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Common Law Malpractice Liability Of Accountants To Third Parties

COMMON LAW MALPRACTICE LIABILITY OF ACCOUNTANTS TO THIRD PARTIES

When conducting an independent audit for a client, an accountant must provide auditing services with reasonable care, in good faith, without fraud or collusion.[1] Originally, the primary function of the independent auditor was to uncover employee theft and to reveal bookkeeping discrepancies for the benefit of the client.[2] Today, the audit principally serves as an unbiased indication to persons not connected with the client of a company's financial health.[3] If an accountant negligently overstates the financial position of a company, third parties, investors, and creditors who rely upon an audit opinion, may suffer damages.[4] While the accountant could have foreseen the damage, most jurisdictions seldom allow third parties to recover the damages that the accountant's negligence directly caused in a suit against the accountant.[5]

Although the client hires the accountant, the present day accountant strives to be independent from the client throughout the auditing process.[6] An accountant seeks to maintain independence from the client in order to

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1. *See* Weiner, *Common Law Liability of the Certified Public Accountant for Negligent Misrepresentation*, 20 San Diego L. Rev. 233, 237 (1983)[hereinafter Weiner](discussing the various duties owed under accounting contract by an accountant to client). Independent audit is a broad term used to describe the outside review of management by an independent auditor. 2 J. Carey, The Rise of the Accounting Profession 175 (1970). The audit is a professional examination, meeting certain standards, in which the auditor expresses an independent professional opinion regarding a client's financial statements. S. Davidson, Handbook of Modern Accounting § 3-4 (1977); *see infra* note 18 (discussing the nature and content of financial statements). The accountant must conduct an audit according to Generally Accepted Accounting Principles [GAAP]. A American Institute of Certified Public Accountants, Professional Standards § 150 (1985)[hereinafter AICPA]. GAAP is a detailed set of procedures guiding the performance of the audit. AICPA at § 150. The audit must meet standards of professional quality known as Generally Accepted Auditing Standards [GAAS]. AICPA at § 150. In order for an audit to meet GAAS, the auditor must have had adequate technical training for the particular audit. AICPA at § 150. In all matters relating to the audit, the auditor must maintain independence in mental attitude and must exercise due professional care. AICPA at § 150. In presenting the audit, the accountant must state that the accountant presented the financial statements in accordance with GAAP. AICPA at § 150. The accountant then must give an expression of opinion regarding the financial statements. AICPA at § 150; *see infra* note 21 (analyzing various types of opinion that accountants may deliver).

2. *See* D. Causey, Jr., Duties and Liabilities of Public Accountants 3 (1982)(describing original purpose of audit as verification of proper management for owners of property).

3. *See id.* at 81(discussing primary purpose of audit).

4. *Id.* at 80.

5. *See* D. Stern, An Accountant's Guide to Malpractice Liability 7 (1979)(class of third parties allowed to sue accountant for malpractice is extremely small); *infra* notes 16-17 and accompanying text (introduction to various jurisdictions permitting third party suits against accountants).

6. *See* AICPA, *supra* note 1, at § 220 (general standard of accountant independence applies to accountant's intellectual attitude as well as to appearances to the public).

insure the reliability and correctness of the audit.[7] An independent audit acquires value, not when the accountant delivers the audited financial statements to the client, but when the client presents the audited financial statements to the investing public to raise investment capital.[8]

Despite an accountant's duty to maintain independence from the client, a contract defines the relationship between client and accountant.[9] Parties to a contract are in privity, acquiring rights and duties established by law.[10] At early common law the doctrine of privity barred any person not a party to a contract from suing for negligence in performance of the contract.[11]

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7. *See id.*(asserting that accountant independence forms basis for establishment of reliability and correctness and general usefulness of audit).

8. *See id.*(discussing role of audit and inevitability of third party use of audit); *see also* Texas Tunneling Co. v. City of Chattanooga, 204 F.Supp. 821, 833 (E.D. Tenn. 1962), *aff'd in part, rev'd in part,* 329 F.2d 402 (6th Cir. 1964)(concluding that growing specialization of business functions requires more reliance by third parties in business transactions upon representations of specialists).

9. *See* W. Rich, Legal Responsibilities and Rights of Public Accountants 12-13 (1980)(in contract between accountant and client, provisions, express or implied, define accountant's liability to client). An express contract term is one stated by parties to the contract, while an implied contract term is not so stated. 1 A. Corbin, Corbin on Contracts § 18 (1951)[hereinafter Corbin]. The distinction is founded, not on legal effect, but on the way in which mutual assent is manifested. Corbin, *supra,* at § 18.

10. Corbin, *supra* note 9 at § 778. Privity of contract is the relationship arising from a binding legal agreement. *Id.*

11. *See* J. Davies, CPA Liability 19-47 (1983)(application of common law concepts to accountant liability). At early common law, liability for negligence existed only between parties in privity. *See* Winterbottom v. Wright, 10 M & W 109, 114-15, 152 Eng. Rep. 402, 405 (1842)(due to lack of privity, injured passenger unable to recover from contractor supplying mail coach for negligent work done on coach). The English court in *Winterbottom v. Wright* reasoned that potential liability virtually would be limitless unless the duty of care applied only to the parties to the contract. *See Winterbottom* at 114-15, 152 Eng. Rep. at 405 (1842)(describing consequences of allowing liability without privity as absurd and outrageous). The New York Court of Appeals created the first exception in the United States to the doctrine of privity for the sale of inherently dangerous products. *See* Thomas v. Winchester, 6 N.Y. 397, 411 (1852)(New York Court of Appeals held druggist liable for labeling carelessly poison sold to ordinary consumer as harmless medicine). In 1916, Justice Cardozo of the New York Court of Appeals extended the exception to all products that are reasonably certain to place life and limb in peril when made negligently. *See* MacPherson v. Buick Motor Co., 217 N.Y. 382, 389, 111 N.E. 1050, 1053 (1916)(New York Court of Appeals awarded damages to injured motorist for automobile manufacturer's negligent inspection of product). Theories of strict liability and products liability have preempted the doctrine of privity. *See* E. Keeton, The Law of Torts § 93 (5th ed. 1984) [hereinafter Keeton](discussing tort and contract liability of contracting party to third parties). The law protects a third party from negligent harm to his person and his tangible possessions. Keeton at § 101(summarizing products liability and strict liability); *cf.* 3 F. Harper, F. James & O. Gray, The Law of Torts 18.5 (2d ed. 1986)[hereinafter F. Harper](manufacturer's duty of care extends to almost any risk of unreasonable harm).

The doctrine of privity often remains in force when a tortfeasor causes intangible economic harm to a plaintiff. Restatement (Second) of Torts, § 552 comment a (1977). The doctrine remains in cases of economic harm because enormous losses may result from circulation of a single item of misinformation. Restatement (Second) of Torts, § 552 comment a (1977). An

The doctrine of privity no longer presents an absolute bar to recovery, and many courts have allowed damages to parties not in privity with a negligent party.[12] In the area of accountants' malpractice liability, contemporary American courts have adopted three standards to evaluate whether or not a third party can sue an accountant.[13] Many jurisdictions follow a strict privity standard in accordance with the early standard of strict privity.[14] Current trends modify the strict privity standard and allow recovery in some cases.[15] A majority of jurisdictions allowing third party negligence suits

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accountant has no control over a client's use of a financial statement. *See* Gormley, *The Foreseen, The Foreseeable, & Beyond — Accountants' Liability to NonClients*, 14 SETON HALL L. REV. 528, 553-54 (1984)[hereinafter Gormley](comparing control of business over negligence in manufacturing process to accountants' complete lack of control over clients' records and bookkeeping processes). Thus, each auditing task that an accountant performs has the potential to create inordinate liability for the accountant. Gormley, *supra*, at 554.

12. *See, e.g.*, Greenman v. Yuba Power Products, Inc., 59 Cal.2d 57, 62, 27 Cal.Rptr 697, 701, 377 P.2d. 897, 901 (1963)(privity not necessary in suit by ordinary consumer against product manufacturer); Phipps v. General Motors Corp., 278 Md. 337, 343, 363 A.2d 955, 958 (1976)(privity not necessary in suit by consumer against automobile manufacturer); Keeton, *Products Liability: Some Observations About Allocation of Risks*, 64 MICH. L. REV. 1329, 1331 (discussing eventual demise and ultimate insignificance of privity in actions by consumers for physical harm to person or property)(1966); *supra* note 11 (discussing background and subsequent erosion of doctrine of privity).

13. *See* Mess, *Accountants and the Common Law: Liability to Third Parties*, 52 NOTRE DAME L. REV. 838, 850-53 (1977)[hereinafter Mess](listing the various standards that courts adopted in cases of third party liability); *infra* notes 14-17 and accompanying text (discussing three standards by which courts evaluate whether to extend accountant liability to third parties).

14. *See, e.g.*, Nortek, Inc. v. Alexander Grant & Co., 532 F.2d 1013, 1015-16 (5th Cir. 1976), *cert. denied*, 429 U.S. 1042 (1977)(applying Florida law, lack of privity barred action by purchaser of corporation against accountant); Koch Industries, Inc. v. Vosko, 494 F.2d 713, 725 (10th Cir 1974)(lack of privity barred action by purchaser of corporation against corporation's accountant); Stephens Industries, Inc. v. Haskins & Sells, 438 F.2d 357, 359 (10th Cir. 1971)(in barring action against accountant, the United States Court of Appeals for the Tenth Circuit adopted what the court terms the predominant rule); Robertson v. White, 633 F.Supp. 954, 971 (W.D.Ark. 1986)(lack of privity barred class action by 23,000 shareholders against corporate accountant); Aeronca, Inc. v. Gorin, 561 F.Supp. 370, 376 (S.D.N.Y. 1983)(lack of privity barred action by naval supplier against accountant of bankrupt corporation); Briggs v. Sterner, 529 F.Supp. 1155, 1177 (S.D.Iowa 1981)(lack of privity barred action by trustee of profit sharing trust against accountants of industrial loan company); Shofstall v. Allied Van Lines, Inc., 455 F.Supp 351, 360 (N.D.Ill 1978)(lack of privity barred action by stock purchaser against accountant); Canaveral Capital Co. v. Bruce, 214 So.2d 505, 506 (Fla. 1968)(lack of privity barred action by lender against debtor's accountant); Investors Tax Sheltered Real Estate, Ltd. v. Laventhol, Krekstein, Horwath & Horwath, 370 So. 2d 815, 817 (Fla.Dist.Ct.App. 1979), *cert. denied*, 381 So.2d 767 (Fla. 1980)(lack of privity barred action by lessor against lessee's accountant); Investment Corp. of Florida v. Buchman, 208 So.2d 291, 293 (Fla.Dist.Ct.App. 1968), *cert. dism'd*, 216 So.2d 748 (Fla. 1968)(lack of privity barred action by stock purchasers against accountant); MacNerland v. Barnes, 129 Ga.App. 367, 370-371, 199 S.E.2d 564, 566 (1973)(lack of privity barred action by ultimate purchaser of corporation against accountant); *infra* notes 138 and 145 (discussing cases following the strict privity standard in New York); notes 16 and 17 (courts rejecting strict privity standard). *See generally* Annotation, *Liability of Public Accountant to Third Parties*, 46 ALR 3d 979, 982 (1972)(depicting strict privity standard as majority position).

15. *See infra* notes 16 - 17 (listing jurisdictions departing from strict privity standard);

apply the approach set forth in the Restatement (Second) of Torts (Restatement standard) allowing recovery by certain limited classes of third parties.[16] A minority of jurisdictions disregard the strict privity standard and follow a foreseeability standard, allowing all foreseeable third parties to sue the accountant.[17]

In *Ultramares v. Touche*[18], the New York Court of Appeals applied the strict privity standard to determine an accountant's liability to third parties.[19]

Weiner, *supra* note 1, at 249-53 (describing current trend of cautious but inevitable extension of accountants' liability to third parties).

16. RESTATEMENT (SECOND) OF TORTS, § 552 (1977). The Restatement establishes a two-prong test to determine if a professional owes a duty of care to a third party. *Id.* The first prong admits a duty only to a limited class of persons the professional intended to influence. *Id.* at § 552(2)(a) (1977). The second restricts the duty to intended types of transactions. *Id.* at § 552(2)(b) (1977); *see infra* notes 75-81 and accompanying text (describing more fully Restatement standard for accountants' malpractice liability to third parties). *See, e.g.*, Badische Corp. v. Caylor, 630 F.Supp. 1196, 1198 (N.D.Ga. 1986)(rejecting strict privity rule); Merit Insurance Co. v. Colao, 603 F.2d 654, 659 (7th Cir. 1979)(court allowed casualty insurance company to sue accountant of company's defunct agency); Rhode Island Hosp. Trust Nat'l. Bank v. Swartz, Bresenoff, Yavner and Jacobs, 455 F.2d 847, 851(4th Cir. 1972)(court allowed creditor actually known to accountant to bring action against debtor's accountant); Badische Corp v. Caylor, 630 F.Supp, 1196, 1198 (N.D.Ga. 1986)(applying Georgia law, United States District Court for the Northern District of Georgia allowed supplier actually known to accountant to bring suit); 999 v. Cox & Co., 574 F.Supp. 1026, 1031-32 (E.D.Mo. 1983)(United States District Court for the Eastern District of Missouri dismissed action for failure to allege a particular and limited class); Ingram Industries, Inc. v. Nowicki, 527 F.Supp. 683, 684 (E.D.Ky. 1981)(United States District Court for the Eastern District of Kentucky adopted Restatement standard without comment); Seedkem Inc. v. Safranek, 466 F.Supp 340, 343 (D.Neb 1979)(court allowed creditor to bring action against debtor's accountant); Rusch Factors, Inc. v. Levin, 284 F.Supp. 85, 91-92 (D.R.I. 1968)(court allowed corporation to bring suit against accountant that former sole proprietor hired in anticipation of incorporation); Brumley v. Touche, Ross & Co., 123 Ill.App.3d 636, 642, 463 N.E.2d 195, 200 (1984)(Illinois Court of Appeals allowed shareholder member of known class of third parties to sue accountants); Ryan v. Kanne, 170 N.W.2d 395, 401(Iowa 1969)(Supreme Court of Iowa allowed recovery by third party actually known to accountant); Spherex, Inc. v. Alexander Grant & Co., 122 N.H. 898, 903-04, 451 A.2d 1308, 1311 (1982)(Supreme Court of New Hampshire allowed supplier member of actually foreseeable class to sue accountant); Haddon View Inv. Co. v. Coopers & Lybrand, 70 Ohio St.2d 154, 156, 436 N.E.2d 212, 214 (1982)(Ohio Supreme Court allowed limited partners to sue partnership's accountant for negligence); Shatterproof Glass Corp. v. James, 466 S.W.2d 873, 877 (Tex.Civ.App. 1971)(court allowed plaintiff creditor actually known to accountant to bring suit against debtor's accountant).

17. *See* Rosenblum, Inc. v. Adler, 93 N.J. 324, 356-57, 461 A.2d 138, 151 (1983)(court allowed purchaser of stock in public corporation to bring negligence action against accountant); Raritan River Steel Co. v. Cherry, Bekaert & Holland, 79 N.C. App 81, 91, 339 S.E.2d 62, 68 (1986), *review granted*, 316 N.C. 734, 345 SE.2d 392 (1986)(court allowed supplier's suit against accountant on basis of tort duty defined by balancing test); Citizens State Bank v. Timm, Schmidt & Co. 113 Wis.2d 376, —, 335 N.W.2d 361, 366(1983)(Wisconsin Supreme Court held that, in action by lending bank against accountant, accountant liable for all foreseeable consequences unless court denied recovery on grounds of public policy).

18. 255 N.Y. 170, 174 N.E. 441 (1931).

19. 255 N.Y. 170, 180-81, 174 N.E. 441, 444 (1931). Most commentators view the *Ultramares* decision as the first significant example of a third party claim against an accountant for negligence. *See, e.g.*, Gruenbaum & Steinberg, *Accountants' Liability & Responsibility:*

In *Ultramares*, Fred Stern & Company, importers and sellers of rubber, engaged the accounting firm of Touche, Niven & Company to prepare and certify a balance sheet.[20] Upon completion of the audit, the accounting firm supplied Fred Stern & Company with thirty-two certified copies of the balance sheet.[21] The audit reported assets in excess of 2.5 million dollars,

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Securities, Criminal & Common Law, 13 LOY. L.A.L. REV. 247, 309 (1980)(describing *Ultramares* as starting point in discussion of accountants' common law liability to non-clients); Weiner, *supra* note 1, at 235 (describing *Ultramares* as essential starting point in analyzing accountant malpractice liability); Note, *Accountants' Liabilities For False and Misleading Financial Statements*, 67 COLUM. L. REV. 1437, 1438 (1967)(viewing *Ultramares* as predominant authority on accountants' liability for negligence).

A third party suing an accountant for negligence sues on a theory of negligent misrepresentation. *See Ultramares v. Touche*, 255 N.Y. at 182, 174 N.E. at 442 (discussing legal basis for plaintiff's claim). Early common law courts did not recognize a tort of negligent misrepresentation. *See* International Prod. Co. v. Erie R.R., 244 N.Y. 331, 335-36, 155 N.E. 660, 663 (1927)(New York Court of Appeals traced history of negligent misrepresentation in action by importer against railroad for negligently supplying incorrect information). Eventually, courts accepted a narrow definition of negligent misrepresentation, allowing recovery in tort when the defendant had knowledge or the equivalent of knowledge that the plaintiff sought the information for a serious purpose. *International Products*, 244 N.Y. at 335-36, 155 N.E. at 663. Furthermore, the defendant accountant must have known that the plaintiff intended to rely upon the information, and that the reliance would harm the plaintiff should the information prove false. *International Products*, 244 N.Y. at 335-36, 155 N.E. at 663. *See generally*, HARPER, *supra* note 11, at § 7.6 (discussing liability arising from duty of persons operating businesses to exercise care); KEETON, *supra* note 11, at § 107 (discussing liability of professionals for negligent misrepresentation).

20. *Ultramares*, 255 N.Y. at —, 174 N.E. at 442. An accountant preparing an audit generally works with a financial statement that the client has supplied. S. DAVIDSON, *supra* note 1, at § 3-2 (1970). "Financial Statement" is a broad term intended to include a balance sheet, an income statement, or any supporting statement of financial data that the accountant derived from accounting records. *Id.* A balance sheet sets forth the assets, liabilities and equity of a company at a given date. *Id.* An income statement sets forth the increase or decrease of a company's equity arising from profit-seeking operations. *Id.* The financial statement often includes a Statement of Changes in Financial Position (Statement of Changes). I. KELLOGG, HOW TO FIND NEGLIGENCE AND MISREPRESENTATIONS IN FINANCIAL STATEMENTS 5 (1983). The Statement of Changes enumerates the changes in a company's working capital from the beginning to the end of the reporting period. *Id.* The Statement of Changes does not replace the income statement or the balance sheet. *Id.* Rather, the Statement of Changes supplements the income statement and the balance sheet. *Id.*

21. *Ultramares*, 255 N.Y. at 174, 174 N.E. at 442. After conducting an audit, an accountant delivers an opinion that certifies the work that the accountant has done. AICPA, *supra* note 1, at § 150. The unqualified or certified opinion must state that the accountant used GAAP in accordance with GAAS to determine that the financial statements fairly represent the true financial position of the client at the time of the audit. *See* A AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, AUDITING STANDARDS § 509.07 (1985)[hereinafter STANDARDS](setting forth example of audit opinion). An accountant instead may deliver a qualified opinion, an adverse opinion, or a disclaimer of opinion. *Id.* at § 509.04. A qualified opinion states that except for certain departures from GAAP that are listed in detail, the financial statements give a fair representation of the client's financial position. *Id.* at § 509.29. An adverse opinion states that the accountant does not believe that the financial statements fairly represent the financial position of the client. *Id.* at § 509.41. A disclaimer of opinion states that the auditor has not performed an examination sufficient in scope to allow him to deliver an opinion. *Id.* at § 509.45. A disclaimer must state specifically the respects in which the audit has departed from GAAS. *Id.* at § 509.46.

with a net worth exceeding one million dollars.[22] In fact, management of Fred Stern & Company had falsified records submitted to the accounting firm.[23] The assets reported in the audit were fictitious, and the company actually was insolvent.[24]

Upon receipt of the audit, Fred Stern & Company approached the Ultramares Corporation, a factor that had only minor dealings with Fred Stern & Co. in the past, and requested a loan.[25] In deciding whether to extend a loan to Fred Stern & Company, management of the Ultramares Corporation reviewed one of the certified balance sheets.[26] Relying upon the favorable report, the Ultramares Corporation made unsecured loans to Fred Stern & Company in excess of $160,000.[27] Fred Stern & Company subsequently defaulted on the loans and filed in bankruptcy.[28]

Shortly thereafter, Ultramares brought suit in New York against the defendant accounting firm, charging negligence in the preparation of the audit.[29] At trial, the plaintiff further claimed that the accounting firm had committed fraud in the preparation of the Fred Stern & Company balance sheet.[30] Reserving decision on the defendants' motion to dismiss, the trial judge dismissed the fraud charge and submitted the negligence charge to the jury.[31] The jury decided in favor of the plaintiff.[32] The trial judge, however, set aside the jury verdict.[33] On appeal, the appellate division affirmed the dismissal of the fraud action, but reversed the dismissal of the

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22. *Ultramares*, 255 N.Y. at 174, 174 N.E. at 442.

23. *Ultramares*, 255 N.Y. at 175-76, 174 N.E. at 442.

24. *Id.*

25. *Id.*, 255 N.Y. at 177, 174 N.E. at 443. At common law, a factor was an agent employed to sell goods for a principal and to receive a commission on goods sold. In re Freeman, 294 F.2d 126, 131 (3d Cir. 1961). The modern factor is a financier who generally lends money and takes in return an assignment of accounts receivable or some other security. In re Freeman, 294 F.2d at 131. Factoring is the purchase of accounts receivable from a business by a factor who assumes the risk of loss in return for some agreed discount. Manhattan Factoring Corp. v. Orsburn, 238 Ark. 947, 385 S.W.2d 785, 789 (1965).

26. *Ultramares*, 255 N.Y. at 177, 174 N.E. at 443.

27. *Id.*

28. *Ultramares*, 255 N.Y. at 177, 174 N.E. at 443.

29. *Id.* A junior clerk of the accounting firm committed the negligence alleged in *Ultramares*. *Id.*, 255 N.Y. at 177, 174 N.E. at 443. While the accounting firm was preparing the audit, an employee of Fred Stern & Company entered in his own handwriting entries totalling over $700,000 in additional accounts receivable. *Id.* The entries were completely fictitous, and the junior clerk accepted the information at face value. *Id.*

30. *Id.* In order to gain recovery in an action for fraudulent misrepresentation, a plaintiff must prove that the defendant made a false representation of fact with knowledge or the equivalent of knowledge that the statement was false. HARPER, *supra* note 11, at § 7.1; KEETON, *supra* note 11, at § 105. The defendant must have made the representation intending to induce the plaintiff to act or refrain from acting, and the plaintiff must have reasonably relied on the misrepresentation and suffered damage as a result. HARPER, *supra* note 11, at § 7.1; KEETON, *supra* note 11, at § 105.

31. *Ultramares*, 255 N.Y. at 176, 174 N.E. at 443.

32. *Id.*

33. *Id.*

negligence action.[34] The appellate division also reinstated the jury verdict for the plaintiff.[35]

The New York Court of Appeals affirmed the trial court's dismissal of the negligence charge, reversed the dismissal of the fraud charge and remanded the case for further proceedings.[36] The Court of Appeals held that an accountant had a duty to conduct his trade without fraud.[37] The court explained that the duty extended to all persons that the accountant knew or should have known would use the fraudulent work product.[38] The court reasoned that the complaint had stated an actionable charge of fraud because a jury could infer the intent necessary for fraud from a reckless misrepresentation, amounting to gross negligence.[39] The court further held that the doctrine of privity barred the suit in negligence.[40]

In dismissing the action for negligence, the *Ultramares* court acknowledged that many courts, including the New York Court of Appeals, had rejected the doctrine of privity as a bar to negligence recovery in cases of physical injury and injury to property.[41] The New York Court of Appeals stated that relaxing the privity standard would subject the accountant committing a simple error to an indeterminate and potentially unlimited liability to an indeterminate class of people.[42] The New York court indicated that the enormous potential liability created a risk far greater than any benefit an accountant received for performing auditing services.[43] The *Ultramares* court emphasized that an accountant is public only in the sense that anyone may choose to engage the public accountant's service.[44] The

34. *Id.*

35. *Id.*

36. *Ultramares*, 255 N.Y. at 191, 174 N.E. at 450. The New York Court of Appeals remanded *Ultramares* to allow the trial court to determine if the plaintiff could prove a valid claim of fraud. *Id.*

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

38. *Id.*

39. *Ultramares*, 255 N.Y. at 189-91, 174 N.E. at 449. Other courts have followed the *Ultramares* ruling, allowing a third party to bring an action for fraud against an accountant through a permissable inference of fraud from conduct amounting to gross negligence. *See, e.g.*, O'Connor v. Ludlam, 92 F.2d 50, 54 (2d Cir. 1937), *cert. denied*, 302 U.S. 758 (1937)(holding that, absent privity, court could hold plaintiff liable for knowingly false representation or representation made with reckless disregard of truth or falsity); Ingram Indus., Inc. v. Nowicki, 527 F.Supp. 683, 684 (E.D.Ky. 1981)(finding that accountant might be liable for fraud based on wanton and reckless misstatement); State Street Co. v. Ernst, 278 N.Y. 104, 106-07, 15 N.E.2d 416, 418-19 (1938), *reh. denied*, 278 N.Y. 104, 16 N.E. 2d 851 (1938)(holding that accountant may be liable even when plaintiff can show no actual or deliberate fraud); *see also supra* note 29 (describing nature of negligence alleged in *Ultramares*).

40. *Ultramares*, 255 N.Y. at 188-89, 174 N.E. at 449; *see supra* note 11 (discussing the doctrine of privity).

41. *Ultramares*, 255 N.Y. at 180-81, 174 N.E. at 445.

42. *Id.*

43. *Id.*

44. *Id.* The term *independent auditor* originally paralleled the contemporary meaning of independent contractor, distinguishing the auditor offering his services to the public from an

court reasoned that the accountant, therefore, should owe no duty to the public.[45] The court further stated that the auditing service directly benefits only the client, and any other use of the FFaudit necessarily is incidental or collateral.[46] The New York Court of Appeals ultimately determined that the privity doctrine applied to accountants.[47]

Subsequent to the *Ultramares* decision, many jurisdictions have followed a strict privity standard in third party suits against accountants.[48] Since the standard of privity no longer applies in cases of physical injury or of injury to tangible property, the jurisdictions following the strict privity standard affirm the conclusion of the *Ultramares* court that policy concerns protecting the accountant from indeterminate liability outweigh the policy concerns of protecting the public from economic injury arising out of an accountant's actions.[49] Some jurisdictions, however, do not follow the *Ultramares* strict privity rule in cases of accountant malpractice liability.[50]

The leading opinion advocating a relaxation of the strict privity standard for purely economic injuries was *Glanzer v. Shepard*,[51] In *Glanzer*, the

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auditor exclusively employed by one company. 2 J. CAREY, *supra* note 1, at 175. The *Ultramares* court's definition of public accountant closely follows the early definition of independent auditor. *See Ultramares*, 255 N.Y at 180-81, 174 N.E. at 445 (describing the accountant's role as public only in the sense that the accountant's services are available to any person willing to pay). Today, *independent auditor* refers to an auditor who is independent from the client. *See* AICPA, *supra* note 1, at § 220 (describing accountancy profession's requirement of independence). Unlike the independent contractor who simply performs services for a number of clients, the contemporary independent accountant performs the function of a public guardian to assure certainty in the investing process. *See* United States v. Arthur Young & Co., 465 U.S. 805, 817-18 (1984)(discussing role of Certified Public Accountant in relation to efforts to force disclosure of accountant's tax workpapers).

45. *Ultramares*, 255 N.Y. at 181, 174 N.E. at 445.

46. *See Ultramares*, 255 N.Y. at 182-83, 174 N.E. at 445-446 (discussing rationale for requiring privity in third party suits against accountants).

47. *Id.*

48. *See supra* note 14 (listing jurisdictions following strict privity rule).

49. *Ultramares* 255 N.Y. at 182-83, 174 N.E. at 445. *See, e.g.*, Stephens Industries, Inc. v. Haskins & Sells, 438 F.2d 357, 359 (10th Cir. 1971)(United States Court of Appeals for the Tenth Circuit adopted what court termed predominant rule of *Ultramares*); Robertson v. White, 633 F. Supp. 954, 971 (W.D.Ark. 1986)(class action by 23,000 shareholders would create inordinate liability); Shofstall v. Allied Van Lines, Inc. 455 F.Supp. 351, 360 (N.D.Ill 1978)(affirming *Ultramares* rationale in action by stock purchaser against accountant); *see also supra* note 11 (analyzing reasons for retention of strict privity standard in cases of economic injury). *But see* Rusch Factors, Inc. v. Levin, 284 F.Supp. 85, 91 (D.R.I. 1968)(describing *Ultramares* as an unwarranted inroad upon general principle that risk reasonably perceived defines duty); Ryan v. Kanne, 170 N.W. 395, 401 (Iowa 1969)(Iowa Supreme Court found no reason to exempt accountants from liability to known third parties); Gormley, *supra* note 11, at 530-31 (recounting criticism of *Ultramares*).

50. *See supra* notes 16 and 17 (listing jurisdictions departing from strict privity standard).

51. 233 N.Y. 236, 135 N.E. 275 (1922). *See Rusch Factors*, 284 F.Supp. at 91 (describing *Glanzer* decision as first example of court allowing third party to recover for economic injury); Comment, *Negligent Misrepresentation and the Certified Public Accountant: An Overview of Common Law Liability to Third Parties*, 18 SUFFOLK L. REV. 431, 434-35 (1984)(discussing role of *Glanzer* in movement away from privity doctrine in area of accountant liability).

sellers, Bech, Van Siclen & Company, sold 905 bags of beans to the Glanzer brothers.[52] The Glanzer brothers agreed to pay for the beans in accordance with a certified weight sheet.[53] The sellers engaged a firm of public weighers to perform the weighing task and to supply the buyers with a copy of the certificate.[54] The weighing firm negligently overstated the weight of the beans and, as a result, the buyers paid too much on the contract with the seller.[55]

The buyer brought suit in City Court of New York against the weighing firm on a theory of negligence, requesting as damages the amount overpaid on the contract.[56] The trial judge ordered judgment for the plaintiff.[57] The Appellate Term reversed due to the lack of privity between the parties.[58] The Appellate Division reversed the decision of the Appellate Term and reinstated the trial verdict.[59] The New York Court of Appeals affirmed the trial court.[60] The Court of Appeals held that under the circumstances of the case the public weighers assumed a duty to weigh goods carefully for the benefit of the Glanzer brothers.[61]

The *Glanzer* court reasoned that the buyer's use of the weight certificate was, to the weigher's knowledge, the end and aim of the weigher's contract with the seller.[62] The court concluded, therefore, that principles of usage and fair dealing demanded that the weigher be responsible for the negligent performance of the weigher's duty.[63] The Court of Appeals recognized that the court could have decided *Glanzer* on a strict contract theory of third party beneficiary.[64] Instead, criticizing the privity doctrine, the Court of

Interestingly, Justice Cardozo delivered the *Glanzer* decision for the New York Court of Appeals only nine years before he delivered the *Ultramares* decision. Ultramares v. Touche, 255 N.Y. 170, 174 N.E. 441 (1931); Glanzer v. Shepard, 233 N.Y. 236, 135 N.E. 275 (1922).

52. *Glanzer*, 233 N.Y. at 238, 135 N.E. at 275.

53. *Id.*

54. *Id.*

55. *Id.*

56. *Id.*

57. *Id.*

58. *Id.*

59. *Id.*

60. *Id.*

61. *Id.*, 233 N.Y. at 242, 135 N.E. at 277.

62. *Id.*, 233 N.Y at 242, 135 N.E. at 276.

63. *Id.*

64. *Id.* In some cases, a court does not require privity to enforce a valid contract. 2 WILLISTON, A TREATISE ON THE LAW OF CONTRACTS § 347 (1959)[hereinafter WILLISTON]. A third party beneficiary may sue on a contract, which by its express terms, directly confers on that party a benefit. FARNSWORTH, CONTRACTS § 10.1 (1982)[hereinafter FARNSWORTH]. At early common law, two specific types of third party beneficiaries acquired rights under contract: creditor beneficiaries and donee beneficiaries. *Id.* A contract created a creditor beneficiary when performance of the contract satisfied an actual or supposed duty of the promisee to the beneficiary. *Id.* A contract created a donee beneficiary when the promisee intended to make a gift to the beneficiary. *Id.* Any beneficiary not within the two definitions was an incidental beneficiary and acquired no right under the contract. *Id.* More recently, the two classifications

Appeals acknowledged the growth of the negligence theory of recovery and declared that the duty owed by the weighing firm to the Glanzer brothers sounded not merely in contract but in tort as well.[65] The court concluded, therefore, that the doctrine of privity did not apply to the public weighing firm.[66]

In comparing the *Glanzer* and *Ultramares* decisions of the New York Court of Appeals, many courts, attempting to reconcile the *Glanzer* and *Ultramares* decisions, have concluded that *Ultramares* does not set forth an absolute rule against accountant liability to third parties.[67] The New York Court of Appeals in *Ultramares* distinguished the *Glanzer* decision on several grounds.[68] The *Ultramares* court noted that the accounting firm, unlike the public weighing firm in *Glanzer*, did not know that a specific third party, the Ultramares Corporation, would rely on the financial statements.[69] More importantly, the court in *Ultramares* stated that third party use of the auditing product was not an end and aim of the transaction.[70] Under a traditional third party beneficiary analysis, therefore, creditors and investors would be incidental beneficiaries of the contract between the client and the accountant and entitled to no direct relief from an action on the contract.[71] The *Ultramares* court reasoned that the accountant owed no duty in contract or in tort to the third party.[72] Since the *Ultramares* court did not overrule *Glanzer*, however, possible theories of recovery exist for third parties against the accountant.[73] An action as third party beneficiary would succeed, for

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of beneficiary allowed to enforce a contract have merged into one, known as an intended beneficiary. *Id.* A contract creates an intended beneficiary when the performance of the promise will satisfy an obligation of the promisee to pay money to the beneficiary. RESTATEMENT (SECOND) OF CONTRACTS § 302 (1981). Alternatively, a contract creates an intended beneficiary when circumstances indicate that the promisee intends to give the beneficiary the benefit of the promised performance. *Id.*

65. *Glanzer*, 233 N.Y. at 242, 135 N.E. at 276.

66. *Id.*

67. *See supra* notes 16 and 17 (reciting jurisdictions rejecting the strict privity standard found in *Ultramares* and adopting Restatement or simple negligence standards in third party suits against accountants).

68. *Ultramares*, 255 N.Y. at 182-83, 174 N.E. at 445-46.

69. *Id.*, 255 N.Y. at 175-76, 174 N.E. at 442.

70. *Id.*, 255 N.Y. at 183, 174 N.E. at 445-46.

71. *Id.*, 255 N.Y. at 183, 174 N.E. at 446. An incidental beneficiary of a contract is a person who will benefit from the performance of a contract, but who is neither the promisee of a contract nor a person to whom a party to the contract promises to render performance. WILLISTON, *supra* note 64, at § 402. *See supra* note 64 (discussing evolution of concept of intended beneficiary).

72. *Ultramares*, 255 N.Y. at 185, 174 N.E. at 447. The court in *Ultramares* acknowledged that the legislature could impose a duty in tort without relation to privity upon accountants. *Id.* at 184, 174 N.E. at 446. For example, accountants today owe a statutory duty to purchasers of securities in public offerings when they have misstated a material fact in a financial statement. Securities Act of 1933, 15 U.S.C. § 77k (1983).

73. *See Ultramares*, 255 N.Y. at 183-84, 174 N.E. at 445-46 (distinguishing and not overruling *Glanzer*). In all strict privity jurisdictions, a third party may bring a claim either under a theory of third party beneficiary to the accountancy contract, or under a theory of negligence

example, if a third party could allege and prove status as a direct beneficiary of the contract.[74]

While sharing the *Ultramares* court's concern with indeterminate liability, the drafters of the Restatement (Second) of Torts reasoned that the strict privity standard should not bar absolutely extensions of accountant liability.[75] In discussing the malpractice liability of accountants and other professionals, the drafters concluded that a satisfactory middle ground existed between a standard of strict privity and a standard of foreseeability, which *Ultramares* had discouraged.[76] Specifically, the drafters concluded that a middle ground existed in cases of economic loss when a professional has a duty to supply correct information for the guidance of others in business transactions.[77] The drafters of the Restatement established a two-pronged concept of duty.[78] First, a professional's duty only extends to a person or limited class of persons that the professional intends or knows will use the misleading information.[79] Second, the duty only exists for the type of transaction that the professional intended to influence.[80] Under the Restatement standard, the *Glanzer* and *Ultramares* decisions remain valid.[81]

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so gross as to permit an inference of fraud. *See* J. DAVIES, CPA LIABILITY 74 (1983)(describing legal theories under which third party may recover in strict privity jurisdictions).

74. *See* J. DAVIES, *supra* note 73, at 74 (1983)(discussing ability of third party to bring suit as beneficiary of accountant's contract with client).

75. *See* RESTATEMENT (SECOND) OF TORTS § 552 comment h (1977)(discussing extent of professional's liability to third parties for negligent misrepresentation, focusing on concern of indeterminate liability for professional); *infra* notes 77-80 and accompanying text (describing content of Restatement standard).

76. *See* RESTATEMENT (SECOND) OF TORTS § 552 comment a (1977)(comparing reasons for not allowing third party suits with reasons justifying accountants' malpractice liability to third parties). The drafters of the Restatement standard concluded that restrictions upon accountants' liability would encourage the free flow of commercial information and stimulate the economy. *Id.* (discussing interest of society in promoting transfer of information).

77. *See id.* (professional's duty to supply correct information to third parties applies only in situation in which professional supplied information in good faith).

78. *Id.* at § 552 (1977). *See infra* note 16 (discussing two prong test of Restatement).

79. RESTATEMENT (SECOND) OF TORTS § 552(2)(a)(1977).

80. *Id.* at § 552(2)(b)(1977).

81. *See id.* at § 552 comments g & h (1977)(without mentioning *Ultramares* or *Glanzer* by name, drafters presented two hypothetical examples with facts identical to fact patterns in *Ultramares* and *Glanzer*). In *Ultramares*, the accounting firm could only surmise that the plaintiff would use the accounting firm's work product for general business purposes. *See id.* at § 552 comment h (1977)(acknowledging that innumerable kinds of transactions could occur in hypothetical identical to *Ultramares*). Under the Restatement test for professional liability for negligent misrepresentation, the professional did not know the type of transaction he would influence. *Id.* The professional, therefore, would not be liable to the third party plaintiff because the plaintiff could not satisfy the second prong of the Restatement test for professional liability. *See supra* note 80 and accompanying text (stating that professional's duty only extends to type of transaction that professional intended to influence). In *Glanzer*, the weighers not only intended for the Glanzer brothers to rely on the transaction, the weighers delivered the weight certificate into the hands of the buyer. *Glanzer*, 233 N.Y. at 239, 135 N.E. at 276. *See* RESTATEMENT (SECOND) OF TORTS § 552 comment g (1977)(describing direct communication

Numerous jurisdictions have followed the Restatement approach, which provides that an accountant owes a duty to some third parties.[82] Some courts have allowed recovery when a situation is directly analogous to that of *Glanzer*, with a specifically foreseen plaintiff in circumstances that arguably could fall within the bounds of a third party beneficiary contract claim.[83] Other courts have allowed recovery to a limited, identifiable, *class* of persons of which the accountant was aware.[84]

A minority of jurisdictions have discarded the privity doctrine and allowed negligence actions by all foreseeable third parties against accountants to proceed on a theory of simple negligence.[85] For example, in *Biakanja v. Irving*[86], the California Supreme Court asserted that all reasonably foreseeable third parties could institute suits against a professional for negligence.[87] In *Biakanja*, the defendant notary public had drafted a will for the plaintiff's brother without attesting witnesses present.[88] The notary later convinced two witnesses to sign the will.[89] As a result of the improper attestation, a California probate court refused the will, and the plaintiff did not receive the bequest under the will.[90] The plaintiff subsequently instituted suit against the notary public in the Superior Court for the City of San Francisco.[91]

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and delivery of information in hypothetical identical to *Glanzer*). The Restatement Second test includes *Glanzer* in the comments, in which the drafters suggest that even with less specific knowledge on the part of the weigher, the situation satisfied the test for negligent misrepresentation. *See* RESTATEMENT, *supra*, at § 552 comment g (1977)(in hypothetical with same facts found in *Glanzer*, drafters suggested that direct communication of information not necessary to justify liability of professional). The plaintiff in *Glanzer*, therefore, would satisfy both prongs of the Restatement test. *Id. See supra* notes 79 and 80 and accompanying text (describing both prongs of Restatement test).

82. *See supra* note 16 (listing jurisdictions following the Restatement).

83. *See, e.g.*, Rhode Island Hospital Trust National Bank v. Swartz, Bresenoff, Yavner & Jacobs, 455 F.Supp. at 848 (lending bank actually known to accountant); Rusch Factors, Inc. v. Levin, 284 F.Supp. 85, 90-92 (D.R.I. 1968)(lending corporation actually known to accountant); Ryan v. Kanne, 170 N.W.2d 395, 401 (Iowa 1969)(third party shareholders actually known to accountant). *See* Gormley, *supra* note 11, at 542 (discussing assimilation of *Glanzer* and Restatement); *supra* note 64 (discussing concept of third party beneficiary).

84. *See, e.g.*, Merit Insurance v. Colao, 603 F.2d 654, 654 (7th Cir. 1979)(court held that accountant could owe duty to class of insurance companies providing certain kind of insurance); Seedkem, Inc. v. Safranek, 466 F.Supp 340, 345 (D.Neb. 1979)(court held that accountant could owe duty to limited class of businesses); Haddon View Investment Co. v. Coopers & Lybrand, 70 Ohio St.2d 154, 156, 436 N.E.2d 212, 214 (1982)(court held that accountant owed duty to limited class of four limited partners).

85. *See supra* note 17 (listing jurisdictions allowing foreseeable third parties to sue accountants).

86. 49 Cal.2d 647, 320 P.2d 16 (1958).

87. Biakanja v. Irving, 49 Cal.2d 647, —, 320 P.2d 16, 18 (1958).

88. *Biakanja* at ___, 320 P.2d at 17. An attesting witness is a witness who must observe and verify the various acts necessary for the legal execution of a will. 2 W.PAGE, THE LAW OF WILLS § 19.74 (3d ed. 1960). In most states, a testator must sign or acknowledge his will in the presence of attesting witnesses. Id. at § 19.73.

89. *Biakanja* at ___, 320 P.2d at 17.

90. *Id.*

91. *Id.*

The Superior Court granted judgment to the plaintiff upon successful proof of economic loss resulting from the notary's negligence.[92]

On appeal, the California Supreme Court affirmed the decision of the Superior Court and directly addressed the defendant's argument that the doctrine of privity barred the suit.[93] The *Biakanja* court held that the existence of a tort duty depends upon an evaluation or balancing of certain elements.[94] Although admittedly not giving an exhaustive list, the California Supreme Court recited a list of factors to guide a court in determining the existence of a duty.[95] The court determined that the first factor was the extent to which the defendant intended the transaction to effect the plaintiff and the foreseeability of harm to the plaintiff.[96] The second factor that the court suggested was the closeness of the connection between the defendant's conduct and the injury suffered, as well as the moral blame attached to the defendant's conduct.[97] Finally, the court included as a factor the policy of preventing future harm.[98] After balancing the elements, the California Supreme Court held that the doctrine of privity should not apply to the defendant Irving.[99]

The California Supreme Court subsequently used the *Biakanja* balancing test to determine that attorneys drafting a will owed a duty of reasonable skill and care to beneficiaries under a will.[100] Although one jurisdiction has applied the *Biakanja* balancing test in a third party suit against an accountant,[101] no California court utilized the *Biakanja* test in an accountant

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92. *Id.*

93. *Id.*

94. *Biakanja* at ____, 320 P.2d at 19; *see infra* notes 95-98 and accompanying text (outlining factors in balancing text that *Biakanja* court used).

95. *Biakanja* at ____, 320 P.2d at 19.

96. *Id.*

97. *Id.*

98. *Id.*

99. *Id.*

100. *See* Lucas v. Hamm, 15 Cal.Rptr 821, 364 P.2d 685 (1961), *cert. denied*, 385 U.S. 987 (1962)(beneficiaries of trust created under will sued attorney for negligence). In *Lucas v. Hamm*, the defendant attorney drafted a trust that violated the Rule Against Perpetuities. *Lucas*, 15 Cal.Rptr at 823, 364 P.2d at 687. Beneficiaries under the trust brought suit in the Superior Court of San Francisco. *Id.* The court dismissed the action for lack of privity. *Id.* The California Supreme Court reversed the dismissal of the Superior Court. *Id.* at 824, 364 P.2d at 688. The California Supreme Court reasoned that unless the attorney was vulnerable to suit, an innocent party would suffer harm with no possible remedy at law. *Id.* The court, however, found that as a matter of law the attorney had not been negligent because the trust only could violate the Rule Against Perpetuities if probate lasted more than sixteen years. *Id.* at 826, 364 P.2d at 690.

In *Heyer v. Flaig*, the California Supreme Court, citing both *Biakanja* and *Lucas*, affirmed the right of a beneficiary to sue the decedent's attorney for negligence. Heyer v. Flaig, 74 Cal.Rptr 225, 228, 449 P.2d 161, 164(1969)(decedent's daughters brought suit against attorney for failing to account for decedent's post-testamentary spouse). The court reasoned that if the privity rule barred the action, the social policy of preventing future harm would not prevail. *Heyer*, 74 Cal.Rptr at 229, 449 P.2d at 165.

101. *See* Raritan River Steel Co. v. Cherry, Bekaert & Holland, 79 N.C.App. 81, 91, 339

malpractice suit until the recent case of *International Mortgage Company v. John P. Butler Accountancy Corporation.*[102] In *International Mortgage*, Westside Mortgage, Inc. (Westside) hired the John P. Butler accounting firm (Butler) to perform an audit.[103] Butler delivered unqualified financial statements to Westside stating assets in excess of $175,000.[104] Westside's primary asset was a $100,000 note secured by a deed of trust on certain real property.[105] A foreclosure on the property by a prior deed of trust had destroyed the security on the note.[106]

International Mortgage Co. (IMC) approached Westside for the purpose of buying and selling loans on the secondary market.[107] After reviewing the financial statements that Butler had prepared, IMC entered into a number

S.E.2d 62, 68-69 (directly adopting the *Biakanja* test because balancing test avoids necessity for arbitrary determination of liability). Some courts distinguish the *Biakanja* balancing test from a simple negligence test. *Raritan* at 91, 339 S.E.2d at 68; *see also* D. CAUSEY, JR., *supra* note 2, at 90 (distinguishing accountant liability based upon foreseeability from accountant liability based on weighing of policy factors). In *Raritan*, the North Carolina court expressly rejected the Restatement (Second) Torts standard of liability as too restrictive. *Raritan* at 91, 339 S.E.2d at 68. In adopting the *Biakanja* standard, the court also rejected the simple negligence theory. *Raritan* at 91, 339 S.E.2d at 68. As one court has pointed out, however, the *Biakanja* test is nothing more than a synthesis of various definitions of duty and public policy. International Mortgage Co. v. John P. Butler Accountancy Corp., 177 Cal.App.3d 806, 816, 223 Cal.Rptr 218, 219 (Cal.Ct.App. 1986). Since both tests spring from the same list of factors, the difference existing between a test of simple negligence and the *Biakanja* test is in title only. *See* Note, *Negligent Misrepresentation and the Certified Public Accountant: An Overview of Common Law Liability to Third Parties*, 18 SUFFOLK L. REV. 431, 437 (1984)(aknowledging the similarity between standard of foreseeability and *Biakanja* test). Both tests allow a judge to declare on a case by case basis that public policy will not permit a duty under the particular circumstances involved in each case. *Id. Cf.* W. PROSSER, THE LAW OF TORTS, § §36, 88, 107 (2d ed. 1955)(listing portion of factors *Biakanja* court used in determining duty); HARPER, *supra* note 11, at § 18.6 (1956)(listing remaining portion of factors *Biakanja* court used in determining duty).

Although expressing a balancing test in negative terms of when a duty does not exist, a Wisconsin court that adopted a standard of simple negligence in third party suits against accountants recited a test similar to the *Biakanja* test. Citizens State Bank v. Timm, Schmidt & Co. 113 Wis.2d 376, —, 335 N.W.2d 361, at 366. Under the Wisconsin test, a court will impose no duty as a matter of public policy when the injury is too remote from, or out of proportion with, the culpability of the negligent tortfeasor. *Citizens State*, 113 Wis.2d at —, 335 N.W.2d at 366. The Wisconsin court would not impose a duty when allowance of recovery would open the way for fraudulent claims, or when the recovery would be so large and so limitless that the court could find no sensible or just stopping point. *Id.*

102. 177 Cal.App.3d 806, 821, 223 Cal.Rptr 218, 227 (1986).

103. *International Mortgage*, 177 Cal.App.3d at 810, 223 Cal.Rptr. at 219.

104. *Id.*

105. *Id.* A deed of trust is a conveyance of realty to a third person in trust to hold as security for the payment of a debt. G. OSBORNE, G. NELSON, & D. WHITMAN, REAL ESTATE FINANCE LAW § 1.6 (1979). Deeds of trust usually contain a power of sale in the trustee that the trustee may exercise after default on the secured debt. *Id.* Under most real estate recording acts, the earliest or prior deed of trust recorded according to statutory procedure takes precedence over all others. *Id.*

106. *International Mortgage* at 810, 223 Cal.Rptr. at 219.

107. *Id.*

of contracts to buy government loans from Westside.[108] Butler had no knowledge of IMC at the time of the audit, and IMC did not contact Butler to verify the accuracy of the financial statements.[109] Westside failed to deliver the promised deeds, resulting in alleged damages of over $475,000 to IMC.[110] Westside subsequently signed a promissory note to IMC for the amount of damages.[111] Having paid only $40,000 on the note, the mortgage company defaulted on the balance.[112] IMC brought suit against the accounting firm, alleging negligence and negligent misrepresentation in the preparation of the financial statements.[113] The trial judge adopted the Restatement approach and granted the defendant's motion for summary judgment on the ground that the accountant owed no duty to third parties not specifically known as intended recipients of the financial statements. [114]

The California Court of Appeal reversed the lower court's decision, holding that an independent auditor owed a duty of skill and care to a reasonably foreseeable plaintiff who relied on negligently prepared financial statements, regardless of privity.[115] While recognizing the logic of the *Ultramares* decision as compelling, the court reasoned that the strict privity standard no longer was consistent with California negligence law.[116] The court reasoned that the *Biakanja* decision had supplanted the strict privity standard in all third party claims of professional negligence and required a case-by-case balancing approach.[117] In response to the defendants' argument supporting the Restatement position that the trial court adopted, the Court of Appeal stated that the Restatement standard was a standard of limited liability.[118] The court further reasoned that the limited liability standard, like the privity standard, rested on the reluctance of common law courts to impose liability for financial loss without privity.[119] The California court concluded that the limitation was as inconsistent with California tort principles as was the strict privity standard.[120]

Despite criticism of the strict privity standard, no American or English case had held an accountant liable to a third party before a 1968 Rhode

108. *Id.*
109. *Id.* at 811, 223 Cal.Rptr at 220.
110. *Id.*
111. *Id.*
112. *Id.*
113. *Id.*
114. *Id.*
115. *Id.* at 821, 223 Cal.Rptr at 227.
116. *Id.*
117. *Id.*, at 813, 223 Cal.Rptr at 221
118. *Id.*, at 815-817, 223 Cal.Rptr at 223-24; *see supra* notes 77-81 and accompanying text (discussing Restatement standard).
119. *Id.* at 816, 223 Cal.Rptr at 223; *see supra* note 11 (discussing original rationale for strict privity standard, as well as reasons for retaining strict privity standard in cases of economic injury).
120. *International Mortgage* at 817, 223 Cal.Rptr. at 224.

Island decision.[121] Since *Ultramares*, however, the rise of public ownership has changed the business community that the accountant serves.[122] Licensing procedures and federal securities legislation impose duties of independence and disclosure on the accountant.[123] In the wake of new responsibilities and duties, accounting has become a multibillion dollar industry.[124] Until 1968 when a Rhode Island court refused to apply the strict privity standard to accountants, however, no accountant experienced a corresponding increase in legal liability to the public.[125]

The Rhode Island decision embodies the maxim that when legal principles that once served their day expire, courts can and should create new principles.[126] In the time of *Ultramares*, courts already had replaced the doctrine of privity with simple negligence theory in cases of product liability.[127] The *Ultramares* court refused to supplant the privity doctrine when

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121. *See Rusch Factors*, 284 F.Supp. at 90 (federal district court adopting Restatement standard acknowledged that no appellate court, English or American had held accountants liable to parties not in privity); Solomon, Ultramares *Revisited; A Modern Study of Accountants' Liability to the Public*, 18 DEPAUL L. REV. 56, 64-65 (1968)(analyzing criticism of *Ultramares* decision made by innumerable scholars); Comment, *Accountants' Liabilities to Third Parties Under Common Law and Federal Securities Law*, 9 B.C.L. REV. 137, 144-45 (1967)(recounting various criticisms of *Ultramares*).

122. *See* Mess, *supra* note 13, at 839 (arguing that individuals or small numbers of people had managed most businesses in the past compared with large, centrally managed conglomerates that predominate in today's business world). In the early twentieth century, closely held businesses had little need for outside capital, and the owner was generally both manager and investor. *Id.* Thus, unlike today, the accountant would perform primarily a bookkeeping task for management. *Id.*

123. *See, e.g.*, Securities Act of 1933. 15 U.S.C. § 77k (1983)(in preparing financial statements for public offerings of stock, accountants owe duty of care to investors for misstating material fact in financial statement);. VA. CODE ANN. § §54-85 — 54-102 (1950)(setting forth state licensing procedures for certified public accountants, and creating State Board of Accountancy to regulate accountants' practice); N.Y. EDUCATION LAW § §7400 — 7408 (McKinney 1985)(setting forth state licensing procedures for certified public accountants and creating State Board for Public Accountants to regulate accountants' practice).

124. *See* Wayne, *The Year of the Accountant*, N.Y. Times, Jan. 3, 1982, at F1, col. 2. In 1981, the accounting profession received over six billion dollars in gross revenues. *Id.*

125. *Rusch Factors*, 284 F.Supp. at 90. *See supra* note 121 and accompanying text (describing *Rusch* decision as first example of accountant's liability to third parties); *see also* Mess, *supra* note 13, at 839 (discussing increase in accountant responsibilities and lack of increase in accountant liability to third parties).

126. *Rusch Factors*, 284 F.Supp. at 90. *See* B.CARDOZO, THE NATURE OF THE JUDICIAL PROCESS, 166-67 (1921)(advocating activist role for judiciary in implementing new legal principles); *infra* notes 157 - 74 and accompanying text (discussion showing that privity standard should be abandoned by judiciary).

127. *See, e.g.*, Harriman v. New York, Chicago & St. Louis Railroad Co., 253 N.Y. 398, 401, 171 N.E. 686, 687 (1930)(court held that railroad had obligation when building crossing to make crossing safe for travel by public); Roserock v. General Electric Co., 236 N.Y. 227, 232, 140 N.E. 571, 574 (1923)(court held that company had duty to pack product with care to avoid injury to others); MacPherson v. Buick Motor Co., 217 N.Y. 382, 389, 111 N.E. 1050, 1053 (1916)(court held that automobile manufacturer owed duty of product inspection to public); *supra*, note 11 (discussing relationship of product liability with erosion of privity standard).

applying the doctrine to accountants because of the need to ensure the certainty of potential economic liability.[128] In recent years, however, the strict privity standard has created considerable uncertainty.[129]

The manner in which courts approach allegations of fraud reveals one aspect of courts' uncertainty in the interpretation of the *Ultramares* decision.[130] According to the *Ultramares* court, an allegation of negligence may give rise to an action for fraud when the evidence supports a conclusion that the accountant could not have believed in the truthfulness of a financial statement.[131] Commentators criticize the idea of establishing degrees of negligence because any distinction in degrees of negligence is inherently vague and impractical in nature.[132] One commentator has criticized a case involving accountant's liability because the third party succeeded under a theory of gross negligence amounting to fraud when the conduct in question was, in the opinion of disinterested experts, an uncertain example of even ordinary negligence.[133] Furthermore, some courts have extended the fraud

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128. *See Ultramares*, 255 N.Y. at 179, 174 N.E. at 444 (court found that allowing third party liability would create unreasonable liability hazard in conducting accounting profession). One recent decision described the *Ultramares* court's decision to apply the strict privity standard as a decision founded upon the social utility rationale of the need to protect and encourage the accounting profession. *See Ryan v. Kanne*, 170 N.W.2d 395, 401 (Iowa, 1969)(attacking *Ultramares* as an unwarranted restriction upon tort theory based upon outdated social policy considerations).

129. *See* Gormley, *supra* note 11, at 538 (arguing that various courts' interpretations of strict privity standard have produced results inconsistent with *Ultramares*).

130. *See* Mess, *supra* note 13, at 845-48 (arguing that courts use fraud theory to subvert strict privity standard, creating uncertain results in cases of third party suits against accountants).

131. *Ultramares*, 255 N.Y. at 178, 174 N.E. at 444.

132. *See* KEETON, *supra* note 11, at § 34(stating that degrees of negligence are vague and impractical, adding difficulty and confusion to already uncertain standards that courts must submit to juries); HARPER, *supra* note 11, at § 16.15 (stating that disagreement and confusion mark judicial attempts to define terms such as gross negligence, even within a single jurisdiction).

133. Dohr, *Some Reservations on the State Street Trust Company Case*, 70 J. ACCOUNTANCY 218 (1940). *See* State Street Trust Co. v. Ernst, 278 N.Y. 104, 109, 15 N.E.2d 416, 418(1958)(court affirms jury finding of gross negligence amounting to fraud). In *State Street Trust Co. v. Ernst*, two officers of Pelz-Greenstein, a company engaged in financing wholesalers or mills, presented various credit references, together with a series of financial statements prepared by the defendant accountants, to the plaintiff to secure a line of credit. *State Street*, 278 N.Y. at 109-110, 15 N.E.2d at 417-18. The plaintiff subsequently advanced several unsecured loans to Pelz-Greenstein. *State Street*, 278 N.Y. at 110, 15 N.E.2d at 418. In fact, the officers of Pelz-Greenstein actively had defrauded both the accountants and the plaintiff. *State Street*, 278 N.Y. at 111, 15 N.E.2d at 418. Pelz-Greenstein eventually went into receivership, and the plaintiff only could recover half of the amount lent to Pelz-Greenstein. *State Street*, 278 N.Y. at 110, 15 N.E.2d at 418.

At trial, the defendant accounting firm presented no evidence. *State Street*, 278 N.Y. at 111, 15 N.E.2d at 418. The jury brought a verdict against the accountants, finding that the accountants' conduct in preparing audits for Pelz-Greenstein was so grossly negligent as to permit an inference of fraud. *State Street*, 278 N.Y. at 111, 15 N.E.2d at 418. The trial judge overturned the verdict, finding that the jury's decision was against the weight of credible definition found in *Ultramares* and allowed plaintiffs to prove gross negligence as though it were an automatic substitute for fraud.[134] Without expanding the strict privity standard, therefore, some courts have utilized fraud claims to expand the liability of the accountant.[135] The extent of that expansion is unclear.[136]

In attempting to expand accountant liability, many commentators look to New York, a leading forum in cases involving accountant liability,[137] which still follows the strict privity standard that the New York Court of Appeals set forth in *Ultramares*.[138] In *White v. Guarante*,[139] however, another New York court modified the strict privity standard and allowed recovery

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evidence. *State Street*, 278 N.Y. at 111, 15 N.E.2d at 418. The New York Court of Appeals reinstated the verdict. *State Street*, 278 N.Y. at 128, 15 N.E.2d at 424. As one commentator has argued, however, the uncontested evidence of the plaintiff established at worst a reasonable case for negligence. *See* Dohr, supra, at 224 (analysing *State Street*'s rationale from viewpoint of accountant).

According to the commentator, the majority of the New York Court of Appeals misunderstood the accounting procedures that the plaintiff had contested. *See* Dohr, *supra*, at 222-223 (reducing elements of accountant misconduct in *State Street* to nine points, and showing how New York Court of Appeals misinterpreted either financial statement or accounting principle at each point). The *State Street* decision reportedly stretches the principles of fraud found in *Ultramares* to the point of intellectual dishonesty. Note, *The Accountant's Liability — For What and To Whom*, 36 IOWA L. REV. 319, 328 (1951)(criticizing *State Street* court's use of fraud to incur accountant liability to third parties). Because of the resulting uncertainty in the definition of fraud, courts should state forthrightly a cause of action in negligence rather than find fraud in merely negligent conduct. Bohlen, *Should Negligent Misrepresentations Be Treated As Negligence or Fraud?*, 18 VA. L. REV.703, 703 (1932)(stating that court should change fraud standard to negligence standard in misrepresentation, rather than manipulate fraud definition).

134. *See* C.I.T. Financial Corp v. Glover, 224 F.2d 44 (2d Cir. 1955)(dicta approving of jury instructions that allowed assumption that gross negligence alone could create liability for accountant); Duro Sportswear, Inc. v. Cogen, 131 N.Y.S.2d. 20, 25 (1954), *aff'd.* 285 App.Div. 867, 137 N.Y.S.2d 829 (1955)(New York Supreme Court held that heedlessness and wanton disregard of normal, careful procedure replace fraud); Mess, *supra* note 13, at 845-48 (discussing evolution of fraud claims in accountant liability suits).

135. *See supra* note 133 and 134 (listing examples of courts mishandling or misinterpreting fraud claims by third parties against accountants).

136. *See* Mess, *supra* note 13, at 839 (arguing that courts often distort fraud claim to allow accountant liability).

137. *See* Matter of DeLorean Motor Co., 56 Bankr. 936, 940 (Bankr. E.D. Mich. 1986)(recounting history of third party suits against accountants in New York and noting that New York was most influential and active jurisdiction in area of accountants' malpractice liability).

138. *See* Credit Alliance v. Arthur Anderson & Co., 65 N.Y. 2d 536, 551, 483 N.E.2d 110, 118, 493 N.Y.S.2d 435, 442-43 (1985)(reaffirming *Ultramares* and analyzing current trends toward foreseeability). The New York Court of Appeals first affirmed *Ultramares* in *State Street Co. v. Ernst*. *See State Street*, 278 N.Y. 104, 121, 15 N.E.2d 416, 424 (1939)(privity barred action by corporate creditor against accountant). *Accord*, O'Connor v. Ludlam, 92 F.2d 50, 52 (2d Cir. 1938)(privity barred action by investors against corporation's accountant). *See also* C.I.T. Financial Corp. v. Glover, 224 F.2d 44, 46 (1955)(dicta affirming *O'Connor*); *supra* note 12 (listing strict privity standards adopted by jurisdictions other than New York).

139. White v. Guarante, 43 N.Y.2d 356, 372 N.E.2d 315, 401 N.Y.S.2d 474 (1977).

for a third party.[140] In *White*, a limited partner suffered damages as a result of an accountant's allegedly negligent audit prepared for the plaintiff's limited partnership, and the limited partner brought suit to recover the damages.[141] The trial court in New York County dismissed the plaintiff's negligence claim.[142] The New York Court of Appeals reversed the trial judge, allowing recovery for the plaintiff.[143] The appellate court reasoned that the limited partner was a member of a settled and particularized class that the defendant knew would use the report.[144] Subsequent judicial interpretations of the *White* decision reveal that the *Ultramares* standard remains in New York, rendered more flexible by *Glanzer*, in cases involving accountant liability.[145] In New York, a third party not in privity may bring an action

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140. *White*, 43 N.Y.2d at 359-60, 372 N.E.2d at 317, 401 N.Y.S. at 476.

141. *Id.* In *White v. Guarante*, the accounting firm performed an audit for a limited partnership, Guarante-Harrington Industries. *Id.* The partnership agreement for the limited partnership stipulated that no partner could withdraw any part of that partner's share of the partnership capital without giving thirty days notice to all other partners. *Id.* Over a period of time, the two managing partners withdrew two million dollars from the partnership capital. *Id.* Despite discovering the managing partners' irregular action, the accounting firm did not notify partnership members of the withdrawals from the capital. *Id.* Furthermore, the accounting firm presented the audit in such a fashion that a reader of the financial statement would not realize that the managing partners had withdrawn a major portion of the partnership capital. *Id.* As a result, the plaintiffs did not discover the actions of the managing partners until the managing partners had withdrawn most of the partnership assets. *Id.*

142. *Id.*

143. *Id.* at 360, 372 N.E.2d at 318, 401 N.Y.S.2d at 476.

144. *Id.* In *White*, the Guarante-Harrington Industries retained the accounting firm to perform an audit and to prepare tax returns for the limited partnership. *Id.* The New York court concluded that the accountant, therefore, must have been aware that a limited partner necessarily would rely on and make use of the audit. *Id.* at 361, 372 N.E.2d at 319, 401 N.Y.S.2d at 477.

145. *See* Credit Alliance v. Arthur Andersen & Co.. 65 N.Y.2d 536, 553, 483 N.E.2d 110, 119, 493 N.Y.S.2d 435, 440 (1985)(New York Court of Appeals reexamined and reaffirmed principles stated in *Ultramares* and *Glanzer*). *Accord* Matter of DeLorean Motor Co., 56 Bankr. 936, 940 (Bankr. E.D. Mich. 1986)(United States Bankruptcy Court examined progression of accountant's increasing liability to third parties); Lumbard v. Maglia, 621 F.Supp. 1542, 1545,46 (D.C.N.Y. 1985)(discussing New York precedent in third party suits against accountants). In *Credit Alliance v. Arthur Andersen & Co.*, the plaintiffs, engaged in financing the purchase of equpment through installment sales or leasing agreements, acquired from L.B. Smith, Inc. (Smith) a number of audits that Arthur Andersen & Co. [Andersen] had prepared. *Credit Alliance*, 65 N.Y.2d at 541, 483 N.E.2d at 111, 493 N.Y.S.2d at 436. Relying upon the audits, the plaintiff extended credit to Smith. The audits overstated Smith's financial condition. Smith subsequently declared bankruptcy. *Id.* The plaintiff brought suit in the Supreme Court for New York County in August 1981, claiming negligence, gross negligence, and fraud. *Credit Alliance*, 65 N.Y.2d at 542-43, 483 N.E.2d at 112, 493 N.Y.S.2d at 435-37. The trial court denied Anderson's motion to dismiss the negligence claim. *Id.*

The New York Court of Appeals reversed the trial court and dismissed the negligence claim. *Credit Alliance*, 65 N.Y.2d at 554-55, 483 N.E.2d at 120, 493 N.Y.S.2d at 445. The court reasoned that in claims for negligence by third parties against accountants, the strict privity standard of *Ultramares* remained in force. *Credit Alliance*, 65 N.Y.2d at 548-52, 485 N.E.2d at 115-118, 493 N.Y.2d at 440-443. According to the *Credit Alliance* court, *Glanzer* applied only in cases in which an accountant's relationship with a third party was so close as to approach that for negligence against an accountant when the accountant knew that a client planned to present the financial statements to a known party for a particular purpose.[146] The accountant also must have understood that the third party would rely on the financial statements.[147]

The interpretation of *Ultramares* that New York currently has adopted is functionally the same as a narrow interpretation of the Restatement standard.[148] Commentators have critized even the most broad application of the Restatement approach, because the standard leads to arbitrary results.[149] For example, if the plaintiff in *White* had replaced a retiring partner after the defendant accountant delivered the audit, the doctrine of privity would have barred the action.[150] While the plaintiff had suffered the same damage

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of privity *Credit Alliance*, 65 N.Y.2d at 548, 483 N.E.2d at 115, 493 N.Y.S.2d at 440. The *Credit Alliance* court reviewed decisions by other jurisdictions and concluded that, to the extent that other courts predicated holding an accountant liable to a third party upon three criteria, the courts were consistent with *Ultramares* and *Glanzer*. *Credit Alliance*, 65 N.Y.2d at 554, 483 N.E.2d at 119, 493 N.Y.S.2d at 444. According to the *Credit Alliance* court, a court first must find that a client had a particular purpose for an accountant's report. *Id.* The court then must find that the accountant knew that the plaintiff would rely on the accountant's audit. *Id.* Finally, the court must find some conduct by the accountant that linked the accountant with the plaintiff. *Id.*

In an earlier decision, the New York Court of Appeals rejected an argument that *White* had created a broad exception to *Ultramares* and *Glanzer*. *See* Aeronca, Inc. v. Gorin, 561 F.Supp 370, 377 (D.C.N.Y. 1983)(rejecting plaintiff's argument for an extension of *White* based on trial court decision in *Credit Alliance*). The *Aeronca* court held that *White* created a special exemption to the strict privity standard for limited partners. *Aeronca*, 561 F.Supp. at 378. *Credit Alliance* affirmed the *Aeronca* court's interpretation of *White*. *Credit Alliance*, 65 N.Y.2d at 554, 483 N.E.2d at 119-120, 483 N.Y.S.2d at 442; *see Lombard v. Maglia*, 621 F.Supp. 1542, 1546(D.C.N.Y. 1983)(subsequently affirming *Credit Alliance*).

146. *See Credit Alliance*, 65 N.Y.2d at 552-554, 483 N.E.2d at 119-120, 493 N.Y.S.2d at 442-43 (New York court set forth requirement for third party to recover from accountant for negligence). *Accord Lombard*, 621 F.Supp at 1545 (subsequently affirming *Credit Alliance*).

147. *See Credit Alliance*, 65 N.Y.2d at 552-554, 483 N.E.2d at 119-120, 493 N.Y.S.2d at 442-43 (New York court set forth additional requirement for thrid party to recover from accountant for negligence).

148. *See* Gormley, *supra* note 11, at 538 (arguing that current interpretations of Restatement standard are interchangeable with New York's current reading of *Ultramares*).

149. *See* Gormley, *supra* note 11, at 839 (criticizing arbitrary limitations of limited class analysis of Restatement standard). The Restatement standard, in effect, offers no protection to persons not in an allowable limited class. *Id.* At the same time, members of a limited class, such as the limited partners in *White*, may litigate freely claims of negligence against an accountant. *Id.* Despite the importance of belonging to a limited class in an action against an accountant, there are few guidelines to aid in defining the limited class. *Id.* The difference between the acceptable limited class of all limited partners in *White* and one of all stock purchasers is one only of degree. *Id.* In practice, the distinction between the classes is arbitrary. *Id.* (speculating that the limited class in *White* would become unlimited if sufficient number of limited partners invested in a partnership).

150. *See White*, 43 N.Y.2d at 361, 372 N.E.2d at 317, 401 N.Y.S.2d at 477-478(settled and particularized class would include only partners in partnership at time of audit). A person not a partner at the time the partnership contracted with the accounting firm would be a member of an overly broad class of prospective limited partners, and privity would bar a suit by that subsequent partner against the accountant. *Id.*

arising from the same error by the accountant, the plaintiff would have fallen outside the scope of the *Glanzer* exception in *Ultramares*, as well as the Restatement codification of that exception, because the accountant was not aware of the limited partner when the accountant performed the audit.[151]

Using the same rationale as the strict privity standard, the Restatement approach restricts the accountant's liability to known or intended classes of third parties.[152] Theoretically, courts should apply uniformly the Restatement standard.[153] In practice, however, the standard has created considerable inconsistencies among courts seeking to apply the Restatement approach.[154] While less stringent than the restrictions of the privity doctrine, the Restatement restrictions on third party liability are arbitrary limitations that deny recovery to third parties simply because the third parties do not fall within a specific class of persons.[155] Similar to the special retention of the privity standard for accountant liability, the Restatement standard violates the rational judicial policy that the same criteria govern the imposition of negligence liability, regardless of the context in which the liability arose.[156]

Modern judicial policy has abolished the standard of strict privity in most areas of negligence law.[157] The application to accountants and other professionals of the strict privity doctrine remains as an exception based on policy determinations made in 1933 when the New York Court of Appeals decided *Ultramares*.[158] The determination that accountants owe no duty to persons other than their clients conflicts with current business practices and with publications and standards that the accounting profession has created.[159]

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151. *Id*; *see Ultramares*, 255 N.Y. at 182, 174 N.E. at 447 (stating that bean weigher intended to influence conduct of plaintiff); *supra* note 81 (discussing implicit inclusion of *Glanzer* and *Ultramares* in Restatement).

152. RESTATEMENT (SECOND) OF TORTS § 552 (1977). *See* Note, *Negligent Misrepresentation and the Certified Public Accountant: An Overview of Common Law Liability to Third Parties*, 18 SUFFOLK L. REV. 431, 444-46 (1984)(comparing strict privity standard's harsh restriction on liability with arbitrary limitations of Restatement standard); *supra* notes 148 - 51 and accompanying text (describing arbitrary nature of Restatement standard).

153. *See* Gormley, *supra* note 11, at 530 (Restatement standard formulated with clarity and intended as synthesis of majority judicial view).

154. *See id.* (commentator discusses and lists various inconsistent interpretations of Restatement approach). One commentator argues that much of the confusion arises from a failure to distinguish between a foreseeable plaintiff, like much of tort law envisions, and a foreseen plaintiff, like the drafters of the Restatement envisioned *Id.* Often, while following the Restatement standard, a court will describe the plaintiff in terms of the more familiar concept of foreseeability, causing confusion for readers of the opinion. *Id.*

155. *See* Gormley, *supra* note 11 (source describing arbitrary limitation of Restatement standard); *see also supra* note 141 (describing indefinite nature of Restatement standard restrictions); *supra* note 11 (discussion of strict privity standard and stringent applications).

156. *See* Weiner, *supra* note 1, at 260 (author discusses need for judicial consistency in third party suits against accountants, thus allowing the judicial system to function without hint of special favor or special disfavor by given courts).

157. *See supra* note 11 (discussing erosion of doctrine of privity).

158. *See supra* notes 15-17 and 121 (listing various jurisdictions no longer following *Ultramares* and commentators' criticism of *Ultramares* rationale).

159. *See* Weiner, *supra* note 1, at 249-50 (criticizing *Ultramares* decision as outdated in

While the accounting profession in the time of the *Ultramares* decision was a fledgling industry of uncertain purpose or standards, the accountant is now an integral part of the industrial economy, and the special, blanket application of the privity standard is no longer necessary.[160]

The underlying judicial rationale of all negligence theory is to deter harmful conduct and to award relief to the innocent person who suffers from negligent acts.[161] By restricting an accountant's liability to third parties, a court encourages the accountant to rely exclusively on the information that the client gives to the accountant.[162] The accountant thus may present the accounts in an adversarial fashion, putting forward the best possible presentation of the accounts without expressing any personal opinion.[163] The accountant, however, does not perform an adversarial function but acts as a public watchdog of corporate activity.[164] Rather, the accountant must remain neutral, not performing an adversarial role, separating the client's wishes from the auditing task and serving the interest of the investing public, thus meeting public expectations of the accounting profession.[165] Negligence theory encourages the accountant to remain independent, allowing trade to move more freely.[166] If the New York Court of Appeals in *Ultramares* was

today's commercial setting); AICPA, *supra* note 1, § §220.1-220.7 (describing necessity of accountant independence to accomodate investing public's needs).

160. *See* Mess, *supra* note 13, at 839 (describing importance of accountant to free flow of investment capital).

161. *See* KEETON, *supra* note 11, at § 4 (describing the fundamental purpose of tort law); *supra* note 101 (listing various factors that courts have balanced in determining tort liability).

162. *See* Candler v. Crane, Christmas & Co., [1951] All ER 426, 436 (L. J. Denning, *dissenting*)(claiming that effect of majority decision was to encourage negligence and malfeasance by accountants and to bar action by third parties against accountant). Lord Denning's dissenting argument in *Candler v. Crane, Christmas, & Co.* proved so persuasive that English courts subsequently allowed a charge of negligence in a suit by a third party against an accountant. *See* Candler v. Crane, Christmas & Co., [1951] All ER 426, 436 (L. J. Denning, *dissenting*) *See* JEB Fasteners v. Marks, Bloom & Co., [1981] 3 All ER 289, 289 (stock purchaser claimed reliance on accountant's negligent preparation of corporate financial statements).

163. *Candler*, [1951] All E.R. at 436. Lord Denning argued that once you take a third party out of consideration for the accountant the accountants only concern is to please the client. *Id.* Thus, not only could the accountant accept information from the client without question, he could interpret that information so that the client is more pleased with the results. *Id.*

164. *See* United States v. Arthur Young & Co., 465 U.S. 805, 817-18 (1984)(court described fiduciary duty of impartiality of accountant to investing public while unanimously determining that tax workpapers prepared by a corporation's independent certified public accountant are not protected from disclosure).

165. *Id.*; *See* Comment, *Auditor's Responsibility for Misrepresentation: Inadequate Protection for Users of Financial Statements*, 44 WASH. L. REV. 139, 177 (1968)(arguing that civil liability is most effective means of providing incentive to accountants to remain neutral and to undertake adequate self-regulation to insure neutrality).

166. *See* Rosenblum Inc. v. Adler, 93 N.J. 324, 345, 461 A.2d 138, 151 (1983) (discussing the deterrence effect of increased accountant liability with resulting incentive for accountant

correct in concluding that allowing all foreseeable third parties to sue the accountant for negligence would overcome and eventually destroy the accounting industry, then public policy would require courts to restrict liability.[167]

Restriction of accountant liability, however, is possible under the *Biakanja* foreseeability test, on a case-by-case analysis rather than by an arbitrary limit based on classification according to the size of a class.[168] More importantly, courts now question whether an accountant's liability indeed is limitless and inordinate.[169] Such concern may be unfounded because the accountant does not guarantee that audited financial statements are correct.[170] The audit opinion merely assures the investor that an audit conducted under Generally Accepted Accounting Principles [GAAP] and Generally Accepted Auditing Standards [GAAS] did not uncover any errors.[171] As the *International Mortgage* court stated, the content of a financial statement does not determine an accountant's liability.[172] Rather, the accountant is liable in negligence for the failure to use ordinary skill and care in preparing the audit.[173] Thus, the accountant does not become an insurer for every disappointed investor.[174]

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to perform work more carefully). One argument supporting a restriction of accountant liability is that the third party could easily protect himself by demanding and hiring a separate accountant to assess audited financial statements of other businesses. *See id.* (discussing and refuting various arguments against extension of accountant liability to third parties). This argument ignores the present business climate, which routinely depends upon independent audits. *See Rosenblum* at 340, 461 A.2d at 149 (discussing role of audit in current business community).

167. *See Ultramares,* 255 N.Y. at 181, 174 N.E. at 444 (concluding that consequences of accountant liability would overcome the industry, perhaps making accounting services unobtainable); *Citizens* 113 Wis.2d at —, 335 N.W.2d at 366 (public policy may limit liability for consequences of negligence).

168. *See Biakanja,* 49 Cal.2d at —, 320 P.2d at 17 (affirming that balancing test used by court meant to instill flexibility for court's determination of public policy); *Accord Raritan,* 79 N.C.App. at 91, 339 S.E.2d at 68-69 (North Carolina Supreme Court follows *Biakanja* balancing test because of flexibility in balancing approach).

169. *See supra* note 16 (listing jurisdictions rejecting both rationale of unlimited accountant liability and *Ultramares* decision altogether, adopting a foreseeability standard for accountants' malpractice liability because foreseeability standard would put sufficient restrictions on accountant liability).

170. *See* AICPA, COMMISSION ON AUDITOR'S RESPONSIBILITIES 45 (1978)(financial statements can be no more reliable than the underlying accounting methodology, and professional standards do not require auditor to investigate every supporting document).

171. *See International Mortgage,* 177 Cal.App.3d at 818, 223 Cal.Rptr. at 225(describing limitations that GAAP and GAAS place upon accountants' liabilities to third parties); *Rosenblum,*93 N.J. at 339, 461 A.2d at 148 (auditor only should have to detect illegal acts that auditor would uncover in the exercise of normal professional skill); *see also supra* notes 20 — 21 (describing auditing process).

172. *See International Mortgage,* 177 Cal.App.3d at 181, 223 Cal.Rptr. at 225 (describing inherent limitation of accounting process upon accoutants' liability).

173. *See id.*(describing extent of accountants' liability to third parties under foreseeability standard).

174. AICPA, *supra* note 1, at 327.13 (discussing inherent limitations of auditing process).

Concerns about indeterminate liability are also unfounded because an accountant may limit his liability to a large extent by using disclaimers.[175] A disclaimer would, in clear terms and with precision, state how a particular audit did not meet proper standards, and the reasons for that failure.[176] The successful third party plaintiff in an action for negligence must prove reasonable reliance on the audited financial material.[177] The reliance requirement helps to limit the accountant's liability because the third party must prove that the third party understood the audit and acted reasonably in relying upon the audit.[178] If the accountant states in the audit that the investigation was irregular in certain specific respects, or if the accountant states an adverse opinion with supporting explanations, the plaintiff will have difficulty showing that reliance upon the report was reasonable.[179] A simple, blanket disclaimer without further explanation would not be effective.[180] Public policy would not permit an accountant to disclaim all responsibility to the accountant's clients and to third parties through reciting a simple sentence.[181] Furthermore, the disclaimer must be intelligible to the

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One commentator has suggested that courts should impose an implied warranty of results on accountants who have delivered an opinion that is false. Comment, *Extensions of Accountant's Liability for Negligence: One Step Closer to a New Implied Warranty of Results*, 56 U. COLO. L REV. 265, 277-86 (1985). Under the implied warranty analysis, an accountant would be liable for the dishonesty of a client, even when the accountant could not have uncovered the deception through reasonable, diligent effort. *Id.* That any court would follow a theory of strict liability is unlikely, though the author is firmly convinced of the viability of an implied warranty analysis. *See id.* (student writer discusses likelihood of courts adopting strict liability for accouting work, as well as repercussions of strict liability). *But see* Solomon, *supra* note 121, at 89 (author dismisses any chance of strict liability for accoutning profession); Comment, *Accountant Liable to Third Party for Negligent Misrepresentation*, 53 MINN. L. REV. 1375, 1382, 83 (1969)(in discussing future of accountant liability, writer considers strict liability least viable alternative).

175. *See* AICPA, *supra* note 1, at § 504.01(stating that if accountant cannot give general opinion, accountant must state reasons for not giving opinion); Comment, *supra* note 174, at 1385 (describing disclaimers as convenient, legally acceptable means for accountant to limit liability); *supra* note 20 (describing more fully types of statements accountant must give).

176. *See* AICPA, *supra* note 1, at § §504.06 - .08 (describing requirements for proper disclaimer).

177. *See* KEETON, *supra* note 11, at § 107 (discussing elements of reasonable reliance successful plaintiff must prove); *see also* Weiner, *supra* note 1, at 257 (acknowledging possibility of disclaimer limiting liability of accountants to third parties.).

178. *See* CAUSEY, *supra* note 2, at 95 (stating that effective disclaimer will prevent third party from claiming reliance on portions of opinion that accountant has properly disclaimed responsibility).

179. *See Ryan*, 170 N.W.2d at 404 (effective disclaimer would preclude plaintiff from showing reasonable reliance upon disclaimed audit); Note, *Accountants' Liability to Third Parties For An Audit*. 52 MARQ. L. REV. 158, 164 (1968)(accountant may limit basis for liability to third parties by noting the limits of the accountant's investigation).

180. *See* CAUSEY, *supra* note 2, at 67 (stating that courts reject contractual provisions that exempt professionals from all liability for negligence on grounds of public policy).

181. *See Ryan*, 170 N.W.2d at 177 (court stated that public policy would prohibit accountant from using disclaimer as general excuse from exercising professional care); *accord*

becomes prohibitive in any given case, courts have the ability to limit liability by determining as a matter of public policy that the law should not allow liability.[187] The cost of insurance, like availability, is a matter of concern, but accountants practice a high risk profession, and, as with other professions, the cost of the service should reflect the risk.[188]

As with courts refusal to consider the cost of insurance, the growing weight of authority does not accept the special application of the strict privity standard to the accounting profession.[189] Courts adopting the Restatement standard have produced conflicting and inconsistent results.[190] Furthermore, the same arguments that have caused a growing rejection of the privity standard also apply to the Restatement standard, which remains a restrictive rule of arbitrary limitation.[191] Although existing in a minority of jurisdictions, the foreseeability standard offers a familiar, consistent, and workable solution to the growing expansion of accountants' malpractice liability.[192]

ALAN F. GARRISON

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187. *See Raritan*, 79 N.C. App. at 90-91, 339 S.E.2d at 68 (stating that court using *Biakanja* balancing test could determine as a matter of public policy that liability in a given case would be too large); Note, *Liability to Third Parties for Economic Injury, Privity as a Useful Animal or a Blind Imitation of the Past*, 12 Sw. 87, 123-24 (arguing that use of insurance coupled with *Biakanja* balancing test sufficiently would restrict accountant's malpractice liability to third parties).

188. *See* Solomon, *supra* note 121, at 86-87 (describing accounting as ultrahazardous activity with inherent risk of damage to public from accountants' error). While conceding that extending strict liability principles to include accountants' malpractice liability was an unworkable proposition, one commentator has pointed out that arguments based on the inherent risk of accounting nevertheless mitigate against restrictions of recovery based on a strict privity standard. *Id.*

189. *See supra* notes 17 and 18 (listing jurisdictions adopting Restatement standard or foreseeability standard in third party suits against accountants); notes 67-120 and accompanying text (discussing rationale various courts have used in expanding accountant liability to third parties); *see also* note 11 (discussing growing unpopularity of strict privity standard).

190. *See supra* notes 75-84 and accompanying text (discussing courts' various interpretations of Restatement standard); notes 148-56 and accompanying text (comparing inconsistent results from application of Restatement standard).

191. *See supra* notes 148-51 and accompanying text (describing even liberal interpretation of Restatement standard as arbitrary restriction upon accountant liability to third parties).

192. *See supra* notes 161-74 and accompanying text (discussing application of foreseeability standard upon accountant liability to third parties; 175-80 (relating effect of disclaimers upon accountant liability to third parties under foreseeability standard).

average reader of a financial statement for the disclaimer to be effective.[182]

In addition to limiting liability through a proper use of disclaimers, an accountant may use insurance to protect against additional losses that would arise with third party liability.[183] Factors that limit an accountant's liability under a standard of foreseeability also will limit collection against insurance policies, assuring the continued availability of currently offered insurance coverage.[184] Predictions about the availability of accountant malpractice insurance necessarily are speculative and, therefore, are not dispositive.[185] Availability of insurance is a peripheral issue in the determination of tort liability, and courts pointedly have disregarded the insurance issue in other areas of enterprise liability.[186] In the event that the amount of liability

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Seedkem, Inc. v. Safranek, 466 F.Supp. 340, 345 (D.Neb. 1979); Spherex, Inc. v. Alexander Grant & Co., 122 N.H. 898, ____, 451 A.2d 1308, 1313 (1982); *supra* note 178 (describing courts' rejection of general disclaimers).

182. *See* Rhode Island Hospital Trust National Bank v. Swartz, Bresenoff, Yavner & Jacobs, 455 F.2d 847, 852 (4th Cir. 1972) (court held that, consistent with industry standards, disclaimer must give clear explanation of reason for disclaimer and explanation of effect of disclaimer upon truthfulness of audit).

183. *See* Rusch Factors, Inc. v. Levin, 284 F.Supp 85, 91 (D.R.I. 1968)(stating that accountants can insure against risk of liability to third parties and spread cost of insurance to consumer); Note, *supra* note 152, at 448 (availability of malpractice insurance and ability to pass insurance costs on to general public should protect accounting profession from increased liability to third parties). *But see* Briggs v. Sterner, 529 F.Supp. 1155, 1177 (S.D. Iowa 1981)(stating that accountant's cost of insuring against third party liability would exceed benefit derived from spreading risk); Note, *Third Party Liability for Negligence — The Accountant's Price for Producing a Reliable Commodity:* Haddon View Investment Company v. Coopers & Lybrand, 14 U. Tol. L. Rev. 1371, 1394-96 (1983)(stating that accountants face unlimited amounts of damages for which insurance either is not or may not be available).

184. *See International Mortgage*, 177 Cal.App.3d at 816, 223 Cal.Rptr at 226 (stating that foreseeability standard will limit recovery by third parties); Causey, *supra* note 2, at 141-144 (discussing types of malpractice insurance available to accountants); Mess, *supra* note 13, at 853 (concluding that while malpractice insurance costs will rise, accountant can effectively pass increasing cost of insurance on to consuming public); *supra* notes 165-182 and accompanying text (discussing factors that will limit liability under foreseeability standard).

185. Weiner, *supra* note 1, at 252-53 (arguing that current literature contains no support for assumption that dire economic consequences will ensue if accountants are liable to third parties for negligence); Gormley, *supra* note 11, at 571-73 (arguing that statements by courts concerning availability of malpractice insurance for accountants are speculative, and pointing to need for data comparing amounts of payments for premiums with actual losses).

186. *See, e.g.*, Codling v. Paglia, 32 N.Y.2d 330, 341, 345 N.Y.S.2d 461, 468-69, 298 N.E.2d 622, 627-28 (1973)(stating that additional costs of liability will force manufacturer to make safety improvements in product and safety improvement is court's paramount concern); Greenman v. Yuba Power Products, Inc., 59 Cal.2d 57, 63, 27 Cal.Rptr 697, 701, 377 P.2d 897, 901 (1963)(holding that manufacturer should bear cost of injuries resulting from defective products regardless of insurance); Restatement (Second) of Torts § 402 comment c (1977)(manufacturers' liability for injuries is production cost for which manufacturer may obtain insurance protection); Weiner, *supra* note 1, at 252 (stating that courts, when choosing between passing loss on to innocent victim and passing loss on to negligent party, will place burden of showing inordinate economic consequences on negligent party). Since it is nearly impossible to prove that insurance costs will rise inordinately, a defendant could not meet the burden of proof without great difficulty. *Id.*