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PRIVITY?—AN OBSOLETE APPROACH TO THE LIABILITY OF ACCOUNTANTS TO THIRD PARTIES

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INTRODUCTION

Accompanying the unparalleled economic growth experienced by this nation during the twentieth century has been an increased sophistication in the methodology required to accurately monitor and report on corporate financial matters. The accounting profession, in the course of its audit function, plays a major role in the complex numbers game of corporate finance by furnishing the business community with data purporting to indicate the true fiscal condition of commercial enterprises.[1]

However, the auditing mistakes of accountants often result in significant losses to those persons who rely upon financial statements. Furthermore, the recent recession, with its abundance of economic woes, has accelerated the drive by disappointed investors to find a "deep pocket" from which to recoup their losses.[2] Responding to

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[1] The audit is a primary function of accounting firms. The profession also provides services in the areas of tax planning, management consulting, and executive recruiting. *See* Fiflis, *Current Problems of Accountants' Responsibilities to Third Parties*, 28 VAND. L. REV. 31, 34–35 (1975).

In his description of a full audit, Professor Fiflis structures the accountant's function into the following four-step process:

(1) preliminary fact-finding to familiarize the accountant with "the nature of the client's business, its operations and organization;" *id.* at 37,

(2) formulation of the specific audit procedure which will be employed;

(3) performance of the audit; and

(4) report of findings.

Id. at 35–42.

[2] There has been a significant rise in the number of lawsuits brought against accountants in the past decade. In 1966 it was reported that approximately 100 suits were

these increased challenges to the work product of accountants, recent judicial decisions have expanded the scope of accountants' liability to their own clients[3] and have eroded their traditional common law insulation from liability to third persons with whom they are not in privity.[4]

Simultaneously, a second battleground has developed, with numerous plaintiffs proceeding against accountants under section 10b of the Securities and Exchange Act of 1934, which makes it unlawful "[t]o use or employ . . . any manipulative or deceptive device . . . in contravention" of SEC rules "in connection with the purchase or sale of any security,"[5] and its companion SEC rule 10b-5, which also makes it unlawful "[t]o make any untrue statement of a material fact or to omit to state a material fact."[6] This statute and its accompanying rule had been viewed as particularly useful in avoiding the common law privity obstacles.[7] However, momentum under the federal securities laws has been thwarted, at least temporarily, by *Ernst & Ernst v. Hochfelder*,[8] in which the Supreme Court recently held that

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in various stages of litigation. Wall St. J., Nov. 15, 1966, at 1, col. 6, at 13, col. 2. By 1973, "more than 500 companies ha[d] litigation or claims in process involving auditors." Hawes, *Truth in Financial Statements: An Introduction*, 28 VAND. L. REV. 1, 1 & n.1 (1975). Recently *The New York Times* reported that about 300 suits were in progress against less than twelve of the largest domestic accounting firms. N.Y. Times, Nov. 23, 1975, § 3, at 14, col. 8. It has also been estimated that over two hundred claims are pending against the smaller firms. *See* Griffin, *The Beleaguered Accountants: A Defendant's Viewpoint*, 62 A.B.A.J. 759, 759 (1976).

The reasons for the increase in litigation are complex, but some contributing factors may be the recession, the popularity of the class action proceeding, and the practice of many attorneys of charging fees on a contingent basis, as well as the negligence of accountants. *See id.* at 760–61.

[3] *See, e.g.*, Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, 378 F. Supp. 112, 122 (S.D.N.Y. 1974) (accountant's duties to client and third parties not fulfilled merely by following generally accepted accounting principles); 1136 Tenants' Corp. v. Max Rothenberg & Co., 36 App. Div. 2d 804, 804, 319 N.Y.S.2d 1007, 1008 (1971), *aff'd*, 30 N.Y.2d 585, 330 N.Y.S.2d 800 (1972) (same duty of care applied, in dictum, to the preparation of unaudited financial reports as had previously been reserved only for the preparation of audited statements).

[4] *See, e.g.*, Rusch Factors, Inc. v. Levin, 284 F. Supp. 85, 90–93 (D.R.I. 1968); Ryan v. Kanne, 170 N.W.2d 395, 401–03 (Iowa 1969). For a general discussion of accountants' liability to third parties see Levitin, *Accountants' Scope of Liability For Defective Financial Reports*, 15 HASTINGS L.J. 436 (1964); Note, *Public Accountants and Attorneys: Negligence and the Third Party*, 47 NOTRE DAME LAW. 588 (1971).

[5] 15 U.S.C. § 78j (1970).

[6] 17 C.F.R. § 240.10b-5(b) (1975).

[7] In the context of the federal securities laws, privity is no longer a prerequisite to recovery. *See, e.g.*, Drake v. Thor Power Tool Co., 282 F. Supp. 94, 104 (N.D. Ill. 1967); Fischer v. Kletz, 266 F. Supp. 180, 192–93 (S.D.N.Y. 1967). For further discussion of the issue of privity in rule 10b-5 actions see notes 90–95 *infra* and accompanying text.

[8] 96 S. Ct. 1375 (1976).

mere negligence will not subject an accountant to liability under these securities fraud provisions. Such actions require a demonstration of scienter, defined as "a mental state embracing intent to deceive, manipulate, or defraud,"[9] a burden much more difficult to sustain than mere deviation from the reasonable behavior standard by which negligence is determined.

With the range of federal actions now limited by *Hochfelder*, and the rationale for seeking pendent federal jurisdiction thus eliminated, a rebirth of state actions and accentuated drives to expand the accountant's common law liability under traditional negligence can be anticipated. It is that area of potential exposure with which this article is primarily concerned. Focusing on the common law setting, this article will examine the role played by the privity of contract doctrine in determining the parties to whom accountants and other professionals have been held legally responsible for their negligent misrepresentations.[10] A balancing approach as an alternative to the strict

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[9] *Id.* at 1381 & n.12. The plaintiffs in *Hochfelder* had been victimized by a fraudulent investment scheme perpetrated by the president of a registered broker-dealer. They alleged that if the defendants had properly conducted their audits, mandated by section 17(a) of the 1934 Act, for which they had been engaged by the broker, the fraud would have been detected. There was no allegation that the defendants knew of the fraud —only a claim of negligence. *Id.* at 1378–80.

The Court's holding that scienter is a necessary ingredient in 10b–5 cases was presaged by several circuits. *See*, *e.g.*, Clegg v. Conk, 507 F.2d 1351, 1361–62 (10th Cir. 1974), *cert. denied*, 422 U.S. 1007 (1975); Vohs v. Dickson, 495 F.2d 607, 622 (5th Cir. 1974); SEC v. Coffey, 493 F.2d 1304, 1314 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975); Lanza v. Drexel & Co., 479 F.2d 1277, 1305–06 (2d Cir. 1973); Shemtob v. Shearson, Hammill & Co., 448 F.2d 442, 445 (2d Cir. 1971). *But see* White v. Abrams, 495 F.2d 724, 734–36 (9th Cir. 1974); Vanderboom v. Sexton, 422 F.2d 1233, 1238 (8th Cir. 1970); Myzel v. Fields, 386 F.2d 718, 734–35 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); Kohler v. Kohler Co., 319 F.2d 634, 637 (7th Cir. 1963).

In Lanza v. Drexel, *supra*, the Second Circuit dismissed a 10b-5 action brought by purchasers against a corporate director for failure to investigate false representations and fraudulent omissions of material facts of which other corporate officers and directors were guilty, because the defendant had no actual knowledge that false representations and material omissions had been made. 479 F.2d at 1280–81. The court concluded that "[a]bsent knowledge or substantial participation we have refused to impose such affirmative duties of disclosure upon Rule 10b–5 defendants." *Id.* at 1302. In addition, the court held that the express language of section 10b "bars adoption of a negligence standard," *id.* at 1305, and that, at the very least, "willful or reckless disregard for the truth," must be demonstrated, *id.* at 1306. In *Hochfelder*, the Supreme Court deliberately avoided deciding "whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b–5." 96 S. Ct. at 1381 n.12.

[10] There is no question concerning the duty owed by accountants to their clients to perform the contracted services without negligence or fraud. The audit contract imposes a duty upon the accountant to render services to the client with a recognized degree of skill and judgment. Failure to exercise the necessary care—a breach of the auditor's professional obligation—may result in an action by the client in contract or tort for any

application of privity will then be proposed.

PRIVITY OF CONTRACT AND ACCOUNTANTS' LIABILITY

Ever since the 1931 decision in *Ultramares v. Touche*,[11] the first major judicial discussion of an accountant's liability to non-clients, courts have been reluctant to extend a cause of action to third parties not in privity with a defendant-accountant unless fraud or conduct closely resembling fraud is alleged.[12] In *Ultramares*, a party who had relied on a negligently prepared audit was denied recovery for his economic losses because of the lack of contractual privity with the accountant.[13] In oft-quoted language, Judge Cardozo articulated the fear that

> [i]f liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class.[14]

A requirement that parties be in privity of contract before a duty of care is imposed is obviously not of concern only to accountants. The "assault upon the citadel of privity,"[15] as recognized by Judge

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pecuniary loss suffered. Most clients' actions are spawned by the accountant's failure to discover embezzlements commited by the client's employees or the client's use of negligently prepared financial statements. *See* Hawkins, *Professional Negligence Liability of Public Accountants*, 12 VAND. L. REV. 797, 797–812 (1959); Levitin, *supra* note 4, at 437–39; 36 IOWA L. REV. 319, 320–21 (1951).

[11] 255 N.Y. 170, 174 N.E. 441 (1931).

[12] *See, e.g.*, O'Connor v. Ludlam, 92 F.2d 50, 53–54 (2d Cir.), *cert. denied*, 302 U.S. 758 (1937); State Street Trust Co. v. Ernst, 278 N.Y. 104, 111–12, 15 N.E.2d 416, 418–19 (1938); Duro Sportswear, Inc. v. Cogen, 131 N.Y.S.2d 20, 24–25 (Sup. Ct. 1954), *aff'd*, 285 App. Div. 867, 137 N.Y.S.2d 829 (1955); Candler v. Crane, Christmas & Co., [1951] 2 K.B. 164, 196–207 (C.A.).

[13] 255 N.Y. at 173–89, 174 N.E. at 442–48. For an expanded discussion of *Ultramares* see notes 27–33 *infra* and accompanying text.

[14] 255 N.Y. at 179, 174 N.E. at 444.

This fear echoes the concern expressed by Lord Abinger in Winterbottom v. Wright, 10 M. & W. 109, 114–15, 152 Eng. Rep. 402, 405 (Ex. 1842), that unlimited liability might ensue if privity was not retained in third party negligence actions. For a detailed discussion of *Winterbottom* see note 15 *infra*.

[15] 255 N.Y. at 180, 174 N.E. at 445.

The privity doctrine evolved in the context of physical torts. By the middle of the nineteenth century it was a concept firmly embedded in the common law. *See, e.g.*, Winterbottom v. Wright, 10 M. & W. 109, 152 Eng. Rep. 402 (Ex. 1842); Tollit v. Sherstone, 5 M. & W. 283, 151 Eng. Rep. 120 (Ex. 1839). In *Winterbottom*, the plaintiff, injured when a mailcoach which he was hired to drive collapsed, was denied relief because he was not in contractual privity with the defendant who had been responsible for the repair and maintenance of the coach. *Id.* at 110, 113–15, 152 Eng. Rep. at 403–05. Lord Abinger reasoned that

> if the plaintiff can sue, every passenger, or even any person passing along the

Cardozo in *Ultramares*, has been rapid and effective in a number of

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> road, who was injured by the upsetting of the coach, might bring a similar action. Unless we confine the operation of such contracts as this to the parties who entered into them, the most absurd and outrageous consequences, to which I can see no limit, would ensue.

Id. at 114, 152 Eng. Rep. at 405. The general rule that evolved from *Winterbottom* was that negligent performance of contractual obligations leading to physical injuries would render one liable only to those persons privy to the contract. *See* W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 93, at 622 (4th ed. 1971) [hereinafter cited as PROSSER].

The *Winterbottom* rule reflected pre-industrial revolution concepts of social justice. Professor Seavey has criticized *Winterbottom* as either

> an interesting illustration of judicial frailty, or . . . an example of temporary protective judicial legislation given the manufacturers until they became sufficiently strong as a group to pay for the consequences of their employees' mistakes.

Seavey, *Mr. Justice Cardozo and the Law of Torts*, 52 HARV. L. REV. 372, 379 (1939).

Later courts, more in tune with rapidly changing socio-economic conditions, recognized the need to effectively limit the rule's potential broad application. *See* Note, *Accountants' Liability to Third Parties for an Audit*, 52 MARQ. L. REV. 158, 160–61 (1968). Thus, exceptions were soon carved out of *Winterbottom*'s absolute privity requirement. For a comprehensive discussion of the pre-1900 exceptions to this general rule see Huset v. J. I. Case Threshing Mach. Co., 120 F. 865, 870–72 (8th Cir. 1903).

An early exception, when the defendant's acts posed a serious threat to public safety, was recognized in Thomas v. Winchester, 6 N.Y. 397 (1852). In *Thomas*, a drug vendor was held liable, despite the absence of privity, to a remote purchaser, who had ingested a poisonous drug negligently mislabeled by the vendor. *Id.* at 407–10. The court took cognizance of *Winterbottom*'s third party duty limitations but, nevertheless, expanded the scope of a negligent party's obligation to the general public where "death or great bodily harm of some person was the natural and almost inevitable consequence" of the negligent act. *Id.* at 408–10. The court did not reject *Winterbottom*, but rather felt the holding of that case to be applicable only in situations where (1) the general public was not the ultimate foreseeable reliant, *i.e.*, where "[m]isfortune to third persons, not parties to the contract, would not be a natural and necessary consequence of the . . . negligence," and (2) where "such negligence is not an act imminently dangerous to human life." *Id.* at 408.

An English court recognized a second major exception to *Winterbottom*, based also on a threat to public safety. In Heaven v. Pender, 11 Q.B.D. 503 (C.A. 1883), a defendant drydock owner, under contract with a shipowner, constructed a scaffolding to be utilized by a ship painter's workman. The workman was injured when the scaffolding collapsed due to unfit support ropes. *Id.* at 506. The court held that the dockowner had a duty to the workman to take reasonable care to supply and construct a scaffolding that was fit for the intended use. Finding that this duty had been breached, the court imposed liability on the defendant for injuries sustained by the workman. *Id.* at 509–10, 514. In considering this duty, Judge Brett, by way of dictum, concluded:

> [W]henever one person is by circumstances placed in such a position with regard to another that every one of ordinary sense who did think would at once recognise that if he did not use ordinary care and skill in his own conduct with regard to those circumstances he would cause danger of injury to the person or property of the other, a duty arises to use ordinary care and skill to avoid such danger.

Id. at 509. *See* Devlin v. Smith, 89 N.Y. 470 (1882).

Heaven's retreat from *Winterbottom* was not, however, extreme. In *Winterbottom*, Lord Abinger was concerned with an unknown and potentially limitless class of plainareas. *MacPherson v. Buick Motor Co.*[16] virtually eliminated privity as a relevant consideration in products liability actions where strict liability has been imposed on manufacturers for personal injuries resulting from defective products.[17] Liability for negligent misrepresentation has also been extended to parties not in privity when injury to tangible interests has been sustained.[18] But where negligent misrepresentation has resulted solely in pecuniary loss, a greater reluctance to extend liability to those not in privity can be found,[19] because of the fear of opening the door to "unlimited liability" in favor of an "indeterminate class."

Although commentators have argued that the different treatment afforded economic and physical losses should be eliminated,[20] the

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tiffs; the *Heaven* court merely involved itself with plaintiffs who were ostensibly invited to use the services provided by the defendant dockowner. Thus, much of the policy which had dictated the result in *Winterbottom* was inapplicable to *Heaven*. Following *Heaven*, the role of privity in negligence actions was to decline even further. *See* notes 16–48 *infra* and accompanying text.

[16] 217 N.Y. 382, 111 N.E. 1050 (1916).

[17] *Id.* at 389, 111 N.E. at 1053. *See, e.g.*, Moraca v. Ford Motor Co., 66 N.J. 454, 332 A.2d 599 (1975); Santor v. A & M Karagheusian, Inc., 44 N.J. 52, 207 A.2d 305 (1965); Henningsen v. Bloomfield Motors, Inc., 32 N.J. 358, 161 A.2d 69 (1960). *See also* PROSSER, *supra* note 15, § 98; RESTATEMENT (SECOND) OF TORTS § 402A(2)(b) (1965).

The *MacPherson* court, considering whether a defendant car manufacturer owed a duty of care to anyone other than an immediate purchaser, adopted the foreseeability concept originally applied in Thomas v. Winchester, 6 N.Y. 397 (1852), to objects which are inherent instruments of destruction, and extended it to items which are "reasonably certain to place life and limb in peril when negligently made." 217 N.Y. at 384–85, 389, 111 N.E. at 1051, 1053. This quality of dangerousness, when coupled with the manufacturer's knowledge that the product would be used by remote purchasers, was sufficient to impose liability on the manufacturer who failed to properly construct or inspect the article for defects. *Id.* at 389–90, 111 N.E. at 1053. For a discussion of Judge Cardozo's opinion in *MacPherson* see Seavey, *supra* note 15, at 376–79.

Thus, in cases involving physical harm caused by a manufacturer's negligence, the last vestige of *Winterbottom*'s general rule of nonliability without privity was consumed by the recognized exceptions. *See* Bohlen, *Fifty Years of Torts*, 50 HARV. L. REV. 1225, 1233 (1937); Prosser, *The Assault Upon the Citadel (Strict Liability to the Consumer)*, 69 YALE L.J. 1099, 1100 (1960).

[18] PROSSER, *supra* note 15, § 105, at 683.

[19] Pecuniary loss has historically been afforded less protection than physical injury in all tort actions. Professor James gives this explanation for the courts' objection to extending liability to allow recovery for indirect economic loss: "the physical consequences of negligence usually have been limited, but the indirect economic repercussions of negligence may be wider, indeed virtually open-ended." James, *Limitations on Liability for Economic Loss Caused by Negligence: A Pragmatic Appraisal*, 25 VAND. L. REV. 43, 45 (1972) (footnote omitted). But business realities are changing, or at least society's view of the significance of economic loss is evolving, so that pecuniary loss by third parties may now be compensated in some circumstances. *See generally* Comment, *Foreseeability of Third-Party Economic Injuries—A Problem in Analysis*, 20 U. CHI. L. REV. 283 (1953); 60 IOWA L. REV. 315 (1974).

[20] *See, e.g.*, Comment, *Accountants' Liabilities to Third Parties Under Common*

courts have departed from it only reluctantly,[21] and many still bar potential plaintiffs entirely through the use of the privity doctrine. Increasingly complex business practices have, however, heightened the need to rely on the statements of others, and commencing in 1922 with *Glanzer v. Shepard*,[22] the role of privity in suits for recovery of economic loss caused by negligent misrepresentation has slowly been eroded.

In *Glanzer*, the defendants were public weighers who certified the weight of a quantity of beans in order to establish a contract purchase price. The purchasers of the beans, to whom the defendants supplied a weight certificate, paid accordingly, only to discover that the weight had been overstated. They sued to recover the excess in price from the defendant-weighers because of the latter's negligence.[23] The court, speaking through Judge Cardozo, acknowledged the absence of a contractual relationship between the two parties but, nevertheless, held the defendants liable.[24] Judge Cardozo noted that the duty of care owed by the defendants was not only for the benefit of those privy to the contract, but also extended to any specific party who would foreseeably be induced to act in reliance on the information contained in the certification.[25] Since the plaintiffs' use of and reliance on the certification was, in the court's opinion, "a consequence which, to the weighers' knowledge, was the end and aim of the transaction," and because "[t]he defendants held themselves out to the public as skilled and careful in their calling," the defendants'

Law and Federal Securities Law, 9 B.C. IND. & COM. L. REV. 137, 149 (1967); Comment, *Auditors' Responsibility for Misrepresentation: Inadequate Protection for Users of Financial Statements*, 44 WASH. L. REV. 139, 181 (1968).

[21] Professor James attributes this general reluctance to "pragmatic" objections—courts' fears concerning the effect of a finding of liability on the defendants—rather than to any theoretical considerations. He acknowledges that the different treatment afforded economic and physical losses is "crude and unreliable." James, *supra* note 19, at 50–51.

[22] 233 N.Y. 236, 135 N.E. 275 (1922). For an excellent analysis of *Glanzer* see Seavey, *supra* note 15, at 394–98; 7 CORNELL L.Q. 355 (1922); 21 MICH. L. REV. 200 (1923).

[23] 233 N.Y. at 237–38, 135 N.E. at 275.

[24] *Id.* at 238–39, 135 N.E. at 275–76.

[25] *Id.* In reaching this conclusion, the court noted that the defendants

> knew that the beans had been sold, and that on the faith of their certificate payment would be made. They sent a copy to the plaintiffs for the very purpose of inducing action. All this they admit. In such circumstances, assumption of the task of weighing was the assumption of a duty to weigh carefully for the benefit of all whose conduct was to be governed.

Id. at 239, 135 N.E. at 176. Judge Cardozo did not discuss what role the element of reliance would play in such a case, but it can be inferred that a plaintiff needed only to show that the reliance on the negligent representation was reasonable. *Cf.* 36 IOWA L. REV. 319, 323–24 (1951).

duty of care was extended to encompass the plaintiff-purchasers.[26]

Thus, as in the context of physical injury, the boundaries of liability imposed by contract began to give way in favor of a duty requirement sounding in tort. It logically might have been anticipated that the *Glanzer* rationale would be equally applicable to accountants, but nine years later the *Ultramares* court rejected this extension. The defendant in *Ultramares* was a certified public accounting firm which had been retained to perform the annual examination and certification of Fred Stern & Company's corporate financial records.[27] The accountants were aware that Stern would exhibit these certified statements to third-party creditors in order to facilitate the acquisition of business loans necessary to finance its operations, but did not know specifically the particular parties to whom the statement would be shown.[28] The completed audit indicated that Stern's net worth exceeded $1,000,000 when, in fact, the company was insolvent.[29] Plaintiff-creditor, in reliance upon the statements which it had received from Stern, advanced the company loans totalling approximately $165,000. When Stern was later declared bankrupt, the plaintiff sued the accountants for the economic loss sustained, alleging that the audit was both negligently and fraudulently performed. Having determined that the audit had been done negligently, the court of appeals considered at length the question of whether any duty of care was owed to this particular plaintiff which could overcome the absence of contractual privity.[30]

Whatever the rationale employed, it seems clear that the *Ultramares* court was not yet ready to destroy the privity barrier in favor of an "indeterminate" class of potential plaintiffs, as distinguished from the single plaintiff who was allowed to recover because of the single transaction in *Glanzer*. To achieve this result, "primary" versus "incidental or collateral" beneficiary language was utilized. Thus, the relationship of the *Glanzer* purchaser who had relied on the weight certificate, regarded by the *Ultramares* court as "so close" to the transaction between the weigher and the seller "as to approach that of privity, if not completely one with it,"[31] was designated "primary."

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[26] 233 N.Y. at 238–39, 135 N.E. at 275–76. Judge Cardozo concluded:

> We do not need to state the duty in terms of contract or of privity. Growing out of a contract, it has none the less an origin not exclusively contractual. Given the contract and the relation, the duty is imposed by law.

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

[27] 255 N.Y. at 173, 174 N.E. at 442.

[28] *Id.* at 173–74, 174 N.E. at 442.

[29] *Id.* at 174–75, 174 N.E. at 442.

[30] *Id.* at 176–89, 174 N.E. at 443–48.

[31] *Id.* at 182–83, 174 N.E. at 446.

On the other hand, the persons in *Ultramares* to whom the client might later exhibit the accountants' audit were only "incidentally or collaterally" the beneficiaries thereof—much more remotely removed from the accountant-client contract.[32] By this semantic hair-splitting, the court was able to avoid what it envisaged as impending economic catastrophe if the accounting profession were exposed to liability for negligence to the "limitless" number of parties unknown at the moment of contract, who at some "indeterminate" time might fall upon the accountant's work product and use it to their own detriment, suffering damage in an "indeterminate" amount.[33]

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[32] *Id.* The *Glanzer* court could have achieved the same result through the third party beneficiary doctrine instead of employing tort concepts, thus avoiding the embarassing *Ultramares* confrontation. *See, e.g.*, Seaver v. Ransom, 224 N.Y. 233, 234, 120 N.E. 639, 640 (1918); Lawrence v. Fox, 20 N.Y. 268, 271–72 (1859).

Indeed, a recent court has viewed *Glanzer* as in fact a third party beneficiary case, thus limiting its applicability. *See* Investment Corp. v. Buchman, 208 So.2d 291, 295 (Fla. Dist. Ct. App. 1968).

[33] Seavey, *supra* note 15, at 400; *see* Levitin, *supra* note 4, at 445; Marinelli, *The Expanding Scope of Accountants' Liability to Third Parties*, 23 CASE W. RES. L. REV. 113, 118 (1971). Professor Seavey has argued that "Cardozo weakened his opinion by making distinctions where there are no differences." Seavey, *supra* note 15, at 400. Such a criticism seems well-founded. There can be no doubt that Stern reaped a substantial benefit from the accounting services rendered. Yet, there clearly had been a benefit accruing to third parties as well. Thus, it is questionable whether such a benefit is properly classified as merely "incidental," as Judge Cardozo suggested. Certainly, commercial lenders rely on accountants' expert opinions as to the financial soundness of potential borrowers. They, including the *Ultramares* plaintiff, would be unable to function effectively without the availability of fiscal verifications. It follows that the very survival of the commercial credit industry hinges, to a large extent, on the availability of accurate financial reporting. One observer has concluded:

> In fact, to say that the *primary* utility derived from the independent accountant's report and statements rests with third parties, such as suppliers, credit lenders, potential and present investors, and financial analysts is certainly no great overstatement.

Solomon, *Ultramares Revisited: A Modern Study of Accountants' Liability to the Public*, 18 DE PAUL L. REV. 56, 74 (1968) (emphasis added) (footnote omitted).

A realistic appraisal, moreover, fosters the conclusion that the plaintiff in *Ultramares* should not have been viewed as an "incidental" beneficiary of the accountants' service, but rather as one whose ultimate use was foreseeable and whose needs were certainly "primary." *See* Levitin, *supra* note 4, at 445; Solomon, *supra* at 74; Comment, *Accountants' Liabilities to Third Parties Under Common Law and Federal Securities Law*, 9 B.C. IND. & COM. L. REV. 137, 145 (1967). That the audit was intended for the use of third party creditors in *Ultramares* was, in the words of Professor Seavey, "reasonably obvious." Seavey, *supra* at 400. First, the accountants had knowledge that the certified financial statement would be shown to Stern's creditors and investors; and second, in order to facilitate Stern's borrowing, the accountants supplied Stern with *thirty-two* copies of the certified balance sheet. 255 N.Y. at 173–74, 174 N.E. at 442.

Additionally, Judge Cardozo's concern with a duty owed to an "indeterminate class" of potential plaintiffs does not appear to be fully warranted under the facts of *Ultramares*; the limits of the class there could have been easily defined as all the recipients of the thirty-two certified audit copies prepared by the defendant. But Judge Cardozo rejected this proposition in *Ultramares* and, in so doing, took an approach appar-

For over thirty years, *Ultramares* and its progeny raised the shield of privity to bar third parties, not standing in a contractual relationship with accountants, from suing for losses suffered because of the latter's negligence. There were only three possible avenues around this privity barrier: an allegation by the plaintiff of fraud on the part of the defendant;[34] conduct raising an inference of fraud;[35] or

ently inconsistent with *Glanzer*. *See* Averill, *Attorney's Liability to Third Persons for Negligent Malpractice*, 2 LAND & WATER L. REV. 379, 390–91 (1967). Recall that in *Glanzer*, Judge Cardozo stated, "[w]e do not need to state the duty in terms of contract or of privity." 233 N.Y. at 239, 135 N.E. at 276. Thus, with a duty grounded in tort, the parties to whom this duty is owed need not be specifically foreseen. Rather, as Judge Cardozo himself once noted, the duty is defined in terms of "[t]he risk reasonably to be perceived." Palsgraf v. Long Island R.R., 248 N.Y. 339, 344, 162 N.E. 99, 100 (1928). *Cf.* Rusch Factors, Inc. v. Levin, 284 F. Supp. 85, 91 (D.R.I. 1968). Unquestionably, the potential risk of harm to those few parties in direct receipt of the Stern audit was reasonably foreseeable, and as such, a duty of care was truly due them, despite the fact that their actual identity was unknown to the accountants at the time of the certification. But Judge Cardozo side-stepped this approach by abandoning a tort-based duty requirement—instead resurrecting the faltering privity doctrine to define the scope of the duty owed. *See* Note, *Potential Liability of Accountants to Third Parties for Negligence*, 41 ST. JOHN'S L. REV. 588, 592 (1967). Another commentator has observed:

> The New York court is apparently willing to bury the privity concept in some cases and adopt different legal theories under which liability can be more easily rationalized; then, on other occasions, to exhume its remains for purposes of denying recovery . . . .

36 IOWA L. REV. 319, 326 (1951) (footnote omitted).

[34] *See, e.g.*, O'Connor v. Ludlam, 92 F.2d 50, 53 (2d Cir.), *cert. denied*, 302 U.S. 758 (1937); Beardsley v. Ernst, 47 Ohio App. 241, 243–45, 191 N.E. 808, 809–10 (1934).

[35] *See, e.g.*, State Street Trust Co. v. Ernst, 278 N.Y. 104, 15 N.E.2d 416 (1938). In *State Street*, the New York court of appeals held that it was reversible error to direct a verdict for an accountant whose gross negligence was sufficient to support a jury inference of fraud. "[D]eliberate or active fraud" was not a prerequisite to an accountant's liability to third parties. *Id.* at 112, 123, 15 N.E.2d at 418–19, 424. The court relied on *Ultramares* in reaching the following position:

> 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, a 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. at 112, 15 N.E.2d at 419. It was observed, however, that misjudgment, no matter how gross, did not constitute fraud. *Id. But see* Duro Sportswear, Inc. v. Cogen, 131 N.Y.S.2d 20 (Sup. Ct. 1954), *aff'd mem.*, 285 App. Div. 867, 137 N.Y.S.2d 829 (1955). In *Duro*, the plaintiff-shareholder, agreed to purchase all the outstanding capital stock from his sole co-shareholder in reliance on an accountant's audit. 131 N.Y.S.2d at 22. When it was discovered that the audit substantially understated the corporation's deficit, the plaintiff sued the accountant for damages. *Id.* at 21–22. The trial court "found that there [was] not sufficient evidence to warrant a specific finding of fraud." *Id.* at 25. Yet, relying on *State Street*, the court found for the plaintiff on the grounds of a clear finding of a relationship within which the equivalent of privity could be found.[36]

Surprisingly, the theory of recovery recognized in *Glanzer*—that a duty of care is owed to recognized primary beneficiaries of a written representation whether or not strict privity of contract exists—was generally not adopted by the pre-1960 courts,[37] even where the facts were similar to those in *Glanzer*.[38] It was not until the late sixties,

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gross negligence. *Id.* at 25, 27. Such a conclusion seems to be an unwarranted extension of *State Street*, a case which did not suggest that liability could be imposed merely on a finding of gross negligence. Rather, gross negligence was held in *State Street* only to be a vehicle to support an inference of fraud. 278 N.Y. at 112, 15 N.E.2d at 419. *See* Katsoris, *Accountants' Third Party Liability—How Far Do We Go?*, 36 FORDHAM L. REV. 191, 204–05 (1967); Note, *supra* note 33, at 593.

The Supreme Court, in holding that a private cause of action for damages under section 10b of the Securities Act of 1934 and SEC rule 10b-5 requires scienter, left open "the question whether, in some circumstances, reckless behavior" will also suffice. Ernst & Ernst v. Hochfelder, 96 S. Ct. 1375, 1381 n.12 (1976). The decision in Lanza v. Drexel & Co., 479 F.2d 1277, 1306 (2d Cir. 1973), which would apply 10b-5 to "willful or reckless disregard for the truth," may yet have some viability.

[36] *See, e.g.*, C.I.T. Financial Corp. v. Glover, 224 F.2d 44, 46 (2d Cir. 1955) (dictum); *cf.* State Street Trust Co. v. Ernst, 278 N.Y. 104, 111, 15 N.E.2d 416, 418 (1938). In *C.I.T.*, the Second Circuit approved a jury charge which took the position that

> in order to establish a duty to [a non-privity] plaintiff for ordinary negligence in preparation of . . . audits, the jury had to find that these reports had been made for the "primary benefit" of the plaintiff.

224 F.2d at 46. *Cf.* Fidelity & Deposit Co. v. Atherton, 47 N.M. 443, 449, 144 P.2d 157, 161 (1943).

[37] *See* Hawkins, *supra* note 10, at 815–16; Levitin, *supra* note 4, at 447–48.

[38] *See, e.g.*, Investment Corp. v. Buchman, 208 So.2d 291 (Fla. Dist. Ct. App. 1968); Candler v. Crane, Christmas & Co., [1951] 2 K.B. 164 (C.A.). In *Candler*, the defendant-accountants were requested to prepare a financial statement for a client and personally exhibited the statement to a prospective investor. *Id.* at 166–68. In reliance on the balance sheet, the plaintiff invested money in the company which, although appearing financially sound on paper, was near bankruptcy. *Id.* at 167–68. The court relied on *Ultramares* in dismissing the plaintiff's claim, holding that without a showing of privity, accountants may not be held liable for their negligent misrepresentations. *Id.* at 196–207.

Lord Denning strongly dissented from the court's adoption of *Ultramares* and suggested something which approaches the *Glanzer* analysis, *i.e.*, that accountants be liable to those persons

> to whom they know their employer is going to show the accounts, so as to induce him to invest money or take some other action on them.

Id. at 180–81; *see id.* at 183–84; Seavey, Candler v. Crane, Christmas & Co.—*Negligent Misrepresentation by Accountants*, 67 L.Q. REV. 466 (1951). Professor Seavey observed that, as had been the plaintiff in *Glanzer*, the *Candler* plaintiff was a foreseeable reliant and therefore the *Glanzer* rationale should have been applied. *Id.* at 478. The House of Lords, apparently responding to Lord Denning, recognized in Hedley, Byrne Co. v. Heller & Partners, Ltd., [1964] A.C. 465, that a duty of care exists

> where a person is so placed that others could reasonably rely upon his judgment or his skill or upon his ability to make careful inquiry [and] such person takes it upon himself to give information or advice to, or allows his information or advice to be passed on to, another person who, as he knows, or should know, will place reliance upon it . . . .

when public accountants became the objects of increased litigation,[39] that courts explicitly applied the *Glanzer* rationale to impose liability on accountants for ordinary negligence in the preparation of financial statements relied on by third parties.[40]

A non-privity plaintiff was first permitted to maintain an action against an accountant for ordinary negligence in *Rusch Factors, Inc. v. Levin*.[41] Relying on the defendant-accountant's financial statements, the plaintiff loaned the defendant's client more than one third of a million dollars. When the debtor went into receivership, the plaintiff sued the accountant for damages, alleging alternatively fraudulent and negligent misrepresentation. The defendant moved to dismiss the action, one ground being a lack of privity.[42] While acknowledging that "[n]o appellate court, English or American has . . . held an accountant liable in negligence to reliant parties not in privity," the court challenged the "social utility rationale" of *Ultramares*.[43] Furthermore, the *Rusch* court saw the "innocent reliant party" to be less capable of bearing a loss engendered by an accountant's negligence than the accountant himself who could insure his losses distributing premium costs to his clients.[44] The court ob-

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Id. at 514. Thus, the continued vitality of the *Ultramares* rationale in England is suspect.

[39] *See* note 2 *supra*. *See also* Note, *supra* note 33, at 596–97.

[40] *See, e.g.*, Rusch Factors, Inc. v. Levin, 284 F. Supp. 85, 91–93 (D.R.I. 1968); Ryan v. Kanne, 170 N.W.2d 395, 401–03 (Iowa 1969). *But see* Canaveral Capital Corp. v. Bruce, 214 So.2d 505 (Fla. Dist. Ct. App. 1968); Investment Corp. v. Buchman, 208 So.2d 291 (Fla. Dist. Ct. App. 1968). *Buchman* has been noted in 23 MIAMI L. REV. 256 (1968).

[41] 284 F. Supp. 85 (D.R.I. 1968).

[42] *Id.* at 86–87.

[43] *Id.* at 90–91. The *Rusch* court felt that *Ultramares* had been significantly undermined by Fischer v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1967), a case decided one year earlier. 284 F. Supp. at 91. In *Kletz*, a federal district court had sustained a common law cause of action for deceit against an accounting firm in favor of third-party investors for their failure to disclose after-acquired information which, if revealed, would have shown an already widely distributed financial statement to be materially incorrect. 266 F. Supp. at 182–83, 186.

The court apparently disregarded any privity requirement and simply concluded:

> The elements of "good faith and common honesty" which govern the businessman presumably should also apply to the statutory "independent public accountant".

Id. at 186. *See also* Loewer v. Harris, 57 F. 368, 373–74 (2d Cir. 1893) (where the seller of a business discovers recent business declines and has made favorable statements regarding the business operations, "good faith and common honesty require him to correct the misapprehension which he has created"). For extensive discussions of the *Kletz* case see Katsoris, *supra* note 35, at 206–08; Comment, *supra* note 33, at 149–52; Note, *Accountants' Liability for Nondisclosure of After-Acquired Information: Strict Liability Under Rule 10b-5?*, 22 RUTGERS L. REV. 554 (1968).

[44] 284 F. Supp. at 91. In advocating the applicability of an enterprise liability ap-

served that "[h]ere the plaintiff is a single party whose reliance was actually foreseen by the defendant." As such, the court stated that "the case at bar is qualitatively distinguishable from *Ultramares*," and governed by *Glanzer*.[45] Denying the defendant's motion to dismiss, the court held

> that an accountant should be liable in negligence for careless financial misrepresentations relied upon by actually foreseen and limited classes of persons.[46]

Rusch marked the first extension of accountants' liability for negligence to third parties not in privity of contract. Because in so holding, the *Rusch* court found legal precedent—*Glanzer*—upon which to base its conclusions, perhaps the true significance of the case lies in the fact that it represents the first judicial challenge of the blanket Cardozo immunization of accountants from liability to "an indeterminate class" for an "indeterminate time."[47] The court clearly was troubled by its implied repudiation of *Ultramares*, taking great pains to rationalize the results on the strength of the *Glanzer* "primary beneficiary" analysis. But the court went far beyond *Glanzer* when it announced that it would sustain a cause of action in favor not only of

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proach to accountants' third party liability, the court asked rhetorically:

> 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?

Id.

For a discussion of the present-day status of accountant's professional liability insurance see notes 114–25 *infra* and accompanying text.

[45] 284 F. Supp. at 91. The *Rusch* court criticized the result reached in Investment Corp. v. Buchman, 208 So.2d 291 (Fla. Dist. Ct. App. 1968) as "wrong in so far as it failed either to perceive or to give weight to the distinction between *Ultramares* and *Glanzer*." 284 F. Supp. at 92.

The court also noted that the *Glanzer* principle, upon which it relied, had been made applicable to accountants through the tentative drafts of section 552 of the *Restatement (Second) of Torts*. *Id.* at 91. This section, which proposes the rule of law of negligent misrepresentation, states that a representer would be liable to

> the person or one of the persons for whose benefit and guidance he intends to supply the information, or knows that the recipient intends to supply it . . . .

RESTATEMENT (SECOND) OF TORTS § 552 (Tent. Draft No. 12, 1966) (all capitalized in original). For a further discussion of the *Restatement* position see notes 75–79 *infra* and accompanying text.

[46] 284 F. Supp. at 93.

[47] *Id.* at 90–91.

In *Hochfelder*, the *Rusch* approach seems to have been accepted in dictum by both the Seventh Circuit, *see* 503 F.2d at 1107, and the Supreme Court, *see* 96 S. Ct. at 1380 n.9.

specifically foreseen third parties but also of unknown members of specifically "foreseen and limited classes."[48]

One year after the decision in *Rusch*, a specifically foreseeable reliant party was allowed to recover damages by the Iowa supreme court in *Ryan v. Kanne*.[49] The successor corporation of the client sued for losses incurred following its use of an allegedly negligently prepared financial statement.[50] The court held that since the accountants were made aware of both the purpose of the financial statement and the actual party to whom the statement was to be exhibited,[51] "the lack of privity should be no valid defense to a claim for damages due to the accountant's negligence."[52] Thus, a departure from the "strict rule" of *Ultramares* was again warranted, now on the authority of both *Glanzer* and *Rusch*.[53]

The resurrection of the *Glanzer* approach continued as other courts subsequently held that accountants could be liable to foreseen reliant third parties.[54] Nevertheless, none of the courts which stepped away from the pre-1960 mechanical application of *Ultramares* was compelled to forge new law. In each case, the injured party was specifically known by the accountant to be the intended user of the audit. The party was, in short, the "primary beneficiary" contemplated by *Glanzer*.

The recent movement away from *Ultramares* has not, however, found unanimity among the courts. For example, although the Tenth

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[48] 284 F. Supp. at 93. Whether the court was satisfied with restricting liability to limited foreseen classes is questionable in light of its concluding language that

> [t]he Court does not rule upon, but leaves open for reconsideration in the light of trial development, the question of whether an accountant's liability for negligent misrepresentation ought to extend to the full limits of foreseeability.

Id.

[49] 170 N.W. 2d 395, 401–03 (Iowa 1969).

[50] *Id.* at 396–99.

[51] *Id.* at 398–400.

[52] *Id.* at 401.

[53] *Id.* at 401–03. The court concluded that accountants should be subjected to liability

> for negligence to persons for whose benefit and guidance the accountant *knows* the information is intended, especially when the party to be benefited is identified before the statement or report is submitted by the accountant.

Id. at 403 (emphasis in original).

[54] *See* Rhode Island Hosp. Trust Nat'l Bank v. Swartz, Bresenoff, Yavner & Jacobs, 455 F.2d 847, 851 (4th Cir. 1972); Bunge Corp. v. Eide, 372 F. Supp. 1058, 1061–63 (D.N.D. 1974) (dictum); Aluma Kraft Mfg. Co. v. Elmer Fox & Co., 493 S.W.2d 378, 381–83 (Mo. Ct. App. 1973); Shatterproof Glass Corp. v. James, 466 S.W.2d 873, 876–80 (Tex. Civ. App. 1971). *Cf.* Milliner v. Elmer Fox & Co., 529 P.2d 806, 808 (Utah 1974).

Circuit, in *Stephens Industries, Inc. v. Haskins & Sells*,[55] recognized *Rusch* and its progeny as representing a "developing trend," it refused to depart from the "generally accepted rule" established in *Ultramares*, and denied recovery even in the case of a specifically foreseen third party.[56]

In *Milliner v. Elmer Fox & Co.*,[57] the Utah supreme court similarly rejected an invitation to expand accountants' liability to the limits of foreseeability contemplated by the *Rusch* dictum. The plaintiff had purchased publicly held stock in reliance upon defendant's allegedly negligently prepared statement. When the shares became worthless, plaintiff sued.[58] Although the court rejected the *Ultramares* rule in favor of what it regarded as the better approach of *Rusch*, plaintiff's claim was dismissed because he could not bring himself within the *Rusch-Glanzer* class of protected "primary beneficiaries." Furthermore, the court was not willing to hold the accountants responsible to contemplated, but not specifically foreseen, reliant third parties.[59]

The persistent vitality of *Ultramares* has waned, however, and its underlying rationale permanently scarred. Nevertheless, there is presently no common law precedent, save the dictum in *Rusch* and *Ryan*, for extending accountants' liability beyond a limited, specifically foreseen class of third party reliants.

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[55] 438 F.2d 357 (10th Cir. 1971).

[56] *Id.* at 359–60. Since *Stephens* was a diversity action, a burden was imposed upon the plaintiff-appellant to prove that the district court erred in refusing to find that the Colorado state courts would have adopted the *Rusch* standard. *Id.* at 359–60. The court concluded that the appellant's proofs did not sustain this burden of establishing "clear error." *Id.* at 360. Therefore, the strict *Ultramares* rule—no "duty owed to non-privy third parties"—was sustained. *Id.* at 359–60. *See also* MacNerland v. Barnes, 129 Ga. App. 367, 199 S.E.2d 564 (1973).

No reported decision in New Jersey addresses the question of the liability of accountants to third parties for negligence. In an unreported opinion, however, the appellate division in 1974 affirmed the dismissal of a third-party action against an accounting firm because the plaintiffs could not prove that they had actually relied on the financial statement in question, thus avoiding consideration of the role of privity in such a suit. *See* Modell v. Wellington Computer Graphics, Inc., No. A–1416–72 (N.J. Super. Ct., App. Div., Nov. 21, 1974).

New Jersey has not yet extended liability for negligent misrepresentation to third parties for economic loss, *see* Kahl v. Love, 37 N.J.L. 5, 8–9 (Sup. Ct. 1874), but liability has been found for such negligence where physical injury is involved, *see* Pabon v. Hackensack Auto Sales, Inc., 63 N.J. Super. 476, 497–98, 164 A.2d 773, 784 (App. Div. 1960).

[57] 529 P.2d 806 (Utah 1974).

[58] *Id.* at 807.

[59] *Id.* at 808. The court questioned the "foreseeability" of potential stock purchasers. *Id.* For a discussion of this aspect of the case see note 79 *infra*.

ALTERNATIVES TO PRIVITY

The lack of privity of contract has never presented a major barrier to recovery for losses resulting from the negligent performance of services by professionals who have a special responsibility to the public stemming from a duty of public disclosure.[60] When this duty is present, liability has been extended to any member of the "class of persons for whose benefit the duty is created, in any of the transactions in which it is intended to protect them."[61] For example, food inspectors and recording clerks, among others, have been subjected to liability on the basis of their duty to the public.[62] Liability to those not in privity has, however, been extended to persons without a duty of public disclosure.

The Biakanja Test

In *Biakanja v. Irving*,[63] the California supreme court held a notary public, who was wrongfully engaged in the practice of law, liable for the negligent preparation of a will which had been denied probate. The plaintiff, the sole intended beneficiary under the will, recovered on a negligence theory despite her lack of contractual privity with the notary.[64] The *Biakanja* court expressly rejected the concept of privity as applied to negligence actions and held that liability should instead be determined on a case-by-case basis with the court weighing several factors, including

> the extent to which the transaction was intended to affect the plaintiff, the foreseeability of harm to him, the degree of certainty that the plaintiff suffered injury, the closeness of the connection between the defendant's conduct and the injury suffered, the moral

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[60] *See* PROSSER, *supra* note 15, § 107, at 709 & nn.62–65. Dean Prosser points out that those services which are of a public nature are often governed by statutory provisions defining liability. *Id.*

[61] RESTATEMENT (SECOND) OF TORTS § 552(3) (Tent. Draft No. 12, 1966) (all capitalized in original). Comment k to this section indicates that as well as applying to public officials, "it may [also] apply to private individuals or corporations who are required by law to file information for the benefit of the public." *Id.*, Explanatory Notes, Comment k at 28. *Quaere*: Would the reporting requirements of section 11 of the Securities Act of 1933 sustain a finding of liability under this section for an accountant's failure to comply with the statutory reporting standards? Responsibilities arising under the federal securities laws have been found to give rise to common law actions. *See, e.g.*, Diamond v. Oreamuno, 24 N.Y.2d 494, 503–04, 248 N.E.2d 910, 915, 301 N.Y.S.2d 78, 85–86 (1969).

[62] *See* PROSSER, *supra* note 15, § 107, at 709 nn.62–65.

[63] 49 Cal. 2d 647, 320 P.2d 16 (1958).

[64] *Id.* at 648, 650–51, 320 P.2d at 17, 19.

blame attached to the defendant's conduct, and the policy of preventing future harm.[65]

This balancing test has been utilized, particularly in California, to thrust liability upon attorneys and other professionals not in privity with the injured party. The first case to reject privity and employ the *Biakanja* test was *Lucas v. Hamm.*[66] In *Lucas*, the court held that an attorney could be liable to an intended beneficiary for a negligently drafted will, although under the specific facts no negligence was found.[67] In reaching this result, in the absence of the moral blame factor present in *Biakanja*, the *Lucas* court applied the *Ultramares* test—whether or not the imposition of liability to intended beneficiaries "would impose an undue burden on the profession"—but reached the opposite conclusion.[68] The *Lucas* court was not dismayed by the prospect of liability to an "indeterminate class" in an "indeterminate amount" because, "[a]lthough in some situations liability could be large and unpredictable in amount, this is also true of an attorney's liability to his client."[69] A converse ruling would thrust the entire burden of the loss upon the "innocent beneficiary."[70]

Privity as a relevant concept has also been abandoned in recent third party actions against design professionals—architects and engi-

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[65] *Id.* at 650, 320 P.2d at 19.

[66] 56 Cal. 2d 583, 364 P.2d 685, 15 Cal. Rptr. 821 (1961). Several law reviews have noted the *Lucas* decision. *See, e.g.*, 75 HARV. L. REV. 620 (1962); 16 RUTGERS L. REV. 475 (1962); 14 STAN. L. REV. 580 (1962).

[67] 56 Cal. 2d at 588–89, 592–93, 364 P.2d at 687–88, 690, 15 Cal. Rptr. at 823–24, 826.

[68] *Id.* at 589, 364 P.2d at 688, 15 Cal. Rptr. at 824.

[69] *Id.*

[70] *Id.* The consideration of who should bear the risk of loss suggests a policy of risk allocation, which is equally as applicable to the accounting profession. A creditor relying on an audit can also be said to be "innocent," and it is equally doubtful whether he should bear the risk of loss for another's negligence.

Later California cases found negligence and imposed liability upon attorneys in favor of non-client, third parties. *See, e.g.*, Heyer v. Flaig, 70 Cal. 2d 223, 449 P.2d 161, 74 Cal. Rptr. 225 (1969); Donald v. Garry, 19 Cal. App. 3d 771, 97 Cal. Rptr. 191 (Ct. App. 1971).

While many states have not yet recognized the liability of attorneys to third parties, a Connecticut court has expressly recognized the *Biakanja-Lucas* test. *See* Licata v. Spector, 26 Conn. Supp. 378, 383–84, 225 A.2d 28, 31 (C.P. Windham County 1966). The *Licata* court held that privity would not bar a beneficiary under a will from bringing an action against an attorney for negligently failing to provide for the requisite number of witnesses to the will. *Id.* at 379–83, 225 A.2d at 29–31. Other states have recognized, at least by implication, that privity is not necessarily a barrier to negligence suits against attorneys. *See, e.g.*, W.L. Douglas Shoe Co. v. Rollwage, 187 Ark. 1084, 63 S.W.2d 841 (1933); Schirmer v. Nethercutt, 157 Wash. 172, 288 P. 265 (1930). *But see* Victor v. Goldman, 74 Misc.2d 685, 344 N.Y.S.2d 672 (Sup. Ct. 1973); Maneri v. Amodeo, 38 Misc. 2d 190, 238 N.Y.S.2d 302 (1963).

neers.[71] Liability to persons physically injured as a result of negligent structural design has been viewed within the ambit of traditional foreseeability-proximate causation tort principles.[72] Design professionals have been held liable for economic damages to surety companies not in privity, but these actions have generally presented situations where only one potential plaintiff existed.[73]

The cases involving other professions have usually presented situations in which the specific plaintiff suffering damage was foreseeable, but the increasing use of the *Biakanja* test may have consequences in terms of liability expansion. In any event, the *Biakanja* rationale certainly permits a court to impose liability on professionals who negligently convey information to a member of a class that they know or have reason to know would rely upon the information.[74]

The Purpose-Oriented Test of the Restatement

Once the requirement of privity is abandoned, the distinction between an actually foreseen and a reasonably foreseeable class of reliants has enormous implications for professionals in terms of the scope of their ultimate potential liability. The *Restatement (Second) of Torts*, in a tentative draft, would apparently extend liability only to a member of an *actually* foreseen class,[75] as distinguished from a specifically foreseen plaintiff. Section 552 provides:

> (1) One who, in the course of his business, profession or employment, or in a transaction in which he has a pecuniary interest,

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[71] *See, e.g.*, Montijo v. Swift, 219 Cal. App. 2d 351, 33 Cal. Rptr. 133 (Dist. Ct. App. 1963); A.R. Moyer, Inc. v. Graham, 285 So. 2d 397 (Fla. Sup. Ct. 1973); Laukkanen v. Jewel Tea Co., 78 Ill. App. 2d 153, 222 N.E.2d 584 (1966), *cert. denied*, 78 Ill. App. 2d 114 (1969).

[72] *See* Laukkanen v. Jewel Tea Co., 78 Ill. App. 2d 153, 161–62, 222 N.E.2d 584, 588–89 (1966), *cert. denied*, 78 Ill. App. 2d 114 (1969).

[73] *See* Aetna Ins. Co. v. Hellmuth, Obata & Kassabaum, 392 F.2d 472 (8th Cir. 1968) (lack of privity held not to bar recovery of economic damages from architect by surety company); Westerhold v. Carroll, 419 S.W.2d 73 (Mo. 1967) (lack of privity does not bar indemnitor of surety from suing architect). The court in *Westerhold*, utilizing a *Biakanja*-type balancing test, had little difficulty imposing liability because "[t]he potential liability [was] strictly limited as to the total amount and one known claimant which was not in privity." *Id.* at 79.

[74] Although the language of *Biakanja* would permit a finding of more expansive liability, the court in *Biakanja* adopted the "end and aim" analysis of *Glanzer*. 49 Cal. 2d at 647, 320 P.2d at 19. *See* M. Miller Co. v. Central Contra Costa Sanitary Dist., 198 Cal. App. 2d 305, 308–09, 18 Cal. Rptr. 13, 15 (Dist. Ct. App. 1962).

[75] *See* RESTATEMENT (SECOND) OF TORTS § 552(2)(a) (Tent. Draft No. 12, 1966); Comment, *supra* note 3, at 147–49. But even the Reporter, Dean Prosser, professed when submitting the draft to being "not entirely happy with it, and hope[d] that it [could] be improved." RESTATEMENT (SECOND) OF TORTS, Explanatory Notes, § 552, at 14 (Tent. Draft No. 12, 1966).

> 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 the 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 which he intends the information to influence, or knows that the recipient so intends, or in a substantially similar transaction.
>
> (3) The liability of one who is under a public duty to give the information extends to loss suffered by any of the class of persons for whose benefit the duty is created, in any of the transactions in which it is intended to protect them.[76]

The *Restatement* position regarding liability to parties not in contractual privity—subsection (2)(a)—is not limited to a specifically foreseen plaintiff. This section, which limits liability to "the person or one of the persons" clearly must include a plaintiff who is a member of *a class* to which the conveyor of the information intends the information be supplied.[77] The liability of the provider of information is

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[76] RESTATEMENT (SECOND) OF TORTS § 552 (Tent. Draft No. 12, 1966) (emphasis added) (all capitalized in original).

The 1938 version of section 552 was much broader in scope because it extended liability to "the person or one of the class of persons for whose guidance the information was supplied." RESTATEMENT (SECOND) OF TORTS § 552(b)(i) (1938). Thus, liability would effectively have extended to any foreseeable class of persons. *See* Bradley, *Liability to Third Persons for Negligent Audit*, 1966 J. BUS. L. 190, 192; Katsoris, *supra* note 35, at 198. The section was revised, however, to bring it in line with case law. *See id.*

[77] RESTATEMENT (SECOND) OF TORTS, Explanatory Notes § 552, comment h at 23 (Tent. Draft No. 12, 1966), provides in part:

> Under this Section . . . it is not necessary that the maker should have any particular person in mind as the intended, or even the probable recipient of the information. . . . It is sufficient, in other words, that the maker *knows* that the information is intended for repetition to a *certain group or class of persons*, and that the plaintiff proves to be one of them, even though the maker never had heard of him when the information was given.

(Emphasis added.) *See also* Fiflis, *supra* note 1, at 108; Comment, *supra* note 3, at 147.

One court has interpreted this comment as suggesting "that liability is to be limited to persons dealing with the employer of the supplier of the information." Anderson v. Boone County Abstract Co., 418 S.W.2d 123, 129 (Mo. Sup. Ct. 1967). In that case, recovery for negligent preparation of a title abstract was denied to a person who purchased from the original seller for whom the abstract was prepared. *Id.* at 124, 126. *See also* Hawkins v. Oakland Title Ins. & Guar. Co., 165 Cal. App. 2d 116, 128–29, 331 P.2d 742, 749 (1958).

defined by the nature of the transaction in which the prospective plaintiff has received the information in that it must be the same transaction or one substantially similar to the transaction that it was intended to or known to be intended to influence.

While the *Restatement* supports liability to members of an actually foreseen class, it does not go so far as to allow recovery where the reliance by the injured party is merely "foreseeable."[78] Thus, the minimum standard is that the conveyor of information at least actually know that the recipient intends to supply it to a particular person or class of persons before liability for negligent misrepresentation can ensue. This requirement of scienter is more than foreseeability but less than personal intent. Herein lies the difficulty in drafting a rule; something more than foreseeability is necessary, but exactly how much more is difficult to articulate.[79]

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[78] The Reporter noted:

> It is not enough that it is "foreseeable" that the information will reach third persons. In one sense it is always "foreseeable" that any information will be communicated to others.

RESTATEMENT (SECOND) OF TORTS, Explanatory Notes § 552, at 15 (Tent. Draft No. 12, 1966).

The District of Columbia Circuit recognized the limitations which must be placed on foreseeability in a suit brought by Ralph Nader and an organization before which he was scheduled to speak against Allegheny Airlines for fraudulent misrepresentation which resulted in dishonoring Nader's confirmed reservation because the flight had been overbooked. Nader v. Allegheny Airlines, Inc., 512 F.2d 527, 548–49 (D.C. Cir. 1975), *rev'd on other grounds and remanded*, 96 S. Ct. 1978 (1976). The court found that Nader could bring the suit because "he was within an identifiable class of third persons—potential passengers—that Allegheny intended to influence," but dismissed the action brought by the organization because the airline "had no special reason to know of [its] reliance or even of its existence." 512 F.2d at 548–49.

[79] RESTATEMENT (SECOND) OF TORTS, Explanatory Notes § 552, at 16 (Tent. Draft No. 12, 1966). *See* Rozny v. Marnul, 43 Ill. 2d 54, 66–67, 250 N.E.2d 656, 663 (1969). It would appear, however, that there is no limit to the size of the class of actually foreseen reliants:

> What if an art expert certifies a painting as a genuine Vermeer, knowing that the dealer to whom he gives the certificate intends to publish it in a bulletin to be sent to 1,000 prospective purchasers in the hope of making the sale. Is he liable for negligence to the man who buys? The Reporter would say yes.

RESTATEMENT (SECOND) OF TORTS, Explanatory Notes § 552, at 16 (Tent. Draft No. 12, 1966).

This question is causing confusion as evidenced by the holding in *Rusch* that liability should only extend to "actually foreseen and *limited* classes of persons." 284 F. Supp. at 93 (emphasis added). No guidance is offered as to what might constitute a limited class. In the hypothetical offered by the Reporter to the Restatement probably only one person will eventually suffer harm. The court in Milliner v. Elmer Fox & Co., 529 P.2d 806 (Utah 1974) apparently looked to numerical certainty when it determined that

> [a] future purchaser of shares of stock of a corporation . . . belongs to an unlimited class of equity holders who could not be reasonably foreseen as a third

It seems evident that imposition of liability to all parties who "foreseeably" rely can effectuate unjust results if taken to the extreme. The purpose-oriented analysis of the *Restatement* is deceptive, however. Although the "purpose" of a particular audit, for example, may be relevant as to foreseeability, it should not be determinative.[80] To make purpose determinative is to ignore business realities, particularly when liability for a negligently performed certified audit is at issue. The "purpose" of the preparation of a certified audit may be specific, *i.e.*, only for creditors, but is more often "general," *i.e.*, "for the use of government agencies, investors, creditors, unions, and other interested parties."[81]

To follow the *Restatement* strictly would be to allow accountants to escape liability when performing a "general purpose" audit if they could show that they had no specific knowledge of the audited company's intention to show the audit to a member of a particular class. This is illogical, considering that the same standards of care must be observed regardless of the identity of the actual recipient.

The limitations imposed by the tentative draft of the *Restatement* were clearly intended to accommodate the "pragmatic" objection voiced in *Ultramares*. The *Restatement* is thus a compromise position,[82] which many courts have had little difficulty accepting.[83] But

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> party who would be expected to rely on a financial statement prepared by an accountant for the corporation.

Id. at 808.

The problem of a large class of potential plaintiffs with a consequent potential for extensive cumulative liability is what haunted Judge Cardozo and even recent courts. The fear is not insubstantial, but there are certain factors which, when dealing with a common law action for negligent misrepresentation, will minimize this "numerical" threat. First, each plaintiff must plead and prove reliance, negligence, and proximate causation, a difficult task which will significantly limit the number of successful plaintiffs. Frivolous actions might thus be easily eliminated on motions for summary judgment. Second, the need to show specific, individual reliance would probably preclude the finding of predominant common questions of fact, thereby minimizing the likelihood of a devastating class action. And furthermore, if brought in a federal court as a diversity action, the recent decision in Eisen v. Carlisle & Jacquelin, 417 U.S. 156 (1974), which held that persons bringing a class action must notify, at their own expense, all class members, would tend to discourage many such actions against accountants.

[80] The relevant element of the *Biakanja* test is the question of "the extent to which the transaction was intended to affect the plaintiff." 49 Cal. 2d at 650, 320 P.2d at 19.

[81] Stern, *Accountants' Liability to Third Parties*, 17 CLEV.-MAR. L. REV. 490, 493 (1968) (footnote omitted).

[82] *See* Bunge Corp. v. Eide, 372 F. Supp. 1058, 1063 (D.N.D. 1974).

[83] *See, e.g.*, Rozny v. Marnul, 43 Ill. 2d 54, 66, 250 N.E.2d 656, 662 (1969) (surveyor defendant liable to third party because, *inter alia*, defendant knew of third party reliance); Ryan v. Kanne, 170 N.W.2d 395, 402–03 (Iowa 1969) (accountants liable to "limited class" of third party reliants who were "actually foreseen"); Tartera v. Palumbo, 453

the empirical basis for the fear that accountants will be forced out of business is subject to challenge in light of modern insurance techniques.[84] Furthermore, the stringency of the *Restatement* approach may be as arbitrary in application as was the privity doctrine. It prevents a court from weighing all the factors before it in determining whether the extension of liability to a particular plaintiff is advisable.

A Balancing Approach to Accountant's Duty

The inequities of the *Ultramares* and *Restatement* approaches may be avoided by considering a balancing test for the finding of a duty. The flexibility of a balancing approach is particularly appropriate to any determination of liability for negligence because of its capacity to permit a court to respond to evolving social mores and business practices. Professors Harper and James have encouraged the use of a balancing test for generally ascertaining the duty of care owed to third parties for negligent misrepresentation.[85] The *Biakanja* court relied upon the Harper and James analysis in formulating its balancing test.[86] Professor Fiflis has specifically advocated the adoption of a *Biakanja*-type balancing test for the determination of the third party liability of accountants.[87] He argued that

S.W.2d 780, 784 (Tenn. 1970) (surveyor may be liable to specifically foreseen third party for damages resulting from negligently performed boundary survey).

[84] *See* notes 118–25 *infra* and accompanying text.

[85] 2 F. HARPER & F. JAMES, LAW OF TORTS § 18.6, at 1052 (1956). They argued that in determining whether a duty is owed to those parties with whom there is no contract

> [t]he ultimate question is whether such a duty *should* be imposed as a matter of policy. This in turn will depend on the balancing of several factors, namely, the burden it would put on defendant's activity; the extent to which the risk is one normally incident to that activity; the risk and the burden to plaintiff; the respective availability and cost of insurance to the two parties; the prevalence of insurance in fact; the desirability and effectiveness of putting the pressure to insure on one rather than the other, and the like. A judicious regard for such realistic considerations might justify liability in some situations and not in others even where there is no basis in doctrine for such a distinction.

Id. (emphasis in original). *See also* Licata v. Spector, 26 Conn. 378, 380–82, 225 A.2d 28, 29–30 (C.P. Windham County 1966).

[86] 49 Cal. 2d at 650, 320 P.2d at 19.

[87] Fiflis, *supra* note 1, at 109. Professor Fiflis attacks the actually foreseen plaintiff approach which "would leave no room for the very real consideration in a case involving auditors because of the" possibility that a finding of liability may be too burdensome. *Id.* at 110. His desire in adopting such a test is apparently to allow courts to be more restrictive than the Restatement. He illustrated the need for flexibility:

> In one case the audit may be of a closely held company for use in making a new public offering, or in another case, for reporting to the existing management. One would not be offended in the former case with a finding of liability to the investors despite the absence of privity, whereas in the second case imposition of liability for loss in an unintended transaction would be unthinkable.

Id.

> the merit of the balancing process is that it permits the court to weigh *any* pertinent considerations as they appear more or less relevant in each case, including changing public policy.[88]

Within the framework of rule 10b-5, Professor Fiflis noted that privity of contract as a viable doctrine in securities act litigation has virtually disappeared.[89] Rather than pertaining to the existence of a duty, privity has become a factor of secondary importance which may or may not be considered by a court at a later stage of a proceeding for purposes of determining the strengths or weaknesses of the primary elements of 10b–5 liability.[90]

Such an approach to the role of privity is illustrated in *Brown v. Bullock*,[91] a non-10b–5 case, where the court nevertheless addressed itself to the rule's application vis-à-vis private remedies:

> [P]rivity is not an ultimate or operative fact. It is an evidentiary fact to be considered in conjunction with other material facts in determining whether the relationship . . . between the plaintiffs and the defendants and the nature of the particular acts and transactions involve the duty created by the statute.[92]

Courts subsequent to *Brown* have looked to the above language for the proposition that the relationship between privity and rule 10b–5

Whether or not the imposition of liability would be "unthinkable" would depend to a large extent on the representations made in the audit and the nature of the disclaimers, if any. It is hard to believe, however, given present business practices, that an accountant would not expect the corporation to show a certified audit to third parties.

[88] *Id.* at 110 (emphasis in original).

[89] *Id.* at 110–11.

[90] *See* Sargent v. Genesco, Inc., 492 F.2d 750, 760–61 (5th Cir. 1974); Cochran v. Channing Corp., 211 F. Supp. 239, 245 (S.D.N.Y. 1962).

Rule 10b–5 requires a causal nexus; the injury complained of must have arisen "in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b–5(c) (1974). From this language courts have determined that some relationship between private 10b–5 litigants must exist. *See, e.g., In re* Caesars Palace Securities Litigation, 360 F. Supp. 366, 376–77 (S.D.N.Y. 1973). Initially, the class of potential plaintiffs was limited, for this "connection" between the proscribed conduct and the injury suffered was deemed satisfied only if at least a modicum of contractual privity between the parties could be shown. *See, e.g.*, Joseph v. Farnsworth Radio & Television Corp., 99 F. Supp. 701, 706 (S.D.N.Y. 1951), *aff'd*, 198 F.2d 883 (2d Cir. 1952) ("semblance of privity" required).

The *Farnsworth* directive has, however, been given little more than lip service. The general rule that has emerged is that the failure by a private 10b–5 plaintiff to allege privity, in the form of a contemporaneous market trading or even a purchase or sale by a purported 10b–5 violator, will not be fatal to the complaint. *See* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 353 F. Supp. 264, 274 (S.D.N.Y. 1972), *aff'd*, 495 F.2d 228 (2d Cir. 1974).

[91] 194 F. Supp. 207 (S.D.N.Y. 1961), *aff'd*, 294 F.2d 415 (2d Cir. 1961).

[92] *Id.* at 230.

must assume a non-absolute perspective, thereby becoming merely an inconclusive consideration in the determination of whether a statutory duty of care was owed to the plaintiff.[93]

In *Brown*, the court stated that in determining the existence of such a duty under 10b–5 there should be considered

> [t]he relationship between the plaintiffs and the defendants, the nature of the defendants' participation in the challenged transactions, and the plaintiffs' reliance upon the defendants' acts . . . .[94]

Professor Fiflis noted that such an approach is strikingly similar to the highly fact-oriented analysis employed in *Biakanja*.[95] The balancing approach embodied in *Biakanja* has been applied by at least one court to find accountants liable to third parties for negligent misrepresentations.

In *Aluma Kraft Manufacturing Co. v. Elmer Fox & Co.*,[96] the court rejected the doctrine of privity and announced that the following factors must be considered in determining whether or not liability should extend to a particular third-party plaintiff:

> (1) the extent to which the transaction was intended to affect the plaintiff; (2) the foreseeability of harm to him; (3) the degree of certainty that the plaintiff suffered injury; and (4) the closeness of the connection between the defendant's conduct and the injury suffered.[97]

The court found that the facts as alleged satisfied this test, and incorporated the *Glanzer-Restatement* view so that a showing that the defendant knew that the plaintiff would be relying on the financial statement satisfied the first element of the balancing test.[98]

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[93] *See, e.g.*, Miller v. Bargain City, U.S.A., Inc., 229 F. Supp. 33, 37–38 (E.D. Pa. 1969); Cochran v. Channing Corp., 211 F. Supp. 239, 244 (S.D.N.Y. 1962).

[94] 194 F. Supp. at 230.

[95] Fiflis, *supra* note 1, at 111. Professor Fiflis observed:

> This system under Rule 10b–5, considering the whole mosaic of the relationship of the parties, the degree of culpability of the defendant, whether the defendant profited, and the plaintiff's reliance on the defendant, is nothing less than the same sort of consideration used in the California balancing process.

Id.

[96] 493 S.W.2d 378 (Mo. Ct. App. 1973). The plaintiff was an investor of an audited company who, relying on the audited financial statement, eventually bought one hundred percent of the shares in the company at an inflated price because of a negligent overvaluation of the assets. *Id.* at 379–80.

[97] *Id.* at 383. The court relied on the balancing test used in Westerhold v. Carroll, 419 S.W.2d 73, 81 (Mo. 1967), which had adopted the *Biakanja* test. 493 S.W.2d at 183.

[98] *See* 493 S.W.2d at 382–83. One commentator has criticized the *Aluma Kraft* court's reliance on *Glanzer*:

> [B]y analyzing the economic injury cases through contract terms and concepts

Although Professor Fiflis, and to some extent the court in *Aluma Kraft*, may have been concerned with the ability of a court to limit liability, a balancing approach may also permit expansion of liability where evolving business practices mandate an expansive view of duty.

ANALYSIS OF THE BALANCING APPROACH

The function of the balancing approach is, of course, to determine whether or not a legal duty is owed by a defendant to a particular plaintiff. Without such duty no liability can be imposed. Although the question of duty is ultimately determined on a case-by-case basis, there are certain general policy considerations relevant to the accounting profession which are significant in any determination of duty.

The Accountant's Professional Role As "Relationship"

The role of the accountant in the normal functioning of business has been expanding significantly since 1931 when Judge Cardozo was able to declare that public accountants were only "public" to the extent that they held themselves out to the public for hire but in no sense owed a duty to the public.[99] Whereas at one time an audit was performed primarily for the purpose of informing management of possible defalcations and irregularities in its business,[100] the reality now is that

> the principal effect of the auditor's opinion to management is to meet the requirements of, and influence the actions of, third parties with whom the auditor has no contract.[101]

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rather than negligence theory, the court perpetuates an arbitrary, though more constricted, perimeter of immunity, leaving the plaintiff less able to submit his case to a jury than in personal injury cases.

39 MO. L. REV. 466, 472 (1974).

[99] 255 N.Y. at 188, 174 N.E. at 448.

It has been argued that accountants are in a fiduciary relationship with third parties whose reliance the accountants might reasonably foresee and thus owe them a high duty of care. *See* Stern, *supra* note 81, at 493–94. While the spirit of this contention is commendable, the analogy is unacceptable: fiduciary relationships are direct relationships.

[100] Comment, *Auditors' Responsibility for Misrepresentation: Inadequate Protection for Users of Financial Statements*, 44 WASH. L. REV. 139, 178 (1968).

The author explained that "as the ownership and management of business separated, it became necessary for corporate owners to review the performance of corporate managers." *Id.* (footnote omitted). *See also* Fiflis, *supra* note 1, at 106; Meek, *Liability of the Accountant to Parties Other than His Employer*, 1942 WIS. L. REV. 371.

[101] Comment, *supra* note 100, at 178. When many copies of an audited financial statement are supplied by the accountant to the client at the client's request, "as a practical matter, the accountant knows that third parties . . . will rely upon the audit." Carroll, *Accountant's Third Party Liability*, 33 INS. COUNSEL J. 252, 254 (1966).

The accounting profession itself has long recognized the accountant's duty of impartiality and independence from the client.[102] The American Institute of Certified Public Accountants (AICPA) stresses the accountant's responsibility to the public in its *Code of Professional Ethics*.[103] The federal securities laws, recognizing this responsibility, impose certain duties on accountants in their participation in securities transactions.[104] Many state statutes, while not specifically imposing liability to third parties on accountants for violations, do at least recognize the importance of the accountant's function to the public and attempt to regulate the profession.[105]

The nature of the certified audit also argues for the imposition of a duty to persons other than the client, for the responsibilities of the auditor in certifying a financial statement do not change with the intended recipient.[106]If some accountants are fearful of reporting or un-

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[102] *See* AICPA CODE OF PROFESSIONAL ETHICS Rule 1.01, at 2 (1970); Fiflis, *supra* note 1, at 45–52. Independence is of particular importance when the accountant is performing an "independent audit." AICPA CODE OF PROFESSIONAL ETHICS, Opinion No. 12, at 23–24 (1970).

[103] In its introduction to the *Code of Professional Ethics*, the AICPA has declared:

> The reliance of the public and the business community on sound financial reporting and advice on business affairs imposes on the accounting profession an obligation to maintain high standards of technical competence, morality and integrity.

AICPA CODE OF PROFESSIONAL ETHICS 1 (1970).

[104] Section 11 of the Securities Act of 1933, 15 U.S.C. § 77k (1970), imposes liability on accountants to third parties for misstatements of material facts in financial reports used in connection with a registration statement, where the accountant has failed to exercise due diligence. *See, e.g.*, Escott v. Barchris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968).

Section 17 of the 1933 Act, 15 U.S.C. § 77q (1970), and section 10b of the 1934 Securities and Exchange Act, 15 U.S.C. § 78j(b) (1970), may also permit the imposition of liability on accountants for various fraudulent activities. *See, e.g.*, Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, 378 F. Supp. 112, 126–29 (S.D.N.Y. 1974) (10b–5 liability imposed for misleading statements in financial report and audited statements distributed to investors for private placement); Drake v. Thor Power Tool Co., 282 F. Supp. 94, 104–05 (N.D. Ill. 1967) (10b–5 liability imposed for accountants' failure to disclose management's falsifications of financial status which would have been discovered had GAAP been followed).

[105] *See, e.g.*, CAL. BUS. & PROF. CODE § 5000 *et seq.* (West 1974); N.J. STAT. ANN. § 45:2A–1 *et seq.* (Supp. 1975–76); N.Y. EDUC. LAW § 7400 *et seq.* (McKinney 1972); PA. STAT. ANN. tit. 63 § 9.1 *et seq.* (1968), *as amended*, PA. STAT. ANN. tit. 63, § 9.2 *et seq.* (Supp. 1975–76).

[106] The scope of a specific audit may be determined by many variables such as the purpose of the particular engagement as well as the nature of the business and industry being audited. *See* Fiflis, *supra* note 1, at 36. Obviously these variables will affect or relate to the foreseeability of a particular class of plaintiffs, but the accountant must still comply with the standards of the profession regardless of who actually receives the audit. Thus, when there is deviation from these standards, the question is not whether a negligent misrepresentation was made, but rather whether the accountant should be

covering information which is not favorable to management,[107] they are clearly violating their professional responsibility and should not be protected by the courts. As one commentator has noted:

> [I]t becomes a highly questionable practice to allow a profession to be employed and gain the benefits of a position of trust, without insisting it assume the responsibilities which accompany that position.[108]

Thus, insofar as the existence of a "relationship" is requisite to the existence of a duty, it may be found generally in the role and responsibility of the accounting profession vis-à-vis the public. The artificial and absolute barrier of privity arose for reasons of policy. Those considerations, as they now apply to accountants, must be reexamined in light of modern social realities.

Social Utility Analysis

In suits for negligence courts often examine the social utility of a defendant's action in order to determine whether its value to society far outweighs the risk of harm.[109] This process involves the consideration of several factors.

One factor to be considered is the burden on the defendant to avoid resulting harm. In view of the fact that there is already a duty imposed on the defendant–accountant to avoid harm to the client, extension of liability for negligence to third parties does not significantly increase the accountant's task. By adhering generally to the standards of the profession, an accountant will minimize the risk of loss to any possible plaintiff.

The burden and consequences to the plaintiff must also be examined.[110] The onerousness of the burden on the plaintiff to avoid

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liable to this plaintiff for the negligence. *See* notes 137–143 *infra* and accompanying text.

[107] Several commentators have suggested that the extension of liability for negligent misrepresentation to third parties would tend to force the profession to formulate and strictly adhere to high professional standards for the auditing function. *See, e.g.*, Comment, *supra* note 33, at 149; Note, *supra* note 4, at 606; Note, *supra* note 15, at 163.

Experience under the securities laws may support this argument. It has been noted that although section 11 of the Securities Act of 1933 would seemingly open accountants to numerous suits, few suits have been brought, in part because "the accounting profession prepares registration statements more carefully than their other certifications." Frye, *Extending Accountants' Professional Liability*, 14 NAT'L PUBLIC ACCOUNTANT, Feb. 1969, at 12, 14.

[108] Note, *supra* note 15, at 163.

[109] *See* PROSSER, *supra* note 17, § 31, at 148.

[110] *See* Schwartz v. Helms Bakery, Ltd., 67 Cal. 2d 232, 242, 430 P.2d 68, 72, 60 Cal. Rptr. 510, 517 (1967).

injury results from the usual lack of access to the information used by the accountant and the inability to analyze it—precisely the role assumed by the accountant. The consequences of the accountant's failure to adhere at least to professional standards may be devastating to the plaintiffs. The combination of the plaintiff's burden and potentially great loss in comparison to the minimal burden placed on the accountant serves to demonstrate prima facie the social disutility of insulating accountants from third party liability.

While courts have often protected new industries engaging in high risk-high benefit activities from burdensome liability in order to encourage future participation,[111] this aspect of the social utility analysis is inapplicable to accountants' third party liability. The accounting profession is neither new nor are its services inherently dangerous, and liability can be avoided by following the accepted standards of what is now a mature, highly skilled profession.

While it is no longer necessary to protect the activities of accountants because of the inherent nature of their services, the fact remains that because of the extensive use of certified financial statements, the potential for burdensome liability exists. The question therefore arises: Can the accounting profession insure itself against such liability?

The Viability of the Pragmatic Objection

The most widely cited reason for the longevity of *Ultramares* is its policy determination that the accounting profession would never survive the imposition of liability for negligence to third parties.[112] Professor Fleming James has suggested that a determination of the insurability of the loss is an important aspect of any evaluation of the validity of the "pragmatic objection."[113] It seems that many of the apprehensions which have been expressed over the years concerning the availability and cost of insurance may have been overstated.[114]

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[111] *See* PROSSER, *supra* note 15, § 4, at 22–23.

[112] *See* Katsoris, *supra* note 35, at 199; Meek, *supra* note 100, at 389; Comment, *supra* note 100, at 180.

[113] James, *supra* note 19, at 51.

[114] Proponents of an expansion of liability have maintained that the financial burden of higher insurance premiums may be largely mitigated by the accounting profession's ability to pass on the cost of increased rates to their clients in the form of higher fees. This "enterprise liability" approach suggests that the ultimate burden would be funneled down until it reached the consuming public. *See* Marinelli, *supra* note 33, at 119; 36 IOWA L. REV. 319, 327–28 (1951). An interesting extension of this approach is the suggestion that the public could be provided with "insurance [which] would be funded by premiums paid by businesses." Griffin, *The Beleaguered Accountants: A Defendant's Viewpoint*, 62 A.B.A.J. 759, 762 (1976).

The results of a survey conducted recently by the Practising Law Institute to which fifty accounting firms responded, none larger than fifty members, indicates that many firms have had no difficulty in obtaining adequate insurance coverage and that the premiums paid are not prohibitive.[115]

Ten years ago, one AICPA committee forecast that an expansion of liability would be accompanied by the necessity for the accounting profession to charge fees which many clients would find overly

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Although malpractice insurance is probably the best way to deal with the losses caused by accountants' negligence, other interesting approaches to the problem have been suggested, such as the establishment of state boards which would screen out frivolous cases, the passage of no-fault insurance legislation for accountants by the states, and the protection of accountants through legalization of a right to incorporate. *See* Cosby & Rubin, *A Risk Management Analysis of the CPA's Professional Liability Exposure*, J. BUS., May 1976, at 15, 24–25.

Opponents of extended liability often cite the unavailability of coverage. *See, e.g.*, Louis, *The Accountants Are Changing the Rules*, FORTUNE, June 15, 1968, at 177; Comment, *Auditors' Third Party Liability: An Ill-Considered Extension of the Law*, 46 WASH. L. REV. 675, 683, 685 (1971). Others express concern over the withdrawal from the market of carriers once willing to underwrite accountants' malpractice insurance, as well as the rapid increase in the cost of annual premiums and size of deductible amounts. *See* Bakay, *A Review of Selected Claims Against Public Accountants*, J. ACCOUNTANCY, May 1970, at 54, 57–58; Comment, *supra*, at 685; Weyrich, *Exposure to Professional Liability*, N.Y.C.P.A., July 1970, at 556, 561.

Other fears that have been expressed are that expansion of liability will force small firms out of the public sector, discourage competitive pricing, and diminish the availability of audits to high risk clients, all of which will have a harmful effect on the nation's economy. *See* Comment, *Auditors' Third Party Liability: An Ill-Considered Extension of the Law*, 46 WASH. L. REV. 675, 698–705 (1971).

Many of the insurance problems which accountants have encountered may be due to unsophisticated rate making. Increased experience will undoubtedly result in improved insurance plans. *See Accountants Liability Problems*, N.Y.C.P.A., March 1971, at 229, 231.

[115] PLI PROFESSIONAL LIABILITY INSURANCE FOR LAWYERS AND ACCOUNTANTS 259–73 (1976). The survey is not conclusive, as only 42 out of 150 accounting firms contacted returned the survey questionnaire. But the results are, nonetheless, instructive.

The median policy limit for accountants who responded was $1,000,000 with the highest deductible reported to be $1,000. *Id.* at 264. The premiums paid, although difficult to average because dependent upon a myriad of factors such as size and location of the firm and the size of the deductible, were, on a $1,000,000 policy, as high as $767.00 per member and as low as $122.52 per member, with an apparent national average of $357.80 per member. *Id.* at 265–66.

In an apparent contrast to reported trends of increased litigation, the results of the survey might indicate that there is no serious cause for alarm, at least for the firms of less than fifty members. Of 37 firms which responded, only

> [s]ix firms reported one claim and two firms reported two claims during the last five years. Three accounting firms reported that the insurance carriers had made a payment to the claimant to settle a lawsuit, but the highest such payment was reported to be $1,700.

Id. at 271.

excessive.[116] Eight years ago, it was reported that because of the rise in premium costs, the largest accounting firms, some insured in excess of $10 million, were uncertain as to their ability to continue coverage eligibility.[117] Hindsight reveals that these concerns were largely unfounded. The ability of accounting firms, both large and small, to presently secure adequate coverage is enhanced by the availability of a new insurance program sponsored by the AICPA.[118] This program has been touted as "offer[ing] more coverage in higher limits to a greater number of firms and promises greater stability than has been the case previously."[119] The superiority of this plan over those previously available is evidenced by its widespread subscription,[120] as well as its endorsement by many state CPA societies.[121] Some of the noteworthy provisions of this policy include: (1) coverage for all claims (including all costs of legal defense) except those involving intentional fraud; (2) coverage limits up to $5 million where appropriate; (3) three-year premiums; (4) a "nominal range of deductibles . . . for firms with staffs between 11 and 250"; and (5) a general objective of spreading risk nationwide.[122]

It would appear, then, that the accounting profession has available an attractive insurance package which may very well prove to be a major factor in stemming the tide of the profession's mounting overhead. The broad base of the plan, as well as the growing subscription, should serve to keep premiums lower than previously anticipated. The real test of the plan may come after the first claims surface; if each claim were to cause cancellation of the particular insured's policy, as may threaten to be the case, the profession would have a constantly reducing group of insured accountants.[123]

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[116] N.Y. Times, Nov. 20, 1966, § 3, at 1, col. 1.

[117] Louis, *supra* note 115, at 177.

[118] J. ACCOUNTANCY, July 1975, at 7–8.

[119] *Id.* at 7.

[120] Wallace E. Olson, President of the AICPA, reported in a recent letter to the association's members that "[a]lthough the program was first offered in May of 1974, it is already over twice as large as the prior AICPA plan." Letter from Wallace E. Olson to members of the AICPA (undated) (on file at *Seton Hall Law Review*).

[121] At least "[t]hirty state CPA societies have decided to co-sponsor the program and others have sponsorship under consideration." J. ACCOUNTANCY, July 1975, at 7.

[122] RBH/Reid & Carr, Inc., The AICPA Professional Liability Insurance Program (1976).

[123] The major carriers of the AICPA program will not release information concerning their loss experience under the present program, nor their methods of determining possible premium rates if legal liability were to be expanded. It is hoped that experience will result in coverage which is acceptable to the carriers as well as the insured accountants.

For a discussion of how accountants can best evaluate their insurance needs see

However, the carriers may no longer point to the increasing claims under the federal securities laws to justify increased premiums or cancellations, because 10b-5 violations are now maintainable only for intentional fraud, not mere negligence, as a result of the recent Supreme Court decision in *Ernst & Ernst v. Hochfelder.*[124] That limitation, plus the difficult burden of proving actual reliance and causation in any common law action, will serve to diminish the number of successful suits and will further lower the costs of insurance.[125]

Thus, it appears that to date there has not been any serious threat of harm to accountants from policy cancellations or premium increases. In the absence of any negative experience with insurance, the "pragmatic objection" to an extension of liability for negligent misrepresentation is no longer valid with respect to the accounting profession.

ELEMENTS OF A CAUSE OF ACTION

The action against an accountant does not differ substantially from any other cause of action for negligent misrepresentation. Thus, liability will not be imposed unless the elements of a cause of action for negligent misrepresentation have been pleaded and proved. The potential for unlimited liability is significantly diminished by the difficulties of proof which are presented by the complex business practices that must be examined in such a law suit.[126]

Reliance

The necessity of proving reliance distinguishes the common law action for negligent misrepresentation from actions brought under the securities laws which may not require proof of reliance.[127] Many

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Francis & Strawser, *Determining the Amount of and the Cost of Professional Liability Insurance*, MICH. C.P.A., Mar.-Apr. 1971, at 53.

[124] 96 S. Ct. 1375 (1976).

[125] *See* Editorial, *Professional Liability—A New Development*, 99 N.J.L.J. 356 (1976).

[126] One commentator has argued: "If the courts adhere to strict rules of proof of causation, foreseeability, and reliance, the profession will not face ruin." Note, *supra* note 4, at 605; *see* Solomon, *supra* note 33, at 89.

[127] *See* Affiliated Ute Citizens v. United States, 406 U.S. 128, 152–54 (1972) (nondisclosure); Competitive Associates, Inc. v. Laventhol, Krekstein, Horwath & Horwath, 516 F.2d 811, 814 (2d Cir. 1975) (same).

Accountants' liability for common law negligent misrepresentation will inevitably involve false representations rather than nondisclosure. The very nature of an audit requires the affirmative communication of some information even if the inaccuracy results from an omission. *See* Mutual Ventures v. Barondess, 17 Misc. 2d 483, 484–85, 186 N.Y.S.2d 308, 309 (1959). Even in 10b–5 actions where affirmative misrepresentations are made, proof of reliance has been required.

courts have avoided the question of the extension of accountants' liability to third parties in common law actions by dismissing claims on the ground that the plaintiffs, in any event, failed to plead or offer proof of reliance.[128]

In order to support a finding of liability, the "false representation must have played a material and substantial part in leading the plaintiff to adopt his particular course."[129] A belief in the truth of the misrepresentation must be shown, and the plaintiff's reliance must have been justifiable.[130] In determining whether reliance was reasonable, the court will measure the plaintiff's conduct against what a normal member of the specific class to which the plaintiff belongs would have believed or would have done with the misrepresentation.[131]

The necessity of proving reliance will serve to limit liability significantly in actions against accountants, for

> [i]n 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.[132]

Proximate Causation

Another element of the cause of action for negligent misrepresentation which involves problems of proof for plaintiffs is the need to show causation. Not only must justifiable reliance be shown, but the misrepresentation must also be shown to have caused the specific injuries suffered by the plaintiff.[133] The inquiry does not stop once

[128] *See, e.g.*, Hochfelder v. Ernst & Ernst, 503 F.2d 1100, 1107 (7th Cir. 1974), *rev'd*, 96 S. Ct. 1375 (1976); Donovan Constr. Co. v. Woosley, 358 F. Supp. 375, 382 (W.D. Ark. 1973).

[129] PROSSER, *supra* note 15, § 108, at 714. The requirement of materiality will probably obviate liability for a "thoughtless slip or blunder" because no person could reasonably rely on such a representation. *See id.* at 718–19.

[130] *Id.* at 715; *see* Note, *supra* note 4, at 605.

[131] *See* PROSSER, *supra* note 15, § 108, at 715–16.

[132] Editorial, *Professional Liability—A New Development*, 99 N.J.L.J. 356 (1976).

[133] *See* PROSSER, *supra* note 15, § 108, at 718. One commentator has rejected this approach, arguing instead that because the burden of proving any kind of causation is so onerous, "lack of causation should be an affirmative defense . . . for which the auditor must bear the burden of proof." Comment, *supra* note 100, at 186–87 (footnote omitted).

In any event, the injury suffered, to be compensable, "must be established with reasonable certainty, and must not be speculative or contingent," or nominal. *See* causation in fact has been shown, however. Liability will not be imposed unless the injuries were proximately caused by the defendant's negligence.[134] It is at this point that the question of foreseeability becomes significant.[135]

The arguments earlier in this article concerning the foreseeability of harm to third parties resulting from the negligent misrepresentations of accountants were presented to discredit the continuing viability of the absolute bar to liability which the doctrine of privity has permitted. However, in order for liability to be imposed in any particular case, the injury to the *specific plaintiff* must still have been reasonably foreseeable. Thus, a court will examine the foreseeability of the harm suffered and make what is clearly a policy determination of whether or not the duty of the accountant should include protecting that plaintiff from the specific kind of injury suffered.[136] An accountant probably should not be liable, for example, for physical injuries resulting from shock over market loss which might be traceable to reliance on the accountant's negligent misrepresentation. Because of the nature of the accountant's services, to be compensable the injury must undoubtedly be pecuniary and suffered by a member of a foreseeable class of reliants.

It is in dealing with the question of proximate causation that courts will have the opportunity to narrow the scope of accountants' liability to third parties. The factors relevant to the balancing approach discussed previously for use in determining whether or not a specific cause of action should be entertained initially, may also be considered in the determination of proximate causation.

Negligence

Of course the most important element of any successful action is proof of negligence on the part of the accountant. Liability will not usually be imposed unless an accountant has deviated from estab-

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PROSSER, *supra* note 15, § 110, at 731 (footnote omitted). If this is proved, a plaintiff may be compensated for either "out of pocket" or "loss-of-bargain" damages, depending upon the jurisdiction. *Id.* at 733–34. In Ryan v. Kanne, 170 N.W.2d 395 (Iowa 1969), the Iowa supreme court determined that the appropriate measure of damages in an action against an accountant for negligent misrepresentation is "[t]he amount necessary to place the defendant corporation in the position it would have been had the [representation] been correct"—loss of the bargain. *Id.* at 407. An out-of-pocket measure may be preferable, however, allowing loss of the bargain compensation where the damages can be established with something more than "reasonable certainty." *Cf.* Comment, *supra* note 100, at 189.

[134] *See* Bunge Corp. v. Eide, 372 F. Supp. 1058, 1061, 1063 (D.N.D. 1974).

[135] *See* PROSSER, *supra* note 15, § 43, at 257–58.

[136] *Id.* §§ 42 & 43.

lished professional standards.[137] The AICPA has established generally accepted accounting standards (GAAS) governing the entire audit investigation which mandate a following of generally accepted accounting principles (GAAP) regarding the methods of reporting certain kinds of facts.[138] While deviation may not always constitute negligence, neither should strict adherence relieve an accountant of responsibility if the circumstances clearly required something more.[139]

Proof of negligence may involve significant financial costs for third parties. Despite the presence of GAAS and GAAP, expert testimony is almost always required in order to establish the "substantial

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[137] *Cf.* Hawkins, *supra* note 13, at 802–03. In Rhode Island Hosp. Trust Nat'l Bank v. Swartz, Bresenoff, Yavner & Jacobs, 455 F.2d 847 (4th Cir. 1972), the court held that the standards of the profession should be "the *minimum* standard by which liability should be determined." *Id.* at 852 (emphasis in original).

An accountant's responsibilities do not necessarily end with the completion of an audit. In Fischer v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1967), the court, in denying a motion to dismiss, held that an accountant has a duty to disclose information discovered after the completion of an audit which renders the financial statement false and misleading. *Id.* at 188. The court acknowledged the possibility that indeterminate liability might result from the imposition of such a duty, but concluded that "[p]roper reconciliation of these . . . policy considerations . . . can only be made after full development of the facts of this case." *Id.* at 189.

[138] Fiflis, *supra* note 1, at 40. The AICPA has promulgated ten standards which govern general field work and reporting standards. *See* AICPA STATEMENT ON AUDITING STANDARDS NO. 1, § 150.02 (1973). Generally accepted accounting principles are not set out specifically, but are defined by "the accounting conventions by which financial information is recorded, attributed to particular periods and summarily presented in the form of financial statements." Strother, *The Establishment of Generally Accepted Accounting Principles and Generally Accepted Auditing Standards*, 28 VAND. L. REV. 201, 203 (1975) (footnote omitted). The conventions, to be "generally accepted," should have "substantial authoritative support." Fiflis, *supra* note 1, at 41.

[139] *See* Rhode Island Hosp. Trust Nat'l Bank v. Swartz, Bresenoff, Yavner & Jacobs, 455 F.2d 847, 852 (4th Cir. 1972); United States v. Simon, 425 F.2d 796, 806–07 (2d Cir. 1969), *cert. denied*, 317 U.S. 1006 (1970); Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, 378 F. Supp. 112, 121 (S.D.N.Y. 1974); 24 CATH. U.L. REV. 393 (1975).

Professor Fiflis has suggested that in determining legal standards of conduct a court must look to

> (a) The actual conduct of the accountant in the particular case, including his own firm's standards, and the conduct of the engagement;
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> (b) Customs and practices of the profession, if any, dealing with the particular problem;
>
> (c) Formal professional standards, if any, covering the situation, established by some organization such as the AICPA, the stock exchanges or the [Financial Accounting Standards Board];
>
> (d) Expert testimony of appropriate conduct in the circumstances;
>
> (e) Writings of accountants and others in treatises and journals; and
>
> (f) The legal standard of conduct to be established for the case. Items (b), (c), (d) and (e) often are referred to, individually or collectively, as sources of GAAS or GAAP without discrimination.

Fiflis, *supra* note 1, at 65 (footnote omitted).

authoritative support" needed to denominate a specific principle a GAAP[140] and to prove the accountant's deviation from standard, generally accepted procedures.

Finally, the accountant often can limit the scope of his duties to the client and third parties. The agreement between the accountant and the client cannot directly limit responsibility to third parties, however, unless the restricted nature of the engagement is clearly set out on the face of the report.[141] The use of disclaimers is permissible,[142] although it is not possible to make a blanket disclaimer of liability for all representations in the report which are made negligently.[143]

CONCLUSION

Ultramares is on the wane, and rightly so!

The accounting profession is light years removed from the limited professional role it customarily played when Judge Cardozo was reluctant to expose it to "liability in an indeterminate amount for an indeterminate time to an indeterminate class." The demands of a consumer oriented economy, governmental regulation, constantly shifting and more complicated taxes and tax regulations, enforcement of fed-

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[140] Fiflis, *supra* note 1, at 41.

[141] *See* M. Miller Co. v. Central Contra Costa Sanitary Dist., 198 Cal. App. 2d 305, 310, 18 Cal. Rptr. 13, 16 (disclaimer of liability in contract does not necessarily extend to third parties); Hedley Byrne & Co. v. Heller & Partners, Ltd., [1964] A.C. 465, 486 ("clear qualification" may act as disclaimer).

[142] *See* NATIONAL CONF. OF BANKERS & CERTIFIED PUBLIC ACCOUNTANTS, AUDITOR'S REPORT 17–19 (1967). The auditor's report may contain the following notations:

(1) "Unqualified"—an expression of the accountant's professional opinion that the audited financial statement represents a fair and accurate presentation of the corporation's financial condition, *see* AICPA STATEMENT ON AUDITING STANDARDS NO. 2, ¶ 28, at 10 (1974);

(2) "Qualified"—while similar to an unqualified opinion, this expression will be accompanied by a description of the effect certain qualifications have on the financial statement issued, *see id.* ¶¶ 29–30;

(3) "Adverse"—indicates that the presentation of the financial statement does not conform with generally accepted accounting principles, *see id.* ¶¶ 41–44;

(4) "Disclaimer of Opinion"—indicates that the accountant offers no opinion because of the limited nature of the examination, *see id.* ¶¶ 45–47.

The AICPA CODE OF PROFESSIONAL ETHICS, Rule 2.03 (1970) mandates that the accountant affix one of these explanatory notations to any audited financial statement.

[143] A disclaimer must be specific. The AICPA STATEMENT ON AUDITING STANDARDS NO. 2, ¶ 45, at 15 (1974) provides that whenever the independent auditor disclaims an opinion, he should give "all of his substantive reasons for doing so." *See also* Rhode Island Hosp. Trust Nat'l Bank v. Swartz, Bresenoff, Yavner & Jacobs, 455 F.2d 847, 852 (4th Cir. 1972). The effect of a disclaimer should ultimately be a question for the jury. *See* C.I.T. Financial Corp. v. Glover, 224 F.2d 44, 46 (2d Cir. 1955).

eral and state securities statutes aimed at fully informing the potential investor, intricate corporate mergers and acquisitions, all have thrust duties upon the accountant, expanded his engagement and complicated his work far beyond what might have been regarded as mere bookkeeping duties 45 years ago.

However, such growth inevitably must bring additional responsibilities. Today, the accountant who is preparing a current audit and reasonably demands that his client's counsel furnish appropriate information concerning loss contingencies stemming from threatened or pending litigation, contractually assumed obligations or even unasserted possible claims or assessments himself must be prepared to stand behind his work, no more, no less than anyone else whose services bring him in contact with the public.

It is to be remembered that an accountant *never* guarantees the accuracy of his work. No one suggests that he must insure the validity of his audit.[144] But, simply stated, it *is* reasonable to require the accountant to prepare his statement carefully and to hold him to general standards of due care. On the other hand, as we have tried to suggest, an attempt to define with precision all those parties to whom the accountant should be liable would be as inequitable as rigid application of the *Ultramares* privity rule.

The balancing approach to such liability, which in the end depends upon a case by case analysis of the accountant's relationship to the particular aggrieved party, offers the fairest solution to the somewhat anomalous goals of protecting the public while simultaneously limiting the profession's exposure, thereby reducing the cost of its necessary services to the very same public. After a few years of empirical experience with such a rule, the profession, its insurers, and the consuming public should have adjusted to one another on a more rational, realistic basis than now exists, and Judge Cardozo's fear of limitless, unpredictable professional liability should become just another imaginary horror, inevitably discarded as legal concepts keep pace with changing social and business patterns.

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[144] No commentator has argued for the imposition of strict liability to accountants, but the trend in products liability cases has been recognized as providing a possible theoretical basis for the extension of such liability to accountants. *Cf.* Solomon, Ultramares *Revisited: A Modern Study of Accountants' Liability to the Public*, 18 DE PAUL L. REV. 56, 85 (1968).