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Countering Unrealistic Expectations: Limiting Auditors' Liability to Investors

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Countering Unrealistic Expectations: Limiting Auditors' Liability to Investors

"They're Bean Counters, Not Gumshoes";[1] so reads a recent headline protesting the increased liability of accountants for professional negligence in failing to detect fraud and embezzlement by employees of their corporate clients.[2] Literature in the accounting and legal fields is replete with statistics showing that both the number of lawsuits and the settlement or damage awards against accounting firms have increased substantially in the last decade.[3] Professional associations in the accounting field have attempted to redefine standards and proposed various solutions to reverse this trend but, as yet, there is no viable solution even remotely within sight.

In the area of liability to third parties relying on accountants' opinions concerning the financial health of their client companies, the largest problem appears to be that, supposedly in the interests of public policy, the courts are unable to agree on the appropriate scope of auditors'[4] liability. Opinions range from the Alabama viewpoint, which holds that there is no duty of care owed to third parties and no liability for fraud unless there is an intent to influence,[5] to the Wisconsin theory, which holds that auditors owe a duty of care to all persons who could reasonably be recipients of

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1. Dean Foust, *They're Bean Counters, Not Gumshoes*, BUS. WK., Sept. 14, 1992, at 92.

2. The reference to accountants as "bean counters" probably can be traced to one of the seminal cases in this area that involved the question of potential liability of public weighers employed by a seller of beans. The weighers were found liable, despite the absence of privity, to the buyer who relied on the weight certificate in paying for the beans. Glanzer v. Shepard, 135 N.E. 275 (N.Y. 1922).

3. In 1991, the accounting profession spent $477 million to settle or defend itself against lawsuits, a figure which, at the time, represented approximately 10% of the Big Six's income. Claims against small and medium-sized firms doubled between 1987 and 1991. Aulana L. Peters, *Survey of Development of Accountants' Liability Law From the Demise of Privity to the Cry For Tort Reform*, C859 A.L.I.-A.B.A. 877, 899-900 (1993) (citing a speech by Philip Chenok, the President of the American Institute of Certified Public Accountants ("AICPA")).

4. Although technically distinguishable, the terms accountant and auditor are used synonymously in this comment.

5. DENZIL Y. CAUSEY, JR. AND SANDRA A. CAUSEY, DUTIES AND LIABILITIES OF PUBLIC ACCOUNTANTS 168 (4th ed. 1991).

the accountants' reports.[6] In addition, the courts, and even the accounting profession itself, are unable to agree on the appropriate standards to define the professional duty owed to both clients and third parties and the level of professional negligence which triggers liability.

Apparently heeding the pleas for reform issued by the accounting profession, the California Supreme Court recently reversed its earlier trend toward expansion of the duty owed to third persons and has sharply restricted the parties who may recover damages from an allegedly negligent accountant.[7] This comment reviews that decision and the reasoning of the opinion and suggests that the court still has not addressed the basic problem. Until specific standards for specific circumstances are delineated and adopted, different courts will readily apply the widely disparate theories of liability in order to achieve what they believe is a fair result. Consensus in the definition of exactly what constitutes appropriate professional standards is necessary before the split in the courts can be resolved. This comment focuses on cases involving alleged ordinary negligence under the common law; areas outside the scope of this analysis are those cases involving gross negligence or fraud by the accountant and cases under the federal securities laws.[8]

I. Background

A. *Defining the Standard of Care*

When performing audits, accountants are expected to use the usual judgment, care, skill and diligence employed by similar professionals in similar communities.[9] In an audit engagement, the ac-

6. Causey, cited at note 5, at 168.

7. Bily v. Arthur Young & Co., 834 P.2d 745 (Cal. 1992).

8. The general view is that gross negligence is not the equivalent of fraud, but may give rise to an inference of fraud. Romualdo P. Eclavea, Annotation, *Liability of Independent Accountant to Investors or Shareholders*, 35 A.L.R. 4th 225, § 4 (1985). In Ultramares v. Touche, 174 N.E. 441 (N.Y. 1931), the court indicated that an accountant who is grossly negligent in the preparation of an audit opinion could be found to be without information leading to a sincere belief in the accuracy of the financial statements thus inferring that the accountant's opinion was fraudulently given. *Ultramares*, 174 N.E. at 448.

9. Causey, cited at note 5, at 18; Restatement (Second) of Torts § 299A (1965). The courts quote Thomas Cooley in describing the standard:

> In all those employments where peculiar skill is requisite, if one offers his services, he is understood as holding himself out to the public as possessing the degree of skill commonly possessed by others in the same employment, and if his pretensions are unfounded, he commits a species of fraud upon every man who employs him in reliance on his public profession. But no man, whether skilled or unskilled, undertakes that the task he assumes shall be performed successfully, and without fault or error;

countant reviews financial statements[10] prepared by the client company in order to express an opinion as to whether the statements present an accurate representation of the company's financial condition.[11]

The typical audit is divided into several stages.[12] First, the auditor plans the scope of the audit; this process involves collecting information about the company's business and accounting systems.[13] This information is used in the second stage to evaluate the client's internal controls.[14] The third stage involves testing by the auditor to determine whether proper procedures are followed by the client company in executing and recording transactions.[15] In the fourth stage, the audit system is tested by examining relevant documentation and verifying balances.[16] The end result of an auditor's analysis is the written opinion, which is issued to accompany the client-prepared financial statements.[17]

In the testing stages, an auditor rarely reviews every transaction since this would be prohibitively expensive.[18] Based on the evaluation of the client's internal controls, the auditor must use professional skill and judgment to determine the extent of the testing required before an informed opinion can be issued.[19] The American Institute of Certified Public Accountants ("AICPA") issues rules and procedures for preparation of financial statements called Generally Accepted Accounting Procedures ("GAAP") and rules and procedures for auditors called Generally Accepted Auditing Stan-

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> he undertakes for good faith and integrity but not for infallibility, and he is liable to his employer for negligence, bad faith, or dishonesty but not for losses consequent upon mere errors of judgment.

CAUSEY, cited at note 5, at 18 (quoting THOMAS COOLEY, TORTS § 335 (4th ed. 1932)).

10. Financial statements are summaries of the financial condition or financial results of an organization. BLACK'S LAW DICTIONARY 631 (6th ed. 1990). The client company is responsible for the recording of financial transactions and preparation of the financial statements which are issued as representations by its management. R. JAMES GORMLEY, THE LAW OF ACCOUNTANTS AND AUDITORS—RIGHTS, DUTIES AND LIABILITIES ¶ 1.01 (1981).

11. Willis W. Hagen II, *Certified Public Accountants' Liability for Malpractice: Effect of Compliance with GAAP and GAAS*, 13 J. CONTEMP. L. 65, 68-69 (1987) (citations omitted).

12. Hagen, cited at note 11, at 67 (citations omitted).

13. *Id.*

14. *Id.* at 68 (citations omitted). "Internal controls" are the administrative and accounting controls used by a company to ensure appropriate procedures are followed for authorizing and recording business transactions. *Id.* at 67 n.21.

15. *Id.* at 68 (citations omitted).

16. *Id.*

17. Hagen, cited at note 11, at 68-69.

18. Bily v. Arthur Young & Co., 834 P.2d 745, 749 (Cal. 1992).

19. *Bily*, 834 P.2d at 749-50 (citing Hagen, cited at note 11, at 67-68).

dards ("GAAS").[20] The auditor's opinion certifies that the client company's financial statements were prepared in accordance with GAAP and that the audit was conducted in compliance with GAAS; thus in the auditor's reasonable judgment, the financial statements fairly represent the client company's financial position.[21] However, auditors do not expressly guarantee either accurate financials or discovery of defalcations.[22]

Litigation in this area normally involves claims by investors that the financial statements do not accurately depict the client company's financial position and that there were deficiencies in the audit process which failed to detect the misrepresentations. While some courts have held that compliance with AICPA standards is sufficient proof of due care,[23] many courts state that compliance with GAAS and GAAP does not ensure freedom from liability.[24]

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20. *Id.* at 750 (citations omitted). GAAP are promulgated by the Financial Accounting Standards Board ("FASB"), an independent group established by the Financial Accounting Foundation. CAUSEY, cited at note 5, at 11. GAAS are promulgated by the Auditing Standards Board, a group established by the AICPA. *Id.*

21. GORMLEY, cited at note 10, at ¶ 1.02. There are several "grades" of opinions that auditors can issue; the first and most common is an unqualified or "clean" opinion. In this case, the auditor certifies that the financial statements have been examined in accordance with GAAS, including tests and other procedures that the auditor considered necessary in the circumstances. Following this representation, the auditor issues the actual opinion which normally states that in the auditor's reasonable judgment, the financial statements present fairly the client's financial position and results of operations in conformance with GAAP. *Id.*

The auditor can also issue a qualified opinion, which is normally the result of some substantial uncertainty such as pending litigation which makes it impossible for the auditor to determine whether the financial statements are a fair presentation of the client company's financial health. In addition, auditors can issue a disclaimer of opinion which is the result of an inability to make a judgment due to financial problems of the client company or limitation of the scope of the engagement. Finally, an auditor can issue an adverse opinion, either wholly or partially, which is a result of the auditor's conclusion that the financial statements deviate materially from GAAP or are somehow unfair. *Id.*

22. CAUSEY, cited at note 5, at 19. The courts in California seem to be cognizant of this limitation; while rejecting a claim for malpractice, one court stated that " '[t]hose who hire such persons are not justified in expecting infallibility, but can expect only reasonable care and competence. They purchase service, not insurance.' " Linder v. Barlow, Davis & Wood, 27 Cal. Rptr. 101, 104 (Cal. Ct. App. 1963) (quoting Gagne v. Bertran, 275 P.2d 15, 21 (Cal. 1954)).

A defalcation is defined as an act of embezzling or misappropriation of trust funds or money held in any fiduciary capacity; commonly spoken of officers of corporations or public officials. BLACK'S LAW DICTIONARY 417 (6th ed. 1990).

23. *See, e.g.*, Securities and Exchange Comm'n v. Arthur Young & Co., 590 F.2d 785, 788 (9th Cir. 1979); *see generally*, Hagen, cited at note 11, at 77-78 (discussing legal effects of compliance with GAAP and GAAS).

24. In Maduff Mortgage Corp. v. Deloitte Haskins & Sells, 779 P.2d 1083 (Ore. Ct. App. 1989), when Deloitte argued on appeal that a jury instruction which stated that an auditor is not liable for failing to detect fraud unless it has failed to comply with GAAS should have been given, the court rejected the argument stating:

B. *Defining the Scope of the Duty of Care*

Generally, in determining the scope of the duty of care owed by the accountant to injured parties, courts have adopted one of three theories. The first, a strict privity formulation, restricts the duty of care to the extent of the contract with the client. A second theory holds that the duty is extended to specific non-contracting parties, or entire categories of such parties, whose reliance on the accountant's report was actually foreseen by the accountant. The third theory, which is the broadest option, defines the scope as encompassing all those persons whose reliance was merely foreseeable, rather than specifically foreseen.

1. *Privity*

Courts applying the privity theory of liability hold that an accountant is not liable for negligence to a third party for errors in the preparation of financial statements for a client because the accountant is not in privity of contract with the third party.[25] The privity concept required for finding accountant liability originated in the often cited opinion of Justice Cardozo in *Ultramares v. Touche*.[26] In that case, a public accounting firm was held not liable for negligence to a third party lending company which had relied on a certified balance sheet prepared by the accounting firm for its client.[27] Justice Cardozo's opinion stated that it would be unfair to impose such broad liability when the accountant had no knowledge that the creditor would rely on the report in determining whether to advance credit to the client company.[28] The court distinguished

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> [T]he AICPA standards are only evidentiary. . . . They are principles and procedures developed by the accounting profession itself, not by the courts or the legislature. They may be useful to a jury in determining the standard of care for an auditor, but they are not controlling. The amount of care, skill and diligence required to be used by defendant in conducting an audit is a question of fact for the jury, just as it is in other fields for other professionals.

Maduff Mortgage Corp., 779 P.2d at 1086.

25. *See, e.g.*, Ultramares Corp. v. Touche, 174 N.E. 441 (N.Y. 1931).

26. *Ultramares*, 174 N.E. at 442. A Pennsylvania case, Landell v. Lybrand, 107 A. 783 (Pa. 1919), decided before *Ultramares*, held that privity of contract is required for an accountant to be liable to an investor for negligence. *Landell*, 107 A. at 783. It is, however, the *Ultramares* case that is credited for establishing this theory.

27. *Ultramares*, 174 N.E. at 442.

28. *Id.* at 444. The portion of the opinion frequently quoted states:

> [I]f liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkin-

prior cases that had imposed liability to third parties, on the basis that in those instances, the reports had been prepared primarily for the benefit of the third party as opposed to primarily for the benefit of the client.[29] The justification for this view is that liability to "an indeterminate class in an indeterminate amount" is contrary to public policy.[30] The reasoning stressed that the accountant owed no duty to a "stranger," even when the accountant knew that the reports would be relied upon by others besides the client; the duty should be only to the client for whose "primary benefit" the report was made.[31]

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

The second theory of liability, which is based on section 552 of the Restatement (Second) of Torts, takes the position that, under certain circumstances, public accountants may be held liable to a third party, with whom they are not in privity, for their negligence in the preparation of a financial statement or other report.[32] The

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> dle doubt whether a flaw may not exist in the implication of a duty that exposes accountants to these consequences.

Id.

29. *Id.* at 446.

30. *Id.* at 444.

31. *Ultramares*, 174 N.E. at 446-47. In a subsequent opinion, the New York Court of Appeals adopted a modified version of the privity requirement. Credit Alliance Corp. v. Arthur Andersen & Co., 483 N.E.2d 110 (N.Y. 1985). In *Credit Alliance*, the court held that an accountant may owe a duty to third parties if the relationship between them "sufficiently approach[es] privity." *Credit Alliance*, 483 N.E.2d at 119. In order to establish this relationship, three requirements must be met: (1) the accountant must be aware that the financial statements are to be used for a particular purpose; (2) the accountant must intend for the third party to rely on the statement; and (3) there must be some conduct linking the accountant to the third party which demonstrates the accountant's understanding of the third party's reliance. *Id.* at 118. The court specifically stated that although these requirements allow some flexibility in the application of the privity doctrine, the principles articulated in *Ultramares* are still applicable. *Id.*

32. *See* Rusch Factors Inc. v. Levin, 284 F. Supp. 85, 91-93 (D.R.I. 1968). The text of the Restatement (Second) is as follows:

> (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) Except as stated in Subsection (3), the 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 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. (3) The liability of one who is under a public duty to give the information extends to loss suffered by any of the

appropriate circumstances would be where the information was supplied for the guidance of the third party, or a class of which the third party is a member, and was justifiably relied upon in a type of transaction in which the accountant's representations were intended to have an effect.[33] The reasoning behind this rule is that the accountant's knowledge of intended reliance imposes a duty of care.[34] This rule restricts the scope of liability to only those third parties whose reliance was actually foreseen by the accountant due to the magnitude of pecuniary harm which can result when misinformation is widely disseminated.[35] This approach is justified on the basis that pecuniary harm is substantially different from property or physical injury that is the result of other types of negligence.[36] The Restatement (Second) approach is followed by more jurisdictions than either the privity or the broad foreseeability theories, probably because it represents a satisfactory compromise between strict privity and unlimited liability.[37]

3. *Broad Foreseeability*

The broadest view of the scope of duty owed by accountants to third parties, which was first adopted by the supreme courts of New Jersey and Wisconsin, extends liability to the potentially very large class of all foreseeable third persons who might use reports prepared by the accountant.[38] In *Rosenblum v. Adler*, the Supreme Court of New Jersey decided that public policy should be considered in determining the extent of accountants' liability to third parties; so, imposing a duty depends upon a balancing of the interests of the injured third party, the accountant and the public.[39] The court reasoned that extending the scope of liability to all potentially foreseeable third parties would encourage the accounting firms to engage in more thorough reviews and would also serve to compensate the innocent third parties while shifting the risk of a

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class of persons for whose benefit the duty is created, in any of the transactions in which it is intended to protect them.

RESTATEMENT (SECOND) OF TORTS § 552 (1976).

33. *See* RESTATEMENT (SECOND) OF TORTS § 552, cmt. (a); cmt. (h), illus. 10; cmt. (j) (1976).

34. *Id.* at cmt. (h).

35. *Id.* at cmt. (a).

36. *Id.*

37. *Bily*, 834 P.2d at 758-59 (citations omitted).

38. H. Rosenblum, Inc. v. Adler, 461 A.2d 138 (N.J. 1983); Citizens State Bank v. Timm, Schmidt & Co., 335 N.W.2d 361 (Wis. 1983).

39. *Rosenblum*, 461 A.2d at 147.

negligent audit to the party responsible for the loss.[40]

Applying a different analysis, the Wisconsin Supreme Court adopted a position similar to that of the New Jersey Supreme Court in *Rosenblum*.[41] Rejecting the Restatement (Second) position because it does not extend liability to all foreseeable users of financial statements, the Wisconsin court decided that negligence law determines the extent of accountants' liability to third parties.[42] Thus, liability would be imposed for the foreseeable injuries resulting from negligent acts.[43] The court qualified the decision by stating that liability would be limited by public policy considerations normally applied in negligence cases.[44]

C. *The Bily Decision*

Although the California courts once led the way in breaching the privity barrier,[45] the recent decision in *Bily v. Arthur Young & Co.*[46] indicates that courts are reconsidering the presumed benefits of enlarging the scope of accountant's liability.[47] In *Bily*, the accountant defendant had been retained by a manufacturer of portable personal computers to audit its financial statements.[48] The plaintiffs were investors in the company and included both individual and institutional investors who had purchased stock or warrants from the company.[49] The accountant issued "clean" audit opinions and when the company subsequently declared bankruptcy, the investors sued the accountant alleging, among other

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40. *Id.* at 152.

41. *See Citizens State Bank*, 335 N.W.2d at 362.

42. *Id.* at 366.

43. *Id.*

44. *Id.* The court listed a number of such policy reasons set out in previous negligence cases:

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

Id. (citations omitted).

45. *See, e.g.*, Biakanja v. Irving, 320 P.2d 16, 19 (Cal. 1958); International Mortgage Co. v. John P. Butler Accountancy Corp., 223 Cal. Rptr. 218, 227 (Cal. App. 1986), *overruled by* Bily v. Arthur Young & Co., 834 P.2d 745 (Cal. 1992).

46. 834 P.2d 745 (Cal. 1992).

47. Peters, cited at note 3, at 891-92.

48. *Bily*, 834 P.2d at 747.

49. *Id.*

claims, professional negligence in preparation of the audit reports.[50] Overruling a prior decision, the California Supreme Court held that auditors are liable for general negligence in the conduct of an audit only to their client.[51] However, the court did create a limited exception to this rule, holding that auditors may be liable for negligent misrepresentations to a narrow class of persons who are "specifically intended beneficiaries of the audit report who are known to the auditor and for whose benefit it renders the audit report."[52] The decision left intact the common law rule that any party who foreseeably relies on an intentionally fraudulent representation can recover.[53]

The primary concern expressed by the court was that allowing all foreseeable third parties to recover would subject auditors to liability out of proportion to their fault.[54] By differentiating professional negligence from negligent misrepresentation, the court sought to focus the inquiry away from the auditor's conduct and on to the third party's claim of reasonable reliance.[55] The court discussed the difficulties inherent in the audit process, emphasizing the restrictions faced by accountants and the wide range of permissible judgments that an auditor, performing under the applicable standard of care, can exercise appropriately.[56]

Throughout the opinion, the court frequently noted that claims of reasonable reliance on the audit reports in transactions involving sophisticated financial institutions are suspect.[57] The court particularly stressed that investment decisions are complex and multifaceted and that "professions of reliance on audit reports may be easily fabricated"; thus a claim of reliance should be rigorously questioned.[58]

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50. *Id.* at 747-49.
51. *Id.* at 767.
52. *Id.*
53. *Bily*, 834 P.2d at 747.
54. *Id.* at 761.
55. *Id.* at 772.
56. Peters, cited at note 3, at 894; *Bily*, 834 P.2d at 762-63.
57. *See, e.g.*, *Bily*, 834 P.2d at 763-65.
58. *Bily*, 834 P.2d at 763-64 n.12. The court explained why claims of reliance should be suspect, stating:

> Although an audit report might play a role in such decisions, reasonable and prudent investors and lenders will dig far deeper in their "due diligence" investigations than the surface level of an auditor's opinion. And, particularly in financially large transactions, the ultimate decision to lend or invest is often based on numerous business factors that have little to do with the audit report.

Id. at 763.

The *Bily* court thus established a very restricted view of an accountant's duty by limiting it to third parties who actually and reasonably relied on the financial statements and "whom the auditor intended to induce into action or influence in a specific transaction."[59] One commentator has noted that the language of the California Supreme Court in *Bily* suggests that the court wanted to significantly restrict an accountant's liability in general, not just to third parties.[60]

II. ANALYSIS

A. *Limiting Liability—Costs vs. Benefits*

In attempting to decide the issue of the appropriate scope of an auditor's liability to third party investors, the courts have articulated a number of reasons for either limiting or expanding the duty owed. Those courts that favor expansion of liability generally have based their decisions on the traditional tort concepts of compensation for the injured party and deterrence of negligent conduct.[61] These courts believe it is inherently unfair for an "innocent" investor, who relies on a financial statement, to suffer damage.[62] However, as the *Bily* court pointed out, both individual and sophisticated institutional investors' presumed reliance on the auditor's certified financial statements is questionable.[63] Several courts and commentators have suggested that the basis for the "not so innocent" investors' alleged reliance is actually the fact that in many

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59. Peters, cited at note 3, at 894.

60. *Id.*

61. *See, e.g.*, *Citizens State Bank*, 335 N.W.2d at 365; *Rusch Factors*, 284 F. Supp. at 91. Proponents of expansion of accountants' liability to third parties note that the accountant has a different role than other professionals such as doctors or attorneys; that the accountant has a "public watchdog" function that transcends any employment relationship with the client. United States v. Arthur Young & Co., 465 U.S. 805, 818 (1984). "The independent public accountant performing this special function [of certifying the public reports that collectively depict a corporation's financial status] owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public." *Arthur Young & Co.*, 465 U.S. at 817-18. Note that this case involved an attempt to create an accountant's workpapers privilege to prevent disclosure to the IRS under § 7602 of the IRC.

62. *See, e.g.*, *Rosenblum*, 461 A.2d at 152; *Rusch Factors*, 284 F. Supp. at 91.

63. *Bily*, 834 P.2d at 765. The reasoning of the court was as follows:

> If a third party possesses sufficient financial sophistication to understand and appreciate the contents of audit reports . . ., he or she should also be aware of their limitations and of the alternative ways of privately ordering the relevant risks. If, on the other hand, a third party lacks the threshold knowledge to understand the audit report and its terms, he or she has no reasonable basis for reliance.

Id. at 765 n.13.

cases, the auditor is the only potential defendant from whom a recovery can be obtained.[64]

Courts and commentators express fear that expansion of liability to all foreseeable third parties will not deter negligent audits, but instead, will result in a decline in the number of accounting firms willing to perform audit services.[65] This, in turn, will ultimately restrict the flow of financial information available to the investing public.[66] In many instances, accounting firms refuse to perform audit and review engagements and are being much more selective in choosing their clients.[67] Companies involved in high-risk industries, e.g., real estate investment, insurance and finance, and fledgling companies will encounter difficulty finding a firm to perform auditing for a reasonable fee.[68] The reduction in firms willing to perform audits and the corresponding reduction in the number of public companies able to obtain these services are not in the best interests of the investing public.

Another justification given by the courts favoring expansion of auditors' liability is that the accountants are in a better position than the client company or third parties to buy adequate insurance and to pass the insurance and litigation costs on to their clients, thus allocating the risk of negligently audited financial statements.[69] These courts compare the injured investor with the injured consumer in products liability cases and conclude that ac-

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64. *See e.g.*, Eric R. Fencl, Note, *Rebuilding the Citadel: State Legislative Responses to Accountant Non-Privity Suits*, 67 WASH. U. L.Q. 863, 874 (1989). The *Bily* court noted that it is inherently unfair to hold the auditor liable to investors because the accountant has no expertise in or control over the client's business, but when the business fails, the accountant is a prime target in litigation since it is the only available solvent entity. *Bily*, 834 P.2d at 763 (citing John A. Siliciano, *Negligent Accounting and the Limits of Instrumental Tort Reform*, 86 MICH. L. REV. 1929, 1932-33 (1988)).

65. *See, e.g., Bily*, 834 P.2d at 766; Siliciano, cited at note 64, at 1959-60 (citations omitted). In a case brought under section 10(b) of the Securities Exchange Act of 1934, the Supreme Court expressed concern that a broadening of the concept of the independent auditor's liability to third parties will ultimately result in more harm than good. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 n.33 (1976) (citations omitted).

66. *See, e.g.*, RESTATEMENT (SECOND) TORTS § 552, cmt. (a) (1976); *Bily*, 834 P.2d at 766 (citing Siliciano, cited at note 64, at 1960-65).

67. *Bily*, 834 P.2d at 766 (citing Siliciano, cited at note 64, at 1960).

68. *Id.*

69. *See, e.g., Rosenblum*, 461 A.2d at 151; *Rusch Factors*, 284 F. Supp. at 91. The assumption that accountants can easily obtain affordable insurance is questionable. As competition and insurance costs increase, many accounting firms are finding that it is increasingly difficult to obtain adequate insurance at a reasonable price. *See* Lee Berton, *Accounting Profession, Once a Staid Field, Is Torn by Incivility*, WALL ST. J., July 24, 1991 at A1; Victor P. Goldberg, *Accountable Accountants, Is Third Party Liability Necessary?*, 17 J. LEGAL STUD. 295, 295-96 (1988).

countants' liability should be expanded in accordance with the principle of strict products liability to protect the investor from negligent audits.[70] However, as the *Bily* court pointed out, this analogy is faulty for two reasons: (1) the manufacturer of a deficient product has complete control over its production, whereas the auditor merely expresses an opinion about financial statements prepared by the client company, and (2) the sophisticated investor is considerably different in character from the ordinary consumer.[71] Those in favor of limiting liability have noted that the risk can be better allocated through private ordering.[72] An investor who plans to rely on an audit report can contract directly with the client company to obtain a special security arrangement, can become an intended beneficiary of the audit or can hire an auditor to conduct a separate audit of the client company on the investor's behalf.[73] Investors, particularly sophisticated institutional investors, can be considered to have "assumed the risk" of potentially negligent management of the client company, negligent audits by the accountant and the potential provision of imperfect information.

B. *Potential Solutions*

The accounting profession, the courts and legal commentators have proposed a number of solutions to prevent the negative consequences of expansion of auditors' liability to third parties. Proposed solutions include: (1) limited liability incorporation for accounting firms; (2) full reliance on contract principles as opposed to tort in determining liability; (3) statutory caps on tort liability; and (4) structural reform of the accounting profession.[74] Another solution proposed by several commentators advocates limitation of auditors' liability through apportionment of damages in relation to fault.[75] These commentators suggest that application of the princi-

70. *Bily*, 834 P.2d at 764 (citing *Rosenblum*, 461 A.2d at 145-47).

71. *Bily*, 834 P.2d at 764-65.

72. *Id.* at 765 (citing Siliciano, cited at note 64, at 1956-57). Private ordering employs contract principles rather than tort law to allocate the risk between parties. *Bily*, 834 P.2d at 761.

73. *Id.* at 765 (citing Siliciano, cited at note 64, at 1956-57).

74. Jordan H. Leibman and Anne S. Kelly, *Accountants' Liability to Third Parties for Negligent Misrepresentation: The Search for a New Limiting Principle*, 30 AM. BUS. L.J. 345, 425-37 (1992).

75. Leibman, cited at note 74, at 375-425; *See generally*, Eric R. Dinallo, Note, *The Peculiar Treatment of Contributory Negligence in Accountants' Liability Cases*, 65 N.Y.U. L. REV. 329 (1990); Dennis V. Dahle, Note, *Comparative Negligence in Suits Against Ac-*

ples of contributory and comparative negligence in lawsuits against accountants will allow just and reasonable compensation for the injured party without unfairly damaging the accountant.[76] However, this proposal is subject to problems in application; there currently is a split in the courts concerning the issue of "whether and to what extent" contributory negligence can be used as a defense in accountant liability lawsuits.[77] And, even when the courts allow apportionment of damages, judges and juries who have difficulty determining whether an auditor is negligent under the prevailing standard will encounter even more confusion when trying to allocate fault among co-defendants.[78]

One specific solution proposed by the profession is expanding the function of the AICPA quality control inquiry committee ("QCIC"), which currently is limited to determining whether allegations in cases reported to the QCIC "suggest a flaw in the accused [accounting] firm's quality controls or compliance with them or a fault in the profession's standards."[79] The proposed expansion would allow a committee of experienced auditors to examine the records of the accounting firm to determine if there had been a faulty audit, if so, what caused it and what steps could be taken to ensure that similar problems could be avoided in the future.[80] However, instead of simply expanding the peer review and quality control process, the accounting profession should establish a professional committee to determine definitive standards of care and lobby for legislative recognition of these standards as the basis for determining the level of professional negligence which triggers liability. An issue left unresolved by the *Bily* court was whether an auditor's compliance with GAAS and GAAP ensures freedom from

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countants: A Statutory and Policy Analysis, 5 B.Y.U. J. PUB. L. 155 (1991).

76. *Id.*

77. Dahle, cited at note 75, at 155. Some jurisdictions follow National Surety Corp. v. Lybrand, 9 N.Y.S.2d 554 (1939), which held that accountants can use the defense of contributory negligence only when the plaintiff's negligence interferes with the accountant's ability to perform his duty. Dinallo, cited at note 75, at 346 (citing *National Surety*, 9 N.Y.S.2d at 563). Other courts follow Craig v. Anyon, 208 N.Y.S. 259 (1925), which permits accountants to use the defense of contributory negligence without limitation. Dinallo, cited at note 75, at 345 (citing *Craig*, 208 N.Y.S. at 268-69).

Another potential problem with this solution occurs when the auditor is merely negligent while management of the client company has engaged in intentionally fraudulent conduct. Most jurisdictions hold that comparative negligence principles cannot be applied in these situations, i.e., intentional conduct cannot be compared with a co-defendant's negligence to determine proportional fault. Leibman, cited at note 74, at 396-97 (citations omitted).

78. Leibman, cited at note 74, at 385.

79. *POB Annual Report Stresses Liability Crises*, J. ACCT., Feb. 1993, at 21.

80. *Id.*

liability or if other factors can be considered.[81] A case of this nature against an accountant normally presents a complex factual situation that requires interpretation of technical accounting principles which the average jury member is unable to understand.[82] Fair and consistent results can only be obtained with a standardized evaluation system.

III. CONCLUSION

The dissenting opinion in *Bily* incorrectly states that "an accountant performing an audit is subjected to negligence liability only upon proof of a failure to perform a reasonably careful audit according to generally accepted auditing standards."[83] Currently, accountants can be held liable even when they have fully complied with recognized industry standards. Nationwide recognition of definitive standards is essential to provide some measure of consistency and certainty to accountants.

In view of the astounding potential liability that accountants are subject to,[84] a limiting principle must be adopted to restrict the

81. The appellate court held that it was proper for the jury to consider the standards in the auditor's own accounting manual even though these procedures were more rigorous than those in GAAS. Bily v. Arthur Young & Co., 271 Cal. Rptr. 470, 476 (1990), *rev'd on other grounds*, 834 P.2d 745 (1992).

82. One commentator has identified a problem in this area known as the "expectation gap" which occurs because the public and accountants view the purposes of audits differently. Kean K. McDonald, *Accountants' Liability to Third Parties: Unmanageable Risks of Foreseeability*, 57 DEF. COUNS. J. 194, 197 (1990). Generally, the public believes that the auditor has a duty to detect fraud. *Id.* However, when a client perpetrates and actively hides fraud, it can be difficult to detect as shown by the following example:

> [A] company that wants to overstate its assets could either increase its accounts receivable by creating false sales documents or effectuate a double counting of the inventory by transferring goods between locations during the observation phase of the audit. In both cases, either by testing the accounts receivable or by varying the inventory counting tests, an audit may uncover the fraud. On the other hand, as a result of the combination of the auditors' professional judgment and the use of sampling techniques, it is possible for a client's fraudulent misrepresentation to go undetected by auditors despite following techniques that are accepted throughout the profession.

Id. at 198.

83. *Bily*, 834 P.2d at 779 (Kennard, J. dissenting).

84. For instance, in the recent Phar-Mor bankruptcy, in which the auditor is being sued by the client, investors and creditors, Westinghouse Electric Corp., with an $84 million investment in Phar-Mor, is taking a $155 million pretax charge against earnings that has virtually wiped out third quarter per share earnings according to Westinghouse officials. Westinghouse sold $61 million of Phar Mor stock to Massachusetts Financial Services Co., a mutual fund, which subsequent to the bankruptcy filing, demanded a return of the $61 million plus an additional $5 million for expenses and interest. *Fallout From Phar-Mor Sends Firms Reeling*, PRIVATE PLACEMENT REP., Oct. 19, 1992, at 1.

The largest judgment against an accounting firm involved Coopers & Lybrand's allegedly scope of the accountant's duty of care. The Supreme Court has previously demonstrated a willingness to limit auditors' liability to third parties for negligent audits under the federal securities laws.[85] A "federalization" of standards and redefinition of the scope of liability as per the *Bily* decision is a solution which adequately addresses the current problems. This can be achieved through statutory preemption of the common law in this area or an unequivocal ruling by the Supreme Court.

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faulty audits of Miniscribe, a defunct Colorado disk-drive maker. Although the case was appealed and subsequently settled out of court, a jury originally ordered the firm to pay damages of $200 million. Another example — Arthur Andersen paid $22 million for fraud claims brought as a result of the Lincoln Savings & Loan scandal; Ernst & Young paid $63 million in settlements in the same action. *A Flood of Litigation: Liability Suits Add Up on Accountants*, AUSTIN BUS. J., Sept. 28, 1992, at 9.

In a recent Arizona case, a purchaser of a bank who claimed to have relied on financial statements negligently prepared by Price Waterhouse was awarded $338 million even though the financial statements were not prepared for the sale. "The award was more than the amount the buyer paid for the company, more than twice the out-of-pocket loss allegedly suffered by the purchaser and more than 2,400 times the $140,000 annual fee Price Waterhouse earned for each of the audit engagements. Edward Brodsky, *Liabilities of Accountants*, N.Y. L. J., Dec. 9, 1992, at 3.

85. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 n.33 (1976) (citations omitted).