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by
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Introduction

When an accountant is negligent in conducting an audit of a corporation's financial statements, investors who rely on the audit may incur losses. The question of whether or under what circumstances an investor may recover from the accountant is a source of continuing controversy. This question arises when an accountant negligently issues an opinion about the accuracy of a business’s financial statements. Investors and creditors who sustain losses when the business fails often attempt to recover from the accountant under negligence theories.

Recently, in Bily v. Arthur Young & Co., the California Supreme Court placed severe restrictions on investors seeking to recover for an accountant’s negligence. Under prior California law, such third parties could recover if they showed that it was reasonably foreseeable to the accountant that they would rely on the opinion. After Bily, third parties must show that the accountant actually foresaw that they would rely on the opinion. This change from objective to subjective foreseeability effectively forecloses large numbers of third parties who

* J.D. Candidate, 1994; B.S. 1991, California State University, Northridge. I would like to thank my brother John for providing me with valuable insights into the accounting industry. I am also greatly appreciative of those who participated in the editing and production of this Note.
1. This Note focuses on the accountant’s function of auditing the financial statements of business entities. Therefore, the terms “auditor” and “accountant” will be used interchangeably to describe the professionals who perform this function. In addition, the term “Certified Public Accountant” (CPA) may be used from time to time to refer to accountants who are licensed to conduct audits and issue opinions.
3. See infra notes 78-85 and accompanying text.
4. See infra notes 86-97 and accompanying text.
actually relied on the audit from recovering damages for the accountant’s negligence.

The question of accountant liability to third parties was first addressed in 1931 by Judge Benjamin Cardozo in his famous opinion *Ultramares v. Touche.*\(^5\) The *Ultramares* decision established a requirement of contractual privity between an accountant and a party suing for negligence. Because the services of an accountant are procured and paid for by the business being audited, injured investors and creditors of the business, who are not in contractual privity with the auditor, are barred under *Ultramares* from suing the accountant to recover their losses.

Major changes have occurred in the business world since Cardozo penned the *Ultramares* opinion. These changes have altered the accountant’s relationship with corporations, investors, creditors, and the government. The “unqualified opinion,” an auditor’s statement that a business’s financial statements conform to accounting industry standards,\(^6\) has become a prerequisite for any firm to borrow money, obtain government approval to raise funds in the capital markets, or attract investors who are willing to fund the firm’s activities.\(^7\) The auditor’s opinion has served to streamline the allocation of resources by reducing the risks, and therefore costs, of investing in business ventures.\(^8\)

These changes in the business world have also altered the accountant’s role. The importance of reliance on unqualified opinions places the accountant between those businesses that pay for the accountant’s work and the third parties who rely on the accountant’s audit.\(^9\) While the auditor’s paying client is the business whose financial data is to be analyzed, the accountant’s service is critical to a wide variety of parties, all of whom are concerned with whether the data represents a true and accurate statement of the business’s financial

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5. 174 N.E. 441 (N.Y. 1931) (Cardozo, J.).
6. The American Institute of Certified Public Accountants (AICPA), a national professional organization comprised of state-certified accountants, promulgates rules governing the proper preparation of financial statements and guidelines to be followed in testing the level of adherence to these rules. Willis W. Hagen III, *Certified Public Accountants' Liability for Malpractice: Effect of Compliance with GAAP and GAAS*, 13 J. CONTEMP. L. 65, 72-73 (1987).
ACCOUNTANTS' LIABILITY TO THIRD PARTIES

When an audit is negligently performed, all parties who have relied on the financial statements of the business find their investments imperiled. Because reliance by third parties sometimes results in injury, differing views have emerged and many jurisdictions have allowed third parties, subject to varying requirements, to recover from accountants despite the lack of a contractual relationship. What happens when these third parties actually incur losses is the subject of this Note.

This Note examines the extent to which reliance on an auditor's representations creates a duty owed by the accountant to the relying third party. Generally, three approaches govern the scope of the duty owed by an accountant to a third party. First, the privity standard enunciated in Ultramares requires contractual privity or its close equivalent; foreseeability does not create a duty on the accountant. The second approach is based upon negligent misrepresentation as defined by the Restatement (Second) of Torts. Jurisdictions applying this approach expand the accountant's duty to include a limited group of third parties who the accountant anticipated would rely upon her audit, and who actually engage in the type of transactions that the auditor specifically anticipated. Although foreseeability defines the group to which an accountant may be liable, the group is restricted to those third parties actually foreseen by the accountant. The third approach is a true reasonable foreseeability standard. In contrast to the negligent misrepresentation approach, under this standard a third party is owed a duty by the accountant under the common-law notion of reasonable foreseeability. Whereas the negligent misrepresentation theory requires that the accountant actually foresee the reliance by the third party, the reasonable foreseeability standard looks to whether the accountant should have foreseen the reliance.

In a 1986 court of appeal decision, California embraced the third approach—reasonable foreseeability. This approach was viewed as comporting with the common law of California relating to negligence and duty. However, in the summer of 1992, in Bily v. Arthur Young & Co., the California Supreme Court discarded this approach in favor of a new standard that incorporates the privity and Restate-
ment approaches. The net effect of *Bily* is a drastic reduction in the availability of any remedy for injured investors, creditors, and other third parties against negligent accountants.

Part I of this Note reviews the evolving, or perhaps regressing, view of the accountant's duty to third parties, particularly in California. Part II examines the public policy rationales set forth by the California Supreme Court as justifications for its decision in *Bily*. It concludes that these rationales are insufficient to justify the "wholesale curtailment of legal duty" that shields accountants from liability to those who justifiably relied upon their work.

Part III of this Note proposes that a more reasonable alternative to the new California rule would be to adopt proportional liability to determine damages in accountant's liability lawsuits. By discarding joint and several liability in favor of proportional liability, the threat of unlimited liability, which distressed the Court in *Bily*, would be substantially reduced. Resumption of the reasonable foreseeability standard along with the adoption of proportional liability would allow deserving third parties to recover a portion of their losses from negligent accountants, while slowing down the freight train of liability suits that threatens accounting firms in the 1990s.

I. The Development of Alternative Approaches to the Accountant's Duty to Third Parties

A major function of CPAs is to provide an external evaluation of the accuracy of the financial statements produced by their clients. The result of the accountant's evaluation is a written opinion discussing whether the financial statements of the audited entity conform to Generally Accepted Accounting Principles (GAAP). When the auditor finds that the statements conform to GAAP, the auditor issues an unqualified opinion. An unqualified opinion represents that the financial statements conform with GAAP and "present fairly in all material respects the . . . changes in financial position of the client in

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17. *Id.* at 775 (Kennard, J., dissenting).
18. *Id.* at 763.
20. GAAP are principles of accounting technique established by the AICPA. GAAP includes guidelines for accountants to follow when developing financial statements. The guidelines discuss the recording of assets and liabilities, changes in assets and liabilities, disclosure of pertinent information, and appropriate preparation of financial statements in various situations. See 3 AICPA PROFESSIONAL STANDARDS AC § 1026.01 (1979); see also *Bily*, 834 P.2d at 750 (discussing scope of defendant's "unqualified audit" of Osborne Computer Corp.); Wiener, *supra* note 8, at 237-39.
the relevant periods.” Alternatively, an accountant may issue either a “qualified opinion,” or an “adverse opinion.” These latter two opinions reduce the credibility of the audited entity in the eyes of investors, creditors, and others considering doing business with the entity.

In the early stages of the accounting industry, such “audits” were conducted primarily for the purposes of assuring the owner of a business that its financial status was accurately represented and that the employees of the business were not defrauding the owner. Today, however, the business environment has changed such that the audit opinion serves a much greater purpose than simply providing the client with the comfort of knowing all is well. Businesses that expect to thrive and grow in today’s market must be able to demonstrate to a wide variety of outsiders that their reported financial condition is true and accurate. Universally, creditors who contemplate loaning money to a business entity require audited financial statements. In order to issue new securities, and thus raise capital for business operations, federal law requires that corporations maintain audited financial statements. The audit is perhaps most important to the stockholders of the modern corporation. Just as early owners of businesses needed to be assured that their employees were not defrauding them, shareholders need the ability to monitor the executives and managers who safeguard their property, and the audit gives shareholders that ability.

The work of accountants in modern society is relied on by large numbers of individuals and businesses other than the client. Thus, when an accountant is negligent in the performance of auditing services, many third parties may be injured. Despite the danger of injury, courts have historically felt constrained to limit accountant liability for these injuries.

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21. Bily, 834 P.2d at 750; see also Hagen, supra note 6, at 69-70.
22. Hagen, supra note 6, at 70-71.
23. An adverse opinion, the direct opposite of an unqualified opinion, states that the financial statements have not been prepared in sufficient accordance with GAAP and do not fairly represent the financial condition of the audited entity. Id.
24. Wiener, supra note 8, at 250.
26. Wiener, supra note 8, at 250.
27. See, e.g., Rusch Factors v. Levin, 284 F. Supp. 85, 86 (D.R.I. 1968) (holding that pecuniary loss resulting from reliance on fraudulent or negligent misrepresentation is not an injury to the person).
A. Ultramares and the Privity Requirement

The first case to address the problem of accountant liability to third parties was Ultramares Corp. v. Touche.30 In that case, Touche, Niven & Company (Touche),31 a CPA firm, was employed by Fred Stern & Company (Stern) for the purposes of preparing and certifying a balance sheet.32 Touche prepared the balance sheet and attested to its accuracy.33 Touche knew that Stern relied upon credit in order to operate its business, and that Stern would show the balance sheet to banks, lenders, stockholders, and other third parties.34 After receiving a copy of the certified balance sheet, Ultramares Corporation extended a loan to Stern.35 Subsequently, Stern went bankrupt.36 Ultramares then sued Touche, alleging both negligence and fraud in the preparation of the balance sheet.37

The case eventually reached the New York Court of Appeals, where Judge Cardozo wrote that if an accountant is negligent “the ensuing liability . . . is one that is bound by the contract, and is to be enforced between the parties by whom the contract has been made.”38 However, in order to comport with one of his earlier decisions,39 Cardozo was forced to enlarge the notion of contractual privity to allow recovery by a third party for whose primary benefit the accountant performed the audit. Barring a clear showing that the third party's benefit was not the “end and aim of the transaction,” however, only the auditor's client could recover.40 The end result was that while the court felt there was evidence of Touche's negligence,41 Ultramares could not recover from Touche under a negligence theory because Ul-

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30. 174 N.E. 441 (N.Y. 1931) (Cardozo, J).
31. Touche, Niven & Company, now called Deloitte & Touche, is one of the largest accounting firms in the United States and is a member of the “Big Six” accounting firms. The other “Big Six” accounting firms are Arthur Andersen & Co., Ernst & Young, Price Waterhouse, KPMG Peat Marwick, and Coopers & Lybrand.
32. Ultramares, 174 N.E. at 442.
33. Id.
34. Id.
35. Id. at 443.
36. Id.
37. Id. at 442-43.
38. Id. at 448.
39. In Glanzer v. Shepard, 135 N.E. 275 (N.Y. 1922), a public weigher contracted with a bean seller to certify the weight of bags of beans. When the purchasers of the beans found that the weights were inaccurate they sued the public weigher. Judge Cardozo held that the weigher could be liable to the buyers. Id. at 275. A distinction made clear in Ultramares is that the seller of the beans had directed the weigher to supply the buyer with a copy of the weight certification, and thus “the transmission of the certificate . . . was not merely one possibility among many, but the ‘end and aim of the transaction.’” Ultramares, 174 N.E. at 445.
41. Id. at 443-44.
tramares did not contract directly with Touche to audit Stern's books.\(^4\)

Thus, the *Ultramares* decision established the privity requirement in accountants' negligence actions. The primary motivation for establishing the restrictive standard was a desire to protect accountants, who otherwise may be exposed to "liability in an indeterminate amount for an indeterminate time to an indeterminate class."\(^4\)

In 1985, the New York Court of Appeals issued an opinion reaffirming, but modifying, *Ultramares*. In *Credit Alliance Corp. v. Arthur Andersen & Co.*,\(^4\) the court established a three-prong test for determining when a third party not in privity with an accountant may nevertheless recover from that accountant. The court instructed:

Before accountants may be held liable in negligence to noncontractual parties who rely to their detriment on inaccurate financial reports, certain prerequisites must be satisfied: (1) the accountants must have been aware that the financial reports were to be used for a particular purpose or purposes; (2) in the furtherance of which a known party or parties was intended to rely; and (3) there must have been some conduct on the part of the accountants linking them to that party or parties, which evinces the accountant's understanding of that party or parties' reliance.\(^5\)

The *Ultramares* privity requirement, as modified in *Credit Alliance*, is the current state of New York's law regarding the accountant's duty to third parties. A large number of states have followed *Ultramares*, making it the majority view today.\(^6\)

**B. The Restatement Approach**

Some courts, finding the privity approach followed in New York to be unduly restrictive, have looked to the definition of negligent

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42. The court found that causes of action would lie, however, for fraud or intentional or reckless misrepresentation. *Id.* at 444.

43. *Id.* In the decision, Judge Cardozo seemed concerned with protecting the accounting profession, which was still in its infancy. One commentator has noted that, given the wealth and power of the industry today, the decision has far exceeded that objective. See *Paschall, supra* note 29, at 714.

44. 483 N.E.2d 110 (N.Y. 1985).

45. *Id.* at 118. An obvious example of "linking conduct" sufficient to satisfy the third prong would be the accountant personally contacting the third party during the course of the audit, or delivering a copy of the audit directly to the third party. In New York, this requirement seems to be more difficult to fulfill in light of the recent court of appeals decision, *Security Pacific Business Credit, Inc. v. Peat, Marwick, Main & Co.*, 597 N.E.2d 1080 (N.Y. 1992). In *Security Pacific*, the court held that although the third party plaintiff alleged that it directly communicated with the auditor and received general assurances from the partner in charge of the audit, there was insufficient pleading to satisfy the linking conduct requirement. *Id.* at 1085-86.

misrepresentation in the Restatement (Second) of Torts for a slightly more inclusive standard. The key feature of this approach is that the duty to third parties is expanded to include a class of persons whom the accountant intended would rely on the audit. Under this approach, liability extends to transactions in which the auditor intended to influence a third party or knew that the client intended to influence a specific third party. In other words, the extension of the accountant's duty is to a class of persons actually foreseen as well as individuals specifically foreseen.

North Carolina recently joined the growing number of jurisdictions that adhere to the Restatement approach. In Raritan River Steel Co. v. Cherry, Bekaert & Holland, two plaintiffs who had extended credit to Intercontinental Metals Corporation alleged damages for their reliance on a negligently prepared audit. One plaintiff had relied on a net worth figure in a report published by Dun & Bradstreet. However, this plaintiff's claim was dismissed quickly because there was no showing of direct reliance upon the financial statements audited by the accountant. The other plaintiff claimed reliance on the financial statements themselves. The court found direct reliance as

47. Restatement (Second) of Torts § 552 (1977).
51. See Restatement (Second) of Torts § 552 cmt. h, illus. 5-7 (1977). A troubling limitation is explained in the illustrations of the Restatement. If an accountant is aware that a specific bank will use the audit in determining whether to extend credit, but in the end a different bank uses the audit for the very same purpose, then the bank which actually relies will not be able to recover from the accountant. See Restatement (Second) of Torts § 552 cmt. h, illus. 5. The second bank, acting in the same capacity and manner as the first, is foreclosed from recovering. Thus, despite the fact that the accountant foresaw reliance by a bank, and that a bank actually relied, the mere substitution of the banks prohibits any recovery. See John W. Bagby & John C. Ruhnka, The Controversy Over Third Party Rights: Toward More Predictable Parameters of Auditor Liability, 22 Ga. L. Rev. 149, 164-65 (1987).
52. 367 S.E.2d 609 (N.C. 1988).
53. Id. at 612.
54. Id. at 613.
55. Id.
to this plaintiff and proceeded to address whether a duty was owed to the plaintiff by the accountant.\textsuperscript{56}

The North Carolina court rejected the \textit{Ultramares} approach as too restrictive, and adopted the Restatement standard holding that the right to recover against an accountant should extend to any "person, or one of a group of persons, whom the accountant or his client intends the information to benefit."\textsuperscript{57} The court also instructed that if the benefit is intended by the client, then the accountant must have actual knowledge of the client's intent at the time the accountant conducts the audit or prepares the opinion.\textsuperscript{58}

The court in \textit{Raritan} believed that adoption of the Restatement approach would strike a balance between "the need to hold accountants to a standard that accounts for their contemporary role in the financial world with the need to protect them from liability that unreasonably exceeds the bounds of their real undertaking."\textsuperscript{59} Indeed, this desire to hold accountants accountable has been a common theme among courts and jurisdictions that have rejected the \textit{Ultramares} doctrine. The Ohio Supreme Court, in adopting the Restatement approach, complained that the privity rule "ignores the modern verity that accountants make reports on which people other than their clients foreseeably rely in the ordinary course of business."\textsuperscript{60} Despite complaints that the \textit{Ultramares} approach is too restrictive, the Restatement approach retains considerable restrictions and similarly limits the class of third parties who may recover because the accountant must have actually foreseen that the complaining third party would rely.

C. The Reasonable Foreseeability Approach

A few jurisdictions have found the restrictions of the Restatement approach unnecessary and have chosen to analyze accountant liability to third parties under common-law foreseeability analysis. This approach examines the reasonable foreseeability of the harm done to the third party. Jurisdictions adopting this view have carried the reasoning of the Restatement approach to its logical conclusion. These jurisdictions adopted this approach by reasoning that if accountants truly have such an important role in the financial commu-

\textsuperscript{56} Id.
\textsuperscript{57} Id. at 614.
\textsuperscript{58} Id.
\textsuperscript{59} Id. at 617.
\textsuperscript{60} Haddon View Inv. Co. v. Coopers & Lybrand, 436 N.E.2d 212, 214 (Ohio 1982). Here, the limited partners in a partnership that was audited by Coopers & Lybrand sued the accountants for professional negligence. The court found that the limited partners belonged to a limited group whose reliance on the accountants' representations was specifically foreseen. Id. at 215.
nity, then the artificial privity requirement cannot stand and the limitations on third party recovery under the Restatement approach are arbitrary and unnecessary.\(^6\)

This approach has garnered the support of many commentators.\(^6\) In 1983, California court of appeal Justice Harold B. Wiener authored an article in which he called for the demise of the *Ultramares* doctrine in favor of the reasonable foreseeability approach.\(^6\) Justice Wiener attacked *Ultramares* as an "aberration" even at the time it was decided and further asserted that the Restatement view was only a slight departure from the privity approach.\(^6\) He claimed that both views ignore the role of accountants in "provid[ing] the lending and investing public with independent opinions on how fairly financial statements had been made."\(^6\) Justice Wiener concluded that the reasonable foreseeability approach most appropriately recognized the importance of the accountant's work and allocated financial loss in a manner fair to both the parties and the market.\(^6\)

The New Jersey Supreme Court has endorsed the reasonable foreseeability approach. In *H. Rosenblum, Inc. v. Adler*,\(^6\) plaintiffs sold their business to Giant Stores Corporation in exchange for common stock in Giant. The stock turned out to be worthless, and the plaintiffs sued Touche Ross & Company alleging reliance upon financial statements audited by Touche Ross.\(^6\) In rejecting the *Ultramares* doctrine, the court said:

So long as the privity rule is no longer viable in the area of tort liability there is no reason why a contractor should not have the same duties toward a stranger to the contract as any member of society to another, i.e., to exercise due care to avoid injury to another's person or property.\(^6\)

The court adopted the reasonable foreseeability approach, based on the abandonment of privity in the general tort doctrine of the state

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\(^{63}\) Wiener, *supra* note 8.

\(^{64}\) *Id.* at 248; see also Solomon, *supra* note 62 (analyzing the *Ultramares* decision and discussing factors leading to a determination of privity).

\(^{65}\) Wiener, *supra* note 8, at 250.

\(^{66}\) *Id.* at 254-56. The favorable effect on the market would derive from increased care by accountants in the performance of audits.

\(^{67}\) 461 A.2d 138 (N.J. 1983).

\(^{68}\) *Id.* at 140.

\(^{69}\) *Id.* at 144 (quoting Gold Mills, Inc. v. Orbit Processing Corp., 297 A.2d 203 (N.J. Super. Ct. 1972)).
and on the general recognition that audited financial statements are largely prepared for third parties not in contractual privity with the auditor.\textsuperscript{70}

In addition, the court stated that imposing such liability would improve the accuracy of audits and reduce the necessity for “costly separate investigations by each party at interest . . . which are so much sand in the economic machine.”\textsuperscript{71} In an effort to ensure that a plaintiff actually relied on an accountant’s work, however, the court retained the requirement that a third party have received audited financial statements from either the accountant or the audited entity for there to be accountant liability.\textsuperscript{72}

Two additional state supreme courts, Wisconsin and Mississippi,\textsuperscript{73} have followed the New Jersey Supreme Court’s lead. Wisconsin adopted a version of the reasonable foreseeability test approximately one month after the \textit{Rosenblum} decision. In \textit{Citizens State Bank v. Timm, Schmidt & Co.},\textsuperscript{74} the Wisconsin Supreme Court held that accountants would be liable for foreseeable injuries to third parties unless public policy reasons dictated otherwise.\textsuperscript{75} The court held that such public policy determinations should be considered by the courts on a case-by-case basis. This approach brought Wisconsin’s treatment of negligent accounting cases in line with the general tort principles of the state.\textsuperscript{76} In Mississippi, the reasonable foreseeability standard was adopted, including the requirement that a third party request and receive audited financial statements from the audited entity.\textsuperscript{77}

D. The State of the Law in California

Prior to the \textit{Bily} decision, California was among the states adhering to the reasonable foreseeability approach. California had adopted the reasonable foreseeability standard over the privity standard in a 1986 court of appeal decision, \textit{International Mortgage Co. v. John P.}

\textsuperscript{70} \textit{Id.} at 149.
\textsuperscript{71} \textit{Id.} at 150 (quoting \textit{In re Touche, Niven, Bailey & Smart}, 37 S.E.C. 629, 671 (1957)).
\textsuperscript{72} \textit{Id.}
\textsuperscript{73} In addition to Wisconsin and Mississippi, Texas has embraced reasonable foreseeability through an appellate decision. In \textit{Shatterproof Glass Corp. v. James}, 466 S.W.2d 873, 880 (Tex. Ct. App. 1971), the Texas Court of Appeals adopted the Restatement approach. However, in dicta in a later case, the court expanded the test to include all third parties of whom an accountant either was or should have been aware. \textit{See Blue Bell, Inc. v. Peat, Marwick, Mitchell & Co.}, 715 S.W.2d 408, 413 (Tex. Ct. App. 1986).
\textsuperscript{74} 335 N.W.2d 361 (Wis. 1983).
\textsuperscript{75} \textit{Id.} at 366.
\textsuperscript{76} \textit{Id.}
\textsuperscript{77} \textit{Touche Ross & Co. v. Commercial Union Ins. Co.}, 514 So.2d 315 (Miss. 1987). In rejecting the Restatement approach, the court stated that “there is no reason to prefer a foreseen user over a foreseeable user.” \textit{Id.} at 321.
Butler Accountancy Corp. This measure of a third party's ability to recover from an accountant was announced as "consistent with the fundamental principles of California negligence law." The court traced the demise of the privity requirement in other contexts and concluded that no justification existed for retaining the privity requirement in liability suits against accountants. In so holding, the court relied on language in *United States v. Arthur Andersen*, in which the United States Supreme Court acknowledged the public responsibility of CPAs. The court also noted that the accounting industry itself acknowledges its duty to parties other than clients.

In *International Mortgage*, the court of appeal addressed concerns that accountants might become guarantors of their clients' financial statements under the reasonable foreseeability approach. The court noted that in an audit opinion accountants were only stating whether and to what extent a client's financial statements comply with GAAP, measured through the application of Generally Accepted Accounting Standards (GAAS). An action for negligence against the accountant should depend upon whether the GAAP and GAAS were negligently applied, rather than the ultimate condition of the financial statements. Limiting the responsibility of the accountant, to deter-

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79. Id. at 221.
80. See, e.g., Heyer v. Flaig, 449 P.2d 161 (Cal. 1969) (finding attorney who drafted a will for his client liable to the client's beneficiaries despite the lack of a contractual relationship with them).
81. *International Mortgage*, 223 Cal. Rptr. at 227.
82. 465 U.S. 805 (1984). In *Arthur Andersen*, the Court denied a work product privilege, similar to that afforded attorneys, to accountants for their work papers. Chief Justice Burger wrote that "the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public." *Id.* at 817-18.
83. *Id.* The Court cited the AICPA as acknowledging "the profession's responsibility to the public, a responsibility that has grown as the number of investors has grown, as the relationship between corporate managers and stockholders has become more impersonal, and as government increasingly relies on accounting information." *Id.* (citing 2 AICPA Professional Standards ET § 53.01 (1988)).
84. *International Mortgage*, 223 Cal. Rptr. at 225; see 1 AICPA Professional Standards AU § 110.01 (1992).
85. *Id.* In some jurisdictions it is unsettled whether adherence to GAAP and GAAS is sufficient to absolve an accountant of liability. See Herzfeld v. Laventhal, Krekstein, Horwath & Horwath, 378 F. Supp. 112 (S.D.N.Y. 1978) (holding that compliance with GAAP is not determinative of liability under SEC Rule 10b-5), rev'd in part on other grounds, 540 F.2d 27 (2d Cir. 1976). *Contra* Monroe v. Hughes, [1991-92 Transfer Binder] Fed. Sec. L. Rep. (CCH) § 96,621 (D. Or. Dec. 9, 1991) (holding accountants not negligent because they complied with the rules of their profession); see also Bily v. Arthur Young & Co., 834 P.2d 745, 779 (Cal. 1992) (Kennard, J. dissenting) (arguing that when the cause of action is based on an opinion which discusses the client's financial records only in terms of their conformity with GAAP and GAAS, then adherence to those standards should be
mining whether GAAP and GAAS were complied with, significantly undercuts the argument that reasonable foreseeability will impose undue burdens on auditors.

II. Bily v. Arthur Young & Co.: Abandoning Reasonable Foreseeability in California

*International Mortgage* was the law in California regarding accountants’ liability to third parties for about six years. In 1992, however, the California Supreme Court swept the decision out the door with *Bily v. Arthur Young & Co.*, returning California to a narrower view of the accountant’s duty. While the *Bily* court pays lip service to and incorporates the strict privity requirement into its decision, the essence of the decision is a version of the Restatement approach.

In *Bily*, the plaintiffs were investors, ranging from individuals to pension and venture capital investment funds. Some of the plaintiffs had purchased stock in the Osborne Computer Company, and others had purchased warrants entitling them to purchase stock at favorable prices in a future stock offering. Arthur Young had issued unqualified opinions for Osborne’s financial statements for the two years previous to the transactions. After the failure of Osborne, plaintiffs sued Arthur Young, asserting that they had relied on its accountants’ opinions to their detriment.

Plaintiffs alleged fraud, negligent misrepresentation, and professional negligence. At trial, the jury instructions on the professional negligence claim were in accord with the reasonable foreseeability standard of *International Mortgage*. For the negligent misrepresentation cause of action, however, instructions substantially similar to the Restatement approach were given. They required that the accountant have made representations with the “intent to induce plaintiff or a particular class of persons to which plaintiff belongs to rely on [them]” to be liable. Based upon these instructions, the jury ruled in determinative of the accountant’s liability); *International Mortgage*, 223 Cal. Rptr. at 225; Hagen, *supra* note 6, at 78; Edward Brodsky, *Liability of Accountants*, N.Y.L.J. (Corporate and Securities Litigation Section), Sept. 9, 1992, at 3.

86. 834 P.2d at 747-49.
87. For a fairly detailed account of the rise and fall of the Osborne Computer Company, see *Bily*, 834 P.2d at 747-49. The fall was due in part to the major presence of IBM and other companies in the personal computer industry.
88. Arthur Young & Co. was a member of the exclusive “Big Eight” accounting firms. Since the institution of the lawsuit, Arthur Young has merged with Ernst & Whinney and is now called Ernst & Young. Ernst & Young is currently a member of the Big Six. For a list of the other members of the Big Six, see *supra* note 31.
89. *Bily*, 834 P.2d at 747.
90. *Id. at 748-49.*
91. *Id. at 749.*
favor of Arthur Young on the fraud and negligent misrepresentation claims, but found for the plaintiffs on the professional negligence theory.92

On appeal to the California Supreme Court, the theories of professional negligence and negligent misrepresentation were treated separately. With respect to professional negligence, the court endorsed strict privity of the type found in Ultramares.93 The court held that even intended beneficiaries cannot sue on general negligence grounds because, in the absence of privity, the accountant owes no duty to third parties.94 With respect to negligent misrepresentation, however, the court approved of the Restatement approach.95 The court went so far as to suggest a special jury instruction to be used in negligent misrepresentation claims against accountants.96 The jury instruction emphasized the court’s intent to narrowly define the class of third parties who can recover from accountants.97

A. Distinguishing Between Professional Negligence and Negligent Misrepresentation

The California Supreme Court’s distinction between professional negligence and negligent misrepresentation is curious and perhaps unnecessary. As the majority itself points out, courts and commentators have not carefully distinguished between the theories of recovery in the context of accountants’ liability.98 Justice Kennard, in her dissent, rejects the distinction between such factually similar theories of recovery.99 Kennard argues that “under these two liability theories, essentially the same standard of care is applied to the same conduct by the accountant.”100

92. Id.
93. Id. at 767.
94. Id.
95. Id. at 769.
96. Id. at 773. The jury instruction reads, in relevant part:
   Defendant is deemed to have intended to influence [its client’s] transaction with plaintiff whenever defendant knows with substantial certainty that plaintiff, or the particular class of persons to which plaintiff belongs, will rely on the representation in the course of the transaction. If others become aware of the representation and act upon it, there is no liability even though defendant should reasonably have foreseen such a possibility.

Id.
97. Id.
98. Id. at 767-68; see also H. Rosenblum, Inc. v. Adler, 461 A.2d 138, 142 (N.J. 1983) (stating that “[t]hough the theory advanced here by the plaintiffs is . . . in the nature of malpractice, their claim can be viewed as grounded in negligent misrepresentation”).
99. Bily, 834 P.2d at 775-76 (Kennard, J., dissenting).
100. Id. at 776.
Indeed, in the context of liability suits against accountants there seems to be no significant difference between professional negligence and negligent misrepresentation. It is difficult to imagine a situation in which a negligence suit against an accountant by a third party would not be based upon representations made by the accountant through an audit opinion. The very function of accountants that exposes them to liability is not so much the negligent performance of the audit, as it is the representations made regarding the results of the audit. Therefore, third party complaints almost universally include causes of action for professional negligence and negligent misrepresentation. The privity requirement effectively forecloses third parties from recovering under professional negligence, forcing plaintiffs to rely upon the lower standard under negligent misrepresentation. Thus, despite the court's separate treatment of professional negligence and negligent misrepresentation, the practical result of the court's decision is that third party recovery is based on the Restatement approach.

Why did the court go to such lengths to establish the privity requirement in professional negligence suits only to adopt the Restatement view in the context of negligent misrepresentation? As written, the decision has the potential to lead to misinterpretations of the court's ruling and confusion over the proper standard for third party recovery. There are two probable reasons for the court's distinction between the two torts: (1) The court wanted to emphasize the need for reliance on the audit opinion; and (2) The court, by thoroughly discussing privity, intended to prevent lower courts from expanding the class of plaintiffs able to recover under negligent misrepresentation.

With respect to the first reason, the distinction between the two similar torts indicates the court's desire to emphasize the importance of justifiable reliance on the audit report in a negligent misrepresentation action and the need for the accountant to actually foresee that the third party will rely upon her representation. The court stated that "because the audit report, not the audit itself, is the foundation of the third person's claim, negligent misrepresentation more precisely captures the gravamen of the cause of action." As opposed to professional negligence, negligent misrepresentation depends on an ac-

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101. The portion of the opinion discussing negligence and the privity requirement spans approximately seven pages. Id. at 760-68.
102. See, e.g., Bill Ainsworth, Capitol Abuzz Over Accountants, Recorder, Sept. 3, 1992, at 1 (reporting that the court adopted the privity rule in professional negligence cases, with no mention of negligent misrepresentation or the Restatement approach).
103. Bily, 834 P.2d at 772.
104. Id.
105. Id.
tual communication for liability to be imposed. Since a third party action against an accountant is based on communications contained in the audit opinion, the court preferred to discuss liability based upon negligent misrepresentation.

The second reason for the court’s distinction between the two torts is the court’s desire to limit the class of third parties who may recover. By discussing privity in the professional negligence context, the court intended to guide future decisions of the courts of appeal in defining the class of third parties who may recover.\textsuperscript{106} The discussion of privity in the professional negligence context may prevent lower courts from expanding the class by explaining that the accountant actually foresees many more third parties than the court in \textit{Bily} would allow to recover.\textsuperscript{107}

Whatever the purpose of the court’s distinction between professional negligence and negligent misrepresentation, it is important to realize that the court ultimately adopted the approach to third party recovery as defined by the Restatement (Second) of Torts, and not the \textit{Ultramares} privity doctrine.\textsuperscript{108}

\section*{B. Public Policy Rationales}

In \textit{Bily}, the California Supreme Court advanced three main public policy rationales in support of its abandonment of the reasonable foreseeability standard: (1) the prospect of the accountant’s liability being disproportionate to her fault; (2) the ability of third parties to engage in “private ordering”; and (3) the deleterious effects that liability to third parties would impose on auditors.\textsuperscript{109}

In forwarding these rationales, the court referred to \textit{Biakanja v. Irving},\textsuperscript{110} a 1958 case in which the court held that a defendant’s liability to a third party depends on the consideration of public policy factors.\textsuperscript{111} In \textit{Biakanja}, the court listed the factors to be considered:

\begin{itemize}
  \item [1] the extent to which the transaction was intended to affect the plaintiff,
  \item [2] the foreseeability of harm to him,
  \item [3] the degree of certainty that the plaintiff suffered injury,
  \item [4] the closeness of the connection between the defendant’s conduct and the injury suffered,
  \item [5]
\end{itemize}

\textsuperscript{106} \textit{Bily}, 834 P.2d at 767-74; see supra text accompanying note 105.

\textsuperscript{107} For an examination of arguments that the class of foreseen third parties is larger than the court recognizes, see infra text accompanying notes 136-138.

\textsuperscript{108} In a more simple statement of its holding, the court wrote, “For the reasons stated above, we have rejected the rule of \textit{International Mortgage Co}. in favor of a negligent misrepresentation rule substantially in accord with section 552 of the Restatement Second of Torts.” \textit{Bily}, 834 P.2d at 774.

\textsuperscript{109} \textit{Id.} at 761.

\textsuperscript{110} 320 P.2d 16 (Cal. 1958).

\textsuperscript{111} \textit{Id.} at 19.
the moral blame attached to the defendant's conduct, and [6] the policy of preventing future harm.\textsuperscript{112} The \textit{Biakanja} court wanted such policy factors to be balanced against each other in determining liability on a case-by-case basis.\textsuperscript{113} In \textit{Bily}, however, the policy factors were used in order to restrict the \textit{general} class of third parties as a justification for the rejection of reasonable foreseeability.\textsuperscript{114} In \textit{Bily} the court focused on three of the \textit{Biakanja} policy factors, which will now be considered in turn.

\textbf{(1) Disproportionate Liability}

In \textit{Bily}, the court stated, "Although the auditor's role in the financial reporting process is secondary and the subject of complex professional judgment, the liability it faces in a negligence suit by a third party is primary and personal and can be massive."\textsuperscript{115} Relying on law review commentary,\textsuperscript{116} the court cited the accountant's lack of control over the information on which the financial statements are based, and the need for the accountant to exercise professional judgment in the interpretation of broadly phrased professional standards.\textsuperscript{117} The court believed that these facts, coupled with what it assumed would be an attenuated connection to the third party's injury,\textsuperscript{118} would make the accountant's liability disproportionate to her fault.

The court stated that the audit report is but one factor among many that the investor will consider in making decisions because "reasonable and prudent" investors will go beyond the audit report in verifying the accuracy of financial statements.\textsuperscript{119} Therefore, the court reasoned, any injury to a third party is only remotely connected to the accountant's negligence.\textsuperscript{120}

This reasoning fails to recognize the realities of the marketplace. While it is certainly probable that an investor will consider a vast array of criteria in determining whether to invest, including the market position of the business, its management, and future prospects, it is overly optimistic to assume that all investors, large and small, will investigate

\textsuperscript{113} \textit{Biakanja}, 320 P.2d at 19 ("The determination whether in a specific case the defendant will be held liable to a third person . . . is a matter of policy . . . ").
\textsuperscript{114} \textit{Bily}, 834 P.2d at 761.
\textsuperscript{115} Id. at 763.
\textsuperscript{117} \textit{Bily}, 834 P.2d at 763.
\textsuperscript{118} Id. at 764.
\textsuperscript{119} Id. at 763.
\textsuperscript{120} Id.
the veracity of financial statements beyond an examination of the audit opinion.\textsuperscript{121} As Justice Wiener suggests, such considerations are best left to the defense of comparative negligence.\textsuperscript{122} Rather than absolving accountants of all liability to third parties, a third party’s reasonable reliance on the accountant’s audit might depend, in part, on the level of business sophistication of the third party.\textsuperscript{123}

In addition, the court’s concern regarding the accountant’s lack of control over the client’s information and the need for professional judgment overlooks the basis of the negligence action in the first place. Liability of the accountant should be based on the improper application of GAAP and GAAS, not whether the financial statements are ultimately determined to be erroneous.\textsuperscript{124} Control of the client’s information should not affect the accountant’s ability to properly apply accounting standards. An accountant’s liability can be determined regardless of the state of the financial statements. If the client is not forthcoming or is particularly evasive, or the accountant suspects a problem with the financial statements, then the accountant should not issue a positive opinion.

(2) Private Ordering

The second policy rationale on which the \textit{Bily} court based its rejection of a reasonable foreseeability standard involves a third party’s ability to “privately order” the risk of an accountant’s negligence. The court explained that a third party has various options to protect itself, including expending its own resources to verify the client’s financial data or contracting with the accountant who is issuing the opinion.\textsuperscript{125} In support, the court referred to an article written by Professor Siliciano in which he decried the expanding scope of accountant liabil-

\textsuperscript{121} See \textit{Mess}, supra note 62, at 839.
\textsuperscript{122} Wiener, supra note 8, at 253.
\textsuperscript{123} Professor Siliciano, who generally argues against the reasonable foreseeability approach, nevertheless suggests “a stratified negligence rule that accounts for the varying ability of third parties to implement their preferences through private ordering.” Siliciano, supra note 116, at 1974 n.210. As investor sophistication increases, so does the ability to closely scrutinize the business entity’s financial data and verify the accuracy of the accountant’s opinion. This ability to “privately order” the risk of inaccurate financial statements reduces the investor’s reliance on the auditor, and therefore should reduce the auditor’s liability. Such a rule might draw support from the approach taken to determining whether private offerings of securities are exempt from the securities laws. In \textit{SEC v. Ralston Purina Co.}, 346 U.S. 119 (1953), the Supreme Court looked at stock purchaser’s access to information in determining whether a stock offer was exempt from registration requirements. \textit{Id.} at 126-27. If proportionate liability were to be adopted in auditor’s liability cases, as this Note proposes, then one factor to be considered in allocating liability should be the level of sophistication of the plaintiffs who claim to have relied on the audit opinion.
\textsuperscript{124} See \textit{supra} note 85 and accompanying text.
\textsuperscript{125} \textit{Bily}, 834 P.2d at 765.
ity and advocated a more restrictive approach.\textsuperscript{126} He argued that third parties possess a level of sophistication that enables them to commission their own audit, or have the corporation conduct an audit specifically for them.\textsuperscript{127}

Putting aside the problem of generalizing that all third parties possess such a level of sophistication,\textsuperscript{128} to require such private ordering would substantially reduce the efficiency of the investing and lending markets. As stated earlier in this Note, the unqualified opinion of a reputable accountant in our modern economy is a condition precedent to an investor accessing the various financial markets.\textsuperscript{129} If the opinion conducted for the client by its accountant cannot be relied upon, then each individual investor or lender would have to conduct its own costly audit. Such a requirement would substantially increase the costs of lending or investing, and therefore borrowing or raising capital.\textsuperscript{130} Duplicitous auditing of an entity does not make much sense and is not economically feasible to most third parties who contemplate investing or lending to corporate entities.

Professor Siliciano argues that, under the reasonable foreseeability approach and without such private ordering, the accountant is incurring risk for which she is not compensated.\textsuperscript{131} Professor Siliciano contends that since the accountant’s bill is paid by the client, the fee only compensates the accountant for the benefit received by the client.\textsuperscript{132} Additional risk of exposure to relying third parties is not reflected in the fee because “the accountant often does not know the extent to which the client will circulate the audit to third parties.”\textsuperscript{133} For this reason it is argued that accountants will not be able to charge their clients for the additional exposure even if they can estimate which third parties will rely.\textsuperscript{134}

The problem with this argument relates back to the nature of the modern accounting industry. As Justice Wiener points out, accounting “fees have risen . . . with the accountant’s increased sophistication,

\textsuperscript{126} Siliciano, supra note 116.
\textsuperscript{127} Id. at 1956.
\textsuperscript{128} See Mess, supra note 62, at 839.
\textsuperscript{129} See supra notes 25-29 and accompanying text.
\textsuperscript{130} See Bily, 834 P.2d at 785 (Kennard, J., dissenting) (“[S]eparate audits by each lender and investor, although no doubt a boon to the accounting profession, will result in a socially wasteful duplication of effort and expense, resulting in disruption and delay of business activity . . .”); see also H. Rosenblum, Inc. v. Adler, 461 A.2d 138, 150 (N.J. 1983) (decrying “costly separate investigations by each party at interest . . . which are so much sand in the economic machine”).
\textsuperscript{131} Siliciano, supra note 116, at 1965.
\textsuperscript{132} Id.
\textsuperscript{133} Id.
\textsuperscript{134} Id.
and the complexity and risk associated with their endeavors."  
Indeed, the reliance by so many third parties on verification of financial statements generates demand for the accountant's services. As the economy has become increasingly complex, the need for audited financial statements by third parties has created a much larger market for accounting services than was the case in 1931, when *Ultramares* was decided. This increased demand has logically led to an increase in the earnings of accountants. Thus, the aggregate earnings of accountants have risen as a result of the increased risks created by increased third party reliance.

To assert that accountants cannot charge individual clients additional fees based upon third party reliance ignores the reality that auditing fees have already risen in response to the demand created by these third parties. This rise in demand has created a corresponding increase in fees, which represents compensation for the increased reliance on audit opinions. Accountants are therefore paid for the risks that they undertake with respect to third parties.

(3) Effect of Imposition of Liability to Third Parties

The final public policy justification advanced by the *Bily* court in rejecting reasonable foreseeability is a rebuttal to arguments that the standard will encourage more careful audits. The court suggested that the nature of auditing is such that it is doubtful "whether audits can be done in ways that would yield significantly greater accuracy without disadvantages." Again, this argument overlooks the nature of an action for negligence. Liability will follow from a failure of the accountant to conform to the proper standard of care. In asserting that imposition of liability to third parties will improve the accuracy of audits, proponents of reasonable foreseeability are simply stating that accountants have extra incentive to avoid falling below the established standard of care. Indeed, the threat of liability is essential to counterbalance the

135. Wiener, supra note 8, at 250 (emphasis added).
136. See H. Rosenblum, Inc. v. Adler, 461 A.2d 138, 149 (N.J. 1983) (noting that demand for audits is generated by stock exchanges, the SEC, institutional investors, investment specialists, stockholders, and lenders); see also Lawson & Mattison, supra note 7, at 1335.
137. See Mess, supra note 62, at 839 (quoting Arthur R. Wyatt, *Auditors' Responsibilities*, 12 *St. Louis U. L.J.* 331, 333 (1968) (noting that the emergence of the modern corporation, with increased reliance on outside capital, has created "a [new] consumer for their reports beyond their direct client[s]").
138. See Solomon, supra note 62, at 74 ("Obviously, the CPA is aware of [the] use of his certificates and reports by 'the public' and takes this factor into consideration in billing the client.").
139. *Bily*, 834 P.2d at 766.
140. Id.
accountant’s motivation to satisfy her client with an unqualified opinion.141

The court also cites concerns that, faced with the prospect of liability to third parties, accounting firms will refuse to perform audits for upstart, risky businesses.142 Although the auditor’s liability should result only from the improper application of GAAP and GAAS,143 accounting firms may hesitate to audit companies when there is an increased likelihood that litigation will ensue. Understandably, this consequence would have a deleterious effect on the stimulation of the economy.

However, neither limiting nor expanding accountant liability to third parties represents a complete solution. If accountants are shielded from third party liability, then investors and creditors might have less confidence in the accuracy of the auditor’s report. But the additional expense of independent verification would impose the same burdens on new businesses in attracting financial backing. Either way, the potential for inaccurate financial statements will impose a burden on new business ventures.

C. Reasonable Foreseeability Should Not Have Been Abandoned

The Restatement approach adopted by the California Supreme Court in Bily does not go far enough in protecting third parties who justifiably rely upon an accountant’s representations. The critical distinction between the Restatement and the reasonable foreseeability approaches is whether the accountant actually knew that the third party would rely versus whether the accountant should have known.144 Courts and commentators have criticized this distinction as arbitrary and based upon the subjective thoughts of the accountant.145 Once the decision is made to allow foreseen third parties to recover, it seems inequitable to create “limited groups” of actually foreseen third

141. Id. at 780-82 (Kennard, J., dissenting); see also Mess, supra note 62, at 857 (“[P]lacing greater responsibility for reports on the accountant, and increasing correspondingly the independence and legal responsibility of the accountant, would increase the reliability of the reports.”); cf. Daniel R. Fischel, The Regulation of Accounting: Some Economic Issues, 52 BROOK. L. REV. 1051, 1055 (1987) (granting that “an accounting firm contemplating what to do when a client pressures it... might be deterred by the threat of liability,” but arguing that accountants will not be more careful if they feel they will be sued regardless of their level of care).
142. Bily, 834 P.2d at 766.
143. See supra note 85 and accompanying text.
144. Boveri & Marshall, supra note 10, at 291; see also RESTATEMENT (SECOND) OF TORTS § 552 cmt. a (1977).
Accountants actually foresee third party investors and creditors to a far greater degree than the Restatement approach acknowledges. The majority in Bily recognized this reality. Additionally, the AICPA formally recognizes that the audit report is "a principal means of communicating accounting information to those outside an enterprise." This being the case, it is difficult to assert that accountants do not actually foresee that a wide variety of investors and creditors may act in reliance on their representations. Thus, to draw a dividing line around a "limited class" of third parties who may sue—those whose reliance was subjectively foreseen by the accountant—is to erect an artificial and unreasonable barrier.

The policy rationales advanced by the court in Bily do not justify the abandonment of the reasonable foreseeability standard. The lack of "empirical data" showing that liability creates incentives to exercise proper professional care does not obviate the logical conclusion that this is so. Further, private ordering is not feasible because it overestimates the sophistication of some third parties and unreasonably inhibits the flow of financial resources in modern capital markets.

While accountants may face liability disproportionate to their fault in causing injury to third parties, the blanket restriction against those parties whom the accountant actually knew would rely is far too arbitrary and far too harsh a solution. Rather, looking at the measure of damages in accountants' liability lawsuits provides a more equitable remedy by providing third parties the right to recover while at the same time protecting accountants from disproportionate liability.

146. Bonhiver v. Graff, 248 N.W.2d 291, 302 (Minn. 1976) ("Once it is admitted that a certain number of people have been injured as a result of an accountant's malpractice, there is no logical justification for denying any of them relief based upon the 'limited' or 'unlimited' nature of their 'class,' or whether the reliance of the particular injured parties was or was not 'specifically' foreseeable."); see also Citizens State Bank v. Timm, Schmidt & Co., 335 N.W.2d 361, 366 (Wis. 1983); Pace, supra note 25, at 431-51.

147. Bily, 834 P.2d at 751 ("[A]udit reports are very frequently (if not almost universally) used by businesses to establish the financial credibility of their enterprises in the perceptions of outside persons, e.g., existing and prospective investors, financial institutions, and others who extend credit to an enterprise . . . ."). Some have argued that, even under the privity approach, third parties should be able to recover as real parties in interest because of the accountant's cognizance of their reliance. Solomon, supra note 62, at 74 (citing Note, Scope of Liability of a Negligent Report, 8 TEMP. L.Q. 404, 410 (1934)).


149. Bily, 834 P.2d at 765.
III. The Problem of Joint and Several Liability

Of all the public policy arguments against the reasonable foreseeability standard, the critical concern of the court is that accountants are being held liable for damages out of proportion to their fault. Indeed, damage awards against accounting firms are reaching staggering levels. In 1992, for example, investors in a now-defunct computer company, Miniscribe, Inc., were awarded a $568 million jury verdict against Coopers & Lybrand, a Big Six accounting firm. Although the verdict was set aside and the firm settled for an undisclosed amount, the case illustrates the potential liability accountants face.

At the root of the problem is the doctrine of joint and several liability. In addition to the accounting firm, a plaintiff may have a valid cause of action against a number of individuals and entities, such as the corporation, its managers, and its officers. However, often the corporation becomes bankrupt, and most of the other potential defendants become judgment proof. As a result, the accounting firm is left as the only remaining and financially viable target. Because each individual tortfeasor may be held jointly and severally liable, the accounting firm is often liable for all of the plaintiff's damages regardless of its degree of fault in relation to the other defendants.

Most commentators and courts have not specifically addressed the effect of joint and several liability on accountants' liability to third parties. However, most of the courts that have restricted such liability

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150. Id. at 764. The court concluded that "disproportionate liability can not fairly be justified on moral, ethical, or economic grounds." Id.

151. A report distributed by the Big Six accounting firms claims that in 1990 the firms paid out an aggregate of $404 million in damages, equal to 7.7% of the firms' accounting revenues. This amount increased in 1992 to $477 million, or 9% of revenues. Gail Diane Cox, Unlimited Liability, NAT'L L.J., Dec. 21, 1992, at 1; see also Lee Berton, Price Waterhouse Damage Award Fuels Industry's Campaign to Limit Liability, WALL ST. J., May 21, 1992, at A3.


153. Id.

154. See Brodsky, supra note 85, at 3.

155. See Bily, 834 P.2d at 763 (noting that in most accountant liability cases "[t]he client, its promoters, and its managers have generally left the scene, headed in most cases for government-supervised liquidation of the bankruptcy court"). Even Justice Wiener acknowledges the "discomfort in saddling the merely negligent accountant with economic responsibility for the fraud and dishonesty of the corporate manager." Wiener, supra note 8, at 258; see also H. Rosenblum, Inc. v. Adler, 461 A.2d 138, 151 (N.J. 1983) (acknowledging that "in all likelihood the audited clients will be judgment proof or unable to satisfy their share of the indebtedness due").

156. Mike Steenson, Recent Legislative Responses to the Rule of Joint and Several Liability, XXIII TORT & INS. L.J. 482, 488 (1988) (criticizing joint and several liability for encouraging plaintiffs to seek out "deep pocket" defendants).
center their concerns upon this issue. Judge Cardozo himself was similarly concerned when he warned of "liability in an indeterminate amount for an indeterminate time to an indeterminate class."

Accounting firms, however, have not overlooked the joint and several liability doctrine. The industry has decried joint and several liability as a primary cause of their woes, and has rallied behind the introduction of a bill in Congress that will replace joint and several liability with proportionate liability in lawsuits brought under Securities and Exchange Commission Rule 10b-5. The bill, the Securities Private Enforcement Act, seeks to amend the Securities and Exchange Act of 1934 to require that damages be measured under proportionate liability, unless the defendant in a private action is found to have engaged in "knowing securities fraud." It provides that the trier of fact in the suit shall determine the percentage of responsibility of each party to the action, as well as the percentage of responsibility of nonparties alleged to have contributed to the plaintiff's injury.

The abrogation of joint and several liability would not be new to California. In 1986, California voters approved Proposition 51, which established proportional liability for cases in which noneconomic damages are awarded. The proposition was aimed at alleviating the problem of city and local governments being targeted as "deep-pocket" defendants in cases with large pain and suffering awards. Such problems are strikingly analogous to the concerns expressed by

157. In Bily, the court repeatedly expressed its concern that accountants, as the sole remaining solvent defendant, will be faced with claims for all of the damages incurred by third parties. 834 P.2d at 763; see also Raritan River Steel v. Cherry, 367 S.E.2d 609, 617 (N.C. 1988) (expressing concern over the "potential for inordinate liability"). In most cases touching on the question of accountants liability to third parties, the audited entity is bankrupt or otherwise judgment-proof and the accountants are left standing alone. See Touche Ross & Co. v. Commercial Union Ins. Co., 514 So.2d 315, 315 (Miss. 1987) (audited company went bankrupt); Credit Alliance Corp. v. Arthur Andersen & Co., 483 N.E.2d 110, 112 (N.Y. 1985) (same); Ultramares Corp. v. Touche, 174 N.E. 441, 443 (N.Y. 1931) (same).

158. Ultramares, 174 N.E. at 444 (Cardozo, J.).

159. The "Big Six" have claimed that "[t]he tort liability system in the United States is out of control" and that joint and several liability encourages lawsuits targeted at them as "deep-pocket defendants." Big Six Accounting Firms Launch Legal Attack, NAT'L L.J., Sept. 14, 1992, at 12. In fact, they contend that joint and several liability encourages "the common [and egregious] practice of plaintiff's attorneys settling with the prime wrongdoers... at a fraction of what these parties should pay... then pursu[ing] the case against the 'deep pocket' professionals." Id.


161. Id.

162. Id.


the *Bily* court with respect to accountants. Current concerns over the growing liability of accountants would be better addressed by adopting a similar stance in professional negligence suits.

Of course, the California Supreme Court has taken a strong stance in favor of joint and several liability. In *American Motorcycle Ass'n v. Superior Court*, the court forcefully affirmed its support for the doctrine. The principle justification for joint and several liability was that absent the doctrine, injured parties' ability to recover would be seriously impaired. However, such a rationale has no application when the court has prevented injured plaintiffs from recovering at all, as in *Bily*. To allow third parties to recover under proportional liability is more equitable than to totally prohibit recovery.

Such an approach applied to state negligence claims may go a long way toward allaying fears of disproportionate liability in third party lawsuits. Proportionate liability combined with a reasonable foreseeability standard of third party recovery strikes a proper balance between the concerns of third parties and accountants. Deserving third parties would not be denied a remedy, as they are under the privity and Restatement approaches, but accountants would not be targeted as the “deep-pocket” defendants, as they might be under joint and several liability. Because of the California Supreme Court's strong stand in favor of joint and several liability in *American Motorcycle*, proposals favoring proportional liability would be most appropriately established through legislative enactment.

**Conclusion**

A large number of individuals and businesses other than the client rely on the representations of accountants in modern society. Businesses that expect to thrive and grow must demonstrate to a wide variety of outsiders that their reported financial condition is true and accurate. In rejecting the *Ultramares* doctrine, courts have tried to balance the need to recognize accountants' contemporary role in the

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165. 578 P.2d 899 (Cal. 1978).
166. *Id.* at 901-02.
167. *Id.* at 906.
168. Wiener, *supra* note 8, at 259 (“When imperfect justice is compared with no justice at all, the law generally will select the former as being the lesser of two evils.”).
169. In fact, almost immediately following the *Bily* decision, a short-lived attempt was made to legislatively reverse the decision of the California Supreme Court. The attempt was beaten back by accounting lobbyists on the technical basis that it was being attached to a bill deemed unrelated in subject matter. See Ainsworth, *supra* note 102, at 10 (“[T]he Senate agreed that accountant liability has little in common with mosquito abatement divisions, and the bill was squashed.”).
170. *See supra* notes 25-28 and accompanying text.
financial world with the need to protect them from liability that unreasonably exceeds the bounds of their real undertaking. The Restatement approach has often been advanced as striking such a balance. However, by creating “limited groups” of third parties that accountants must have specifically foreseen would rely upon their representations, the approach erects artificial and unjustifiable barriers to third parties who deserve to recover. Since accountants have such an important role in the financial community, the artificial privity requirement cannot stand because such strict limitations on which third parties can sue are arbitrary and unnecessary.

Audited financial statements are largely, if not primarily, prepared for third parties not in contractual privity with the auditor. Accountants, third parties, and courts are aware of this reality. The fact that so many third parties need to rely on auditors’ verification of financial statements generates demand for the accountants’ services. In view of this benefit, accountants should be liable for damages caused to third parties who have actually and reasonably relied on their negligent work. Such liability should not be based on whether accountants actually foresaw that third parties would rely, but rather whether they should have foreseen the reliance. Arguably, these are one in the same, since a modern accountant must foresee the extent of the purposes for which an audit report may be used.

One valid concern is the rise of damage awards against accountants. Because the audited entity, often more at fault than anyone else, is usually defunct, accountants become attractive targets as “deep-pocket” defendants. The doctrine of joint and several liability has often worked to hold accountants liable for damages out of proportion to their fault.

This reasoning, however, does not provide a valid justification for limiting the number of third parties who may sue defendants. Rather, adoption of a proportional method of allocating damages among defendants would strike a more equitable balance among the concerns of third parties and accountants. Such a solution should be adopted through legislative act, along with a reinstatement of the reasonable foreseeability approach to the third party’s ability to recover from ac-

171. See Spherex, Inc. v. Alexander Grant & Co., 451 A.2d 1308, 1312 (N.H. 1982) (emphasizing the need to “harmonize the accountant’s contemporary role and his potential liability”).
172. Id.
173. See supra notes 145-146 and accompanying text.
174. See supra note 70 and accompanying text.
175. See supra notes 136-138, 147-148 and accompanying text.
176. See supra notes 134-137 and accompanying text.
177. See supra notes 154-156 and accompanying text.
178. Id.
Accountants. This solution gives deserving third parties a cause of action against negligent accountants while protecting accountants against disproportionate damage awards.