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ROSENBLUM, INC. V. ADLER: CPAs LIABLE AT COMMON LAW TO CERTAIN REASONABLY FORESEEABLE THIRD PARTIES WHO DETRIMENTALLY RELY ON NEGLIGENTLY AUDITED FINANCIAL STATEMENTS

The Supreme Court of New Jersey, in *Rosenblum, Inc. v. Adler*,[1] became the first court in the United States[2] to hold certified public accountants (CPAs) liable at common law[3] to certain reasonably foreseeable third parties[4] who detrimentally rely on negligently[5] audited

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[1] 93 N.J. 324, 461 A.2d 138 (1983).

[2] Since 1980, England has held accountants liable to reasonably foreseeable third parties who detrimentally rely on negligently audited financial statements. In JEB Fasteners Ltd. v. Marks, Bloom & Co., [1981] 3 All E.R. 289 (Q.B.), *aff'd*, [1983] 1 All E.R. 583 (C.A.), the defendant accounting firm negligently auditcd the financial statements of a manufacturing company. The plaintiff, JEB Fasteners, later acquired the financially troubled manufacturer. The plaintiff subsequently discovered that the audited financial statements of the manufacturing company significantly overstated the company's net worth. JEB Fasteners sued the manufacturer's auditors for negligence. The court held that accountants are liable to all reasonably foreseeable third parties, such as the plaintiff, for negligently conducting an audit. *Id.* at 300-01. The court, however, granted judgment for the defendant auditors because their negligence did not eause plaintiff's losses. Evidence indicated that the plaintiff would have acquired the manufacturer even if it had known of the financial misstatement. *Id.* at 304-05.

For a discussion of this case by English commentators, see Stanton & Dugdale, *Recent Developments in Professional Negligence - II: Accountant's Liability to Third Parties*, 132 NEW L.J. 4 (1982).

[3] This Note does not analyze in detail auditors' legal liability to third parties under federal securities laws. A brief discussion of this statutory liability, however, is useful for comparative purposes.

Under the Securities Act of 1933, accountants are liable for negligcnce to third parties who purchase newly issued securities if the financial section of the registration statement required to be filed with the Securities and Exchange Commission (SEC) is materially misleading. Securities Act of 1933, § 11, 15 U.S.C. § 77(k) (1982). Under § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78(j)(b) (1982), mere negligence in the presentation of annual reports and other documents required to be filed under the 1934 Act has been hcld insufficient to state a claim against a CPA. *See* Ernst & Ernst v. Hochfclder, 425 U.S. 185, 201 (1976) (to hold CPA liable under the 1934 Act, CPA must have scienter or intent to deceive and manipulate). Accountants are liable under the 1934 Act for recklessness to third parties who buy or sell securities if the financial section of the annual report required to be filed with the SEC is materially misleading. McLean v. Alexander, 420 F. Supp. 1057, 1084 (D. Del. 1976) (liability of accountant who had prepared opinion audit under antifraud provision of Securities Exchange Act of 1934 could properly attach upon a showing of reckless disregard of truth).

[4] The New Jersey court did not create an all-inclusive list of what third parties are "reasonably foreseeable." The scope of this class will differ somewhat depending on the nature of the auditcd clicnt's business. For example, the rcasonably foreseeable users of a manufacturing company's financial statements may include suppliers of inventory who sell inventory to the company on credit, or others who factor the company's accounts receivable. Those types of third party users of financial statemcnts, however, would probably not be

financial statements.[6] Even though the principal effect of the auditor's opinion to management about the accuracy of the examined financial statements[7] is to influence third parties,[8] prior to *Rosenblum* all state courts severely limited the rights of third parties against negligent CPAs. A minority of state courts still precludes *all* third parties from suing CPAs for negligence, holding that a CPA's legal duty extends only to those with whom he is in privity.[9] The majority of state courts allows only specifically known or intended third party users or classes of users of financial statements[10] to sue CPAs for negligent auditing.[11]

The New Jersey ruling is a rational extension of the rights of third parties against negligent CPAs.[12] This state now provides the primary users of audited financial statements, including stockholders, investors, and creditors,[13] with increased access to its courts to recover economic losses sustained as a result of CPA negligence. The well-reasoned *Rosenblum* decision should provide the impetus for other states to modernize[14]

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reasonably foreseeable in the case of a bank or financial institution. At a minimum, the New Jersey court includes "stockholders, potential investors, creditors and potential creditors" as reasonably foreseeable third parties. *Rosenblum,* 93 N.J. at 332, 461 A.2d at 142.

The CPA, of course, is liable at common law to his client for negligence, *see id.* at 333, 461 A.2d at 142, and to third parties for fraudulent conduct, *see infra* note 27.

5 This Note is concerned with negligence, not recklessness. Many courts already hold CPAs liable at common law to third parties for recklessness. *See Rosenblum,* 93 N.J. at 349, 461 A.2d at 151.

6 *See infra* notes 16-18 and accompanying text (discussing auditing and financial statements).

7 *See infra* notes 19-20 and accompanying text (discussing auditor's opinions).

8 *See* Comment, *Auditors' Responsibility For Misrepresentation: Inadequate Protection For Users of Financial Statements,* 44 WASH. L. REV. 139, 178 (1968) (audit evaluates "the adequacy and fairness of financial statements issued by management to shareholders, creditors, and others"); *see also infra* note 40.

9 *See, e.g.,* Investors Tax Sheltered Real Estate, Ltd. v. Laventhol, Krekstein, Horwath & Horwath, 370 So. 2d 815 (Fla. Dist. Ct. App. 1979) (accounting firm cannot be held liable to investing enterprise for negligence when there is no privity); *cf.* MacNerland v. Barnes, 129 Ga. App. 367, 199 S.E.2d 564 (1973) (accountant not liable for negligence regarding uncertified financial statement to third parties who are not in privity, even though he knew of or could have anticipated reliance). For other cases with similar holdings, see Annot., 46 A.L.R.3d 979, 991-94 (1972).

10 See *infra* notes 34-38 and accompanying text for definition of "known or intended" third party users or classes of users of financial statements.

11 *See, e.g.,* Rusch Factors, Inc. v. Levin, 284 F. Supp. 85 (D.R.I. 1968) (applying Rhode Island state law) (CPAs liable to third party banking and factoring corporation they knew would rely on negligently audited financial statements in extending credit); Ryan v. Kanne, 170 N.W.2d 395 (Iowa 1969) (CPAs liable to third parties they knew would rely on negligently determined accounts payable information); Shatterproof Glass Corp. v. James, 466 S.W.2d 873 (Tex. Civ. App. 1971) (accountant owed duty of care to creditor to whom he knew audit would be given). For other cases with similar holdings, see Annot., *supra* note 9, at 989-91.

12 *See* Note, *The Enlarging Scope of Auditors' Liability to Relying Third Parties,* 59 NOTRE DAME L. REV. 281, 295-96 (1984) (concluding that privity rule is anachronistic and that *Rosenblum* rule is workable alternative).

13 *See infra* note 40.

14 The "reasonably foreseeable" standard adopted in *Rosenblum* to define the scope of a

their view of the legal duty and liability of auditors to third parties.[15]

I
ACCOUNTANTS AND AUDITING OF FINANCIAL STATEMENTS

In the typical audit engagement, financial statements prepared by a company's management are examined, tested, and reviewed by independent CPAs. This independent testing is intended to ensure that financial statements provide reasonably complete, accurate, and unbiased information. The availability of such reliable information is essential to the efficient functioning of a free market economy. Unreliable information misleads decision makers and causes inefficient use and allocation of scarce resources.[16]

A CPA must conduct an audit in accordance with "generally accepted auditing standards" (GAAS).[17] The membership of the American Institute of Certified Public Accountants has approved and adopted

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CPA's duty is "already applied as an integral part of general negligence law." Note, *supra* note 12, at 295. A possible reason that the law of accountants' negligence has lagged behind general negligence law in this respect is the nature of accountants' negligence claims. In cases of accountants' negligence, the CPA is usually neither the only nor the primary wrongdoer. He is usually only a secondary wrongdoer because he has failed, by his negligence, to detect the fraud of his client. *See, e.g., Rosenblum,* 93 N.J. 324, 461 A.2d 138 (auditor allegedly negligent, but client fraudulent). The fact that CPAs are usually only secondary wrongdoers does not justify circumscribing their negligence liability.

> It must be remembered that one of the specific functions for which the accountant is employed is the detection of corporate fraud. Accountants and accounting firms derive substantial economic benefit because of their abilities in this regard. It hardly seems oppressive to require that they perform this task in a professionally reasonable manner.

Wiener, *Common Law Liability of the Certified Public Accountant for Negligent Misrepresentation,* 20 SAN DIEGO L. REV. 233, 258 (1983).

A more common rationale for circumscribing accountants' liability for their negligence is the fear of exposing them to unlimited liability. *See infra* notes 29, 32 & 33 and accompanying text.

[15] Another state, Wisconsin, has adopted a foreseeability standard. In Citizens State Bank v. Timm, Schmidt & Co., 113 Wis. 2d 376, 335 N.W.2d 361 (1983), a bank sued an accounting firm and its malpractice insurer for losses it allegedly incurred when it loaned money to the auditor's corporate client in reliance on financial statements that were negligently audited. The Wisconsin Supreme Court reversed a lower court's grant of summary judgment for the auditors and remanded the case to the trial court on the negligence claim. The supreme court noted that the absence of privity should not bar such a claim. It then addressed the question of the extent to which CPAs should be liable to third parties for negligence. Citing *Rosenblum,* decided less than a month earlier, the Wisconsin court noted that even the *Restatement (Second) of Torts* position, that negligent CPAs are liable to individually known or intended third party users of financial statements and members of a known or intended class of users of such statements, *see infra* notes 34-41 and accompanying text, was "too restrictive a statement of policy factors for this Court to adopt." 113 Wis. 2d at 386, 335 N.W.2d at 366 (footnote omitted). The court concluded that CPAs will be liable, in Wisconsin, for negligence to all reasonably foreseeable third parties, unless the CPAs prove at trial that public policy requires another outcome. *Id.*

[16] A. ARENS & J. LOEBBECKE, AUDITING: AN INTEGRATED APPROACH 2 (1976).

[17] *See* 2 AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, AICPA PROFESSIONAL STANDARDS ET § 202.01 (1981) [hereinafter cited as AICPA].

ten generally accepted auditing standards that set broad guidelines for CPA audit conduct:

> *General Standards*
> 1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
> 2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.
> 3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.
>
> *Standards of Field Work*
> 1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
> 2. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.
> 3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.
>
> *Standards of Reporting*
> 1. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.
> 2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.
> 3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
> 4. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.[18]

After conducting an audit conforming to GAAS, the CPA expresses his professional opinion about the accuracy of the examined financial statements in a written report that accompanies the financial state-

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[18] *See* 1 AICPA, *supra* note 17, AU § 150.02.

The AICPA also frequently issues Statements on Auditing Standards, which are detailed interpretations of GAAS. A. ARENS & J. LOEBBECKE, *supra* note 16, at 40. CPAs must comply with these Statements in conducting an audit in order to conform to GAAS. 2 AICPA, *supra* note 17, ET § 202.01. "[T]hese AICPA pronouncements should be looked upon by practitioners as *minimum standards* of performance rather than as maximum standards or ideals. Any professional auditor who [relies] only on the standards . . . fails to satisfy the spirit of the standards." A. ARENS & J. LOEBBECKE, *supra* note 16, at 40 (emphasis in original).

ments. The CPA's report usually takes the form of an "unqualified opinion," stating that the CPA performed his examination in accordance with GAAS and that the financial statements are fairly presented in conformity with "generally accepted accounting principles" (GAAP).[19] If the auditor conducts an audit conforming to GAAS and believes that the overall financial statements are fairly presented in accordance with GAAP, with some specific exceptions, he should issue a "qualified opinion." If the auditor conducts an audit conforming to GAAS and believes that the financial statements are not fairly presented in accordance with GAAP, he should issue an "adverse opinion." Finally, if the auditor cannot satisfy himself whether the financial statements are or are not fairly presented in accordance with GAAP, he should issue a "disclaimer of opinion."[20]

The auditor's report "normally forms the basis for any assertion of liability against [the CPA],"[21] because the report usually contains representations that he has conducted the audit in accordance with GAAS and that the financial statements are presented in accordance with GAAP. An auditor meets the standard of a "reasonable CPA" when he performs audits in accordance with GAAS and presents financial statements in accordance with GAAP.[22] When a CPA fails to act as a "reasonable CPA," he has acted negligently and courts may subject him to legal liability. Conversely, "courts generally hold that an accountant will not be liable if his work conforms to the applicable GAAP and GAAS and the financial statement is informative."[23]

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19 *See* A. ARENS & J. LOEBBECKE, *supra* note 16, at 41-43. "Generally accepted accounting principles" are the rules, conventions, and procedures of financial reporting, as defined by the accounting profession's standard-setting body, currently the Financial Accounting Standards Board. See *id.* at 45 for further discussion of GAAP.

20 *See id.* at 43-45. For a discussion of the rare situations warranting disclaimer by the CPA, see *id.* at 649-50.

For an example of an unqualified opinion, see *infra* note 50. For a detailed discussion of the various types of auditors' reports, see A. ARENS & J. LOEBBECKE, *supra* note 16, at 643-63. For a thumbnail sketch of auditing procedures, see Fiflis, *Current Problems of Accountants' Responsibilities to Third Parties,* 28 VAND. L. REV. 31, 35-42 (1975).

21 Wiener, *supra* note 14, at 237.

22 Bloch, Inc. v. Klein, 45 Misc. 2d 1054, 1057, 258 N.Y.S.2d 501, 506 (N.Y. Sup. Ct. 1965) ("certified public accountant . . . must exercise the care and competence reasonably expected of persons in his profession"); Shahmoon v. General Dev. Corp., FED. SEC. L. REP. (CCH) ¶ 94308, at 95,039 (S.D.N.Y. 1973) (generally liability will not attach when audit conforms "with generally accepted accounting procedures as that term is understood by at least a majority of accounting experts"); *see infra* note 23.

23 Volz, *Accountant's Liability to Third Persons: Resistance in Negligence,* 9 BARRISTER 31, 33 (Fall 1982). *See generally* Adams, *Lessening the Legal Liability of Auditors,* 32 BUS. LAW. 1037, 1046-47 (1967) (fulfillment of professional standards generally suffices to show absence of negligence although the trend may be toward requiring more than mere technical competence); Fiflis, *supra* note 20, at 62-87 (professional standards are an important factor, but compliance may be insufficient to insulate accountants from liability for negligence); Solomon, *Ultramares Revisited: A Modern Study of Accountants' Liability to the Public,* 18 DE PAUL L. REV. 56, 58 (1968) (CPAs must act as a "reasonable CPA" would to avoid charges of negligence). Obviously, in

II
HISTORICAL BACKGROUND OF CPA LIABILITY TO THIRD PARTIES

A. The Doctrine of *Ultramares v. Touche*

The landmark opinion regarding CPA liability to third parties is the New York Court of Appeals decision in *Ultramares Corp. v. Touche, Niven & Co.*[24] In *Ultramares,* the plaintiff, a factoring corporation, made loans to Fred Stern & Company (Stern) in reliance on[25] Stern's balance sheet and the auditors' certificate[26] accompanying it. Although Stern was actually insolvent, one of the balance sheets Ultramares relied on indicated Stern's net worth as over $1,000,000. This overstatement of net worth occurred because a Stern employee had recorded fraudulent sales and accounts receivable in the company's accounting records. Ultramares, realizing that its loans to Stern were now uncollectible, sued Stern's independent auditors, Touche, Niven & Co. (Touche), for fraud and negligence.

Chief Judge Cardozo reversed the lower court's dismissal of the fraud claim and ordered a new trial on that claim. He denied the plaintiff recovery on the negligence claim, however, even though he found that the auditors were negligent and that they knew creditors such as Ultramares would rely on the certified balance sheets. Ultramares could not sue Touche for negligence, Cardozo reasoned, because it was not in privity with the CPA firm.[27] Cardozo noted that "[t]he assault upon the

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an audit, it is not reasonable to expect the CPA to examine and test every transaction a client company makes. This task would be insurmountable in most audit engagements due to the volume of companies' transactions each year. Therefore, the auditor must issue his audit report based on something less than a complete examination of every transaction. Due to this inherent limitation in the auditing process, "the auditor is not an insurer or a guarantor of the fairness of [financial statements] . . . ." A. ARENS & J. LOEBBECKE, *supra* note 16, at 18; *see also* Solomon, *supra,* at 89 ("It is clear that the CPA should not be made a guarantor of the absolute accuracy of the financial statements he certifies . . . .") (footnote omitted); *Rosenblum,* 93 N.J. at 344, 461 A.2d at 148 (auditor's review is subject to constraints beeause he is neither required to investigate every supporting document nor deemed to have the training of a criminal investigator).

24 255 N.Y. 170, 174 N.E. 441 (1931) (Cardozo, C.J.) (unanimous decision).

25 Indeed, receipt of Stern's certified balance sheet was a condition precedent to the loans by Ultramares. *Id.* at 175, 174 N.E. at 443.

26 The auditors' certificate in *Ultramares* stated that the balance sheet "presents a true and correct view of the financial condition" of Stern. *Id.* at 174, 174 N.E. at 442. Compare this language with the auditors' unqualified opinion in *Rosenblum, infra* note 50.

27 Cardozo wrote:

> Our holding does not emancipate accountants from the consequences of fraud. It does not relieve them if their audit has been so negligent as to justify a finding that they had no genuine belief in its adequacy, for this again is fraud. It does no more than say that, if less than this is proved, if there has been neither reckless misstatement nor insincere profession of an opinion, but only honest blunder, the ensuing liability for negligence is one that is bounded by the contract, and is to be enforced between the parties by whom the contract has been made. We doubt whether the average business man

citadel of privity is proceeding in these days apace"[28] and stated:

> If liability for negligence [to third parties] 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. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes [auditors] to these consequences.[29]

Courts[30] and legal commentators[31] have criticized the *Ultramares*

> receiving a certificate without paying for it, and receiving it merely as one among a multitude of possible investors, would look for anything more.

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

Compare Cardozo's conclusion regarding "honest blunders" in *Ultramares* with that reached by Dean Prosser. "An honest blunder . . . may absolve [the defendant] from moral blame, but the harm to others is still as great, and the actor's individual standards must give way to those of the public." W. PROSSER, HANDBOOK OF THE LAW OF TORTS 146 (4th ed. 1971) (footnote omitted).

One commentator believes that *Ultramares* did not limit a CPA's liability for negligence to those in privity. Rather, he postulates that the court in *Ultramares* held that a CPA can be sued for negligence by the "primary beneficiaries" of the audit, but that these beneficiaries are usually those in privity with the CPA. Regardless of the correct interpretation, the commentator notes that *Ultramares* is frequently cited by courts as limiting CPA liability to those with whom he is in privity. Fiflis, *supra* note 20, at 105.

It is intriguing to compare Cardozo's language in *Ultramares* with his language in the earlier landmark decision, MacPherson v. Buick Motor Co., 217 N.Y. 382, 111 N.E. 1050 (1916). In *MacPherson,* Cardozo allowed the purchaser of a defective automobile to recover from the manufacturer despite the lack of privity, reasoning that:

> The contractor who builds the scaffold invites the owner's workmen to use it. The manufacturer who sells the automobile to the retail dealer invites the dealer's customers to use it. The invitation is addressed in the one case to determinate persons and in the other to an indeterminate class, but in each case it is equally plain, and in each its consequences must be the same.
>
> There is nothing anomalous in a rule which imposes upon A., who has contracted with B., a duty to C. and D. and others according *as he knows or does not know that the subject-matter of the contract is intended for their use.*

Id. at 393, 111 N.E. at 1054 (emphasis added).

In explaining the contradiction between *Ultramares* and *MacPherson,* one commentator hypothesizes that Cardozo believed that the plaintiffs in *Ultramares* would surely succeed against the auditors on the fraud claim, so he found it unnecessary to fashion a rule that would permit them recovery on the alternative theory of negligence. Solomon, *supra* note 23, at 72. Cardozo himself suggested an obvious, if illogical, distinction between the two approaches. He believed that financial loss incurred through reliance on negligently published words need not give rise to the same liability as an act or omission setting in motion a physical force causing personal injury. *Ultramares,* 255 N.Y. at 181, 174 N.E. at 445.

28 *Ultramares,* 255 N.Y. at 180, 174 N.E. at 445.

29 *Id.* at 179-80, 174 N.E. at 444.

30 *See, e.g.,* Rusch Factors, Inc. v. Levin, 284 F. Supp. 85, 90-91 (D.R.I. 1968) (*Ultramares* decision is an "unwarranted inroad" upon established use of foreseeability as defining the scope of one's duty to others); Aluma Kraft Mfg. Co. v. Elmer Fox & Co., 493 S.W.2d 378, 383 (Mo. Ct. App. 1973) ("[R]ejection of the requirement of the strict rule of privity in this case comports with the concepts of the functions and duties of the modern public accountant . . . .").

31 *See, e.g.,* Besser, *Privity?—An Obsolete Approach to the Liability of Accountants to Third Parties,* 7 SETON HALL L. REV. 507, 541-42 (1976) (accountants' duty should expand to corre-

doctrine for unreasonably insulating negligent CPAs from liability to injured third parties. *Ultramares* remains the law in a minority of jurisdictions today,[32] however, because some courts still fear that any other standard would lead to almost unlimited liability for CPAs.[33]

B. The Erosion of the Doctrine of *Ultramares v. Touche*

A majority of courts soon became dissatisfied with the restrictive *Ultramares* doctrine and abandoned it. These courts replaced the *Ultramares* doctrine with the rule of the *Restatement (Second) of Torts*.[34] The *Restatement* provides that negligent CPAs are liable to individually known or intended third party users of financial statements, and to third parties who are not individually known or intended but are members of a known or intended *class* of users of financial statements.[35] For there to be a "known or intended" third party or class of third parties, however, the CPA must be explicitly informed[36] that the third party or class of

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spond to their expanded functions); Fiflis, *supra* note 20, at 107 (*Ultramares* obsolete because of current public service status of accountants); Solomon, *supra* note 23, at 73 (arguing that Cardozo was imprecise when he asserted that services rendered by public accountants are primarily for benefit of client and that they are "public" only in sense that they offer their services to anyone who chooses to employ them); Wiener, *supra* note 14, at 249-53 (privity requirement does not account for important function CPAs fulfill in economy); Note, *Accountants' Liability for Negligence—A Contemporary Approach for a Modern Profession,* 48 FORDHAM L. REV. 401 (1979) [hereinafter cited as *Accountants' Liability*] (privity shield is no longer appropriate because audits are more sophisticated and policy goals of products liability laws are similar to those for accountants' liability laws); Note, *Public Accountants and Attorneys: Negligence and the Third Party,* 47 NOTRE DAME LAW. 588, 604-07 (1972) (discussing policy reasons for extension of liability).

32 See *supra* note 9 and accompanying text for a sampling of these jurisdictions.

33 Stephens Indus. v. Haskins & Sells, 438 F.2d 357 (10th Cir. 1971) (applying Colorado law) (accountants not liable for negligence to third party absent privity); Investment Corp. of Fla. v. Buchman, 208 So. 2d 291 (Fla. App.), *cert. dismissed,* 216 So. 2d 748 (Fla. 1968); *see supra* note 9 (citing other cases). "When the harm . . . caused [by negligent auditing] is only pecuniary loss, the courts have found it necessary to adopt a more restricted rule of liability [i.e., the *Ultramares* rule], because of the extent to which misinformation may be . . . circulated, and the maguitude of the losses which may follow from reliance upon it." RESTATEMENT (SECOND) OF TORTS § 552 comment a (1977).

34 See *supra* note 11 and accompanying text for a sampling of these jurisdictions.

35 The relevant *Restatement (Second)* position reads in part as follows:

> Information Negligently Supplied for the Guidance of Others
>
> (1) One who, in the course of his . . . profession . . . 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 of competence in obtaining or communicating the information.
>
> (2) [T]he liability stated in Subsection (1) is limited to loss suffered
>
> (a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it . . . .

RESTATEMENT (SECOND) OF TORTS § 552 (1977).

36 Neither the *Restatement (Second)* nor the courts have addressed the issue of whether only the client can inform the CPA of the existence of a contemplated third party user of the financial statements, or whether it is sufficient that the third party alone inform the CPA that

third parties will use the client's audited financial statements. For example, where a CPA's client expressly informs the auditor, before the audit is completed, that he will be using the statements to negotiate a bank loan, the CPA is liable to a bank that detrimentally relies on negligently audited financial statements in extending credit to the CPA's client, because the bank is a member of a "known or intended" class of third parties.[37] The *Restatement (Second)* requires that the client specifically inform the auditor of third parties that intend to use the financial statements even if the auditor "*knows* that the financial statements . . . are *customarily used* in a wide variety of financial transactions by the corporation *and that they may be relied upon* by lenders, investors, shareholders, creditors, [and] purchasers . . . in numerous possible kinds of transactions."[38]

Therefore, despite the role of the auditor in ensuring the availability of reliable information in today's economy,[39] and despite the typical uses made of audited financial statements,[40] almost all third party users of financial statements are precluded from suing negligent CPAs at common law. In most cases, stockholders, creditors, and other third parties are merely "reasonably foreseeable" third parties, not "known or intended" ones,[41] and they, therefore, remain unprotected by the *Restatement (Second)* or by *Ultramares.*

This was the status of the law of accountants' liability for negligence to third parties in 1983, when the New Jersey Supreme Court was confronted with the case of *Rosenblum, Inc. v. Adler.*

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it will be receiving the financial statements from the client. Although the *Restatement (Second)* does not explicitly address this issue, the illustrations set forth in the comment to § 552 all have the client informing the CPA.

37 *See* RESTATEMENT (SECOND) OF TORTS § 552 illustration 7 (1977).

38 *See id.* § 552 illustration 10 (emphasis added).

39 *See supra* note 16 and accompanying text.

40 "It is now well recognized that the audited statements are made for the use of third parties who have no contractual relationship with the auditor. Moreover, it is common knowledge that companies use audits for many proper business purposes [involving third parties]." *Rosenblum,* 93 N.J. at 345, 461 A.2d at 149. *See also* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 218 (1976) (dissenting opinion) ("The critical importance of the auditing accountant's role . . . cannot be overestimated . . . . [T]he accountant's duty 'is to safeguard the public interest, not that of his client.' ") (quoting *In re* Touche, Niven, Bailey & Smart, 37 S.E.C. 629, 670-71 (1957)); Solomon, *supra* note 23, at 74 ("[T]o 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."). For an argument that even under *Ultramares* it is possible that CPAs are liable to third parties for negligence, if third parties are the "primary beneficiaries" of an auditor's examination, see Fifiis, *supra* note 20, at 105.

41 For example, as one court pointed out, the plaintiff factoring corporation in *Ultramares* was a third party that was "not actually foreseen but only foreseeable." Rusch Factors, Inc. v. Levin, 284 F. Supp. 85, 91 (D.R.I. 1968).

III
THE CASE

Harry and Barry Rosenblum executed an agreement on March 9, 1972, to sell their retail catalog businesses to Giant Department Stores (Giant), a publicly held corporation that owned and operated discount department stores, art and gift shops, and retail catalog showrooms.[42] In exchange for their businesses, the Rosenblums received Giant common stock.[43]

Approximately one year after the Rosenblums received their stock, it was discovered that Giant's management had fraudulently prepared the company's financial statements for fiscal years 1971 and 1972.[44] Management had manipulated Giant's accounts by recording assets not owned and by failing to record liabilities incurred, thereby inflating the company's net worth.[45] The American Stock Exchange immediately suspended trading in Giant's stock and trading never resumed.[46] By the time Giant filed for bankruptcy in September of 1973, the stock of Giant held by Harry and Barry Rosenblum had become worthless.[47]

Touche Ross & Co. (Touche), a prominent accounting firm,[48] had been Giant's independent auditor since the company became publicly held in 1969.[49] More recently, Touche had audited Giant's fiscal year 1971 and 1972 financial statements and had issued unqualified opinions[50] as to both years' statements. Touche's audits did not uncover the

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42 *Rosenblum,* 93 N.J. at 329-30, 461 A.2d at 140-41.

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

44 *Id.*

45 *Id.*

46 *Id.*

47 *Id.*

48 Touche Ross & Co. is one of the nation's "Big Eight" CPA firms. *See infra* note 93. Coincidently, Touche Ross & Co. was formerly Touchc, Niven & Co., the auditor involved in *Ultramares. See supra* notes 24-33 and accompanying text.

49 *Rosenblum,* 93 N.J. at 329-30, 461 A.2d at 140.

50 *See supra* notes 19-20 and accompanying text. The relevant portion of the opinion issued by Touche Ross in connection with the 1972 audit of Giant Stores reads:

> We have examined the accompanying consolidated balance sheet of Giant Stores Corp. and wholly-owned subsidiaries as of January 29, 1972 and January 30, 1971, and the related statements of earnings, stockholders' equity and changes in financial position for the years (52 weeks) then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.
>
> In our opinion, the consolidated financial statements referred to above present fairly the financial position of Giant Stores Corp. and wholly-owned subsidiaries at January 29, 1972 and January 30, 1971, the results of their operations and changes in the financial position for the years (52 weeks) thcn ended, in conformity with generally accepted accounting principles applied on a consistent basis.

GIANT STORES CORPORATION, 1972 ANNUAL REPORT 19 (1972). A similar opinion was issued for the 1971 audit. *See Rosenblum,* 93 N.J. at 330, 461 A.2d at 141.

management fraud at Giant.[51]

The Rosenblums sued Touche[52] for the fiscal year 1971 and 1972 audits, charging the accounting firm with fraudulent misrepresentation, gross negligence, negligence, and breach of warranty for each audit.[53] The Rosenblums further alleged that Touche's misconduct was the proximate cause of their financial loss because they relied on Giant's audited statements in their merger dealings with Giant.

At trial, Touche moved to dismiss the negligence claim for the fiscal 1971 audit, and the court granted that motion. Touche also moved to dismiss the negligence, gross negligence, and fraudulent misrepresentation claims for the fiscal 1972 audit, but the court denied that motion.[54] The New Jersey Superior Court affirmed both trial court rulings,[55] and Touche and the Rosenblums appealed. The New Jersey Supreme Court reversed the dismissal of the negligence claim for the 1971 audit and affirmed the denial of summary judgment for Touche for the 1972 audit.[56] The supreme court held that when an independent auditor issues an opinion concerning certain financial statements and does not limit the dissemination of the attached financial statements, he has a legal duty to all reasonably foreseeable[57] third parties who rely on the statements received from the company for "a proper business purpose."[58] The court rejected the limitations on accountants' third party liability imposed by *Ultramares*[59] and the *Restatement (Second)*[60] because " '[t]he accountant, the investor and the general public will in the long run ben-

51 Of course, it is not normally the auditor's duty to detect fraud. "An examination made in accordance with generally accepted auditing standards cannot be expected to provide assurance that illegal [client] acts will be detected." 1 AICPA, *supra* note 17, AU § 328.03 (footnote omitted). "Nonetheless, the independent auditor should be expected to detect illegal or improper acts that would be uncovered in the exercise of normal professional skill and care." *Rosenblum,* 93 N.J. at 344, 461 A.2d at 148.

52 The Rosenblums sued Jack F. Adler and 426 others, individually and as partners trading as Touche Ross & Co., severally, and in the alternative. *Rosenblum,* 93 N.J. at 324, 461 A.2d at 138.

53 *Id.* at 332, 461 A.2d at 141.

54 *Id.* at 332, 461 A.2d at 141-42.

55 Rosenblum, Inc. v. Adler, 183 N.J. Super. 417, 444 A.2d 66 (N.J. Super. Ct. App. Div. 1982). The lower courts dismissed the claims regarding the 1971 audit because that audit was completed on April 16, 1971, and Giant's merger discussions with the Rosenblums did not begin until September 1971. Because the accountants did not know of the plaintiffs when they prepared the 1971 audit report, the lower courts held that the accountants could not be liable to the plaintiffs under either *Ultramares* or the *Restatement (Second) of Torts. Rosenblum,* 93 N.J. at 353, 461 A.2d at 153-54.

The lower courts did not dismiss the claims regarding the 1972 audit; that audit was not finished until after Giant and the Rosenblums started their merger discussions. *Id.* at 356-57, 461 A.2d at 155.

56 *Rosenblum,* 93 N.J. 324, 461 A.2d 138 (1983).

57 *See supra* note 4.

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

59 *See supra* notes 24-33 and accompanying text.

60 *See supra* notes 34-41 and accompanying text.

efit when the liability of the certified public accountant for negligent misrepresentation is measured by the foreseeability standard.' "[61]

The *Rosenblum* court based its decision primarily on three public policy reasons: least-cost avoidance, cost-spreading, and fairness.[62] First, the court implied that the CPA is in a better position than the third party to avoid the costs resulting from negligently performed audits and the circulation of misleading financial information to the business community. Were CPAs to "engage in more thorough reviews," they could "reduce the number of instances" of negligence.[63] Second, the court noted that large CPA firms have or can obtain extensive malpractice insurance coverage and can effectively spread the cost of those premiums, as well as the cost of more extensive auditing review, to a large group of people.[64] The New Jersey Supreme Court concluded that, because of this ability to pass along some of the increased auditing or insurance costs to others, CPAs would not be financially doomed by the additional liability they would shoulder under the *Rosenblum* rule.[65]

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[61] *Rosenblum,* 93 N.J. at 352, 461 A.2d at 153 (quoting Wiener *supra* note 14, at 260).

[62] It was necessary for the court to resort to public policy considerations because of the lack of specific precedent in the United States for such a holding. *See supra* note 2 and accompanying text. The *Rosenblum* decision was not, however, completely without precedent. The expansion of CPA liability to reasonably foreseeable third parties was in accord with developing principles of general negligence law. "The shift on the whole [in tort law] has been heavily toward the side of the plaintiff, with expanded liability in nearly every area." W. PROSSER, *supra* note 27, at XI. Indeed, "the conclusion may well be drawn that [foreseeability] is on its way to ultimate victory as the criterion of what is 'proximate,' if it has not already achieved it." *Id.* at 267.

Further, there was dictum in earlier American cases suggesting the expansion of CPA liability undertaken by the *Rosenblum* court. *See* Rusch Factors, Inc. v. Levin, 284 F. Supp. 85, 91-93 (D.R.I. 1968) (distinguishing and criticizing *Ultramares*; suggesting that accountants ought to bear the full cost of their negligence for efficiency and fairness reasons); Aluma Kraft Mfg. Co. v. Elmer Fox & Co., 493 S.W.2d 378, 381-83 (Mo. Ct. App. 1973) (criticizing the *Ultramares* holding and dispensing with strict rule of privity).

[63] *Rosenblum,* 93 N.J. at 350, 461 A.2d at 152; *see also id.* at 347, 461 A.2d at 150 (accountant's function " 'can eliminate the necessity for costly separate investigations by each party at interest' ") (quoting *In re* Touche, Niven, Bailey & Smart, 37 S.E.C. 629, 671 (1957)).

The belief that tort liability should be imposed on the party who can most easily avoid the cost associated with negligent conduct is a dominant theme in tort literature. *See generally* G. CALABRESI, THE COSTS OF ACCIDENTS 312 (1970) (recommending new system of accident law that, inter alia, "begin[s] by allocating accident costs to those categories that can avoid accidents most cheaply").

[64] *Rosenblum,* 93 N.J. at 350, 461 A.2d at 152 ("Much of the additional costs incurred [by CPAs] either because of more thorough auditing review or increased [CPA malpractice] insurance premiums would be borne by the business entity [being audited] and its stockholders or its customers.").

[65] The court found the reasonableness of this concern to be "questionable." *Id.* at 349, 461 A.2d at 151. "We have no reason to believe that [CPAs] may not purchase malpractice insurance policies that cover [these] negligent acts . . . ." *Id.* In a footnote, the New Jersey court noted that CPAs have obtained insurance to cover their potential liabilities under the federal securities laws, which impose liability similar to that of *Rosenblum.* *Id.* at 349 n.11, 461 A.2d at 151 n.11. See *supra* note 3 for a discussion of CPAs' liability under the federal securities laws. In the same footnote, the court stated that "[a]t oral argument defendants contended that the cost of insurance to cover the claims of all foreseeable users of audits would be

Last, the court believed that, as a matter of fairness, negligent CPAs should have a duty to and be liable for damages incurred by certain innocent, reliant third parties.[66]

In assessing the impact that its opinion would have on the accounting profession, the *Rosenblum* court noted that "[t]he extent of financial exposure has certain built-in limits."[67] First, the court stated that the plaintiff suing the negligent CPA must receive the erroneous financial statements "from the company pursuant to a proper company purpose."[68] The court said that "an institutional investor or portfolio manager who does not obtain audited [financial] statements *from the company* would not come within the stated principle. . . . Those and similar cases beyond the stated rule are not before us and we express no opinion with respect to such situations."[69] Second, the court stated that in making the business decision that ultimately results in economic loss, the plaintiff must reasonably rely on the financial statements.[70] Third, the court emphasized that the misstatement contained in the financial statements must be due to the auditor's negligence and that the misstatement must be the proximate cause of the plaintiff's injury.[71] Next, the court pointed out that the negligence, if any, of the injured plaintiff could bar recovery or limit the amount ultimately recoverable from the negligent CPA.[72] Last, the court asserted that auditing firms may be able to seek indemnification or contribution from their client company or the company's blameworthy officers or employees in those instances where both the negligence of the CPA and of the client company contributed to the misstatement of the financial statements and to the plaintiff's resultant loss.[73]

In concluding, the court remarked that "[c]ertified financial statements have become the benchmark for various reasonably foreseeable business purposes and accountants have been engaged to satisfy those ends. . . . [A]ccounting firms [can] no longer . . . avoid liability for their malpractice. The public interest will be served by the rule we promulgate this day."[74]

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catastrophic. Suffice it to say that defendants have not alerted us to data either within or outside the record to support this position." *Id.* at 350 n.11, 461 A.2d at 152 n.11.

66 *Rosenblum,* 93 N.J. at 351, 461 A.2d at 153. In formulating an expanded scope of duty for accountants to third parties, the court said that " '[w]hether a *duty* exists is ultimately a question of fairness.' " *Id.* at 341, 461 A.2d at 147 (quoting Goldberg v. Housing Auth., 38 N.J. 578, 583, 186 A.2d 291, 293 (1962) (emphasis in original)).

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

68 *Id.*

69 *Id.* at 352-53, 461 A.2d at 153 (emphasis added).

70 *Id.* at 350, 461 A.2d at 152.

71 *Id.*

72 *Id.* at 350-51, 461 A.2d at 152.

73 *Id.* at 351, 461 A.2d at 152.

74 *Id.* at 353, 461 A.2d at 153.

IV
ANALYSIS

A. Policy Reasons for Expanding CPA Liability to Reasonably Foreseeable Third Parties

The three policy reasons for expanding CPA liability to the limits of foreseeability (least-cost avoidance, cost-spreading, and fairness) are not as persuasive as the New Jersey Supreme Court suggests. On balance, however, they do justify the extension of CPA liability formulated by the court.

1. *Least-Cost Avoidance*

The court is correct in implying that, as between CPAs and reasonably foreseeable third parties, CPAs can most cheaply avoid the costs of negligently audited financial statements. CPAs are intimately involved in their client's annual audits and can avoid the costs associated with negligent audits simply by performing higher quality audits.[75] Investors, creditors, and other third parties cannot directly affect the accuracy of another's published financial statements by altering their conduct or behavior. Two arguments can be made, however, that third parties do have means available to protect themselves against negligently audited and materially misleading financial statements. Nevertheless, these arguments are not persuasive in the face of *Rosenblum*'s "least cost avoidance" rationale.

The first argument is based on the so-called "efficient market" theory of investment. One assumption of this theory is that all investors have perfect and complete information with which to make their investment decisions.[76] Based on this assumption, proponents of the efficient market theory, then, may hypothesize that investors are aware that fi-

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75 *See* Besser, *supra* note 31, at 533 ("By adhering generally to the standards of the profession, an accountant will minimize the risk of loss to any possible plaintiff."). Further, by extending CPA liability to reasonably foreseeable third parties, negligent auditing is made more expensive and less attractive to CPAs. *See generally* G. CALABRESI, *supra* note 63, at 73-75 (deterrence, through expanded liability, "reduces accident costs [by] . . . encourag[ing] us to make activities safer"). This creates a strong financial incentive for CPAs to perform more competent examinations of financial statements and to reduce the incidence of negligence.

76 *See* T. DYCKMAN, D. DOWNES & R. MAGEE, EFFICIENT CAPITAL MARKETS AND ACCOUNTING: A CRITICAL ANALYSIS 4-5 (1975) (efficient market theory asserts that securities prices reflect all available information about the issue); *see also* W. SHARPE, INVESTMENTS 97 (1978) ("The market is assumed to be efficient," and "[e]very investor is assumed to have the same information [available to him]."); Winter, *State Law, Shareholder Protection, and the Theory of the Corporation,* 6 J. LEGAL STUD. 251, 257 (1977) ("[R]elatively obscure—even confidential—information is transmitted extremely swiftly and almost automatically affects share price.") (citing J. LORIE & M. HAMILTON, THE STOCK MARKET 70-97 (1973)). *But see* M. FIRTH, THE VALUATION OF SHARES AND THE EFFICIENT-MARKETS THEORY 105-16 (1977) (recognizing that no stock market is perfectly efficient because not all information is available and because even if available such information may not be interpreted properly). For more about the efficient market theory, see W. SHARPE, *supra,* at 23-24, 96-98.

nancial statements may be materially misleading and that investors know that they cannot generally recover their losses from negligent CPAs.[77] Therefore, it is argued that these knowledgable investors account for the risk of such unreimbursable losses by paying a lower price for stocks or securities.

If the efficient market theory is correct, investors can partially protect themselves from potential losses due to auditor negligence by appropriately discounting the price they pay for stocks and securities.[78] This theory, however, does not undercut the "least-cost avoidance" rationale of *Rosenblum*; CPAs, experts at auditing, are still in the most efficient position to ensure that audits are not negligently performed and that financial statements are not materially misleading. The argument that CPAs should not be liable for their negligence because some third parties already may account for this risk by discounting the securities prices they pay "is inconsistent with the general social policy . . . that risk of loss should be imposed on the party best able to prevent its occurence."[79]

The second criticism of *Rosenblum*'s "least cost avoidance" rationale is the argument that third parties who expect to rely on audited financial statements for a transaction can protect themselves from losses due to negligently audited and materially misstated financial statements by asking that the client company have its CPAs issue a representation directly to the third party stating that the financial statements are accurate. This representation would be similar to the "comfort letters" CPAs issue to underwriters in large securities transactions.[80] Thus, under the *Restatement (Second)* standard,[81] accountants would be liable for negligent auditing to these third parties because they would be specifically "known or intended" third parties. Recourse against negligent CPAs would still be unavailable, however, in jurisdictions requiring

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77 *See* Winter, *supra* note 76, at 257 ("That the impact of a legal system on investors [is] known only to law professors . . . seems a rather tenuous proposition.").

78 Presumably, creditors could likewise protect themselves by charging higher interest rates.

79 Wiener, *supra* note 14, at 253 (footnote omitted). An additional weakness of the efficient market theory as a means of protecting investors is that it is based on the concept of the sophisticated investor. Not all investors, however, are institutions knowledgable enough to protect themselves adequately against accountants' negligence. *See id.* It would be anomalous to argue that "the small [investor] in the stock market should be permitted recovery [against CPAs], but on identical facts, the institutional investor [should] be denied that right." *Id.* Indeed, "[a] rule of liability should not fluctuate depending upon the characterization of the plaintiff and the frequency, size or type of his investment. These considerations are better left to the broader concern of whether contributory or comparative negligence should bar or limit a plaintiff's recovery." *Id.* For a discussion of plaintiff's contributory or comparative negligence, see *infra* notes 125-32 and accompanying text.

80 *See generally* L. RAPPAPORT, SEC ACCOUNTING PRACTICE & PROCEDURE 10.25-10.33 (2d ed. 1966) (discussing comfort letters).

81 *See supra* notes 34-41 and accompanying text.

privity, regardless of the representation.[82]

This possibility for third party protection similarly fails to undercut the "least-cost avoidance" rationale of *Rosenblum.* Even if some third parties do have the foresight and ability to obtain comfort letters from the CPA, the CPA is still the party best able to avoid negligent auditing and its resultant costs.[83]

2. *Cost-Spreading*

CPAs, especially large CPA firms, carry extensive malpractice insurance.[84] The expansion of CPA liability to reasonably foreseeable third parties will increase the cost of that insurance for auditors.[85] The costs of conducting an audit will also rise as CPAs perform more detailed and expansive examinations of their clients' financial statements in an effort to reduce the incidence of negligence.[86] As the *Rosenblum* court suggests, these initial increased costs will not fall completely on the accounting firms themselves, but will be spread to the clients of the firms.[87]

The degree to which CPAs can pass these increased costs on to their clients depends on the elasticity of demand[88] for and supply[89] of CPAs' auditing services. To the extent that such demand and supply are relatively inelastic, much of the increased costs of insurance and additional auditing can be passed on. To the extent that such demand and supply

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82 *See supra* notes 24-33 and accompanying text.

83 *See supra* note 75 and accompanying text. There is an additional limitation on this procedure. In practice, this type of representation is issued only in conjunction with large transactions, *see* L. RAPPAPORT, *supra* note 80, at 10.25-10.33, so the potential protection is available only to a few large investors, not the myriad of small investors. As stated earlier, a rule of liability should not depend on whether an investor is large or small. These concerns are more properly viewed in conjunction with the plaintiff's potential contributory or comparative negligence. *See* Wiener, *supra* note 14, at 253. For a discussion of plaintiffs' contributory or comparative negligence, see *infra* notes 125-32 and accompanying text.

84 For a discussion of CPA malpractice insurance, see Comment, *Auditors' Third Party Liability: An Ill-Considered Extension of the Law,* 46 WASH. L. REV. 675, 682-85 (1971).

85 *See generally id.* at 683-85 (noting changes in price and availability of insurance coverage).

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

87 *Id.*

88 The elasticity of demand indicates the extent to which a percentage change in the price of a good or service results in a percentage change in the quantity demanded of that good or service. Generally, as the price of a good or service increases, the demand for that good or service decreases. If a small change in price results in a large change in demand, demand is relatively "elastic." If a large change in price results in a small change in demand, demand is relatively "inelastic." *See* P. SAMUELSON, ECONOMICS 380-81 (9th ed. 1973).

89 The elasticity of supply indicates the extent to which a percentage change in the price of a good or service results in a percentage change in the quantity supplied of that good or service. Generally, as the price of a good or service increases, the supply of that good or service increases. If a small change in price results in a large change in supply, supply is relatively "elastic." If a large change in price results in a small change in supply, supply is relatively "inelastic." *See id.* at 384.

are relatively elastic, however, CPAs will have to bear much of the increased costs of insurance and additional auditing themselves.[90]

Among large publicly held companies,[91] the demand for CPA audit services is inelastic because those companies are required by law to have annual independent audits of their financial statements.[92] The supply of CPA firms with the expertise and resources to perform audits of that size and complexity is also relatively inelastic.[93] Therefore, most, if not

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90 *See* R. POSNER, ECONOMIC ANALYSIS OF LAW 235 n.4 (2d ed. 1977) ("The amount of passing on [of the increased costs of doing business] depends on the elasticity of demand. The more elastic the demand, the less . . . will be passed on . . . ."). For an introductory discussion of the concepts of supply, demand, and market elasticity, see R. LIPSEY & P. STEINER, MICROECONOMICS 53-68 (5th ed. 1979); R. POSNER, *supra,* at 196-97; P. SAMUELSON, *supra* note 88, at 379-88.

91 This Note focuses on these large publicly held companies because auditing their financial statements poses the greatest financial risk to negligent CPAs, due to the potential number of third parties transacting business with the company and the size and frequency of these transactions.

The analysis of cost passing between the CPA and the client corporation developed in the text above is generally inapplicable where the client is a small, privately held corporation. The number of CPA firms capable of auditing companies of this size is much larger than the number of CPA firms capable of auditing large, publicly held corporations. *Cf. infra* note 93 and accompanying text (discussing domination of business of auditing large publicly held companies by "Big Eight" accounting firms). Therefore, the supply of CPAs in this market is not inelastic. Further, these small companies are not subject to the federal securities laws, *see infra* text accompanying note 92, and may not need an audit of their financial statements, except, for example, to comply with bank loan agreements. In other words, the demand for audits among many small companies is not inelastic either.

In light of this relative elasticity of the demand for and the supply of audit services among small privately held corporations, the result of the *Rosenblum* decision for these small corporations and the CPA firms that audit them is two-fold. First, for some small clients, CPA audits are a business necessity. Because of the inelasticity of this demand, CPAs will be able to pass on some of their initial increases in insurance costs and auditing costs to these small companies. They will not, however, be able to pass on these costs to the same extent large firms will be able to pass on costs to their publicly held clients because the supply of small CPA firms is not as inelastic as the supply of large CPA firms. *See infra* note 93. Second, clients that do not require audits but have them performed for management purposes nonetheless may decide to cancel these voluntary audits if CPAs increase their fees. In the alternative, these companies may subsitute audits with "reviews" or "compilations" of their financial statements. These two special CPA services require less work and therefore cost less than a complete audit, but provide less assurance that the financial statements are accurate. Therefore, it appears that, in practice, the *Rosenblum* rule will have more of an adverse financial impact on small and medium sized CPA firms than on large firms.

For a brief discussion of reviews and compilations, see A. ARENS & J. LOEBBECKE, AUDITING: AN INTEGRATED APPROACH 742-50 (2d ed. 1980); Comment, *Accountants' Liability for Compilation and Review Engagements,* 60 TEX. L. REV. 759 (1982).

92 *See Rosenblum,* 93 N.J. at 345 n.9, 461 A.2d at 149 n.9.

93 Eight large international accounting firms dominate the business of auditing large publicly held companies. These CPA firms, commonly known as the "Big Eight," are, in alphabetical order: Arthur Andersen & Co.; Arthur Young & Co.; Coopers & Lybrand; Deloitte Haskins & Sells; Ernst & Whinney; Peat, Marwick, Mitchell & Co.; Price Waterhouse & Co.; and Touche Ross & Co. M. STEVENS, THE BIG EIGHT 2 (1981). These eight firms together employ over 150,000 people in 2,500 offices throughout the world. *Id.* at 8. "[C]lients of the Big Eight account for 94 percent of all sales, 94 percent of all profits, 90 percent of all income taxes paid, 94 percent of all people employed, and 94 percent of all

all, of the initial increase in CPA malpractice insurance premiums and the cost of augmented auditing will be passed from the CPA to the client through higher audit fees, as the New Jersey court predicts.[94]

Although CPAs will pass the initial increased costs of malpractice insurance and augmented auditing procedures on to their clients, it is not clear how CPAs will apportion these costs among those clients. One possibility is that all audit fees for all clients will increase by a fixed percent. A more likely outcome is that audit fees will vary with the degree of risk a client poses of exposing CPAs to liability for negligent auditing. Clients with unreliable systems of internal control,[95] incompetent accounting and financial personnel,[96] and management likely to be engaged in fraud[97] are examples of clients posing great risk to CPAs.

Significant fee increases for these clients will be the result of two factors. First, to the extent that CPAs will be passing on their increased malpractice insurance costs, these clients represent the highest insurance risks, because they are the clients most likely to have materially misstated their financial statements. Second, to the extent that CPAs will be augmenting the scope of their audit work to reduce the incidence of negligent auditing, these clients will require the most extensive increase in auditing procedures because of the weakness of their internal accounting systems, accounting and financial personnel, and management.[98]

Faced with increased CPA audit fees, these risky client companies will either (1) improve their internal accounting systems, personnel, or management so that they require less extensive outside auditing, (2) undergo more extensive auditing and pay the increased audit fee, or (3) forego the independent audit and exit the public capital market.[99] All three alternatives improve the financial information available in the marketplace. The first two alternatives result in better prepared, more

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assets owned by New York Stock Exchange members." *Id. See also* J. SCHWARTZ, CORPORATE POLICY: A CASEBOOK 216 (1978) ("The need for credibility and the large staffs necessary to audit a major corporation have been the primary factors in the development of a high degree of concentration in the [accounting] profession.").

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

95 For a discussion of internal control, see A. ARENS & J. LOEBBECKE, *supra* note 16, at 20 & 97.

96 *See id.* at 161 (auditor must ascertain client's system of internal control; quality of personnel will in part determine depth and breadth of audit).

97 *See id.* at 19-20, 89 & 102 (as part of auditor's examination of client's system of internal control, auditor should account for client's integrity or lack thereof).

98 For a discussion of other factors that affect the nature, timing, and extent of audit procedures, see generally *id.* at 88-109. It is also noteworthy that the typical unqualified auditor's opinion states that the CPA performed "such tests of the accounting records and such other auditing procedures as [he] considered necessary *in the circumstances.*" *See supra* note 50 (emphasis added).

99 *See supra* text accompanying note 92 (discussing annual audit requirement for public held corporations).

accurate financial statements, and the last alternative removes less accurate, potentially deceptive financial statements from the capital markets. Further, because of their inside knowledge of companies' accounting systems, CPAs are generally in a better position than third parties to identify risky companies. Therefore, CPAs will not only pass on the initial increased costs of malpractice insurance and additional auditing to their clients, as the New Jersey court expects. They will also pass on that cost in an economically efficient way to those clients most likely to materially misstate their financial statements.

Once the CPA passes on his increased insurance and auditing costs to the client via higher audit fees, the extent to which a client company can in turn pass the increased audit fee on to its customers or stockholders depends on the elasticity of demand for and supply of its goods or services.[100] If demand and supply are relatively inelastic, the company will pass on much of the increased audit fee to its customers through higher priced products or services. If demand and supply are relatively elastic, the company will absorb much of the increased audit fee and indirectly pass the expense on to its stockholders through lower corporate earnings, dividends, and stock prices.[101]

The demand and supply for most client-produced goods or services vary greatly, but seldom are demand and supply perfectly elastic or perfectly inelastic.[102] Consequently, part of the increased audit fee will probably be passed on to the client's customers, and part will be passed on to its stockholders. Ultimately, the initial increase in CPA malpractice insurance premiums and the cost of augmented auditing procedures, resulting from an expanded law of accountants' liability, will be spread over a large group of people, as the *Rosenblum* court forecasts.[103] Such a result is socially beneficial because it prevents the financial demise of the accounting profession and the concomitant loss of the valuable independent auditing function from the public markets.

Although CPAs will be able to pass along the initial increase in malpractice premiums resulting from the *Rosenblum* rule to their clients, they will still have a significant incentive to perform high quality, non-negligent audits. Malpractice insurance premiums are based on loss experience; the greater the frequency and size of an insured's losses, the higher the insurance premiums and the more difficult it is to obtain insurance.[104] Therefore, a negligent CPA's insurance will cost more than that of a less negligent CPA. To effectively compete with the less

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100 *See supra* notes 88 & 89 and accompanying text (discussing elasticity).

101 *See supra* note 90 and accompanying text.

102 For a sample of actual demand elasticities for certain goods, see R. LIPSEY & P. STEINER, *supra* note 90, at 130-34.

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

104 *See generally* Comment, *supra* note 84.

negligent CPA, the negligent auditor will have to absorb the extra cost of his malpractice insurance, thus lowering his profit. The negligent auditor will not be able to pass this noninitial increase in premiums along to his client. If he attempts to do so, the client will simply hire the less negligent CPA who, because of his lower insurance costs, will be able to perform the same audit at a price lower than the negligent CPA. Thus, there will still be a powerful financial incentive for CPAs to avoid performing negligent audits.

Despite the ability to pass on most, if not all, of the initial increased cost of insurance to others, CPAs violently object to extending their liability at common law for negligence to reasonably foreseeable third party users of financial statements. CPAs claim that their insurance premiums will skyrocket if they are liable to this new class of potential plaintiffs.[105] This concern is overstated because, as noted above, CPAs will actually bear little, if any, of the initial increase in malpractice insurance costs.[106] Until CPAs can convincingly demonstrate in court that a rule holding them liable to reasonably foreseeable third parties will result in their financial demise, courts should follow *Rosenblum* and hold CPAs liable to those plaintiffs.

3. *Fairness*

The court's belief that the negligent CPA rather than the innocent third party should shoulder the risk of loss due to a negligent audit and its attendant costs seems sensible on its face, especially because many third parties, as discussed earlier,[107] cannot effectively protect themselves from the risk of negligent auditing. In practice, however, innocent third parties will bear some of the costs of negligent audits because the increased audit fee resulting from the *Rosenblum* decision[108] will ultimately be passed on to them.[109]

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105 *See Rosenblum,* 93 N.J. at 348-49 & n.11, 461 A.2d at 151 & n.11; *see also* Comment, *supra* note 84, at 682-85 (extension of CPA liability to third parties is not prudent due to increased cost of malpractice insurance that would result from such potential liability).

106 The consensus among legal commentators is that CPAs' fears of financial doom due to third party liability are unjustified. *See* Besser, *supra* note 31, at 534-37 (arguing that insurance is available and that accountants can channel cost of insurance to their clients and ultimately to consuming public); Solomon, *supra* note 23, at 89 (noting that accountants will not have to verify each and every journal entry and that juries have been quite fair to defendant accountants); Wiener, *supra* note 14, at 252 (holding CPAs liable for their negligent auditing of financial statements injuring third party creditors or investors will not result in dire economic consequences); Note, *Public Accountants, supra* note 31, at 605-06 ("The extension of liability to the full limits of foreseeability will not spell the end of the accounting profession."). *But see* Comment, *supra* note 84 (forecasting elimination of many auditing firms from marketplace, unproductive increases in auditing costs, abandonment of risky clients, and deleterious effects on economy's credit system if accountants' liability is expanded).

107 *See supra* notes 79-83.

108 *See supra* text accompanying notes 85-86.

109 *See supra* notes 102-03 and accompanying text.

The apparent inequity in this result may disappear if the increased fees are viewed as a means available to third parties investing in or loaning money to the audited company of insuring themselves and each other against losses they may incur if they should become victims of a negligent audit. The same argument, however, cannot be made with respect to innocent consumers of the audited company's goods or services. These consumers will pay part of the cost of negligent audits through higher prices for the company's goods or services,[110] but they do not stand to be financially reimbursed through future recovery against the CPA, as third party investors and creditors do. To the extent that the initial increase in auditing fees falls on the unwary consumer, it is inequitable.

B. The Impact of *Rosenblum, Inc. v. Adler* on the Accounting Profession

In the future, courts should not read *Rosenblum, Inc. v. Adler* in a narrow and literal manner that would iguore the sound policy reasons on which it is based. The *Rosenblum* decision, when read in a manner consistent with its underlying policy rationales, will expand the accounting profession's liability to third parties in a manner greater than the New Jersey court's holding implies.

1. *The "From the Company" Limitation*

The *Rosenblum* court limited a CPA's potential negligence liability to only those reasonably foreseeable third parties who rely on financial statements that they receive directly *from the company.*[111] This is the narrowest holding that would permit the Rosenblums to recover because they had received Giant's financial statements directly from that company.[112] It is understandable that the court proceeded cautiously in expanding CPA liability to reasonably foreseeable third parties; it was the first court in the United States to so enlarge the scope of accountants' liability. The "from the company" restriction, however, is arbitrary and illogical and should be discarded in future cases.

Where it is reasonably foreseeable that a third party will receive and use the audited financial report, the means by which that party receives the report should be irrelevant in determining liability. Logically, if an investor who relies on an audited annual report that he solicited directly from the company is allowed to sue the company's independent auditor for negligence, an investor who relies on the same annual report that he received from a business school library, for instance, should not be precluded from doing so. Once the CPA and the

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110 *See id.*

111 *Rosenblum,* 93 N.J. at 352, 461 A.2d at 153 (emphasis added).

112 *Id.* at 330, 461 A.2d at 141.

company "[insert] the audit in [the] economic stream,"[113] each investor described above should be allowed to sue a negligent CPA. Any other conclusion would hinder furtherance of the policies behind *Rosenblum* because certain reasonably foreseeable third parties would be able to recover from a negligent CPA, while others would not.[114] The liability of a CPA to third parties who do not receive financial statements directly from the company, however, remains undecided in New Jersey after *Rosenblum.*

2. *Reliance "on the Financial Statements"*

The Rosenblums actually possessed and relied on Giant's financial statements. The court, therefore, did not consider whether third parties who buy a company's securities relying only on the quoted national market price of the securities and not on the company's financial statements would be able to recover against a negligent CPA. Theoretically, the market price for a company's securities is based on information contained in that company's audited financial statements.[115] Further, even though the market may account for the possibility that financial statements are materially misstated,[116] the market generally assumes that those audited statements correctly and fairly present the company's financial condition and operating results.[117] If the underlying financial statements are, in fact, materially misstated, the price of the company's securities will not reflect the true value of the security. Therefore, when a purchaser or seller of a company's securities relies on the market price of that security in making an investment decision, he indirectly relies "on the financial statements" of that company.[118]

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113 *Id.* at 356, 461 A.2d at 155.

114 Neither the Wisconsin court in Citizens State Bank v. Timm, Schmidt & Co., 113 Wis. 2d 376, 335 N.W.2d 361 (1983), discussed *supra* note 15, nor the English court in JEB Fasterners v. Mark, Bloom & Co., [1981] 3 All E.R. 289 (Q.B.), *aff'd,* [1983] 1 All E.R. 583 (C.A), discussed *supra* note 2, adopted "from the company" language when expanding CPA liability.

115 *See* T. DYCKMAN, D. DOWNES & R. MAGEE, *supra* note 76, at 86-94 (accounting information reflected in security prices); M. FIRTH, *supra* note 76, at 140-54 (new information should cause an immediate reaction in share prices).

116 *See supra* notes 76-79 and accompanying text (discussing the "efficient market" theory).

117 M. FIRTH, *supra* note 76, at 140 (efficient market theory posits that information is "instantaneously reflected" in share prices; this assertion suggests that market relies on accounting information).

118 This theory was first articulated in Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975), *cert. denied,* 429 U.S. 816 (1976). The court of appeals said:

> A purchaser on the stock exchanges . . . relies generally on the supposition that the market price is validly set and that no unsuspected manipulation has artificially inflated the price, and thus indirectly on the truth of the representations underlying the stock price—whether he is aware of it or not, the price he pays reflects material misrepresentations. Requiring direct proof from each purchaser that he relied on a particular representation when purchasing would defeat recovery by those whose reliance was indirect, despite the fact

In future cases, if the New Jersey court requires a showing that each particular plaintiff has read the financial statements audited by the defendant CPA and relied upon them in purchasing his securities, it will raise "essentially the same problems as a requirement of privity, although the persons who could sue might be different and possibly more numerous."[119] Although institutional investors may frequently read and rely on financial statements in making investment decisions, many smaller investors may invest without relying on financial statements. These smaller investors may base their investment decisions on nothing more than general economic trends and expectations, a company's general business reputation and stability, or confidence in a company's products and services. If, however, the New Jersey court allows plaintiffs who rely only on market prices to recover from the CPA, "that would seem to be equivalent to saying that reliance [by] the plaintiff is not required at all."[120]

Of course, the degree of reliance that plaintiffs must prove will significantly affect the success or failure of future cases against negligent CPAs.[121] It is unclear which path the New Jersey court, or any other court adopting the *Rosenblum* rule, will follow when confronted with the issue of reliance. Because the overriding theme of the *Rosenblum* rule was to discard the privity requirement of *Ultramares* and because "the same problems . . . of privity"[122] will exist if direct reliance on the company's financial statements is required, courts following *Rosenblum* and its public policies may eventually adopt a rule extending CPA liability to third parties relying on market prices alone.

3. *Proximate Cause*

The *Rosenblum* court properly followed traditional tort law when it limited a plaintiff's recovery to those damages proximately caused by the auditor's negligence.[123] In the case of a third party investor, for ex-

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> that the causational chain is broken only if the purchaser would have purchased the stock even had he known of the misrepresentation.

524 F.2d at 907. This case was decided under federal securities law, but the theory can be adopted in state negligence claims against CPAs. Even under this theory, however, the plaintiff is required to show what effect the misstatement or nondisclosure had on the stock price. R. JENNINGS & H. MARSH, SECURITIES REGULATION: CASES AND MATERIALS 1051 (1982).

119 R. JENNINGS & H. MARSH, *supra* note 118, at 1051.

120 *Id.*

121 This Note does not analyze in detail the issue of reliance on market prices alone or conclude whether courts should or should not adopt a rule extending CPA liability to third parties relying on market prices alone. This section merely presents an issue that courts will have to confront in future cases and discusses how courts may resolve that issue.

122 R. JENNINGS & H. MARSH, *supra* note 118, at 1051.

123 *Rosenblum*, 93 N.J. at 350, 461 A.2d at 152. For a discussion of a case where a negligent CPA was held not liable to a plaintiff because of a lack of proximate cause, see *supra* note 2. For a comprehensive discussion of proximate cause, see W. PROSSER, *supra* note 27, at 236-90.

ample, even if financial statements contain a material misrepresentation, the investor should not and will not be able to recover from a CPA if the real cause of his security's price decline is a general stock market decline, precipitated by unrelated events such as a political assassination or a military invasion in some remote part of the world.[124] This traditional proximate cause requirement will not affect *Rosenblum*'s impact on the accounting profession in any unusual way.

4. *Plaintiff's Contributory Negligence*

As in most other areas of negligence law, the plaintiff's contributory negligence may completely or partially bar his recovery against a negligent CPA.[125] For example, a reasonably foreseeable third party user of financial statements may be negligent if the third party relies on the CPA's unqualified opinion when, through his own investigation of or discussions with the client company, he knows that the financial statements are inaccurate. Also, in a very large transaction such as a merger, the third party may be negligent if he does not obtain a representation directly from the CPA that the financial statements are accurate.[126] Further, a third party user of financial statements may be negligent if he relies on statements that do not carry an unqualified opinion by the CPA, but rather carry an adverse opinion, a qualified opinion, or a disclaimer of opinion.[127]

The extent to which a plaintiff's own negligence abates his recovery against a negligent CPA depends on the contributory negligence or comparative negligence laws of individual states.[128] In a state with a traditional contributory negligence statute, a plaintiff's contributory negligence will completely bar his recovery against the CPA.[129] In a state with some form of comparative negligence statute, the negligent plaintiff's recovery may be reduced by the amount he is determined to

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124 *See* AMERICAN LAW INSTITUTE, PROPOSED FEDERAL SECURITIES CODE § 202(19) comment (4)(c) (1978), *reprinted in* R. JENNINGS & H. MARSH, *supra* note 118, at 1043.

125 *See* W. PROSSER, *supra* note 27, at 416-27.

126 *See supra* notes 80-83 and accompanying text.

127 See *supra* notes 19-20 and accompanying text for a discussion of these other types of auditors' opinions.

128 New Jersey has a Comparative Negligence Act, N.J. STAT. ANN. § 2A:15-5.1 (West Supp. 1983), which eliminates contributory negligence as a bar to recovery provided the negligence of the person seeking recovery is not greater than the negligence of the person from whom recovery is sought or combined negligence of the persons from whom recovery is sought. For an analysis of the various types of comparative negligence statutes in American states and for a current listing of states with comparative negligence statutes, see Note, *Comparative Negligence,* 81 COLUM. L. REV. 1668 (1981). At least 25 states currently have some form of comparative negligence statutes. *See* C. GREGORY, H. KALVEN & R. EPSTEIN, CASES AND MATERIALS ON TORTS 429 & n.6 (3d ed. 1977) (listing states with comparative negligence statutes).

129 *See* W. PROSSER, *supra* note 27, at 416-27.

have contributed to his own loss.[130] As states continue to move away from strict contributory negligence statutes towards more liberal comparativc negligence statutes,[131] negligent CPAs will become liable for damages awards more frequently. Thus, this "built-in limitation"[132] on CPAs' financial exposure due to their expanded liability to third parties will be eroded over time.

5. *Client Indemnification or Contribution*

Theoretically, the court is correct in stating that a negligent accountant can seek indemnification or contribution from a client company or its employees if those employees also contributed to the plaintiff's loss through negligent or fraudulent preparation of the company's financial statements.[133] The effectiveness of this remedy, however, is dubious. Client companies and their employees often are judgment proof due to their poor financial condition. That is precisely why injured plaintiffs sue the "deep pocket" CPAs in the first place.[134] It seems unlikely, therefore, that the remote possibility of client indemnification will significantly limit CPAs' financial exposure due to their expanded liability.

CONCLUSION

In extending the common law liability of CPAs for negligent auditing of financial statements to certain reasonably foreseeable third party users of the statements, the New Jersey Supreme Court has taken the crucial step in rejecting the antiquated privity doctrine embodied in the *Ultramares* decision. The *Rosenblum* decision brings CPA liability up to date with generally accepted tort law principles of duty based on "foreseeability."

This modern theory of CPA liability to third party users of financial statements is a prudent expansion of prior law and is based on sound public policy. As between CPAs and those third parties, CPAs are the least-cost avoiders of the costs associated with negligent auditing. Further, the *Rosenblum* rule poses no threat to the financial integrity of the accounting profession because any initial costs imposed on the pro-

130 *See id.* at 433-39.

131 *See id.* at 418 ("[T]he defense of contributory negligence has gradually come to be looked upon with increasing disfavor by the courts.") (footnote omitted); *see also* C. GREGORY, H. KALVEN & R. EPSTEIN, *supra* note 128, at 433 ("[C]omparative negligence has met with widespread favor . . . in recent years . . . .").

132 *See supra* notes 67 & 72 and accompanying text.

133 *Rosenblum,* 93 N.J. 351, 461 A.2d 152.

134 *See* Besser, *supra* note 31, at 507 n.2 (noting significant increase in numbers of lawsuits against accountants); Volz, *supra* note 23, at 33 (pointing out that accounting firm may be only negligent party from whom an injured party may recover); Note, *supra* note 12, at 289 n.57 (plaintiffs normally sue accountants only when company is insolvent, rendering right to indemnity from that company is valueless).

fession by the rule can be spread to its clients. This cost-spreading will occur in an economically efficient manner as the CPAs will charge higher audit fees to those clients who are most likely to materially misstate their financial statements.

Given the sound policy reasons on which the *Rosenblum* rule is based, other state courts should not hesitate to follow it.[135] In reading the *Rosenblum* opinion, however, other courts must take care to avoid ascribing a narrow and literal meaning to its language that would ignore these sound policy reasons and retard the development of the law in this area.

William J. Casazza

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135 *See supra* note 15.