Co.*, 79 N.C. App. at 88-91, 339 S.E.2d at 67-69, but it contemplates liability to a merely "foreseeable" non-client, and thus appears to be a hybrid of the "reasonably foreseeable" rule. Finally, the court in *Blue Bell, Inc. v. Peat, Marwick, Mitchell & Co.*, 715 S.W.2d 408 (Tex. Ct. App. 1986), combined approaches by modifying section 522 of the *Restatement* to allow reasonably foreseeable third parties to sue accountants provided they are members of a limited class. *Id.* at 412.

105. See *Spherex, Inc. v. Alexander Grant & Co.*, 122 N.H. 898, 451 A.2d 1308 (1982); *State St. Trust Co.*, 278 N.Y. at 112, 15 N.E.2d at 419.

106. RESTATEMENT (SECOND) OF TORTS § 531.

107. See R. GORMLEY, *supra* note 23, at ¶ 6.02; RESTATEMENT (SECOND) OF TORTS § 552 comment a.

108. Hereafter, claims against accountants by non-clients, or those who lack contractual privity, will be denoted as "third party claims." The term is *not* used to refer to third party defendants as defined in Rule 14 of the Federal Rules of Civil Procedure.

109. See *Ryan*, 170 N.W.2d at 406-08; *Shatterproof Glass Corp. v. James*, 466 S.W.2d 873, 877 (Tex. Civ. App. 1971).

110. *Marker v. Greenberg*, 313 N.W.2d 4 (Minn. 1981) (attorney may be liable to heirs for negligent estate planning); *Waldor Pump*, 386 N.W.2d at 377 (engineer may be held liable in negligence).

111. See *Florenzano*, 387 N.W.2d at 173.

D. Traditional Rule

Traditionally, accountants have enjoyed limited immunity from the negligent misrepresentation claims of third parties. The origins of this doctrine can be traced to the opinion of Chief Judge Cardozo in *Ultramares Corp. v. Touche*.¹¹² Even its supporters concede that the accountants' privity defense is a vestige of the once powerful and universal privity limits on tort liability.¹¹³ Despite the contentions of critics that the accountants' privity defense has outlived its usefulness in an era of multinational accounting firms,¹¹⁴ the rule has recently been revitalized in New York,¹¹⁵ and elsewhere.¹¹⁶ For its part, the New York court expressed renewed concern about the "hazards" for accountants of indeterminable liability exposure.¹¹⁷ This view recognizes that it is impossible for an accountant to know exactly who will see his opinion once it leaves his hands, how it will be used, or the length of time during which it will be used.

Strictly speaking, the traditional rule does not require literal contractual privity between an accountant and a plaintiff.¹¹⁸ Instead, it is sufficient that the "end and aim" of the accountant was to supply, even indirectly, his opinion to a known third party.¹¹⁹ The New York court established these "flexible criteria" as prerequisites for a finding of surrogate privity:

- (1) the accountants must have been aware that the financial reports were to be used for a particular purpose or purposes; (2) in the furtherance of which a known party or par-

112. *Ultramares*, 255 N.Y. at 179, 174 N.E. at 445. *Ultramares* and its offspring have been thoroughly dissected elsewhere. See, e.g., *Credit Alliance Corp. v. Arthur Andersen & Co.*, 65 N.Y.2d 536, 536 & n.6, 493 N.Y.S.2d 435, 439 & n.6 (1985).

113. See *Credit Alliance*, 65 N.Y.2d at 546, 493 N.Y.S.2d at 441.

114. See Wiener, *supra* note 97, at 244.

115. *Credit Alliance*, 65 N.Y.2d 536, 493 N.Y.S. 2d 435.

116. See *Robertson v. White*, 633 F. Supp. 954, 970-71 (W.D. Ark. 1986).

117. *Credit Alliance*, 65 N.Y.2d at 548, 493 N.Y.S.2d at 441 (citing *Ultramares*, 225 N.Y. at 179-80, 74 N.E. at 441). *Credit Alliance* involved the separate claims of two creditors against the accountants of their debtors. The claim of one creditor was dismissed because of the lack of any allegation that the accountant prepared financial statements for the purpose of assisting the plaintiff to extend credit or that the accountant had direct contact with the creditor. *Credit Alliance*, 65 N.Y.2d at 543, 493 N.Y.S.2d at 437. In contrast, the second creditor was allowed to maintain its claims because it showed that a primary purpose ("end and aim") of the audited financial statements was known by the accountant to be the provision of information required for the extension of credit to the creditor. *Id.* at 542, 493 N.Y.S. 2d at 439.

118. See *id.* at 546, 493 N.Y.S.2d at 441.

119. *Id.* at 549, 493 N.Y.S.2d at 441.

ties was intended to rely; and (3) there must have been some conduct on the part of the accountants linking them to that party or parties, which evinces the accountants' understanding of that party or parties' reliance.¹²⁰

The New York court laid down the gauntlet and expressly declined to relax its standards to a rule of mere "foreseeability" — or even to follow the *Restatement* into the waters of "limited class" liability.¹²¹ Even so, there was a suggestion in *Credit Alliance* that some judicial interpretations of the *Restatement (Second) of Torts*, Section 552 are "consonant" with the traditional rule.¹²²

E. *Restatement (Second) of Torts, Section 552*

A majority of jurisdictions now follow the modified privity limits of the *Restatement (Second) of Torts*, Section 552.¹²³ The *Restatement* ameliorates the traditional rule by allowing third parties to sue accountants for negligent misrepresentation, provided that they belong to a "limited group" and provided

120. *Id.* at 551, 493 N.Y.S.2d at 443.

121. *Id.* at 553, 493 N.Y.S.2d at 444.

122. *See id.* The court reviewed the "flexible approach" of numerous other courts on the privity defense. The New York Court stressed the elements of privity present in the decisions of those courts and found support for the view that "surrogate privity" is a requisite to third party liability. To the extent the decisions of other courts do not require privity or its surrogate, *Credit Alliance* stated that they are "clearly distinguishable" from its rule. *Id.*

123. Note, H. Rosenblum, Inc. v. Adler: *A Foreseeably Unreasonable Extension of an Auditor's Liability*, 48 ALBANY L. REV. 876, 889 & n.55 (1984). RESTATEMENT (SECOND) OF TORTS § 552, provides:

§ 552. *Information Negligently Supplied for the Guidance of Others*

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

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

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

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

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

Id.

that the accountant had actual knowledge that his professional opinion would be supplied to the limited group.¹²⁴

The American Law Institute (ALI) bases its "restricted rule of liability" on concern about the magnitude of losses posed by more liberal views.¹²⁵ According to the ALI, the duty of care owed in commercial transactions (which only lead to pecuniary loss, and not bodily injury), is relative to the use expected with the circulation of "commercial information."¹²⁶ It also believes that public policy favors the unrestricted flow of information "upon which the operation of the economy rests."¹²⁷

The most important question under Section 552 is the judicial gloss which will be applied to define which third parties belong to "limited groups" within the meaning of the *Restatement*. While the shareholders and equity investors in a corporation may not constitute a limited class,¹²⁸ the fact that members of a "group" are, *in fact*, few in number may lead a court to find that a potentially unlimited group satisfies the test of Section 552.¹²⁹ The view of the ALI is that lenders do not comprise a limited class.¹³⁰

F. Rule of Reasonable Foreseeability

The accountant's privity defense has been abrogated by recent decisions which allow suits by any third party whose reliance upon an accountant's opinion was reasonably foreseeable by the accountant.¹³¹ The rejection of the privity defense for accountants has generated earnest debate and alarm.¹³²

124. RESTATEMENT (SECOND) OF TORTS § 552(2)(a); *see also* Aluma Kraft Mfg. Co. v. Elmer Fox & Co., 493 S.W.2d 378, 382 & n.4 (Mo. Ct. App. 1973); *Spherex, Inc.*, 122 N.H. at 905, 451 A.2d at 1312; *Credit Alliance*, 65 N.Y.2d at 553, 483 N.E.2d at 444.

125. RESTATEMENT (SECOND) OF TORTS § 522 comment a.

126. *See id.*

127. *See id.*

128. *See* Briggs v. Sterner, 529 F. Supp. 1155, 1177 (S.D. Iowa 1981); *Milliner v. Elmer Fox & Co.*, 529 P.2d 806, 807 (Utah 1974).

129. *See* Merit Ins. Co. v. Colao, 603 F.2d 654, 659 (7th Cir. 1979), *cert. denied*, 445 U.S. 929 (1980); *Bonhiver*, 311 Minn. at 130, 248 N.W.2d at 303.

130. *See* RESTATEMENT (SECOND) OF TORTS § 522 comment h, illustration 5 (a view criticized in WIENER, *supra* note 97, at 252).

131. *See* H. Rosenblum, *Inc.*, 93 N.J. at 339, 461 A.2d at 145; *Citizens State Bank*, 113 Wis. 2d at 386, 335 N.W.2d at 366; *International Mortgage*, 177 Cal. App. 3d at 820, 223 Cal. Rptr. at 827.

132. N. MINOW, *supra* note 97; Bilek, *Accountants' Liability to the Third Party and Public Policy: A Calabresi Approach*, 39 Sw. L.J. 689 (1985); Gormley, *The Foreseen, the Foreseeable, and Beyond — Accountants' Liability to Non-Clients*, 14 SETON HALL 528 (1984); Skin-

Proponents of the reasonably foreseeable rule stress that the accounting profession has become a financially powerful institution,¹³³ one uniquely responsible for monitoring the integrity of the marketplace.¹³⁴ Others advance the traditional tort law functions of deterrence,¹³⁵ victim compensation,¹³⁶ and efficient risk allocation.¹³⁷ Critics contend that obviation of the privity defense is based upon fundamental misconceptions about the opinions expressed by accountants and their audit

ner, *Auditors' Liability — Adoption of a Reasonable Foreseeability Standard*, 18 U. RICH. L. REV. 221 (1983); Wiener, *supra* note 97, at 250; Note, *supra* note 123, at 891.

Legislation in Illinois recently restored the privity defense:

No person, partnership or corporation licensed or authorized to practice under this Act or any of its employees, partners, members, officers or shareholders shall be liable to persons not in privity of contract with such person, partnership or corporation, for civil damages resulting from acts, omissions, decisions or other conduct in connection with professional services performed by such person, partnership or corporation, except for:

(1) such acts, omissions, decisions or conduct that constitute fraud or intentional misrepresentations, or

(2) such other acts, omissions, decisions or conduct, if such person, partnership or corporation was aware that a primary intent of the client was for the professional services to benefit or influence the particular person bringing the action; provided, however, for the purposes of this subparagraph (2), if such person, partnership or corporation (i) identifies in writing to the client those persons who are intended to rely on the services, and (ii) sends a copy of such writing or similar statement to those persons identified in the writing or statement, then such person, partnership or corporation or any of its employees, be held liable only to such persons intended to so rely, in addition to those persons in privity of contract with such person, partnership or corporation.

ILL. ANN. STAT. ch. 111, para. 5535.1 (Smith-Hurd Supp. 1987).

133. Wiener, *supra* note 97, at 251. The oligopolistic tendencies of the profession are well-documented. See STEVENS, *THE BIG EIGHT* 7 (1981) (90% of companies on the NYSE are audited by a "Big Eight" accounting firm).

134. This view is best exemplified by Chief Justice Burger's opinion in *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984):

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

Id. at 817.

135. See *Citizens State Bank*, 113 Wis. 2d at 386-88, 335 N.W.2d at 366.

136. See *International Mortgage*, 177 Cal App. 3d at 819, 223 Cal. Rptr. at 226.

137. See *H. Rosenblum Inc.*, 93 N.J. at 340-41, 461 A.2d at 146-47. However, none of these courts or commentators have considered the possibility that the federal and state securities laws adequately protect the interests of the average investor in publicly held companies. See *id.*

services¹³⁸ and upon mistaken analogies between a manufactured product and professional accounting services.¹³⁹ Concern has also been expressed about the potential unavailability of accounting services essential to businesses with "high audit risk," if the privity defense is eliminated.¹⁴⁰

To the chagrin of accountants, the definition of a foreseeable third party can be expansive. The most extreme example is found in *International Mortgage Co. v. Butler*.¹⁴¹ In that case, an accountant audited a mortgage company and issued an unqualified opinion letter on its financial statements.¹⁴² The accountant had no knowledge that the plaintiff, a purchaser of mortgages in the secondary market was to receive the financial statements, was planning to rely on the financial statement — or even that the plaintiff existed.¹⁴³ Nonetheless, the interme-

138. Gormley, *supra* note 132, at 552; N. MINOW, *supra* note 97, at 5. An accountant who expresses an unqualified, or "clean," opinion on the financial statements of a client after an audit merely certifies that the client's financial records were selectively examined in accordance with generally accepted accounting standards, and have been presented in accordance with generally accepted auditing principles. J. BURTIN, R. PALMER & R. KEY, *HANDBOOK OF ACCOUNTING AND AUDITING* ¶ 16-2 (1981).

Accountants do not undertake an audit for the primary purpose of detecting fraud by the audit client or its employees. See R. GORMLEY, *supra* note 1, at § 3.02[1][a]. Instead, the balance sheet and income statement are intended to reflect the financial position of the company and compare it on a consistent basis with prior periods to show whether it is making progress. S. ROSS, *THE ELUSIVE ART OF ACCOUNTING* 34 (1966).

In contrast, 37% of the shareholders of public companies believe that auditors examine all of the financial records of a client and 66% believe that an audit is conducted mainly to discover fraud. OPINION RESEARCH CORP., *PUBLIC ACCOUNTING IN TRANSITION* 47-48 (1974). Judge Wiener shares this belief. Wiener, *supra* note 97, at 258.

139. N. MINOW, *supra* note 97, at 5:

The accountant differs from the auto manufacturer in many important respects. An auditor does not have absolute knowledge of and control over a company's finances and records in the same way that an auto manufacturer has knowledge of and control over its production process. The auditor does have control over his or her examination of a client's financial statement, but the relationship between the statement and a claimed loss is far more indirect than the relationship between a defective product and a claimed harm.

Id.

140. *Briggs*, 529 F. Supp. at 1177; see N. MINOW, *supra* note 97, at 5 ("daring entrepreneurial ventures that our economy so desperately needs, including experimental, high-tech companies."); Note, *United States v. Arthur Young & Co.: Judicial Death Knell for Auditors' Privilege and Suggested Congressional Resolution*, 71 *CORNELL L. REV.* 694, 696 (1986).

141. 177 Cal. App. 3d 806, 223 Cal. Rptr. 218 (Cal. Ct. App. 1986).

142. *Id.* at 809, 223 Cal. Rptr. at 219.

143. *Id.*

diate California Court of Appeals held that the accountant could be liable, stating:

An independent auditor (as opposed to an in-house accountant) is employed to analyze a client's financial status and make public the ultimate findings in accord with recognized accounting principles. Such an undertaking is imbued with considerations of public trust, for the accountant must well realize the finished product, the unqualified financial statement, will be relied upon by creditors, stockholders, investors, lenders, or *anyone else involved in the financial concerns of the audited client*.¹⁴⁴

The only apparent doctrinal limitation on an accountant's exposure to third parties under the "reasonably foreseeable" standard is that the user of the accountant's work product must do so for a proper business purpose.¹⁴⁵

G. *Bonhiver v. Graff*

The question facing litigants in Minnesota is whether Minnesota has adopted Section 552 of the *Restatement* or the rule of reasonable foreseeability. While many commentators assume that Minnesota adopted Section 552 in *Bonhiver*,¹⁴⁶ a close reading reveals that the court, though heavily influenced by Section 552, did not expressly adopt the *Restatement*.¹⁴⁷ Indeed, one of the holdings in *Bonhiver* is anomalous with Section 552.¹⁴⁸ Recently, the Minnesota court declined to go further than to state that Section 552 "parallels" Minnesota law.¹⁴⁹

In *Bonhiver*, an accountant was hired to bring an insurance company's books "up to date."¹⁵⁰ The accountant negligently made inaccurate entries into the client's books and negligently prepared other work papers during the course of his engagement.¹⁵¹ The accountant was not hired to do an audit and did

144. *Id.* (emphasis added).

145. See Note, *supra* note 123, at 902; Comment, *The Enlarging Scope of Auditors' Liability to Relying Third Parties*, 59 NOTRE DAME L. REV. 281 (1983).

146. Note, *supra* note 123, at 889; Note, *Extensions of Accountants' Liability for Negligence: One Step Closer to a New Implied Warranty of Results*, 56 UNIV. COLO. L. REV. 265, 271 (1985); see R. GORMLEY, *supra* note 1, at § 6.01[3] n.32 and 33.

147. *Bonhiver*, 311 Minn. at 131, 248 N.W.2d at 299.

148. R. GORMLEY, *supra* note 1, at 547. "The most egregious example of the specifically foreseen limited class rule is the Minnesota case of *Bonhiver v. Graff*, in which the term was distorted beyond recognition." *Id.*

149. *Florenzano*, 387 N.W.2d at 176.

150. *Bonhiver*, 311 Minn. at 115, 248 N.W.2d at 295.

151. *Id.*

not prepare a financial statement. Instead, the accountant exhibited some inaccurate financial work papers to representatives of the state insurance commissioner who were investigating the financial condition of the insurance company.¹⁵²

One issue in *Bonhiver* was whether the accountant could be liable to the insurance commissioner for merely showing informal work papers to the commissioner's agents.¹⁵³ The court ruled that the accountant was liable to the commissioner, a third party, because the accountant had "actual knowledge" that the commissioner was relying upon the accountant's representation.¹⁵⁴ The court's opinion stressed that the accountant had actual knowledge of the commissioner's reliance no fewer than eight times.¹⁵⁵

The trouble with interpreting *Bonhiver* is that the court also found the accountant liable to general insurance agents for the insurance company who, at best, indirectly relied upon the accountant's work papers in continuing to sell insurance at a time when the insurance company was insolvent.¹⁵⁶ The agents claimed they had relied upon representations by the insurance commissioner about the solvency of the insurance company and that the insurance commissioner, in turn, had relied upon the representations of the accountant.¹⁵⁷ In other words, the *Bonhiver* court was faced with a claim for damages by third parties whose reliance was indirect and was not directly foreseen by the accountant. In ruling that the general agents were entitled to recover, the court seems to have ruled, *sub silentio*, that the insurance commissioner was the alter ego of the agents, entitling them to stand in the commissioner's shoes under Section 552.¹⁵⁸

Since the insurance agents did not constitute a foreseen limited group within any objective view of Section 552(2)(a), the *Bonhiver* court offered this *apologia*:

[T]he extent of an accountant's liability for malpractice is

152. *Id.* at 115, 248 N.W.2d at 295.

153. *Id.* at 120, 248 N.W.2d at 298.

154. *Id.* at 121, 248 N.W.2d at 298.

155. *Id.* at 115, 121, 123, and 128, 248 N.W.2d at 295, 298, 299, and 302.

156. *Id.* at 128, 248 N.W.2d at 302.

157. *Id.*

158. *Id.* (the court also stated that the accountant's "liability arguably should extend to the injured policy-holders under § 552").

not settled. If that liability is to be drawn somewhere short of foreseeability, it must be drawn on pragmatic grounds alone. Once it is admitted that a certain number of people have been injured as a result of an accountant's malpractice, there is no logical justification for denying any of them relief based upon the "limited" or "unlimited" nature of their "class," or whether the reliance of the particular injured parties was or was not "specifically foreseeable."

* * *

Wherever the line will eventually be drawn between those who can recover from the negligent accountant and those who cannot, we feel that on the facts of this case [the insurance agent] falls on the side of those who can recover.¹⁵⁹

In sum, *Bonhiver* left the door ajar for litigants to contend that Minnesota adheres to an *ad hoc* and "pragmatic" privity defense for accountants, with the possibility that the claims of any reasonably foreseeable third party are actionable. Support for this argument can be gleaned from the decision in *Marker v. Greenberg*,¹⁶⁰ where the court adopted a "foreseeability" analysis in disposing of a non-client's claim against an attorney.¹⁶¹ The lesson of *Bonhiver* is that accountants and third parties should be prepared to adduce evidence of "pragmatic grounds" favoring their positions on the privity defense when the next third party claim reaches the appellate level in Minnesota.¹⁶²

CONCLUSION

Persons who litigate the common law liability of accountants in Minnesota face uncertainty about the viability and scope of the privity defense. *Bonhiver v. Graff* analyzed the privity defense within the rubric of Section 552 of the *Restatement (Second) of Torts*, but may have stretched its actual holding to the liability zone of the "reasonably foreseeable." The court ex-

159. *Id.*, 248 N.W.2d at 302-03 (citations omitted).

160. *Marker*, 313 N.W.2d at 5.

161. *Id.*

162. The Wisconsin court specifically determined that final resolution of the privity defense would be postponed until after the facts of the case were "fully explored" at trial. *Citizens State Bank*, 113 Wis. 2d at 335 N.W.2d at 366. It is not clear whether the facts to be "explored" included evidence of the competing public policy positions on the privity defense. Subsequently, the case has been interpreted as holding that lack of privity is not a bar to a third party claim. *Costa v. Neiman*, 123 Wis. 2d 410, 366 N.W.2d 896 (1985).

PLICITLY stated that the line demarcating an accountant's liability to third parties "will be drawn" in the future on the basis of "pragmatic grounds alone."¹⁶³ The wise will heed this *dictum* in presenting future cases — and live for the *nonce* in the shadow of uncertainty.

163. *Bonhiver*, 311 Minn. at 128-31, 248 N.W.2d at 302-03.

