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AUDITORS' LIABILITY — ADOPTION OF A REASONABLE FORESEEABILITY STANDARD

I. INTRODUCTION

The common law liability¹ of auditors to third party users of negligently audited² financial statements is currently in a state of transition.

1. Auditors' liability has been extensively discussed in numerous law review articles. See, e.g., Besser, *Privity? — An Obsolete Approach to the Liability of Accountants to Third Parties*, 7 SETON HALL L. REV. 507 (1976); Burton, *The Developing Role of the Independent Auditor in Corporate Governance*, 56 NOTRE DAME LAW. 813 (1981); Dondanville, *Defending Accountants' Liability: Trends and Implications*, 15 FORUM 173 (1979); Fiflis, *Current Problems of Accountants' Responsibilities to Third Parties*, 28 VAND. L. REV. 31 (1975); Griffin, *The Beleaguered Accountants: A Defendant's Viewpoint*, 62 A.B.A. J. 759 (1976); Gromley, *Accountants' Professional Liability — A Ten Year Review*, 29 BUS. LAW. 1205 (1974); Gruenbaum & Steinberg, *Accountants' Liability and Responsibility: Securities, Criminal and Common Law*, 13 LOY. L.A.L. REV. 247 (1980); Kastoris, *Accountants' Third Party Liability — How Far Do We Go?*, 36 FORDHAM L. REV. 191 (1967); Marinelli, *The Expanding Scope of Accountants' Liability to Third Parties*, 23 CASE W. RES. L. REV. 113 (1971); Mess, *Accountants and the Common Law: Liability to Third Parties*, 52 NOTRE DAME LAW. 838 (1977); Solomon, *Ultramares Revisited: A Modern Study of Accountants' Liability to the Public*, 18 DE PAUL L. REV. 56 (1968); Stern, *Accountants' Liability to Third Parties*, 17 CLEV.-MAR. L. REV. 490 (1968); Wiener, *Common Law Liability of the Certified Public Accountant for Negligent Misrepresentation*, 20 SAN DIEGO L. REV. 233 (1983); Note, *Public Accountants and Attorneys: Negligence and the Third Party*, 47 NOTRE DAME LAW. 588 (1972); Comment, *Auditors' Third Party Liability: An Ill-Considered Extension of the Law*, 46 WASH. L. REV. 675 (1971).

2. This comment is limited to an auditor's third party liability for negligence in auditing financial statements. For a discussion of an auditor's liability in other contexts, see Note, *Accountants' Liability for Compilation and Review Engagements*, 60 TEX. L. REV. 759 (1982).

The objective of an audit performed in accordance with generally accepted auditing standards (GAAS) "is to form an opinion on whether the financial statements present fairly financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles [GAAP] consistently applied." AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, PROFESSIONAL STANDARDS, AU § 327.05 (1983) [hereinafter cited as AICPA]. See also A. ARENS & J. LOEBBECKE, *AUDITING: AN INTEGRATED APPROACH* 3 (2d ed. 1980). An auditor is negligent when he fails to comply with GAAS. *Escott v. Bar Chris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968); Gruenbaum & Steinberg, *Accountants' Liability and Responsibility: Securities, Criminal and Common Law*, 13 LOY. L.A.L. REV. 247, 257-61 (1980).

GAAS requires professional expertise, proper auditing procedures, and proper reporting, as follows:

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

For years, on the basis of *Ultramares Corp. v. Touche*,³ auditors successfully raised a lack of privity of contract with the plaintiff as a defense in negligence actions. Starting in the late 1960's, however, courts began to abandon the privity defense in favor of liability limited to actually foreseen third parties or foreseeable classes of financial statement users.⁴ Two recent cases manifesting the trend toward expanded auditors' liability held for the first time that negligent auditors can be liable to *all* reasonably foreseeable users.⁵

This comment will not only trace the evolution of auditors' liability for negligently audited financial statements, but will also examine the rationale supporting the adoption of a reasonable foreseeability standard⁶ and postulate potential problems created by that standard.⁷

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 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.

AICPA, *supra*, at AU § 150.02. "Auditing standards differ from auditing procedures in that 'procedures' relate to acts to be performed, whereas 'standards' deal with measures of the quality of the performance of those acts and the objectives to be attained by use of the procedures undertaken." *Id.* at AU § 150.01.

Throughout this comment, "accountant" will be used interchangeably with "auditor."

3. 255 N.Y. 170, 174 N.E. 441 (1931). See *infra* notes 9-23 and accompanying text.

4. See *infra* notes 24-40 and accompanying text.

5. See *infra* notes 41-48 and accompanying text.

6. See *infra* notes 49-76 and accompanying text.

7. See *infra* notes 87-93 and accompanying text.

II. THE RISE AND FALL OF *Ultramares*A. *A Citadel of Privity Preserved*

Fifteen years after writing the opinion which abolished the privity defense in actions against negligent manufacturers,⁸ Judge Cardozo, in *Ultramares Corp. v. Touche*,⁹ upheld the privity defense in actions by third parties against negligent auditors.¹⁰ In *Ultramares*, an auditor was employed to prepare and certify a balance sheet, knowing that in the usual course of business the balance sheet would be shown "to banks, creditors, stockholders, purchasers, or sellers, according to the needs of the occasion, as the basis of financial dealings."¹¹ Although the audit was negligently conducted,¹² a creditor who relied on the balance sheet to make loans to the client was denied recovery because he was not in privity of contract with the auditor.¹³

The New York Court of Appeals had to reconcile its opinion in *Ultramares* with its previous products liability decisions¹⁴ and with its decision in *Glanzer v. Shepard*.¹⁵ Distinguishing the products liability cases from a case concerning a negligently performed audit posed little difficulty, as the former involved serious bodily harm to individuals while the latter involved an injury only to property interests.¹⁶ Distinguishing *Glanzer* from the instant case was, however, a more arduous task in light of various factual similarities.

8. *MacPherson v. Buick Motor Co.*, 217 N.Y. 382, 111 N.E. 1050 (1916). See Besser, *Privity? — An Obsolete Approach to the Liability of Accountants to Third Parties*, 7 SETON HALL L. REV. 507, 508 nn.15-17 (1976) (discussing the development of the privity doctrine).

9. 255 N.Y. 170, 174 N.E. 441 (1931).

10. Actions by non-client third parties against the auditor should be distinguished from actions by the client. The auditor can be held liable to the client for his negligence based upon either tort or contract theories. Recovery can be obtained for any pecuniary losses. See Hawkins, *Professional Negligence Liability of Public Accountants*, 12 VAND. L. REV. 797 (1959); see also A. ARENS & J. LOEBBECKE, *supra* note 2, at 81.

11. *Ultramares*, 255 N.Y. at —, 174 N.E. at 442.

12. *Id.* at —, 174 N.E. at 443.

13. *Id.* at —, 174 N.E. at 442-48. Numerous cases have upheld the privity requirement. See, e.g., *Nortek, Inc. v. Alexander Grant & Co.*, 532 F.2d 1013, (5th Cir. 1976) (applying Florida law); *Koch Indus., Inc. v. Vosko*, 494 F.2d 713 (10th Cir. 1974) (applying Kansas law); *Stephens Indus., Inc. v. Haskins & Sells*, 438 F.2d 357 (10th Cir. 1971) (applying Colorado law); *Shofstall v. Allied Van Lines, Inc.*, 455 F. Supp. 351 (N.D. Ill. 1978); *Investment Corp. of Fla. v. Buchman*, 208 So. 2d 291 (Fla. App. 1968), *cert. dismissed*, 216 So. 2d 748 (Fla. 1969); *Canaveral Capital Corp. v. Bruce*, 214 So. 2d 505 (Fla. App. 1968); *MacNerland v. Barnes*, 129 Ga. App. 367, 199 S.E.2d 564 (1973); *Dworman v. Lee*, 83 A.D.2d 507, 441 N.Y.S.2d 90 (1981).

14. *Ultramares*, 255 N.Y. at —, 174 N.E. at 445 (discussing *MacPherson v. Buick Motor Co.*, 217 N.Y. 382, 111 N.E. 1050 (1916) and *H.R. Moch Co. v. Rensselaer Water Co.*, 247 N.Y. 160, 159 N.E. 896 (1928)).

15. 233 N.Y. 236, 135 N.E. 275 (1922).

16. *Ultramares*, 255 N.Y. at —, 174 N.E. at 445.

In *Glanzer*, the defendant was a public weigher. At the request of a bean vendor, the defendant weighed the goods to be sold and furnished a weight certificate to the purchaser. The certificate was incorrect, resulting in an overpayment to the vendor. The purchaser successfully sued the weigher for his economic loss, despite the lack of privity of contract.¹⁷

Rather than follow *Glanzer*, where the distinction between physical and economic injury was treated as insignificant,¹⁸ Cardozo distinguished it from *Ultramares* on the basis of the actual foreseeability of the use by the injured third party. He noted that

the service rendered by the defendant in *Glanzer v. Shepard* was primarily for the information of a third person, in effect, if not in name, a party to the contract, and only incidentally for that of the formal promisee. In the case at hand, the service was primarily for the benefit of the . . . [client], a convenient instrumentality for use in the development of the business, and only incidentally or collaterally for the use of those to whom . . . [the client] and his associates might exhibit it thereafter.¹⁹

Ultimately, however, Cardozo's refusal to find the auditor liable in the absence of privity was premised on a 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."²⁰ The indefiniteness of the liability and the possible extremes to which it could be carried caused Cardozo to "doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences."²¹

Cardozo cited two additional justifications for the privity requirement. First, he felt that liability without privity would "so expand the field of liability for negligent speech as to make it nearly, if not quite, cotermin-

17. *Glanzer*, 233 N.Y. 236, 135 N.E. 275 (1922).

18. See generally Besser, *supra* note 8, at 512 n.19. The distinction between bodily harm and economic loss is significant, however, to the extent that it serves as an underlying reason for courts to seek some method of limiting liability. Thus, the distinction was drawn in *Ultramares*. *Ultramares*, 255 N.Y. at _____, 174 N.E. at 445; see also RESTATEMENT (SECOND) OF TORTS § 552 comment a (1977).

19. *Ultramares*, 255 N.Y. at _____, 174 N.E. at 446. Cardozo also sought support for the distinction in third party beneficiary principles of contract law. He pointed out that [s]omething more must then appear than an intention that the promise shall redound to the benefit of the public or to that of a class of indefinite extension. The promise must be such as to "bespeak the assumption of a duty to make reparation directly to the individual members of the public if the benefit is lost."

Id. at _____, 174 N.E. at 445 (quoting *H.R. Moch Co. v. Rensselaer Water Co.*, 247 N.Y. 160, 164, 159 N.E. 896, 897 (1928)).

20. *Ultramares*, 255 N.Y. at _____, 174 N.E. at 444.

21. *Id.*

nous with that of liability for fraud."²² Second, he was concerned that creation of a duty to the third party would eventually lead to recovery by the third party for negligence in situations where the auditor would not have been liable to the client.²³

B. *A Breach in the Citadel: Glanzer and the Restatement*

As courts started to seek ways of circumventing the strictures of the privity doctrine as applied to negligent auditors,²⁴ they seized upon both the rationale of the *Glanzer*²⁵ case and the *Restatement (Second) of Torts*²⁶ to bolster their opinions. *Glanzer* was cited to support a cause of action against an auditor by an actually foreseen third party, while the *Restatement* was cited to support actions by foreseeable classes of financial statement users.²⁷

The Rhode Island Federal District Court, in *Rusch Factors, Inc. v. Levin*,²⁸ was the first post-*Ultramares* court to uphold an ordinary negligence action against an auditor by a non-client third party.²⁹ In *Rusch*, a creditor requested certified financial statements from a corporation to assess the company's financial well-being. In reliance on financial state-

22. *Id.* at _____, 174 N.E. at 447. Although Cardozo recognized that negligence may serve as a basis for inferring fraud, he held that "negligence alone is not a substitute for fraud." *Id.* An auditor would be liable to a third party for fraud. *Id.* at _____, 174 N.E. at 444.

23. *Id.* at _____, 174 N.E. at 448. Cardozo stated:

Negligence, moreover, will have one standard when viewed in relation to the employer, and another and at times a stricter standard when viewed in relation to the public. Explanations that might seem plausible, omissions that might be reasonable, if the duty is confined to the employer, conducting a business that presumably at least is not a fraud upon his creditors, might wear another aspect if an independent duty to be suspicious even of one's principal is owing to investors.

Id.

24. Until the 1960's, courts seemed to apply the privity doctrine in all negligence actions against auditors. Besser, *supra* note 8, at 517.

25. 233 N.Y. 236, 135 N.E. 275 (1922).

26. RESTATEMENT (SECOND) OF TORTS § 552 (1977). The *Restatement* finds the negligent auditor liable when loss is suffered

(a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it; and (b) through reliance upon it in a transaction that he intends the information to influence or knows that the recipient so intends or in a substantially similar transaction.

Id.

27. Besser, *supra* note 8, at 522 (discussing the tentative draft); see also Wiener, *Common Law Liability of the Certified Public Accountant for Negligent Misrepresentation*, 20 SAN DIEGO L. REV. 233, 248 (1983). Both *Glanzer* and the *Restatement* can be seen as requiring the audit to be for the "primary benefit" of a third party, either specifically or as a member of a limited group. *Id.* See also *H. Rosenblum, Inc. v. Adler*, 93 N.J. 324, _____, 461 A.2d 138, 145 (1983).

28. 284 F. Supp. 85 (D.R.I. 1968).

29. Besser, *supra* note 8, at 518-20.

ments prepared by the defendant auditor indicating the solvency of the corporation, the creditor loaned the corporation \$337,000. The corporation was actually insolvent, however, and went into receivership.³⁰ After criticizing the rationale of *Ultramares*,³¹ the court drew an analogy to *Glanzer* in order to allow the non-privy plaintiff's cause of action.³² In doing so, the court ruled "that an accountant should be liable in negligence for careless financial misrepresentations relied upon by actually foreseen and limited classes of persons."³³ The court, however, left unanswered "the question of whether an accountant's liability for negligent misrepresentation ought to extend to the full limits of foreseeability."³⁴

Subsequent to *Rusch*, several other courts have stated that auditors can be held liable to actually foreseen third party users of financial statements.³⁵ Significantly, the New York Court of Appeals has followed this approach. In *White v. Guarente*,³⁶ it carefully distinguished *Ultramares* in order to find that auditors can be found liable to members "of a settled and particularized class."³⁷ In *White*, the auditor was engaged by a lim-

30. *Rusch Factors, Inc.*, 284 F. Supp. at 86-87.

31. The court expressed its doubt about the rationale of *Ultramares* in a series of rhetorical questions:

Why should an innocent reliant party be forced to carry the weighty burden of an accountant's professional malpractice? 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? Finally, wouldn't a rule of foreseeability elevate the cautionary techniques of the accounting profession?

Id. at 91.

32. See *supra* notes 17-19 and accompanying text for a discussion of *Glanzer*. The *Rusch* court also reviewed the provisions of the tentative draft of § 552 of the *Restatement (Second) of Torts*.

33. *Rusch Factors, Inc.*, 284 F. Supp. at 93. The holding, although ostensibly based on *Glanzer*, actually follows the *Restatement* by finding a cause of action for a foreseen class rather than one limited to an actually foreseen third party.

34. *Rusch Factors, Inc.*, 284 F. Supp. at 93.

35. See, e.g., *Rhode Island Hosp. Trust Nat'l Bank v. Swartz, Bresenoff, Yavner & Jacobs*, 455 F.2d 847 (4th Cir. 1972); *Ryan v. Kanne*, 170 N.W.2d 395 (Iowa 1969); *Aluma Kraft Mfg. Co. v. Elmer Fox & Co.*, 493 S.W.2d 378 (Mo. Ct. App. 1973); *Shatterproof Glass Corp. v. James*, 466 S.W.2d 873 (Tex. Civ. App. 1971).

Other cases, however, have held strictly to the privity requirement of *Ultramares*. See *supra* note 13.

36. 43 N.Y.2d 356, 372 N.E.2d 315, 401 N.Y.S.2d 474 (1977).

37. *Id.* at ____, 372 N.E.2d at 320, 401 N.Y.S.2d at 479. Thus, the New York court can be seen as applying the "actual foreseeability" of *Glanzer*, see *supra* text accompanying note 19 to the members of a foreseeable class. The court stressed the fact that this case "did not involve prospective limited partners, unknown at the time and who might be induced to join, but rather actual limited partners, fixed and determined." *Id.* at ____, 372 N.E.2d at 318, 401 N.Y.S.2d at 477. This contrasts with the *Restatement* approach which seems to allow liability to a member of a foreseeable class, whether the specific class member is foreseeable or not. See *supra* notes 26-27 and accompanying text; see also *Besser*, *supra* note 8, at 524-28 (discussing the tentative draft of § 552 of the *Restatement (Second) of Torts*).

ited partnership to audit the partnership books and prepare its tax returns. A malpractice claim, brought by a limited partner, asserted that the auditor negligently failed to comment on the withdrawal from the partnership of a major portion of the general partners' investment.³⁸ The court characterized the limited partners as "a known group possessed of vested rights, marked by a definable limit and made up of certain components."³⁹ The court reasoned that "[i]n such circumstances, . . . duty is imposed by law and it is not necessary to state the duty in terms of contract or privity."⁴⁰

C. *The Citadel Crumbles*

Despite repeated criticisms of the specialized treatment that defendant auditors were receiving under *Ultramares*, *Glanzer*, and the *Restatement*,⁴¹ it was not until 1983, fifteen years after *Rusch*, that a broad "foreseeable reliance" standard was applied to auditors' negligence by an American court.⁴² Coincidentally, it was in a suit against the partners of Touche Ross & Co. that the New Jersey Supreme Court held that an auditor "has a duty to all those whom that auditor should reasonably foresee as recipients from the company of the statements for its proper business purposes"⁴³ Less than a month later, the Wisconsin Supreme Court held that "[l]iability will be imposed on . . . accountants for the foreseeable injuries resulting from their negligent acts"⁴⁴

In *Haddon View Inv. Co. v. Coopers & Lybrand*, 70 Ohio St. 2d 154, 436 N.E.2d 212 (1982), a case like *White* in that it involved a negligence suit by limited partners against the partnership's auditor, the Ohio Supreme Court held "that an accountant may be held liable by a third party for professional negligence when that third party is a member of a limited class whose reliance on the accountant's representation is specifically foreseen." *Id.* at _____, 436 N.E.2d at 215. It thus failed to subscribe to the view espoused in *White*, even though it cited that case with approval.

38. *White*, 43 N.Y.2d at _____, 372 N.E.2d at 317-18, 401 N.Y.S.2d at 476-77.

39. *Id.* at _____, 372 N.E.2d at 318, 401 N.Y.S.2d at 477.

40. *Id.* at _____, 372 N.E.2d at 319, 401 N.Y.S.2d at 478.

41. See, e.g., Besser, *supra* note 8, at 528-42; Wiener, *supra* note 27, at 249-60; see also Marinelli, *The Expanding Scope of Accountants' Liability to Third Parties*, 23 CASE W. RES. L. REV. 113 (1971); Seavey, *Mr. Justice Cardozo and the Law of Torts*, 52 HARV. L. REV. 372 (1939); Solomon, *Ultramares Revisited: A Modern Study of Accountants' Liability to the Public*, 18 DE PAUL L. REV. 56 (1968).

42. At least one English case had endorsed this standard prior to its adoption by an American court. *JEB Fasteners Ltd. v. Marks, Bloom & Co.*, [1981] 3 All E.R. 289, 296.

The Ohio Supreme Court, in *Haddon View Inv. Co. v. Coopers & Lybrand*, 70 Ohio St. 2d 154, 436 N.E.2d 212 (1982), indicated a willingness to find negligent auditors liable "to any third person to whom they understand the report will be shown for business purposes." *Id.* at _____, 436 N.E.2d at 215. However, the court ultimately followed the *Restatement* approach by allowing liability to "a member of a limited class whose reliance on the accountant's representation is specifically foreseen." *Id.*

43. *H. Rosenblum, Inc. v. Adler*, 93 N.J. 324, _____, 461 A.2d 138, 153 (1983).

44. *Citizens State Bank v. Timm, Schmidt & Co.*, 113 Wis. 2d 376, _____, 335 N.W.2d 361,

The New Jersey case, *H. Rosenblum, Inc. v. Adler*,⁴⁵ involved audits of the financial statements of Giant Stores Corporation (Giant), a publicly traded company which was required to file audited financial statements with the Securities and Exchange Commission. Touche Ross & Co. conducted the audits from 1969 through 1972. During 1971, Giant negotiated to acquire the plaintiffs' business in exchange for stock in Giant. The stock later became worthless when it was discovered that Giant had fraudulently overstated its assets and understated its accounts payable. The plaintiffs sued the Touche Ross partners for negligence, asserting that they relied upon the audited financial statements in selling their business.⁴⁶

The Wisconsin case, *Citizens State Bank v. Timm, Schmidt & Co.*,⁴⁷ involved loans made by Citizens based on financial statements which Timm had prepared for its client. During a subsequent audit, errors in the prior year's financial statements were discovered. Citizens called its loans after being informed of the errors, sending Timm's client into receivership. Citizens then sued Timm for negligence, seeking the uncollected balance of the loans.⁴⁸

The question of whether an auditor can be held liable for negligence in the absence of privity of contract was one of first impression in both New Jersey⁴⁹ and Wisconsin.⁵⁰ In reaching their decisions, the courts analyzed each of the options — duty to only primary beneficiaries (i.e., those in privity with the auditor or those known to be "beneficiaries at the time of the auditor's undertaking"⁵¹); duty to an intended class of beneficiaries under the *Restatement* approach; or duty "to those whom the auditor should reasonably foresee as recipients from the company of the financial statements for authorized business purposes."⁵²

The Wisconsin court rejected the privity approach because "[u]nless liability is imposed, third parties who rely upon the accuracy of the financial statements will not be protected. Unless an accountant can be held liable to a relying third party, this negligence will go undeterred."⁵³ The prevention of increases in the general public's cost of credit and the auditor's ability to spread the risk through insurance were also cited as

366 (1983). *Rosenblum* was decided on June 9, 1983, while *Citizens State Bank* was decided on July 1, 1983.

45. 93 N.J. 324, 461 A.2d 138 (1983).

46. *Id.* at ____, 461 A.2d at 140-41.

47. 113 Wis. 2d 376, 335 N.W.2d 361 (1983).

48. *Id.* at ____, 335 N.W.2d at 362.

49. *H. Rosenblum, Inc.*, 93 N.J. at ____, 461 A.2d at 144.

50. *Citizens State Bank*, 113 Wis. 2d at ____, 335 N.W.2d at 364.

51. *H. Rosenblum, Inc.*, 93 N.J. at ____, 461 A.2d at 142.

52. *Id.*

53. *Citizens State Bank*, 113 Wis. 2d at ____, 335 N.W.2d at 365 (footnote omitted).

additional policy grounds for the rejection of privity.⁵⁴ The *Restatement* approach of "limiting liability to certain third parties" was viewed in Wisconsin as "too restrictive" in light of Wisconsin's negligence law that "a tortfeasor is fully liable for all foreseeable consequences of his act except as those consequences are limited by policy factors."⁵⁵

The New Jersey court's analysis proceeded on two prongs. First, the court characterized *Ultramares*, *Glanzer*, and the *Restatement* as each requiring some "relationship between the relying third party and the auditor."⁵⁶ The necessity for that relationship was rejected by analogizing products liability cases to the negligent misrepresentations of an auditor.⁵⁷ The court held that "[u]nless some policy considerations warrant otherwise, privity should not be, and is not, a salutary predicate to prevent recovery. Generally, within the outer limits fixed by the court as a matter of law, the reasonably foreseeable consequences of the negligent act define the duty and should be actionable."⁵⁸ The court then advanced to the second part of its analysis, assessing the policy considerations involved in determining the scope of an auditor's duty.⁵⁹ Among the factors considered to be important were the following:

- the increased regular use of financial statements by third parties;⁶⁰
- the existence of auditors' liability to investors under the securities laws;⁶¹

54. *Id.* The Wisconsin court was apparently relying on *Rusch*. See *supra* note 31.

55. *Citizens State Bank*, 113 Wis. 2d at ____, 335 N.W.2d at 366.

56. *H. Rosenblum, Inc.*, 93 N.J. at ____, 461 A.2d at 145.

57. *Id.* at ____, 461 A.2d at 142-47. The analogy was summarized succinctly by the court when it said: "The maker of the product and the person making a written representation with intent that it be relied upon are, respectively, impliedly holding out that the product is reasonably fit, suitable and safe and that the representation is reasonably sufficient, suitable and accurate." *Id.* at ____, 461 A.2d at 147.

58. *Id.* at ____, 461 A.2d at 145.

59. "Whether a *duty* exists is ultimately a question of fairness." *Id.* at ____, 461 A.2d at 147 (quoting *Goldberg v. Housing Auth. of Newark*, 38 N.J. 578, 583, 186 A.2d 291, 293 (1962)). The court also referred to the balancing approach of *Harper and James. H. Rosenblum, Inc.*, 93 N.J. at ____, 461 A.2d at 147. Under that approach to duty analysis, the following factors are considered:

[T]he burden [that the suggested duty] would put on the 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.

Id. (quoting 2 HARPER & JAMES, LAW OF TORTS § 18.6, at 1052 (1956)).

60. *H. Rosenblum, Inc.*, 93 N.J. at ____, 461 A.2d at 149.

61. *Id.* at ____, 461 A.2d at 151. Generally, privity is not required for auditors to be held liable to third parties under the securities laws. *Id.* See *Gruenbaum & Steinberg, supra* note 2, at 248-94; see also *Gruenbaum, The SEC's Use of Rule 2(e) to Discipline Accountants and Other Professionals*, 56 NOTRE DAME LAW. 820 (1981); *Karmel, A Delicate Assignment: The Regulation of Accountants by the SEC*, 56 N.Y.U. L. REV. 959 (1981).

- the availability of malpractice insurance for auditors;⁶²
- the possibility that a broad duty will result in audits of a higher quality;⁶³
- the ability of the auditor to pass the increased audit and insurance costs through to the client and its customers;⁶⁴
- the possibility of indemnification or contribution from the client or its employees;⁶⁵
- the ability of the auditor to limit the scope of his engagement or disclaim any opinion on the financial statements;⁶⁶ and
- the desire to compensate the injured.⁶⁷

Although both courts concluded that auditors can be held liable to reasonably foreseeable third party financial statement users,⁶⁸ there are differences between the two holdings. In *Rosenblum*, the New Jersey court performed a balancing test that legally defined the scope of an auditor's

62. *H. Rosenblum, Inc.*, 93 N.J. at ____, 461 A.2d at 151.

63. *Id.* at ____, 461 A.2d at 152. *But see* Comment, *Auditors' Third Party Liability: An Ill-Considered Extension of the Law*, 46 WASH. L. REV. 675, 685-98 (1971) (the writer argues that the incremental increase in financial statement quality is not worth the increased audit costs resulting from a broadened scope of liability).

64. *H. Rosenblum, Inc.*, 93 N.J. at ____, 461 A.2d at 152.

65. *Id.* The court, however, seems to ignore the fact that the auditor may be the only solvent party left. Griffin, *The Beleaguered Accountants: A Defendant's Viewpoint*, 62 A.B.A. J. 759, 760-61 (1976).

66. *H. Rosenblum, Inc.*, 93 N.J. at ____, 461 A.2d at 152.

The court felt that auditors "could in some circumstances, such as when auditing a privately owned company, expressly limit in their certificates the persons or class of persons who would be entitled to rely upon the audit." *Id.* However, this option is not currently available to an auditor under the prescribed professional standards. An example of a standard auditor's report on comparative financial statements is as follows:

We have examined the balance sheets of ABC Company as of [at] December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and changes in financial position for the years then ended. Our examinations were 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 financial statements referred to above present fairly the financial position of ABC Company as of [at] December 31, 19X2 and 19X1, and the results of its operations and the changes in its financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

AICPA, *supra* note 2, at AU § 505.03.

See Note, supra note 2 (discussing limited scope engagements); *see also* Davison, *Auditors' Liability to Third Parties for Negligence*, 12 ACCT. & BUS. RESEARCH 257 (1982) (concluding that auditors should be quicker to disclaim or issue an adverse opinion).

67. *H. Rosenblum, Inc.*, 93 N.J. at ____, 461 A.2d at 152.

68. *Id.* at ____, 461 A.2d at 145, 153; *Citizens State Bank*, 113 Wis. 2d at ____, 335 N.W.2d at 366.

duty as including a duty to reasonably foreseeable financial statement users.⁶⁹ The Wisconsin court, on the other hand, requires a balancing of policy factors in each case to determine if a particular plaintiff falls within the scope of an auditor's duty.⁷⁰ The factors for withholding liability are:

- (1) The injury is too remote from the negligence; or (2) the injury is too wholly out of proportion to the culpability of the negligent tort-feasor; or (3) in retrospect it appears too highly extraordinary that the negligence should have brought about the harm; or (4) because allowance of recovery would place too unreasonable a burden on the negligent tort-feasor; or (5) because allowance of recovery would be too likely to open the way for fraudulent claims; or (6) allowance of recovery would enter a field that has no sensible or just stopping point.⁷¹

Arguably, the difference between the approaches is only in semantics.⁷²

More significantly, the New Jersey court placed a limitation on the auditor's duty. The court, while not calling it a limitation, described the application of its holding:

The principle that we have adopted applies by its terms only to those foreseeable users who receive the audited statements from the business entity for a proper business purpose to influence a business decision of the user, the audit having been made for that business entity. Thus, for example, an institutional investor or portfolio manager who does not obtain audited statements from the company would not come within the stated principle.⁷³

69. *H. Rosenblum, Inc.*, 93 N.J. at ____, 461 A.2d at 145. The court concluded that "[w]hen the independent auditor furnishes an opinion with no limitation in the certificate as to whom the company may disseminate the financial statements, he has a duty to all those whom that auditor should reasonably foresee as recipients . . ." *Id.* at ____, 461 A.2d at 153.

70. *Citizens State Bank*, 113 Wis. 2d at ____, 335 N.W.2d at 366.

71. *Id.* (citations omitted).

72. For the difference to be merely semantic, the New Jersey courts would need to analyze similar policy factors in determining whether a particular plaintiff was foreseeable. Foreseeability of harm is of concern in determining proximate causation. W. PROSSER, *HANDBOOK OF THE LAW OF TORTS* § 43, at 254-60 (4th ed. 1971). While it is a question for the jury, *id.* § 45, it is also of concern to the court in determining whether or not a duty extends to a particular plaintiff. *Id.* §§ 42, 43, 45. Notably, the factors cited by the Wisconsin court cover both foreseeability and social policy concerns, *see supra* text accompanying note 71, thus providing flexibility and comporting with the Harper and James conception of balancing. *See* Besser, *supra* note 8, at 528-35.

To avoid confusion over the duty analysis, it has been suggested that the question should be analyzed in terms of "whether there should be liability." Wiener, *supra* note 27, at 254. To answer this question, the courts would balance the social costs of recovery by the injured plaintiff against those of non-recovery. When recovery is favored, non-liability would be "justified only if there is some external social cause not accounted for in the usual cost balancing system." *Id.* at 254-55.

73. *H. Rosenblum, Inc.*, 93 N.J. at ____, 461 A.2d at 153.

Citizens did not contain such a limitation. It is possible that the New Jersey court only meant to reemphasize the plaintiff's need to establish a prima facie negligence cause of action, including reliance on the financial statements, in order to recover.⁷⁴ However, the court required "[t]he plaintiffs . . . to establish that they received the audited statements from the company pursuant to a proper company purpose . . ."⁷⁵ It is unclear why this is necessary for a negligence cause of action.⁷⁶ Perhaps it is an unarticulated effort by the court to provide additional protection for the auditor from fraudulent claims.

III. AFTER *Ultramares*

A. A Possible Middle Ground

Despite the compulsion to achieve a logical symmetry in the law by finding a duty running from the auditor to the reasonably foreseeable financial statement user, the same uneasiness over the possible breadth of liability that plagued Cardozo over fifty years ago still haunts the courts. This fact may be at the root of the limitation in *Rosenblum* and is certainly one reason why courts clung to the privity defense for a long period of time after its abolition in other contexts.⁷⁷ Such a concern has been recognized by the Supreme Court in actions under the securities laws:

While much of the development of the law of deceit has been the elimination of artificial barriers to recovery on just claims, we are not the first court to express concern that the inexorable broadening of this class of plaintiff who may sue in this area of the law will ultimately result in more harm than good.⁷⁸

Because of the continued fear of indefinite liability if a reasonable foreseeability standard is accepted, some courts, like the *Rosenblum* court, may look to limiting devices other than privity.

The difficulty of proving the plaintiff's prima facie case of negligence is itself a "built-in" limiting device.⁷⁹ The plaintiff must establish that he

74. This interpretation is supported by the court's statement that "stockholders who purchased the stock after a negligent audit [would not] be covered" unless "the necessary conditions precedent" had been satisfied. *Id.*

75. *Id.* at ____, 461 A.2d at 152.

76. Establishing the auditor's negligence under the reasonable foreseeability approach should not differ from any other negligent misrepresentation action. Therefore, the plaintiff must show justifiable reliance, proximate causation, duty, negligence, and damages. Besser, *supra* note 8, at 537-41.

77. *Id.* at 528-29.

78. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 747-48 (1975), *quoted in Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 n.33 (1975). These cases limited the scope of actions under § 10(b) of the Securities Exchange Act of 1934 by requiring an actual purchase or sale of a security by the plaintiff and by requiring scienter on the part of the defendant.

79. *H. Rosenblum, Inc.*, 93 N.J. at ____, 461 A.2d at 152; Besser, *supra* note 8, at 537-41.

justifiably relied on a material misstatement or omission in the audited financial statements,⁸⁰ that the auditor was negligent,⁸¹ and that the negligence was the proximate cause of the plaintiff's damages.⁸² Furthermore, given the complex nature of audits of intricate modern business transactions, expensive investigations and expert testimony must frequently be utilized in order to show a deviation from professional standards.⁸³

The securities laws are a source of procedural restrictions which might be employed to limit baseless claims.⁸⁴ Examples of such restrictions include requiring the plaintiff to post a bond for costs (including attorney fees), assessing costs, and shortening statutes of limitations.⁸⁵ Other suggested limiting devices are insurance for investors covering losses from management fraud and recovery ceilings set at a percentage of the auditor's fees.⁸⁶

B. *Incidental Results of the Foreseeability Standard*

The adoption of the reasonable foreseeability standard may have several undesirable consequences. First, because of the increase in potential liability, auditors will find it necessary to spend more time on their audits in order to ensure against mistakes and oversights.⁸⁷ Second, the expected increase in audit and auditor insurance costs which will be passed on to the clients⁸⁸ may force some clients, such as new, small, or nearly bankrupt businesses, to forego audits in favor of less expensive accounting services.⁸⁹ If this happens, the quality of disclosure and the related level of protection will deteriorate.⁹⁰ Third, situations may arise in which contributory negligence bars the recovery of a client but not that of a "relying" third party. This concern, which parallels Cardozo's fear that an auditor might be held liable to a third party for negligence when there would have been no liability to the client,⁹¹ manifested itself in the Seventh Circuit Court of Appeals' recent decision in *Cenco Inc. v. Seidman & Seid-*

80. W. PROSSER, *supra* note 72, § 108.

81. *Id.* §§ 30, 41-45.

82. *Id.* §§ 30, 37-40.

83. Besser, *supra* note 8, at 539-41; see Wiener, *supra* note 27, at 237-41. For a listing of the professional standards which auditors are expected to meet, see *supra* note 2.

84. Baseless claims can be a problem when a large damage award is sought for the purpose of obtaining a favorable settlement. The costs of investigating and defending these claims are not insignificant. See Griffin, *supra* note 65, at 761.

85. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 208-10 (1975) (summarizing procedural restrictions applied in negligence actions brought under the 1934 Securities Act).

86. Griffin, *supra* note 65, at 762.

87. In fact, this is a desired consequence of the reasonable foreseeability standard. *H. Rosenblum, Inc.*, 93 N.J. at —, 461 A.2d at 152.

88. *Id.*

89. Note, *supra* note 2, at 780 & n.111.

90. See *id.* for a discussion of an auditor's liability for non-audit services.

91. *Ultramares*, 255 N.Y. at —, 174 N.E. at 448. See *supra* note 23.

*man.*⁹² Although the case involved fraud rather than negligence,⁹³ the rationale that a client can be barred from pursuing a claim against his auditor because of his own misconduct is equally applicable in either instance.

IV. CONCLUSION

While the extension of auditors' liability to reasonably foreseeable users of the audited financial statements has a seductive logic to it, the courts should take time to consider the practical ramifications of this step. Before abandoning the privity defense completely, the courts and legislatures should consider alternative limiting devices. After all, auditors "cannot be regarded as the guarantors of their client's financial statements or indemnifiers of investor losses. No sensible person would enter the profession if his risks were so limitless."⁹⁴

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92. 686 F.2d 449 (7th Cir. 1982).

93. *Cenco Inc.*, 686 F.2d at 454-56.

94. Griffin, *supra* note 65, at 762.