Bily v. Arthur Young & Co.: An Unnecessary Return to Privity in Cases of Auditor Negligence

William A. Sinacori

Follow this and additional works at: https://scholarlycommons.law.hofstra.edu/hplj

Part of the Property Law and Real Estate Commons

Recommended Citation

Available at: https://scholarlycommons.law.hofstra.edu/hplj/vol6/iss1/8

This Comment is brought to you for free and open access by Scholarly Commons at Hofstra Law. It has been accepted for inclusion in Hofstra Property Law Journal by an authorized editor of Scholarly Commons at Hofstra Law. For more information, please contact lawcls@hofstra.edu.
COMMENT

BILY v. ARTHUR YOUNG & CO.: AN UNNECESSARY RETURN TO PRIVITY IN CASES OF AUDITOR NEGLIGENCE

INTRODUCTION

In the past fifteen years, accountants have been defendants in more negligence actions than in the previous history of the profession, and the dollar amounts of judgments in such actions have increased dramatically. In August of 1992, Price Waterhouse, one of the “Big Six” accounting firms, was found liable for $338 million to the purchaser of a bank as a result of a negligent audit the firm had performed for the bank. On November 24, 1992, it was reported that Ernst & Young, another firm in the “Big Six,” paid the government of the United States $400 million to settle potential claims for


2. Nancy Chaffee, Note, The Role and Responsibility of Accountants in Today’s Society, 13 J. Corp. L. 863, 863-64 & n.2 (1988). For example, while the Big Eight firms were held liable for a total of $177 million in 75 cases or settlements between 1979 and 1984, in 1986, merely three judgments cost these firms $195 million. Id. n.2. The dollar amounts of judgments and settlements in a single case of auditor negligence can now run into the $300-$400 million range. See, e.g., infra notes 3-5 and accompanying text.

3. In 1988, the business of conducting audits of large publicly held companies was dominated by eight large international firms known as the “Big Eight.” These CPA firms were: Arthur Andersen Co.; Arthur Young & Co.; Coopers & Lybrand; Deloitte, Haskins & Sells; Ernst & Whitney; Peat, Marwick, Mitchell & Co.; Price Waterhouse & Co.; and Touche Ross Co. Samuel S. Paschall, Liability To Non-Clients: The Accountants’ Role and Responsibility, 53 Mo. L. Rev. 693, 694 n.3 (1988). The “Big Eight” have become the “Big Six” through mergers: Ernst & Young, and Deloitte & Touche are the two new merged firms. Alison L. Cowan, Changes in Accounting Leave Big Firms Strong, N.Y. TIMES, Jan. 8, 1990, at D2.

audits performed for 300 collapsed savings and loans institutions.5

Throughout the 1980s, over 500 savings and loan institutions failed,6 and a similar number of banks suffered an equal fate.7 An outgrowth of this crisis has been intense public pressure to prosecute and impose civil liability on the individuals responsible for the failure of these thrifts. Consequently, attention has increasingly focused on the liability of accountants,8 who audited these savings and loan institutions, to financially damaged plaintiffs who were third-parties to the auditor-client contract.

In response to the current escalation of auditor liability and the alleged threat to the existence of the accounting profession, the Supreme Court of California ruled in Bily v. Arthur Young & Co.9 that it was abandoning the foreseeability approach to accountant negligence.10 The foreseeability approach requires that non-client plaintiffs, in an action for accountant negligence, prove that their use of the audited statements and the manner in which the statements were used were specifically foreseeable in the eyes of a reasonably prudent accountant.11 The Bily Court, instead, ruled that accountants may only be liable for negligence to clients with whom they are in privity,12 and that non-clients who are not in privity with the accountants may recover in an action for negligent misrepresentation only if they satisfy the requirements of the Restatement (Second) of Torts § 552.13 Under the so-called “Restatement approach,” an auditor may only be liable to a plaintiff that is not a party to the audit contract if the auditor knows or intends that such third-party or a class of similar persons will utilize and rely upon the financial statements.14

The Restatement approach has many shortcomings. First, it arbitrarily draws a line whereby certain plaintiffs may recover when

6. S. REP. No. 19, 101st Cong., 1st Sess. 2 (1989). This is “more than three-and-a-half times as many as in the previous 45 years combined.” Id.
7. Id.
8. For the purposes of this Comment, accountant and auditor are being used interchangeably. This Comment focuses on the liability that accountants face because of negligent conduct in their capacity as auditors.
10. Id. at 774.
11. See infra notes 76-86 and accompanying text.
12. 834 P.2d at 747, 774.
13. Id. at 747.
14. See infra notes 67-70 and accompanying text.
auditors are negligent, yet denies recovery to other similarly situated plaintiffs. Second, it fails to recognize that the purpose of an audit is to assure investors and creditors about the veracity of the financial position of the client-business as reported in the client's financial statements. Lastly, the Bily approach benefits the auditor's client, while failing to deter negligent conduct by auditors that simultaneously harms non-client third-parties.

Part I of this Comment will briefly describe the scope and objectives of an audit and examine the conflicting conceptions that auditors, the public, and the judiciary have regarding the responsibilities and duties of an auditor. Part II will explain the three theories currently utilized to determine accountant liability to non-client third-parties when an audit is conducted negligently. These three principles are the privity doctrine, the foreseeability rule, and the Restatement (Second) of Torts § 552 approach. Part III then compares and contrasts the foreseeability approach with the Restatement approach, and analyzes some of the shortcomings of the Bily court's reasoning and the Restatement approach that it adopted. Finally, this Comment concludes that the Bily decision encompasses an unnecessary return to the doctrine of privity in cases of negligent audits. It proposes an alternative solution to the problem of liability to third-parties for auditor negligence: a return to the foreseeability approach combined with the stricter enforcement of the burdens imposed on plaintiffs in a tort action, and the adoption of uniform, non-discretionary auditing standards.

I. THE AUDIT PROCESS

During an audit, the duty of an accountant is to determine whether or not the financial statements of the client-business comply with Generally Accepted Accounting Principles (GAAP) through

15. See infra notes 54-66 and accompanying text. This approach was established in Ultramares Corp. v. Touche, 174 N.E. 441 (N.Y. 1931).
16. See infra notes 76-86 and accompanying text. This was the rule previously used in California. It was first employed in the case International Mortgage Co. v. John P. Butler Accountancy Corp., 223 Cal. Rptr. 218 (Cal. Ct. App. 1986), overruled by Bily v. Arthur Young & Co., 834 P.2d 745 (Cal. 1992).
17. See infra notes 67-70 and accompanying text.
19. Generally Accepted Accounting Principles (GAAP) are guidelines reflecting the consensus among accountants, at a particular time, as to the following: 1) which economic resources and obligations should be recorded as assets and liabilities by financial accounting;
an examination of the financial statements of the client in accordance with the Generally Accepted Auditing Standards (GAAS). The auditor is responsible for stating in the audit report whether or not the financial position of the audited business is fairly represented in the financial statements. If the financial statements do not fairly represent the financial standing of the client-business, then the auditor must make a statement explaining why a fair representation does not exist or could not be determined. Misconceptions and ambiguities which changes in assets and liabilities should be recorded and when they should be recorded; 3) how the assets, liabilities, and changes in them should be measured; 4) what information should be disclosed in the financial statements; and 5) how the information should be disclosed in the financial statements; and 6) which financial statements should be prepared. See CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES, Statement on Auditing Standards No. 1, § 150.02 (Am. Inst. of Certified Pub. Accountants 1972).

GAAP, and Generally Accepted Auditing Standards (GAAS), see infra note 20, are promulgated by the American Institute of Certified Public Accountants (AICPA). "The AICPA is the national association of [Certified Public Accountants] in the United States. The institute has served the public and its members for over 100 years. Among its functions, the AICPA develops standards and authoritative guidance on the conduct of audits of financial information." Failure of Independent CPA's to Identify Fraud, Waste and Mismanagement and Assure Accurate Financial Position of Troubled S&Ls: Hearing Before the Committee on Banking, Finance and Urban Affairs, 101st Cong., 1st Sess. 13 (1989) [hereinafter S&L Hearing] (statement of Robert May, Chairman, American Institute of Certified Public Accountants). Membership in the AICPA is open to anyone with a valid, unrevoked CPA certificate from a state's board of accountancy. Hagen II, CPA Liability, supra note 18, at 73 n.47.


22. See id. at AU § 110.01-.02.

23. GAAS requires that an auditor should make qualifications, disclaimers, or render an adverse opinion in his report and give the reasons for such action "when an auditor is restricted in scope of his examination, by actions of the client or by other circumstances such as the timing of his work, the inability to obtain sufficient evidential matter, or inadequacy in existing accounting records." CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES, Statement on Auditing Standards No. 2, § 509.10 (Am. Inst. of Certified Pub. Accountants 1988); see also U.S. AUDITING STANDARDS, supra note 20, at AU § 150.02. Such qualifications, disclaimers or adverse opinions should also be made by the auditor for the following reasons: 1) "[i]f the financial statements are materially affected by a departure from GAAS," CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES, Statement on Auditing Standards No. 2, § 509.15; 2) "[i]f the auditor cannot satisfy himself as to the reasonableness of estimates of future events, or if there are multiple and complex uncertainties which cannot be
ties about the audit process lead to greater liability of accountants for negligence when audits fail to detect fraud, mismanagement, or errors and the insolvent client-business cannot pay for the losses of investors and creditors.\textsuperscript{24}

When establishing the liability of an auditor on the basis of negligence, two main problems arise. First, the standard of care by which the auditor should be judged must be determined. Second, the plaintiffs to whom the auditor may be liable must be ascertained.

A. The Auditor's Standard of Care

Generally, adhering to the standards of GAAP and GAAS does not save an auditor from liability for negligence in conducting an audit.\textsuperscript{25} The question of due care in a negligence case is one of fact

reasonably estimated, including those that may threaten the client's continued existence," see id. § 509.21-26; and 3) "when the auditor detects the presence of errors or possible irregularities, and the auditor remains uncertain whether these errors or possible irregularities will materially affect the financial statements." CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES, Statement on Auditing Standards No. 16, § 327.14 (Am. Inst. of Certified Pub. Accountants 1988). By implication, the auditor may not state that the client's financial statements are a "fair representation" of the financial status of the client if the auditor is restricted in scope of his examination, by actions of the client or by other circumstances such as the timing of his work, the inability to obtain sufficient evidentiary matter, or inadequacy in existing accounting records; if the financial statements are materially affected by a departure from GAAS; if the auditor cannot satisfy himself as to the reasonableness of estimates of future events; if there are multiple and complex uncertainties which cannot be reasonably estimated, including those that may threaten the client's continued existence; and if the auditor detects the presence of errors or possible irregularities, and the auditor remains uncertain whether these errors or possible irregularities will materially affect the financial statements.

24. Generally, an accountant is not a guarantor of the financial statements that are audited. See SEC v. Arthur Young & Co., 590 F.2d 785, 788 (9th Cir. 1979). Even properly performed audits may fail to detect fraud. See S&L Hearing, supra note 19, at 5 (statement of Carroll Hubbard, Jr., Representative from Kentucky); see also infra note 47.


In those cases where application of generally accepted accounting principles fulfills the duty of full and fair disclosure, the accountant need go no further. But if application of accounting principles alone will not adequately inform investors, accountants, as well as insiders, must take pains to lay bare all the facts needed by investors to interpret the financial statements accurately.

for the jury to decide—i.e. a jury may hold an auditor to a higher standard of care than mere compliance with GAAP and GAAS. Therefore, an auditor may be found to be liable for negligence even though he complied with GAAP and GAAS, especially if the jury does not fully understand the role of accountants in an audit.

The Bily Court has, however, ruled by implication that GAAP and GAAS are the standards of professionalism to be applied in cases involving an auditor’s liability to a non-client for a negligent audit. This inference may be drawn from the court’s ruling that accountants may be liable for negligent misrepresentation, but not for negligence. When determining the truth or falsity of the audit opinion or report (which will be the main issue in a negligent misrepresentation lawsuit), the only relevant question is whether or not the audit was conducted in compliance with GAAP and GAAS. This is because the only representation that the accountant makes in the audit report is that the financial statements are in compliance with GAAP as determined by an audit conducted in compliance with GAAS. Thus, in California, an auditor will only be liable to a non-client if the auditor did not comply with GAAS and/or the client’s financial statements did not comply with GAAP. Consequently, an auditor may not be held liable under the negligent misrepresentation rule if his statements about compliance with GAAP and GAAS are true, even though compliance with GAAS and GAAP may lead to misrepresentations on the financial statements.

Mere compliance with GAAP and GAAS should be deemed insufficient as a standard of care in determining accountant liability in all jurisdictions. Compliance with GAAP and GAAS allows the auditor to use too many discretionary judgments, the exercise of

---

26. Gossman, supra note 25, at 236-37; e.g., Evans v. City of Marlin, 986 F.2d 104, 109 (5th Cir. 1993) (“Whether or not the conduct of the Appellees’ [sic] amounts to a breach of the legal standard of due care is a question of fact for the jury.”); Smith v. Ferrel, 852 F.2d 1074, 1076 (8th Cir. 1988) (stating that “[i]n almost all cases, the question of due care . . . is a question for the jury”); Smith v. City of Downey, 238 Cal. Rptr. 351, 354 (Cal. Ct. App. 1987) (stating that “due care as an element of negligence presents a question of fact for the jury”) (citing 4 B. E. Witkin, Summary of California Law. § 492, at 2755 (8th ed. 1974)).

27. Bily, 834 P.2d at 747.

28. Id. at 767.

29. See supra notes 18-22 and accompanying text.

30. This issue was raised in Congressional hearings about the Savings & Loan Crisis. For instance, during the Savings & Loan Crisis, the 1979 AICPA audit guidelines stated that
which can lead to "creative accounting." GAAP and GAAS allow the auditor to use discretion to employ a method of financial analysis that results in the greatest determination of net income and net assets for the auditor's client. Such behavior is not a breach of duty of care if the method of analysis used is generally accepted by the accounting profession. Furthermore, as financing methods change, the American Institute of Certified Public Accountants (AICPA) has been slow in further developing accounting standards, thereby forcing auditors to perform accounting functions under nebulous principles.

A second problem with using compliance with GAAP and GAAS as a standard of care is that accountants will only breach their duty of care if they fail to adhere to standards that they have established, and which they find generally acceptable. When an industry behaves according to self-established standards that are regarded by the public as inadequate, it should not be surprising that the members of that industry are held liable for negligence when they adhered to those standards. This is exactly the situation in which auditors find themselves, and it is a primary reason why today they face such great liability. It is also, therefore, unremarkable that compliance with GAAP and GAAS may not be considered dispositive of a lack of negligence by accountants.

Public perception about the role of auditors is another reason

"auditors 'may visit' construction sites and obtain independent evaluations of the construction completed," which was something that "should be done" for major loans. See S&L Hearing, supra note 19, at 25 (Walter E. Fauntroy, Representative from the District of Columbia, questioning Frederick D. Wolf, Assistant Comptroller of the United States General Accounting Office (GAO)); id. at 175 (written statement of Thomas Myers, President of the accounting firm T.A. Myers & Co.) (such action was rarely taken where it was appropriate). This vagueness allowed accountants to hide behind professional judgment by not making the extra effort of visiting a construction site or obtaining an independent evaluation, and led to errors in calculating reserves for uncollectible loans. See id. at 25.

31. Chaffee, supra note 2, at 889.
32. See, e.g., S&L Hearing, supra note 19, at 5 (statement of Carroll Hubbard, Jr., Representative from Kentucky) (stating that the AICPA did not enact adequate auditing standards to prevent many of the errors, and, thereby, losses in the Savings and Loan Crisis); see id. at 149 (written statement of Russell L. Chupik, Managing Partner of the accounting firm Greenstein, Logan & Co.).

For a definition and description of the AICPA, see supra note 19 (second paragraph).

33. "While the SEC has [had] the authority to establish GAAP, since 1938, the SEC has delegated primary responsibility for that function to the AICPA." Chaffee, supra note 2, at 889 n.253 (citing Note, The Opinion Shopping Phenomenon: Corporate America's Search for the Perfect Auditor, 52 BROOK. L. REV. 1077, 1100 (1987)); cf. Hagen II, CPA Liability, supra note 18, at 72-74; supra note 19 (stating that GAAP and GAAS are promulgated by the AICPA).
why GAAP and GAAS may be insufficient as a standard of care for determining an auditor’s liability. Through an audit, the auditor "primarily tests for unintentional mistakes, not fraud." 34 An auditor must "plan his examination to search for errors 35 or irregularities 36 that would have a material effect on the financial statements [of the client-business], and to exercise due skill and care in the conduct of that examination." 37 In doing so, however, the auditor merely analyzes a sample of the total transactions of the client, 38 making it nearly impossible for the accountant to detect every unintentional error or mistake. This cross-section analysis makes it simple for management to hide fraud from the auditor, especially when the perpetrators are aware of audit procedures. 39 Too often, the public regards the auditor as the guarantor of the veracity of the financial statements of his clients, 40 which he is not. 41

The accountant is merely a reviewer of financial documents who gives his opinion as to whether such documents were prepared in compliance with GAAP. 42 Thus, by regarding an auditor as the guarantor of the veracity of a client’s financial statements, the public may hold the accountant to a

34. Gossman, supra note 25, at 236.
35. Errors are "unintentional misstatements or omissions of amounts or disclosures in financial statements." U.S. AUDITING STANDARDS, supra note 20, at AU § 316.02 (emphasis in original). Errors may involve mistakes in gathering or processing data, incorrect estimates caused by oversights or misinterpretations, or mistakes in application of accounting principles.
36. Irregularities are "intentional mistakes or omissions of amounts or disclosures in financial statements" which include management fraud and defalcations. Id. at AU § 316.03 (emphasis in original). Management fraud is the act of fraudulently reporting financial information in order to render financial statements misleading. Id. Defalcations are misappropriation of assets. Id.
37. Id. at AU § 316.02-.04; see also id. at AU § 230 (regarding an auditor’s duty to perform with due care).
38. Gossman, supra note 25, at 232.
39. Management can override internal controls, partake in collusive acts, or fail to record transactions. See U.S. AUDITING STANDARDS, supra note 20, at AU § 316.07, .16. Two commentators state that holding the auditor liable for fraud makes the position of an auditor intolerable because frauds may be perpetrated by client personnel and go undetected for years by the directors. Brian K. Kirby & Thomas L. Davies, Accountant Liability: New Exposure For an Old Profession, 36 S.D. L. REV. 574, 578 (1991) (citation omitted). Managers who commit fraud are often aware of the audit procedures and their respective limitations. Thus, they can minimize the chance of discovery by an audit. Gossman, supra note 25, at 236. This Comment does not concern itself with the issue of whether or not auditors should be detectors of fraud and liable for such.
40. Kirby & Davies, supra note 39, at 577.
41. See supra note 24.
42. See U.S. AUDITING STANDARDS, supra note 20, at AU § 110.01; Kirby & Davies, supra note 39, at 577-78.
higher standard of care than the accountant believes he can reasonably fulfill.

Nonetheless, auditors are not always innocent victims of management's unscrupulous activities and of the public's misconceptions. When auditors detect discrepancies or have reservations, they often fail to make disclosures in the audit report that would provide the investing public and creditors with the necessary information to enable informed decision-making. The audit statement should furnish a specific explanation of the actions taken during the audit and the findings of the auditor. Instead, the audit assessment, known as "'the standard audit report,' has become a 'boiler plate' [that] is quite inappropriate for communicating the results of the audit to the client . . . [and] the investing public." By neglecting this duty of disclosure, accountants violate the standard of care that they have established for themselves in GAAS. To avoid liability, the accountant should either insist on the appropriate changes in the financial statements or qualify the audit opinion as required by GAAP and GAAS.

Clearly, accountants are often held to a higher standard of care than simple compliance with GAAP and GAAS because they have not sufficiently defined their role to the public. Moreover, they have failed to enact specific standards that would make the audit process less discretionary and more uniform. Additionally, they have frequently neglected their duty of disclosure.

One step that could be taken to decrease auditor liability is for the AICPA to enact more uniform accounting standards, instead of allowing many discretionary judgments and a choice of alternative accounting methods for auditors to utilize. Alternatively, perhaps it is time for Congress to enact federal legislation in this area. If auditors could be judged against national uniform standards, judging whether or not an auditor is negligent would become a much simpler process than it currently is under the more ambiguous and discretionary GAAP and GAAS standards. Like the Bily Court, other courts may now feel compelled to use judicial intervention to remedy the large amount of potential liability that auditors face. As the Bily ruling is now the governing principle in California, that state has now adopted a dangerously inadequate standard of liability in cases of auditor negligence.

43. See supra note 23 and accompanying text.
44. Chaffee, supra note 2, at 887.
45. See supra note 25 and accompanying text.
B. Parties to Whom the Auditor is Responsible

Courts have given the accounting profession the role of a "public watchdog" over the financial transactions of corporate America. Thus, although the accounting profession has attempted to deny such responsibility, auditors are increasingly liable when a company fails. By rendering an independent, objective evaluation of financial statements, the auditor provides reasonable assurance that the financial position of the client is fairly represented to the users of the information. In fact, because of the growing need to acquire extensive capital funding for operations of businesses, the accountant's role is very different today than it was at the time of the adoption of the privity doctrine. Although an audit is addressed to management, its primary purpose is to influence the actions of non-client third-parties by convincing those third-parties that it is safe to extend credit to or invest in the client-business.

At one time the audit was made primarily to inform management of irregularities and inefficiencies in the business. That function remains one of the principle reasons for the audit. Gradually a need for independent audits was generated by public ownership of business enterprises and by requirements of the stock exchanges and the Securities and Exchange Commission (SEC). Institutional investors, investment specialists, stockholders, and lenders demanded more and reliable information. It is now well recognized that the


47. See S&L Hearing, supra note 19, at 162 (written statement of William L. Gladstone, Chairman of Arthur Young & Company, quoting The Report of the National Commission on Fraudulent Financial Reporting, Oct. 1987) (stating that an audit cannot and does not guarantee or provide absolute assurance that the financial statements are reliable or accurate; and also stating that, instead, GAAP and GAAS serve to confirm that management has primary responsibility for the financial statements and also serve to protect users of financial statements from placing more reliance on the audit process than is reasonable).

48. See supra note 22 and accompanying text.

49. The privity doctrine provides that an auditor's tort liability to a non-client third-party exists only where the auditor has a contractual duty to the non-client, i.e. where the non-client and auditor enter a contract, or where the non-client is specifically designated as a third-party beneficiary in the contract between the client and the auditor. See infra notes 54-57 and accompanying text. When Justice Cardozo adopted the privity doctrine in Ultramares Corp. v. Touche, 174 N.E. 441 (N.Y. 1931), he reasoned that the fledgling accounting industry needed protection from ruinous liability. See infra note 58 and accompanying text. Cardozo made this ruling in 1931, before the adoption of modern securities legislation and regulations.
audited statements are made for the use of third-parties who have no contractual relationship with the auditor. Moreover, it is common knowledge that companies use audits for many proper business purposes, such as submission to banks and other lending institutions that might advance funds and to suppliers of services and goods that might advance credit. The SEC [thirty-six] years ago stated: "The responsibility of the public accountant is not only to the client who pays his fee, but also to investors, creditors and others who may rely on the financial statements he certifies." These uses as well as governmental requirements make financial statements reviewed by independent qualified accountants indispensable. Government has increasingly utilized accounting as a means to control business activities. Some examples of such use are public utility rate regulation and regulation of banks and insurance companies. The SEC has emphasized accountability through disclosure, accomplished in part by examinations and reports of independent auditors under the Securities Act of 1933 and the Securities Exchange Act of 1934.

The auditor's function has expanded from that of a watchdog for management to an independent evaluator of the adequacy and fairness of financial statements issued by management to stockholders, creditors, and others.

This use by third-parties certainly should not be considered minor, casual, or subordinate to that of the client. Most businesses now have their own internal accounting control systems that report the results of operations to management. Moreover, federal securities law requires most businesses with publicly traded securities to undergo an annual independent audit.

These factors render the independent audit of only secondary importance to the client. It is, therefore, naive to believe that audited financial statements are not intended for non-client third-parties to rely upon. Any rule of liability in auditor negligence cases should reflect this reality. As will be discussed below, the rule that the Bily

52. Companies whose securities are traded on a national securities exchange, which have assets of $1 million or more, and which have equity securities held by 500 or more persons must file with the SEC an annual report containing certified financial statements. Securities Exchange Act of 1934 § 12(a)(1), 15 U.S.C. § 78l(g)(1) (1988).
Court adopted neglects to incorporate this basic premise.\textsuperscript{53}

II. THREE APPROACHES TO THE TREATMENT OF NON-CLIENT THIRD-PARTIES

Three methods are currently used in determining auditor negligence in the United States. They are the privity doctrine, the foreseeability rule, and the Restatement (Second) of Torts approach. The following is a brief analysis of each of these methods.

A. The Privity Doctrine

The privity doctrine in accountant negligence cases was established by the 1931 New York Court of Appeals decision, \textit{Ultramares Corp. v. Touche.}\textsuperscript{54} In \textit{Ultramares}, Justice Cardozo explained that privity, close enough to create tort liability to a third-party, exists if the third-party would be deemed a third-party beneficiary under a contract analysis.\textsuperscript{55} The court thereby refused to allow recovery by unspecified third-parties which were outside the scope of the contract between the accountant and his client.\textsuperscript{56} Thus, in order for a non-client plaintiff to recover against an accountant under the privity doctrine, the non-client must have had a contract with the accountant or have been a specifically-named third-party beneficiary to the contract between the auditor and his client. Cardozo reasoned that the non-client plaintiff could not recover against the defendant-accountant because the audit was primarily intended to benefit the client-business.\textsuperscript{57} Cardozo created an exception to the tort rule of foreseeability, rather than acceding to that approach. He felt that the economic and social consequences (most importantly, the possibility of imposing ruinous liability upon the fledgling accounting profession) warranted deferral of the decision concerning the adoption of a foreseeability approach to the legislature.\textsuperscript{58}

In 1985, the New York Court of Appeals slightly narrowed the \textit{Ultramares} privity doctrine in \textit{Credit Alliance Corp. v. Arthur Andersen & Co.}\textsuperscript{59} In \textit{Credit Alliance}, the court adopted what has been

\begin{itemize}
\item \textsuperscript{53} See infra part III.B.
\item \textsuperscript{54} 174 N.E. 441 (N.Y. 1931).
\item \textsuperscript{55} See id. at 446-47.
\item \textsuperscript{56} See id. at 448.
\item \textsuperscript{57} Id. at 446. But see supra notes 49-50 and accompanying text.
\item \textsuperscript{58} See \textit{Ultramares}, 174 N.E. at 447 ("A change so revolutionary, if expedient, must be wrought by legislation.").
\item \textsuperscript{59} 483 N.E.2d 110 (N.Y. 1985).
\end{itemize}
called by some a near-privity approach\textsuperscript{60} by developing a three-prong test to determine whether accountants have a limited privity relationship sufficient to hold them liable to non-client third-party plaintiffs. The three factors used by the court were the following: 1) the auditors must be aware that the financial statements will be used for a particular purpose; 2) the plaintiff must be “known” to the auditors and the plaintiff must be intended to rely on the financial statements; and 3) there must be conduct by the auditors which links them to the plaintiff, demonstrating the auditors’ understanding of the reliance by the plaintiff.\textsuperscript{61}

The strict-privity and the near-privity doctrines are used in at least nine states.\textsuperscript{62} Many jurisdictions, however, find a privity approach to be undesirable. One reason is that it fails to consider the manner in which many business transactions are structured, and, therefore, excludes many deserving plaintiffs;\textsuperscript{63} that is, although the negligent conduct is the same, and the injuries sustained are the same as those sustained by non-clients who were in privity with the auditor, non-client plaintiffs who lack privity will be prohibited from receiving compensation from the auditor for their injuries.

Many business arrangements with professionals involved several parties and two or more interrelated contracts. \ldots\ The substance of the transaction, although not the form, is to create a relationship between the professional and the third-party. In such cases it would be economically wasteful and practically cumbersome to require the third-party to hire an independent advisor. He is not getting something for nothing because the cost of the professional’s services

\textsuperscript{60} This approach has been labelled a near-privity rule because the court stated that an auditor may not be liable for negligence to a non-client third-party unless the non-client plaintiff could “demonstrate the existence of a relationship between the parties sufficiently approaching privity.” \textit{Id.} at 119. This Comment does not differentiate between privity and near-privity; hereinafter, the use of the word privity in this Comment means both of these doctrines (since they almost always have the same result), unless specifically distinguished as being one or the other.

\textsuperscript{61} \textit{Id.} at 118.


have been figured into the overall job and, therefore, he is paying for them indirectly. The privity rule does not, however, provide protection for those plaintiffs...64

Moreover, the rationale for the privity approach no longer exists because the accounting profession is not the fledgling industry that it was when Ultramares was decided; the accountant is not solely responsible to the client anymore, but also serves the public through its "watchdog" role.65 Consequently, many states have abandoned the privity rule in favor of the Restatement approach.66

B. The Restatement Approach

Under the Restatement (Second) of Torts, an auditor may be liable to a non-client third-party plaintiff only if the auditor knows or intends that such third-party or a class of similar persons will utilize and rely upon the financial statements.67 To recover for negligent misrepresentation, the third-party plaintiff must also prove reliance on the financial statements in a transaction that the auditor intended to influence, in a transaction that the auditor knew the client intended to influence, or in a substantially similar transaction.68

Comparing the Restatement rule adopted in Bily to the privity rule of Credit Alliance, it is apparent that, under the Restatement rule, the non-client plaintiff must overcome most of the same burdens that were established in the privity rule.69 The only difference

---

64. Id. at 677-78.
65. See supra notes 46, 49-50 and accompanying text.
66. "At least 17 state and federal decisions have endorsed the [Restatement] rule in this and related contexts." See Bily v. Arthur Young & Co., 834 P.2d 745, 759 n.9 (citations omitted).
67. RESTATEMENT (SECOND) OF TORTS § 552(2)(a) (1978). The full text of section 552 reads as follows:

Information Negligently Supplied for the Guidance of Others.

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

(2) [T]he liability stated in Subsection (1) is limited to loss suffered (a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it; and (b) through reliance upon it in a transaction that he intends the information to influence or knows that the recipient so intends or in a substantially similar transaction... 68.
68. Id. § 552(2)(b).
69. Compare the test established in Credit Alliance, supra text accompanying note 61,
between the privity rule in *Ultramares* and the Restatement rule is that the Restatement rule does not require that the auditor specifically know the identity of the relying third-party plaintiff.\(^{70}\) The *Credit Alliance* rule mandates that the plaintiff be "a known party" to the auditors.\(^{71}\) In contrast, the Restatement rule requires that the relying third-party plaintiff be a person or member of a limited group that is known to the auditor and that either the auditor intends to influence or the auditor knows that the client intends to influence.\(^{72}\) The expansion of the privity rule in the Restatement, however, is only slight; the potential number of investors and creditors that may invest in or extend credit to the auditor's client is *not limited.* Thus, to recover under the Restatement approach, these third-parties will have to make both their existence and identity known to the auditor. Therefore, under either rule, the auditor must specifically know the plaintiff at the time of the transaction.

The remaining elements of the two tests are essentially the same. Under the *Credit Alliance* rule, the auditor must be aware that his work product is to be used for a particular purpose, and that the plaintiff is intended to rely upon the work product in furtherance of that purpose. Furthermore, the *Credit Alliance* rule requires that some link exist between the auditor and the plaintiff that justifies the plaintiff's reliance.\(^{73}\) Similarly, the Restatement rule requires that the plaintiff has actually relied on the information and that the auditor knew that the information was intended to influence a transac-

---

70. Under the Restatement rule, for the accountant to be liable, he must be actually aware that the non-client will rely upon the information the accountant prepared, but does not have to be aware of the identity of the relying party. See, e.g., Badische Corp. v. Caylor, 356 S.E.2d 198, 200 (Ga. 1987) (stating that under the Restatement rule, "liability is limited to a foreseeable person or limited class of persons for whom the information was intended, directly or indirectly"); Pahre v. Auditor of Iowa, 422 N.W.2d 178 (Iowa 1988) (holding that an accountant who prepared financial statements for a loan company was not liable under the Restatement rule to the guarantor of the loan company's thrift certificates, although the guarantor used the financial statements because the financial statements were intended solely for the loan company's internal use when made, and were not intended to be disseminated to others such as the plaintiff guarantor); Law Offices of Lawrence J. Stockler, P.C. v. Rose, 436 N.W.2d 70, 82 (Mich. 1989) (stating that "under § 552, the knowledge of the supplier of the information [regarding the plaintiff's reliance] . . . and the particular transaction that the supplier or the recipient . . . intends to influence takes on critical significance in determining the scope of the supplier's liability").


72. *Restatement (Second) of Torts* § 552(2).

73. *See Credit Alliance*, 483 N.E.2d at 118.
Either the auditor or the client-business may intend that the information influence the transaction. If the auditor or client intended the audited financial statements (or representations therein) to influence the transaction, then the plaintiff's reliance on those statements with regard to the transaction is obviously justified. Thus, it is clear that the applications of the privity approach and Restatement rule are virtually identical.

C. The Foreseeability Approach

Some courts felt that the Restatement approach did not sufficiently compensate innocent third-parties for their losses when an auditor was negligent. The main criticism is that the Restatement approach arbitrarily limits the class of plaintiffs eligible to recover when an auditor is negligent. One commentator states that the Restatement rule distinguishes between two different groups of plaintiffs that both rely on audited financial statements where no distinction actually exists. "[A] creditor unknown to an auditor . . . will not rely less on a set of audited financial statements than a creditor who is known by the auditor." The foreseeability rule serves to remedy this perceived problem of the Restatement rule. The foreseeability approach requires that the reasonably prudent accountant reasonably and specifically foresee the relying third-party plaintiffs and the uses for the audited statements.

In 1986, the California Court of Appeals applied the doctrine of foreseeability in cases of accountant negligence and overruled the well-established privity rule. In *International Mortgage v. John P.*
Butler Accountancy Corp., the defendant accounting firm had negligently audited the financial statements of Westside Mortgage, Inc. The court found that the accountant was liable, despite the fact that the accountant lacked knowledge of the plaintiff's existence at the time of the audit, had never contacted the plaintiff, and was unaware of the plaintiff's reliance on the audited financial statements. The court ruled that "an independent auditor owes a duty of care to reasonably foreseeable plaintiffs who rely on negligently prepared and issued unqualified audited financial statements," and that a failure to fulfill any such duty is negligence for which the auditor may be held liable. Thus, before Bily, the foreseeability rule applied to cases of accountant negligence in California.

III. ANALYSIS OF THE BILY DECISION: FORESEEABILITY V. PRIVITY

The Supreme Court of California, sitting in Bily v. Arthur Young & Co., rejected the foreseeability test of International Mortgage and adopted the Restatement approach instead. The Bily Court ruled that an auditor may only be held liable to its client for general negligence that occurs during an audit, and that the auditor may only be held liable to the specifically intended beneficiaries of the audit for negligent misrepresentation. The court gave a number of reasons for its decision. First, given "the difficult and potentially tenuous causal relationships between audit reports and economic losses . . . the [accounting profession] faces potential liability far out of proportion to its fault." Second, the sophistication of business parties that become third-party plaintiffs allows the use of contract to privately order the risk, in lieu of employing tort theory. Third, the asserted advantages of the foreseeability approach

82. Id. at 219.
83. Id. at 220.
84. Id. at 227.
85. Id.
86. Id.
88. Id. at 747.
89. Id. at 761; cf. Raritan River Steel Co. v. Cherry, Bekaert & Holland, 367 S.E.2d 609, 615 (N.C. 1988) (In adopting the Restatement approach, the Supreme Court of North Carolina rejected the reasonable foreseeability test because it imposes "liability more expansive than an accountant should be expected to bear.").
90. Bily, 834 P.2d at 761.
are unlikely to occur.\textsuperscript{91}

The \textit{Bily} Court, however, fails to recognize that the rights of small investors and small creditors are most likely to be neglected and infringed upon by the Restatement rule. Moreover, no distinction should be made among the persons to whom auditors should be liable. In suits against auditors for negligent misrepresentation to non-clients, no such distinction is necessary because the misrepresentation in the financial statements (that the financial statements accurately reflect the financial position of the client business, when, in fact, they do not) results from the negligence in the conduct of the audit. Additionally, the burdens of proof on the plaintiff under the Restatement rule are so high that it will be the rare exception that non-clients will be able to recover. Consequently, under the \textit{Bily} ruling, no deterrence against negligence exists. The auditor knows that negligent overstatements of the client’s worth will benefit the client, and that the client, as the only possible plaintiff that may sue the auditor on a negligence claim, will not sue because he has benefitted from the negligent overstatement. The analysis that follows more fully explains why the \textit{Bily} Court’s reasoning is unpersuasive.

\textbf{A. Is Liability Really Out of Proportion to Fault?}

The major premise of the \textit{Bily} Court’s decision in limiting recovery for general negligence to the auditor’s client, and implementing the Restatement approach for liability to non-client plaintiffs, was that the auditor’s potential liability would otherwise be “far out of proportion to its fault.”\textsuperscript{92} The court began by asserting that the audit is conducted in a client-controlled environment, and that “few CPA audits would be immune from criticism” when the complex audit process is viewed from the perspective of “20-20 hindsight.”\textsuperscript{93} In its opinion, the court also stated that accountants should not be held responsible if they comply with GAAS and GAAP because the many rules that accountants must follow are “broadly phrased and readily subject to different constructions.”\textsuperscript{94}

The court’s conclusion that the liability of auditors is disproportionate to their fault is unpersuasive. First, the court should not use the fact that the accounting industry lacks clear, uniform standards

\textsuperscript{91} Id.

\textsuperscript{92} See supra note 89 and accompanying text.


\textsuperscript{94} See id.
as an argument to excuse liability where the industry is allowed to regulate itself.\textsuperscript{95} It is ironic that in upholding GAAS and GAAP as the standard of care for auditors, the court admitted some of the main weaknesses of using compliance with GAAS and GAAP as the standard of care: compliance with GAAS and GAAP fails to supply auditors with a rigid and uniform framework for the conduct of an audit, which allows too many discretionary judgments and “creative accounting.”\textsuperscript{96} Second, the negligent acts of auditors have resulted in losses to third-parties and the auditors should be held culpable for such losses. Third, auditors have the ability to limit their losses.

1. Examples of Accountant Negligence

Reality paints an unflattering picture regarding the negligent conduct in which auditors have been involved. Their liability has arisen not merely because they have failed to follow ambiguous or discretionary guidelines, but also because they have failed to follow the clearest and simplest of auditing standards.

The events leading up to the Savings and Loan Crisis are very illuminating as to this point. The negligent acts (or failures to act) of accountants in conducting audits of failed thrifts were numerous.\textsuperscript{97} For instance:

In an astoundingly high percentage of failed thrifts, effective real estate lending policy and underwriting controls were virtually non-existent. Effective loan underwriting calls for an elaborate system of documentation and appropriate analysis to evidence management’s prudent decision to approve a loan. Such documentation might include, for example, financial statements on the borrower, tax returns, feasibility analyses for a commercial real estate project, appraisal reports, pro forma projections and other data germane to approving the proposed project. Many failed thrifts either lacked the documentation necessary to evidence a prudent loan decision or else such documentation was inaccurate or poorly prepared and analyzed. A prudent auditor, following AICPA guidelines, which were then in existence, should have been able to identify the majority of problems in this area.\textsuperscript{98}

\textsuperscript{95} See supra part I.A.
\textsuperscript{96} See Bily, 834 P.2d at 763; supra note 94 and accompanying text.
\textsuperscript{98} S&L Hearing, supra note 19, at 172 (written statement of Thomas Myers, President
Another example of negligent conduct is that, in many thrifts, auditors failed to follow up on "significant amounts of restructured loans which [we]re almost ipso facto a [sic] problem loan [sic]."99 Additionally, the mishandling of real estate appraisals was a widespread occurrence in the audits of failed savings and loan institutions.

"The independent auditor should understand and consider the basis' [sic] of the appraised value and the factors used in arriving at such value." . . . Often, in evaluating a commercial real estate loan, the independent auditor would look at appraised value in the file and, so long as such value exceeded the recorded amount of the loan, determine that no loss need be reflected by the institution. The notion of deferring to the opinion of the appraiser as to value, when often, such appraisers were improperly connected with the lender or borrower can clearly lead to poor decisions reflecting the ultimate exposure to the lender. Time after time, auditors of failed institutions depended on valuations exhibited in appraisals that were either fraudulently or incompetently prepared.100

Furthermore, "[i]n some cases, CPAs did not report serious regulatory violations."101 Overall,

'the presence of property flips (which are easily detected by title searches), poor monitoring of loan disbursements, bloated appraisals, out of territory lending, lack of borrower equity, and "related

99. Id. at 28 (statement of Frederick D. Wolf, Assistant Comptroller of the General Accounting Office); see also id. at 61 (statement of Thomas Myers, President of the accounting firm T.A. Myers & Co.). "In many instances appraisals were either absent or exhibited distorted appraisal methodology that derived values which were grossly inflated. The prudent independent auditor should have been able to detect such abuses." Id. at 174 n. (written statement of Thomas Myers, President of the accounting firm T.A. Myers & Co.).

Moreover, professional standards require the auditor to obtain independent corroboration of key management assertions, which is a time-consuming but necessary audit function. Id. at 193 (GAO Report on The Need to Improve Auditing in Savings and Loan Institutions). The auditors often neglected to obtain such independent corroboration and would, instead, rely on management's unsubstantiated oral assertions that problem loans were collectible. Id. Thus, many auditors have clearly failed to comply with professional standards.

100. Id. at 176 (written statement of Thomas Myers, President of the accounting firm T.A. Myers & Co.).

101. Id. at 38 (statement of Richard H. Lehman, Representative from California, quoting Frederick D. Wolf, Assistant Comptroller of the General Accounting Office); id. at 176-77 (written statement of Thomas Myers, President of the accounting firm T.A. Myers & Co.) (Auditors failed to report and follow up on excessive loans to single borrowers and related parties, and failed to note "'formal regulatory actions, such as cease and desist orders:" demanding that the savings and loan institution terminate "'unsafe and unsound operations, and in one case, non-compliance with those orders.' ")
party” lending are all easily ascertainable warning signals for fraud, that, in many instances, the independent auditor should have acted upon, but didn’t.\textsuperscript{102}

Thus, even when information was client-controlled and there was client fraud, the independent auditor could have, should have, and, most likely, would have detected the fraud if the audit was not conducted in a negligent manner.

These are but a few illustrations of the negligence committed by auditors. They indicate that the increase in auditor liability is not solely the product of undetectable client fraud, or unclear or vague standards that are subject to a variety of constructions, as the \textit{Bily} Court alleges. In the \textit{Bily} case, the alleged negligent acts of the accountants were more than a failure to follow broad standards. Arthur Young had given Osborne Computer Corporation clean audit reports for its 1981 and 1982 financial statements.\textsuperscript{103} The plaintiffs’ expert witness identified more than forty deficiencies in the audit.\textsuperscript{104} The liabilities of Osborne in 1982 were understated by $3 million, making Osborne’s apparent $69,000 profit nearly a $3 million loss in actuality.\textsuperscript{105} Arthur Young had, in fact, discovered “material weaknesses in the company’s accounting controls, but failed to report its discovery to management.”\textsuperscript{106} Arthur Young had also found deviations from GAAP, but failed to disclose them.\textsuperscript{107} Additionally, probably the clearest breach of a duty to disclose by Arthur Young occurred when one of its senior auditors uncovered $1.3 million in unrecorded liabilities including failures to account for customer rebates, returns of products, etc. Although the auditor recommended that a letter be sent to the company’s board of directors disclosing material weaknesses in the company’s internal accounting controls, his superiors at Arthur Young did not adopt the recommendation; no weaknesses were disclosed.\textsuperscript{108}

Instead, Arthur Young issued an unqualified audit report.\textsuperscript{109}

\textsuperscript{102} \textit{Id.} at 186 (written statement of Thomas Myers, President of the accounting firm T.A. Myers & Co.).
\textsuperscript{103} \textit{Bily}, 834 P.2d at 747-48.
\textsuperscript{104} \textit{Id.} at 748.
\textsuperscript{105} \textit{Id.}
\textsuperscript{106} \textit{Id.}
\textsuperscript{107} \textit{Id.}
\textsuperscript{108} \textit{Id.}
\textsuperscript{109} \textit{Id.} It appears to be common for auditors to issue an unqualified audit report when there are substantial irregularities or uncertainties about a client’s financial statements. \textit{See}, \textit{e.g.}, First Florida Bank, N.A. v. Max Mitchell & Co., 558 So. 2d 9, 10-11 (Fla. 1990) (audi-
The above examples demonstrate how accountants are often lax in adhering to GAAS and/or reporting violations of GAAP.\textsuperscript{110} It should not be surprising that auditors face greater liability for failing to make the disclosures of irregularities, errors, and uncertainties that \textit{may} materially affect the audited financial statements, and which are mandated by the standards promulgated by the AICPA.\textsuperscript{111}

2. The Fallacy of “Limitless Financial Exposure”

The \textit{Bily} Court further asserts that awards for damages for the economic losses of third-parties raise the specter of increased litigation and “limitless financial exposure.”\textsuperscript{112} The court also points out that when a business entity becomes insolvent, the auditor usually remains as the only possible solvent defendant.\textsuperscript{113}

It may be true that, in many cases, the business entity no longer exists and that the accountant is left as a possible, if not the only, solvent defendant.\textsuperscript{114} However, this fact should not detract from the auditor’s blameworthiness. The financial exposure of the accountant is not limitless. The client uses an audit to secure funds from creditors and investors. However, the client does not have an infinite abil-

\textsuperscript{97} See supra notes 97-109 and accompanying text.
\textsuperscript{98} See supra note 23.
\textsuperscript{99} \textit{Bily}, 834 P.2d at 763.
\textsuperscript{100} \textit{Id.}
\textsuperscript{101} Gossman, supra note 25, at 237 n.126; see Kirby & Davies, supra note 39, at 595 (stating that “any attempted recovery against the [client] is probably fruitless, as the [client] is most likely financially defunct”).
ity to absorb these funds.\textsuperscript{115} The potential for auditor liability to third-parties will be limited by the client's debt-handling ability.\textsuperscript{118} Liability diminishes with the passage of time because the usefulness of an audit declines as time passes and the financial situation of the client changes.\textsuperscript{117} Additionally, the auditor is protected by the adversary process. The plaintiff will not attain recovery if he does not satisfy the burdens of proof imposed on him in a tort case. Clearly, the plaintiff should only be able to recover the damages that he can prove were caused by reliance on the negligently audited financial statements, and for which the accountant cannot prove a defense.\textsuperscript{118} Thus, the Bily Court's characterization of accountant liability resulting from negligent audits as "limitless" is clearly overstated.

The Bily majority also expressed its fear that feigned reliance claims\textsuperscript{119} may add to the auditor's already "potentially limitless" liability.\textsuperscript{120} This problem should similarly be disposed of by the nature of the trial adversary process. The burdens of proof and other inherent limitations imposed on a plaintiff in a tort case protect the defendant auditor.\textsuperscript{121} The relying third-party must prove that the accountant failed to comply with GAAP, adhere to GAAS, or otherwise act reasonably under the circumstances.\textsuperscript{122} The third-party plaintiff must prove that he reasonably relied on the audited financial statements,\textsuperscript{123} that the misinformation led him to decide to enter the transaction,\textsuperscript{124} and that such reliance caused his losses.\textsuperscript{125} Additionally, the plaintiff must demonstrate that his damages were caused by reliance on specific inaccurate data, as opposed to merely proving there was a mistake somewhere in the entire financial re-

\begin{footnotes}
\footnotetext[116]{See id. In other words, the auditor's total potential liability is equal to the value of debt issued during the time period during which it is reasonable to rely on the audited financial statements, plus the value of stock shares issued during that same period of time.}
\footnotetext[117]{Id.}
\footnotetext[118]{See infra notes 122-37 and accompanying text (discussing the role of the plaintiff's burden of proving causation, and defenses available for the auditor's use in limiting liability).}
\footnotetext[119]{Bily, 834 P.2d at 764 & n.12.}
\footnotetext[120]{Id. at 763-64. "[A]llowing third-party recovery for the economic losses may create moral hazards. . . . [S]uch problems are largely of the ex post variety; parties . . . may make fraudulent or exaggerated claims in order to recover from the defendant." Siliciano, supra note 115, at 1945.}
\footnotetext[121]{Hagen II, Common Law Negligence, supra note 51, at 208.}
\footnotetext[122]{Id. at 208-09; Kirby & Davies, supra note 39, at 597.}
\footnotetext[123]{See infra note 127.}
\footnotetext[124]{Paschall, supra note 3, at 706; see infra note 127.}
\footnotetext[125]{Bily, 834 P.2d at 777-78 (Kennard, J., dissenting).}
\end{footnotes}
port. Courts will disallow claims where plaintiffs fail to satisfy these burdens of proof, and disallow recovery by misusers that fail to comprehend the true nature of the audit report.

The Bily Court's adoption of the Restatement rule implies a lack of faith in the trial adversary system, most especially the role of the jury. The Restatement rule requires a ruling on the question of auditor liability as a matter of law—i.e. whether the plaintiff was a part of a limited group specifically foreseen by the auditor. In contrast, the foreseeability rule requires the jury to decide whether the plaintiff was foreseeable in the eyes of a reasonably prudent auditor, and therefore is a question of fact for a jury. Thus, the ruling in Bily may be the product of "[c]orporate fears [that] ... [j]uries are sympathetic to plaintiffs, and they distrust defendants. [Corporations] maintain that jury trials too often are used to force monied defendants to redistribute the wealth."

The Bily Court's mistrust of juries, however, is misplaced. [C]orporate America's fear of juries may be overblown. Three independent studies of jury verdicts and jurors' attitudes completed within the last year suggest that the litigation explosion is on the wane. In fact, the studies show that plaintiffs are actually losing a greater proportion of cases today than they have in many years. Plaintiffs won 63% of all personal injury claims against businesses in 1988; in 1992, they won only 54% of them, according to a study released in November [1993] by Jury Verdict Publications . . .

Jury Verdict's study . . . also refutes the popularly held notion that juries' monetary awards are increasingly out of control. On the contrary, awards have remained relatively constant in the past five years. "The notion that juries are wild, unpredictable, and capricious is not true" . . . "Plaintiff bias has been overstated."

Thus, the adoption of the Restatement rule, which takes the question of auditor liability away from the jury, is unnecessary. Furthermore,
there are many defenses available to the accountant. The best defense for the accountant is that he acknowledged his responsibility and exercised reasonable care under the circumstances. The accountant can also obtain partial indemnification where the client or its management contributed to the misrepresentation. More often than not, however, the auditor is held liable for the entire amount of plaintiff's loss because the courts do not apportion the damages, or because the client is insolvent. Still, an auditor can seek several liability so that he is only liable for his share of fault. The defendant auditor may also be able to eliminate or reduce damages through the defenses of contributory or comparative negligence. Moreover, the statute of limitations, which ordinarily runs from the point of reliance, also protects the defendant accountant.

Clearly, there are numerous safeguards built into the litigation process that will prevent defendant accountants from being liable for

131. Costello, supra note 20, at 297. A starting point would be showing compliance with GAAP and GAAS. Moreover, the auditor may have to do more than comply with GAAP and GAAS in certain circumstances because compliance with GAAP and GAAS may be regarded as insufficient as a standard of care. See supra part I.A. "This means . . . [that the auditor must] recogniz[e] that under certain circumstances auditors must design audit procedures and tests beyond that which a normal GAAS audit requires, such as . . . independently verifying management representations . . . ." Costello, supra note 20, at 297.


133. Diab, supra note 126, at 1467.

134. See supra note 114 and accompanying text.

135. Chaffee, supra note 2, at 891. Similar reform proposals have already been made. For instance, in January 1993, a bill entitled the Securities Private Enforcement Reform Act (SPERA) was introduced in Congress. H.R. 417, 103rd Cong., 1st Sess. (1993). SPERA proposed to replace the current system of joint and several liability for violations of the Securities Exchange Act of 1934 with proportionate liability if the defendant is found to not have made a material misrepresentation with actual knowledge of falsity or omission of material information. H.R. 417 § 3. Although the bill was not passed, it is indicative of a general trend towards lobbying for several liability by accountants.


136. Hagen II, Common Law Negligence, supra note 51, at 209; Kirby & Davies, supra note 39, at 598.

fraudulent claims. If audit reports were not a substantial factor in
the decisions of investors and lenders to lend or extend credit, then
businesses would have little need for independent auditing ser-

vices.\textsuperscript{138} The lenders and creditors that are not specifically foreseen
by the auditor are no less induced to rely on the audited financial
statements than large banks and institutional investors. The small
lenders and investors are probably more reliant on the audited finan-
cial statements in their lending and investing decisions, and the audi-
tor and its client know this.\textsuperscript{139} Thus, the \textit{Bily} Court cannot justify a
rule of liability that arbitrarily deprives parties that truly suffer in-
jury, especially when alternatives are available. Adopting the Re-
statement rule undermines, and expresses a lack of faith in, the ad-
versary system. "Even if the[] unfortunate consequences [asserted by
the court] could be demonstrated, the remedy should come in the
form of carefully crafted legislation, not wholesale curtailment of a
legal duty."\textsuperscript{140} In \textit{Bily}, the Supreme Court of California has estab-
lished arbitrary limitations on a potential plaintiff's ability to recover
in a negligence action in order to solve a perceived tort-reform
problem.

\textbf{B. The Private Ordering of Risk}

In its decision, the \textit{Bily} Court assumed that the third-party
plaintiffs in accounting liability actions are normally sophisticated
commercial enterprises.\textsuperscript{141} The court then expressed its belief that all
third-parties should, therefore, bear the loss for their own risks, or
bargain with the client and auditor to make themselves specifically
foreseeable parties.\textsuperscript{142}

\begin{itemize}
  \item \textsuperscript{138} \textit{Bily}, 834 P.2d at 778 (Kennard, J., dissenting).
  \item \textsuperscript{139} For instance, small lenders and investors rarely possess the large research staff and
          resources that many institutional investors employ in gathering information and data to make
          investment decisions. Small investors and lenders will rarely have direct access in communi-
          cations with a business's chief executive officer or chief financial officer, which is common with
          many institutional investors and large banks. The small lenders and investors are more reliant
          on the financial statements of the client because they are, by definition, small and lack the
          resources to obtain information to which large institutional investors and creditors have access.
  \item \textsuperscript{140} \textit{Bily}, 834 P.2d at 775. However, it is "[t]he judiciary [that] is usually responsible
          for the final determination [of this issue], since state legislatures seldom pass laws stating
          specifically the conditions under which an accountant may be sued." Paschall, \textit{supra} note 3,
          at 696.
  \item \textsuperscript{141} \textit{Bily}, 834 P.2d at 765; Gossman, \textit{supra} note 25, at 229; Siliciano, \textit{supra} note 115,
          at 1955 (Almost all creditors in negligent accounting cases are "banks, commercial creditors,
          or trade creditors" which "routinely evaluate the probable risks associated with contemplated
          transactions.").
  \item \textsuperscript{142} \textit{Bily}, 834 P.2d at 765.
\end{itemize}
Although sophisticated investors and creditors may not need protection from misstated financial statements, the court's reasoning is flawed because many creditors and investors are not sophisticated.\textsuperscript{143} Unlike the investors in the era of the 1920s during which the Ultramares case was decided,\textsuperscript{144} many of today's investors lack the sophistication, ability, and resources to obtain additional information about a corporation's financial health from other sources.\textsuperscript{145} "These investors may be forced to rely on the accountant's statement alone and, therefore, may need the additional protection provided by expanding accountant liability to third-parties."\textsuperscript{146} "The lack of protection under the Restatement rule] is illogical, considering that the same standards of care must be observed regardless of the identity of the actual recipient."\textsuperscript{147} While large investors will be known to the auditor or possess enough clout to be able to bargain with the client and auditor for protection under the Restatement approach, small, individual investors who are unknown to the accountant will be left to bear the risk of their reliance.

1. The Inadequacy of Federal Securities Laws in Cases of Negligent Audits

The Bily Court argued that the existing federal securities laws\textsuperscript{148} protect investors and creditors against fraud and gross negli-

\textsuperscript{143} Chaffee, \textit{supra} note 2, at 875.

\textsuperscript{144} Ultramares Corp. v. Touche, 174 N.E. 441 (N.Y. 1931), was decided after the Stock Market Crash of 1929, but before the enactment of the Securities Act of 1933 and the Securities and Exchange Act of 1934.

\textsuperscript{145} \textit{See} Chaffee, \textit{supra} note 2, at 875.

\textsuperscript{146} \textit{Id.}; \textit{see also} Bily, 834 P.2d at 785 (Kennard, J., dissenting) ("In short, the majority's rule is one that protects the wealthy and financially savvy at the expense of those innocent investors and lenders whose only faults are their modest means and their willingness to place their trust in audit reports."). Investors and creditors that do not invest large amounts of money or extend a large amount of credit to the auditor's client probably cannot afford to engage in sophisticated financial analyses, or pay for their own audit because the cost of doing so would be prohibitive. Thus, the Bily rule implies that only wealthy non-clients should be able to recover when an auditor's negligence causes the non-clients' losses; the auditor is more likely to know about wealthy non-clients because of the amount of money involved in such non-clients' transactions with the client or because the wealthy non-client possesses the financial leverage to negotiate to hold the auditor liable.

\textsuperscript{147} Paschall, \textit{supra} note 3, at 724 n.172 (quoting Albert G. Besser, \textit{Privity—An Obsolete Approach to the Liability of Accountants to Third Parties, 7 Seton Hall L. Rev. 507, 527 (1976)}).

gence, and put auditors on notice as to the "extent of [their] potential liability exposure." The court apparently perceived that the securities laws would be adequate to protect plaintiffs that would not succeed in a lawsuit under the Restatement rule. The problem with these laws, however, is that they provide much greater difficulty for a non-client plaintiff to prevail against a defendant-accountant.

Federal statutes create liability for accountants only under very limited circumstances. For example, the Securities Act of 1933 ("Securities Act") allows recovery against an accountant when third-parties rely on an audit opinion in a registration statement or prospectus. The plaintiff cannot recover in an action under section 11 of the Securities Act if the auditor "had no reasonable ground to believe and did not believe . . . that the [false or misleading] statements [in a registration statement] . . . were untrue." Thus, under section 11 of the Securities Act, which only applies to falsity in a registration statement, a plaintiff does not have to prove scienter or negligence; rather the burden of proof rests on the accountant to show due diligence to absolve himself. More importantly, a non-client plaintiff is unlikely to succeed in a claim under section 11 because, in order to be liable, the auditor must have sold or offered to sell a security. In an action under section 12, which deals with


149. Bily, 834 P.2d at 760.
151. See id. § 77l.
152. See id. § 77k(b)(3)(C).
153. See id. § 77k(a). A "registration statement" is a "[d]ocument required by the Securities Act of 1933 of most companies wishing to issue securities to the public . . . . The statement discloses financial data, purpose of securities offering, and other items of interest to potential investors." BLACK'S LAW DICTIONARY 1284 (6th ed. 1990).
155. 15 U.S.C. § 77l(2); see, e.g., Akin v. Q-L Invs., Inc., 959 F.2d 521, 532 (5th Cir. 1992) (accountant which prepared financial statements used in limited partnership investment transactions could not be liable under 15 U.S.C. § 77l for sale of unregistered securities because it was not a "seller"); Riedel v. Acutote of Colorado, 773 F. Supp. 1055, 1062 (S.D. Ohio 1991) ("those who merely give 'gratuitous advice' or professionals, such as attorneys or accountants, whose participation is confined to providing professional services" are not "seller[s]" as to be liable under § 12 of Securities Act of 1933); Dawe v. Main St. Mgmt. Co., 738 F. Supp. 36, 38 (D. Mass. 1990) (defendant accountant could not be liable under Securities Act of 1933 § 12(2) where it performed its "ordinary accounting services in connection with the private placement memorandum" for a limited partnership); In re Crazy Eddie Sec. Litig., 714 F. Supp. 1285, 1293 (E.D.N.Y. 1989) (defendant accounting firm was not liable
false statements in a prospectus, the auditor must have committed at least gross negligence for the plaintiff to recover. Additionally, under either section 11 or section 12, only a person who purchased the security from the auditor may maintain a cause of action. Hence, these provisions will be of no use where, for example, a small creditor suffers losses as a result of relying on assertions made pursuant to a negligent audit.

In an action brought pursuant to the Securities Exchange Act of 1934 ("Exchange Act"), which is similar to an action brought under section 12 of the Securities Act, a plaintiff is required to prove more than mere negligence. Under section 18 of the Exchange Act, accountants are not held civilly liable if they "acted in good faith and had no knowledge that [the financial] statement[s] were false or misleading." This makes gross negligence the standard for liability under section 18 of the Exchange Act, which governs actions for liability for misleading statements. The plaintiff must further prove that his damages were caused by a false or misleading statement, and that such statement affected the purchase or sale price of the security involved.

In suits concerning the use of manipulative and deceptive devices in sales of securities under section 10(b) and Rule 10b-5 of the

for aiding and abetting a § 12(2) violation where the accountant was not alleged to have sold, offered to sell, or solicited the sale of securities).

156. 15 U.S.C. § 77i(2) (emphasis added) provides:

Any person who—

(2) offers or sells a security ... by means of a prospectus or oral communication, which includes an untrue statement of material fact or omits to state a material fact ... and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,

shall be liable to the person purchasing such security from him ...


Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this chapter or any rule or regulation thereunder ... which statement was false or misleading with respect to any material fact, shall be liable to any person who in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement ... unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading.

Exchange Act, the plaintiff must prove scienter.\textsuperscript{160} Such a high standard is not easily proved by a plaintiff. Furthermore, these provisions may not provide any relief for non-client plaintiffs at all. A cause of action under section 10(b) or Rule 10b-5 may not exist for third persons not in privity with the defendant auditor.\textsuperscript{161} Also, the Supreme Court has recently decided that section 10(b) and Rule 10b-5 do not give a private plaintiff a right of action against an auditor for aiding and abetting a manipulative or deceptive act.\textsuperscript{162}

Therefore, it is obvious that, while it will be extremely difficult for non-client plaintiff investors to recover the losses caused by a negligent audit by using the federal securities laws (if they can recover at all), non-client plaintiffs that are able to use the Restate-

\textsuperscript{160} In action brought pursuant to 11 U.S.C. § 78j(b) and Rule 10b-5, the plaintiff securities purchaser was required to prove that the defendant accounting firm, which prepared financial statements for the issuer of securities, knew that its report was misleading; scienter was construed by the court such that it could be reckless disregard for the truth. Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, 378 F. Supp. 112, 121, 126 (S.D.N.Y. 1974), modified on other grounds, 540 F.2d 27 (2d Cir. 1976); see also Sharp v. Coopers & Lybrand, 649 F.2d 175, 193 (3d Cir. 1981) (stating in a 10b-5 action against accountant that recklessness is the standard for Rule 10b-5 actions in the Third Circuit and Seventh Circuit, and that "[r]eckless conduct may be defined as highly unreasonable [conduct], . . . [that is] an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it' "), reh'g denied, 425 U.S. 986 (1976). But see Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976) (holding that, in actions under § 10(b) and Rule 10b-5, "scienter" refers to a mental state embracing intent to deceive, manipulate, or defraud); cf. Duke v. Touche Ross & Co., 765 F. Supp. 69, 75 (S.D.N.Y. 1991) (In action under 15 U.S.C. § 78j(b), the court stated that "[t]he Second Circuit has held that [the] plaintiff must 'specifically plead those events' that 'give rise to a strong inference' that defendant had knowledge of the alleged falsity.").

\textsuperscript{161} See CL-Alexanders Laing & Cruickshank v. Goldfeld, 739 F. Supp. 158, 164-65 (S.D.N.Y. 1990) (accountant that "did not have duty to report on actual sales or the reasonableness of management's sales assumptions" in engagement letter with the plaintiff investor was not liable to such plaintiff under Rule 10b-5 or § 10(b) for failing to report cancellation of large order affecting corporation's sales projections); Leoni v. Rogers, 719 F. Supp. 555, 565 (E.D. Mich. 1989) (holding that "[i]f there is no fiduciary relationship between the parties, then no duty to disclose exists, and one party's failure to supply another party with material information is not actionable under section 10(b) and Rule 10b-5"). But see Arthur Young & Co. v. Reves, 937 F.2d 1310, 1336 (8th Cir. 1991) (holding that the auditor of financial statements may be liable for rescission damages to purchasers of securities with whom the auditor was not in privity), aff'd, Reves v. Ernst & Young, 113 S. Ct. 1163 (1993); Atlantis Group, Inc. v. Rospatch Corp. (In re Rospatch Sec. Litig.), 760 F. Supp. 1239, 1250-52 (W.D. Mich. 1991) (plaintiff is not required to prove that the defendant auditor had a duty to disclose in order to hold the auditor liable in an action under section 10(b) or Rule 10b-5).

\textsuperscript{162} Central Bank of Denver v. First Interstate Bank of Denver, N.A., 114 S. Ct. 1439, 1446, 1448 (1994) (stating that a "private plaintiff may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of [Exchange Act] § 10(b)"; aiding and abetting a manipulative or deceptive act is not prohibited by Exchange Act § 10(b)).
ment rule—i.e. large institutional investors and creditors—will bear much smaller burdens in proving their claims. This is so, even though the losses of the two classes of plaintiffs are similar, the losses were caused in the same manner by the same negligent acts, and both classes of plaintiffs received the audit opinion and financial statements for free. Moreover, creditors will not be able to avail themselves of federal securities laws which only apply to the sale or issuance of securities.

2. The Small Investors and Small Creditors Are Left Unprotected

The Bily Court asserts that third-party plaintiffs are in a better position to bear the risk associated with false or misleading audits. The rationale is two-fold. First, the auditor is in a worse position to protect against losses because he is an outsider who gets his financial information from the client. Second, many third-parties are in a position to protect their interest when dealing with the client. For instance, a creditor may obtain a security interest in the assets of the auditor's client, require a guarantee of payment from the client, or insure its interest. The third-party can insist that any transaction resulting from reliance on the audited statement be assured through the posting of a bond. Furthermore, a creditor can scruti-

163. See supra notes 141-42 and accompanying text.
165. "Security interest" means an interest in personal property or fixtures which secures payment or performance of an obligation. The retention or reservation of title by a seller of goods notwithstanding shipment or delivery to the buyer . . . is limited in effect to a reservation of a "security interest." The term also includes any interest of a buyer of accounts or chattel paper which is subject to Article 9 [of the Uniform Commercial Code] . . . . Whether a transaction creates a . . . security interest is determined by the facts of each case . . . . U.C.C. § 1-201(37) (1990). For rules of law commonly governing security interests, see generally U.C.C. art. 9 (1990).
167. Gossman, supra note 25, at 229.
168. Goldberg, supra note 166, at 301 (the "bond would reimburse the lenders for all losses suffered in the event that the borrower defaulted and an outside observer (a jury or arbitrator) concluded that the accountant's audit was negligent"). Goldberg further observes that this process is equivalent to a civil trial under the tort standard. Id.
nize a credit application closely, can require an applicant to undergo an audit whereby the creditor is specifically named as a third-party beneficiary, and can take measures to protect against losses through write-offs or insurance. If the creditor must pay for the independent audit, he may pass on the cost to the client in the form of an increase in the cost of credit. This increase in the cost of credit will, in turn, be passed on by the client to its customers in the form of increased prices for its goods and services. This is the exact same result that occurs when the accountant passes the increased cost of insurance on to the client.

It is also contended that, like creditors, investors also have the ability to protect themselves. For instance, an investor may diversify his range of investments. Additionally, it seems evident that creditors and investors can readily evaluate and alter their risks by the amounts of their loans and investments. Thus, arguably, creditors and investors are in a good position to protect themselves against the risk of the insolvency of the auditor's client.

Nonetheless, the small investor and small creditor, who are not protected by the Restatement rule, are left relatively insecure. First, many investors are unsophisticated individuals that lack a significant capacity to bargain directly with the client and auditor over investment risks. For example, if a noninstitutional investor attempted to incorporate the cost associated with overstated financial statements by offering a lower price for the security, the probable result would be a failure to acquire the desired security. This result is likely because of the enormous number of competing investors in the marketplace that take the pricing decisions out of the control of small investors. Second, the small investor may lack the funds to

169. Gossman, supra note 25, at 239.
170. Id.; Siliciano, supra note 115, at 1956. This provides the creditor with privity to the accountant it hires because the creditor would be a direct beneficiary of the contract. The creditor would then fall under the Ultramares privity rule, if the auditor was negligent. See Siliciano, supra note 115, at 1956 & n.139.
171. Gossman, supra note 25, at 239.
173. Id. at 1973.
174. Gossman, supra note 25, at 239; Kirby & Davies, supra note 39, at 593.
175. "Small" denoting small amounts of money invested—i.e. not an institutional investor or wealthy person. For example, the local business furniture and computer stores which sell to a business on a credit basis would be small creditors.
177. See Hagen II, Common Law Negligence, supra note 51, at 207. Whereas some institutional investors, like Fidelity Investments, California Public Employee Retirement System, etc. can change the price of a security when they buy or sell large blocks of shares (often
diversify his investments.\textsuperscript{178} Third, the individual investor and small creditor generally cannot afford the prohibitive cost of paying for their own audit. It is much more efficient for the audit to be conducted once by the client’s auditor, than it is to have every potential creditor or investor conduct its own audit of the client-business. Fourth, the small investor and small creditor have no real ability to redistribute the loss widely across society,\textsuperscript{179} as compared to such ability possessed by an institutional investor or large lending bank. It is these small investors and small creditors that most need protection when an auditor is negligent. However, the \textit{Bily} decision leaves them in the precarious position of bearing the loss themselves because of the arbitrary limitations imposed by the Restatement approach. Lastly, it is the client’s auditor, and not the investor or creditor, who is in the best position to protect against third-party injury by conducting the audit in a non-negligent manner.

C. The Insurance Dilemma

In \textit{Bily}, the California Supreme Court rejected the policy rationale that the risk should be borne by accountants through insurance.\textsuperscript{180} The current crisis in insurance for accountants is largely the reason for this decision by the court. As the liability of auditors has increased, there has been an accompanying increase in the cost of insurance to accountants.\textsuperscript{181} This increase has had the effect of excluding all but the larger accounting firms from obtaining insurance protection.\textsuperscript{182} As awards and settlements in cases of auditor negligence begin to exceed $300 million each,\textsuperscript{183} the number of accounting firms large enough to absorb such losses, even with insurance, is minute at best.

\footnotesize{hundreds of thousands, or millions at a time), the enormous volume and value of the client’s shares being publicly traded prohibits the small investor from impacting the price of the security through its decisions to buy or sell the security.}\textsuperscript{178. However, it has become much easier for an individual to diversify his equity investments in recent years because of the advent of mutual funds as investment vehicles.\textsuperscript{179. Siliciano, supra note 115, at 1973.}\textsuperscript{180. 834 P.2d at 765.}\textsuperscript{181. Kirby & Davies, supra note 39, at 593 (stating that since 1985, the average insurance deductible for accountant malpractice insurance has doubled and the actual premiums have skyrocketed as well).}\textsuperscript{182. Id.}\textsuperscript{183. See, e.g., Lee Berton & Stephen J. Adler, CPA’s Nightmare: How Audit of a Bank Cost Price Waterhouse $338 Million Judgment, \textit{Wall St. J.}, Aug. 14, 1992, at A1, A4; Susan Schmidt, \textit{Ernst & Young Pays $400 Million to Settle Thrift Regulators’ Claims}, \textit{Wash. Post}, Nov. 24, 1992, at A1.}
While, in theory, small CPA firms may be financially squeezed out of the audit business because of fee competition with the "Big Six" firms and an uncertain malpractice insurance market, in reality, small CPA firms do not perform a large amount of audits and, thus, do not need audit malpractice insurance. The number of parties and transactions that rely on audits that are not mandated by federal securities laws is very limited. Most audits of publicly-traded companies are already performed by the largest CPA firms with their great financial resources. This means that most cases of negligent auditing will involve the few largest firms. Common sense, thus, indicates that the smaller CPA firms will not have to bear the burden of greater insurance costs because they will not have to litigate, or pay damages in, auditor negligence actions.

Insurance does not work as well in reality as it does in theory. Although it is theorized that negligent accounting firms will individually incur the additional malpractice premiums resulting from their negligence, an inequitable distribution of the insurance costs will result when courts handle accountant negligence as strict liability—that is, if the courts, in most instances, do not hold the plaintiffs to their burdens of proof. Since courts frequently fail to make plaintiffs prove their burdens of proof, the equitable allocation of the increased costs of insurance has not been effective.

For insurance to operate effectively, the insurer must be able to project the level of possible losses with reasonable certainty. This is straightforward under the privity rule and the Restatement rule, where third-parties that are not in privity must guard against their

185. See supra note 52 (discussing the requirement that companies with publicly traded securities annually file certified financial statements with the SEC).
186. The “Big Six” [accounting firms] audit nearly 90% of all publicly traded corporations with annual revenues of at least one million dollars. Moreover, the “Big Six” audit nearly all of the country's largest corporations, including . . . 494 of the Fortune 500 industrials; 97 of the Fortune 100 fastest growing companies; 99 of the Fortune 100 largest commercial banks; 92 of the top 100 defense contractors; and 195 of the 200 largest insurance companies.” Lewis P. Checchia, Note, Accountants' Liability to Third Parties Under Bily v. Arthur Young & Company: Does a Watchdog Need Protection?, 38 VILL. L. Rev. 249, 269 n.104 (1993) (citation omitted).
188. Id. at 209.
own losses.190 Under the foreseeability approach, the accountant and his insurer lack knowledge about the identity, number and/or financial exposure of the third-parties whose losses they must insure against.191 However, it is possible to estimate such losses under the foreseeability approach by analyzing the clients' business practices, debt structures, etc.192

Additionally, accountants, if they choose, can limit their services by refusing to perform audits for risky clients.193 This is, however, unnecessary because the demand for audits is inelastic;194 federal securities law mandates that publicly traded corporations must have annual independent audits.195 This inelasticity of demand means that risky clients cannot refuse the auditors' services, even if auditors increase their fees to such clients (to cover the increased cost of liability insurance caused by the extra risk in audits of such clients). In this manner, even auditors with risky clients can remain solvent and afford to maintain insurance to protect against negligent audits because it is the client that will pay for the increased insurance premiums in the end. Generally, the client will then spread this cost by increasing the price of its products or services. This is the same result that occurs when the non-client creditor bears the costs of the negligent audit.196

If steps are taken to decrease the amount of damages being paid, the insurance dilemma would probably no longer be a dilemma. If uniform national rules were established, and if courts held plaintiffs responsible for bearing their burdens inherent in the trial adversary system, instead of treating auditor negligence as strict liability, the problem of escalating insurance costs could probably be resolved.

190. See id.
191. Id.
192. Id. at 1949-50.
193. Id. at 1960.
194. Elasticity of demand is the ratio of percentage of change in quantity demanded for a product to the associated percentage of change in the price of the product. Demand for a product is inelastic if this ratio is less than one. That is, if the price of a product increases by 10% and the demand for the product does not decrease, or decreases by less than 10%, the product is said to have inelastic demand. William J. Baumol & Alan S. Blinder, Economics: Principles and Policy 483-84 (4th ed. 1988).
195. Companies whose securities are traded on a national securities exchange, which have assets of $1 million or more, and which have equity securities held by 500 or more persons must file with the SEC an annual report containing certified financial statements. Securities Exchange Act of 1934 § 12(a)(1), 15 U.S.C. § 78l(g)(1) (1988). This makes an audit a necessity for most publicly traded companies. Goods that are necessities tend to have inelastic demand. Baumol & Blinder, supra note 194, at 490.
196. See supra note 172 and accompanying text.
D. Accountants Can Protect Themselves

In deciding that the investors and creditors should bear the loss for a negligent audit, the Bily Court failed to take account of the many actions that auditors can take to limit their liability. Steps may be taken by auditors to better order and limit their risks in case they perform an audit negligently.

For example, during fee negotiations, the auditor may require that clients identify all reasonably foreseeable users and recipients of the financial statements in order to adequately estimate the potential liability exposure. In the audit opinion, the accountant can issue a reasonably prudent disclaimer which, in clear and exact terms, indicates how a particular audited statement does not meet accounting standards, and give the reasons for that inadequacy. Qualifications will not be effective if the matters disclaimed are within the auditor's rightful range of examination, are worded too generally, are unclear, or arrive too late to be meaningful for the end user. However, when done adequately they can greatly decrease the auditor's risk of being liable for negligence.

Consequently, there are actions that the accountants may take to limit their potential liability to third-parties. Although the Bily Court reasons that the third-party plaintiffs should bear the risk be-

197. Bagby & Ruhnka, supra note 184, at 190.
198. Id. at 175; Kirby & Davies, supra note 39, at 597; see supra note 23 and accompanying text.
199. Bagby & Ruhnka, supra note 184, at 178. A qualification was ruled to be too general where it stated that the audit opinion was "subject to realization." Id. (citing Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, 540 F.2d 27, 35-36 (2d Cir. 1986)). The court stated that an auditor had a duty to inquire into the specific facts giving rise to the qualification and provide a clear explanation of the reasons for such qualification. Herzfeld, 540 F.2d at 36. An auditor whose letter qualifying the scope of examination, which arrived 30 days after the financial statements were issued, was held liable for active misrepresentation, and gross negligence for the delay. State St. Trust Co. v. Ernst, 15 N.E.2d 416, 420 (N.Y. 1938). Excessive generality and lack of clarity as to the scope of the qualification are also reasons for courts to disregard such disclaimers. See, e.g., Rhode Island Hosp. Trust Nat'l Bank v. Swartz, Bresenoff, Yavner & Jacobs, 455 F.2d 847, 851-52 (4th Cir. 1972) (auditors were held liable for negligence where they failed to disclaim in certified financial statements that leasehold improvements did not exist, but they did disclaim that "overall . . . they could not express an opinion with regard to their fairness" and that the precise value of leasehold improvements could not be determined); 1136 Tenants' Corp. v. Max Rothenberg & Co., 277 N.Y.S.2d 996, 997 (N.Y. App. Div. 1967), aff'd, 238 N.E.2d 322 (N.Y. 1968) (summary judgment was precluded where a client's financial statements stated "[n]o independent verifications were undertaken thereon" but the annual report submitted to shareholders did not contain such disclaimer).
cause they are in a better position to avoid such risk, the accountants are at least as able to bear the risk as creditors and investors. Moreover, putting the burden on the accountants to avoid negligent conduct fosters the public policy of disseminating a greater amount of truthful information.

E. The Deterrence Rationale

In Bily, the court disregarded the deterrence rationale of the foreseeability approach, deeming it un compelling when compared with the ruinous liability the accounting profession faces. Some commentators claim that professionals already have incentives to do their work carefully because of the duties that they owe to their clients, the economic value of having a good professional reputation, the possibility of adverse publicity, the possible loss of clientele, and the costs of litigation. These arguments are unpersuasive.

As explained throughout this Comment, it is not clear that accountants face ruinous liability at all. The accounting profession may avoid ruinous liability, while maintaining the foreseeability approach, by taking some of the actions previously mentioned in this Comment—e.g. using proper disclaimers and qualifications of audit opinions, using insurance, and developing and adhering to clear, unambiguous, non-discretionary, uniform standards.

In its decision, the Bily Court should have taken into consideration anything that would encourage greater care by auditors in carrying out their professional responsibilities. In the context of auditor liability, the deterrence rationale is more persuasive, and should have been given greater weight by inclusion in the Bily Court's decision. In practice, unless the auditor may be held liable to non-client third-parties, nothing at all exists to deter the auditor from negligent conduct and the dissemination of untruthful information.

Here, some examples are enlightening. Suppose that there is a client (C) that faces a strong possibility of insolvency. C had contracted with auditor (A) to conduct an audit for the year 1993. A conducts the audit, but negligently overstates C's net earnings by

200. Bily, 834 P.2d at 757.
201. E.g., Martin, supra note 63, at 665, 675.
203. See supra notes 112-39 and accompanying text.
204. See supra notes 23, 198-99 and accompanying text.
205. See supra part III.C.
206. See supra part I.A.; supra notes 112-39 and accompanying text.
$20 million, and overstates C's net worth by $20 million. C lost $10 million and is actually insolvent with debts to various creditors totaling $15 million. Unsecured creditor (U), relying on the financial statements audited by A, extends credit to C in the amount of $200,000. A knows about C's transaction with U, but A is not specifically conducting the audit for this particular transaction. A lacks knowledge of the fact that C has supplied U with a copy of the financial statements specifically to assure U of C's financial solvency. Subsequently, C declares bankruptcy and none of the unsecured creditors, such as U, receive what they are owed. Only C may sue A for negligence in the conduct of the audit. However, C would not sue A because A overstated C's earnings and net worth, and C thereby benefitted from A's negligence. Under the Restatement rule, A is not liable to U because A did not specifically know that C intended U to rely on the audited financial statements in the particular transaction between C and U. A gets to enjoy its fees for the audit even though it was conducted negligently, but U suffers a $200,000 loss even though both C and A know that businesses have their financial statements audited so that they may attract investors and/or creditors such as U. Clearly, under the Restatement rule there is nothing to deter negligence by an auditor, especially when the negligence results in an overstatement of the client’s net worth or net earnings.

Likewise, the Restatement rule allows the auditor to engage in selective knowledge. To avoid liability, the auditor may merely request that the client not inform him of any transactions in which the client intends to use the audited financial statements.207 Thus, if the auditor is not informed, as he has requested, he will lack the intent to influence any transaction, and lack knowledge “that the [client] so intends [to influence any transaction].”208 Therefore, the auditor can avoid any liability for negligent conduct which benefits the client.

Under the rule of the Restatement, there is no deterrence against negligent conduct. The Restatement rule allows auditors to engage in negligent conduct with no concomitant liability for losses suffered by non-clients because of such negligence. Additionally, auditors will not suffer a loss of reputation, receive adverse publicity, or lose clientele209 because the audited businesses, which are the auditor’s clientele, will not be harmed under the above circumstances—in fact, the clients will benefit because the misstatement will make it

207. See Boveri & Marshall, supra note 137, at 287.
209. See supra notes 201-03 and accompanying text.
more likely that investors and creditors will invest or extend credit to them. The costs of litigation\textsuperscript{210} will not be great because very few, if any, non-clients will sue as the Restatement rule absolutely precludes their recovery.

\textbf{F. Fundamental Fairness}

The final criteria that must be examined is the fundamental fairness of each approach used in auditor liability cases. An accountant does not guarantee perfection, he only indicates that any errors subsequently discovered could not have been detected by an audit conducted pursuant to GAAS or GAAP.\textsuperscript{211} The accountant can discover mistakes, irregularities and fraud through an audit, but the third-party usually only has limited access to corporate records.\textsuperscript{212} Consequently, equity mandates that the risk of loss be shifted from a blameless, innocent party that usually is unable to protect itself from a negligent audit, to the negligent accountant.\textsuperscript{213} This is especially true in light of the increasing complexity of financial transactions, which causes the public to rely on the work of accountants more now than ever before.\textsuperscript{214} The foreseeability approach seeks to have the innocent injured party compensated by a negligent party, and to deter socially unreasonable conduct.\textsuperscript{215} The Restatement states: “[where] there is no intent to deceive but only good faith coupled with negligence, the fault of the maker of the misrepresentation is sufficiently less to justify a narrower responsibility for its consequences.”\textsuperscript{216} This promotes “the important social policy of encouraging the flow of commercial information upon which the operation of

\begin{itemize}
  \item \textsuperscript{210} See supra note 202 and accompanying text.
  \item \textsuperscript{212} Hagen II, Common Law Negligence, supra note 51, at 207; Kirby & Davies, supra note 39, at 595.
  \item \textsuperscript{213} If it is unfair for a defendant to incur a loss for injuries which could not have been foreseen, it is no less fair for the plaintiff to incur a loss which did not result from his own negligence, but rather, that of the defendant. . . . Thus, as between an innocent third party and a negligent accountant, the latter should be the party who bears the loss resulting from professional malpractice. Hagen II, Common Law Negligence, supra note 51, at 207.
  \item \textsuperscript{214} Diab, supra note 126, at 1459; see Gossman, supra note 25, at 232.
  \item \textsuperscript{216} RESTATEMENT (SECOND) OF TORTS § 552 com. a (1978).
\end{itemize}
the economy rests."217 However, since the securities laws require that most companies whose securities are publicly traded file certified financial statements annually,218 it is unnecessary to encourage the flow of such information through the adoption of the Restatement rule.219 If it is unfair for a defendant to incur a loss for injuries that could not have been foreseen, as the Bily Court asserts, it is just as unfair for a plaintiff to incur a loss that did not result from his own negligence, but rather, from the negligence of the defendant-auditor. Thus, between an innocent non-client plaintiff and the accountant that performed a negligent audit, the accountant should be the party that bears the loss resulting from the negligence. The foreseeability approach incorporates this premise and imposes a duty of care upon each person to refrain from negligent conduct towards others.

Another issue of fairness that arises in the context of auditor liability is the use of selective knowledge by the auditor. For the accountant to be liable to non-client plaintiffs, the Restatement approach requires the accountant to have knowledge of the client’s uses for the audited financial statements.220 This can become complex, as the accountant can have various degrees of knowledge of the client’s stated intentions for the audit.221 In this way the Restatement disregards fairness because a clever accountant can avoid liability under the Restatement by asking his client not to reveal to him the intended users of the financial statements, even though the auditor knows that the client will use the audited financial statements to raise capital from investors and creditors.222 Hence, whereas the foreseeability rule is based upon fundamental fairness by allowing all damaged plaintiffs a right to recovery, the Restatement approach allows for very arbitrary and inequitable results.

IV. CONCLUSION

The Restatement approach, as adopted by Bily, is essentially a return to the doctrine of privity in cases of auditor negligence. In deciding the complicated matter of auditor liability to third-parties, courts throughout the nation must balance the possibility of burden-

217. Id.
218. See supra notes 186, 195 and accompanying text.
220. Restatement (Second) of Torts § 552.
221. Kirby & Davies, supra note 39, at 592.
222. See supra notes 207-08 and accompanying text.
ing auditors with purported ruinous liability against the unjustness of allowing innocent victims to go uncompensated. While the foreseeability approach may seem fairer to investors and creditors, it can be used to achieve fairness for all parties involved in an auditor negligence suit. If the courts frequently and strictly enforce the burdens of proof that plaintiffs must sustain in order to win a case (i.e. that the plaintiff relied on the audit report, that the reliance on the audit report was the proximate cause of injury, etc.), there would be fewer losses by accountants and fewer damages to be paid. For example, if the plaintiff invested in or lent to the client business because of factors other than the audit, the amount of damages or the liability of the defendant accountant should be adjusted accordingly. This would preclude or limit recovery in cases in which the plaintiff is a bank, creditor, or other financial institution which has a great amount of business sophistication and access to information. It is highly unlikely that such entities rely solely on audit reports when extending credit to businesses. However, as the foreseeability approach is being applied by some courts, accountants are strictly liable for negligence.

Moreover, GAAP and GAAS should not be used as a standard of liability for auditor negligence because they are wholly inadequate. Perhaps, the Bily Court did not realize that it was adopting GAAP and GAAS as the liability standard when it ruled that non-clients can sue auditors only for negligent misrepresentation. Nonetheless, uniform, non-discretionary standards are needed, rather than ambiguous rules that accountants themselves have created. Uniform non-discretionary standards would remove much of the guess-work from accountant negligence litigation. Congress should adopt uniform national standards governing the conduct of an audit. Such legislation would improve the usefulness and reliability of financial information.

The Restatement rule and the privity approach as remedies to the problem of auditor negligence are too strict. Creditors and investors have a clear and undeniable right to compensation for losses that result from reliance upon a negligent audit. This right must be protected, especially in the case of individual investors and small creditors, who are less likely than large institutional investors or creditors to receive compensation under the Restatement rule, privity doctrine, or federal securities laws. Unlike the Restatement approach, the foreseeability rule does not arbitrarily deny the right to compensation. Although the adversary system may not work per-
fectly, there is no justification for a court to disregard it or dispose of it, as the California Supreme Court has done in *Bily v. Arthur Young & Co.*

*William A. Sinacori*