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International Mortgage Co. v. John P. Butler Accountancy Corp.: Third Party Liability -- Accountants Beware

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International Mortgage Co. v. John P. Butler Accountancy Corp.: Third Party Liability—Accountants Beware

The California Court of Appeal for the Fourth District recently held in *International Mortgage Co. v. John P. Butler Accountancy Corp.*[1] that an independent auditor owes a duty of care to reasonably foreseeable plaintiffs who rely on unqualified[2] reports issued on audited financial statements.[3] The court of appeal rejected both the well established privity requirement of *Ultramares Corp. v. Touche*,[4] and the more recent knowing reliance standard, which holds accountants liable to foreseeable plaintiffs who rely on audited financial statements.[5] Instead, the California Court of Appeal held that accountants are subject to the same standards of tort liability as are other professionals in California. The *International Mortgage Co.* court noted the changing role of accountants in our society, specifically pointing to the profession's increasing independence from clients and the profession's function as "public watchdogs."[6] The court also emphasized the ability of the accounting profession to pass the risk of loss on to

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1. 177 Cal. App. 3d 806, 223 Cal. Rptr. 218 (1986), *modified*, 178 Cal. App. 3d 682h, *review denied*, May 29, 1986.

2. An unqualified report is issued when the auditor follows generally accepted auditing standards in conducting the examination of the client's financial statements and, in the opinion of the auditor, the financial statements are fairly stated in accord with generally accepted accounting principles (GAAP). Conditions may prevent strict adherence to GAAP or the auditor may find that the financial statements are not fair in which case the auditor will issue a qualified opinion, disclaimer, or adverse opinion. D. TAYLOR & G. W. GLEZEN, AUDITING: INTEGRATED CONCEPTS AND PROCEDURES 18 (3d ed. 1985).

3. *International Mortgage Co.*, 177 Cal. App. 3d at 820, 223 Cal. Rptr. at 227. *See infra* notes 26-51 and accompanying text (discussion of *International Mortgage Co.* opinion). Financial statements consist of a balance sheet, an income statement, and a statement of change in financial position. W. MEIGS & R. MEIGS, ACCOUNTING: THE BASIS FOR BUSINESS DECISIONS 14 (5th ed. 1981).

4. 255 N.Y. 170, 174 N.E. 441 (1931). *See infra* notes 59-67 and accompanying text (discussion of *Ultramares*).

5. *International Mortgage Co.*, 177 Cal. App. 3d at 819-20, 223 Cal. Rptr. at 226-27. *See infra* notes 72-85 and accompanying text (discussion of RESTATEMENT (SECOND) OF TORTS § 552 (1977)).

6. *International Mortgage Co.*, 177 Cal. App. 3d at 819-20, 223 Cal. Rptr. at 226-27. *See infra* notes 40-47 and accompanying text (discussion of modern role of accountants).

its clients and the ultimate consuming public through fee increases and insurance.[7]

Part I of this note will set forth the facts of *International Mortgage Co.* and review the decision of the court of appeal.[8] Part II will discuss the legal background of accountant liability to third parties for negligence.[9] Finally, part III will examine the legal ramifications of the ruling by addressing the credibility of the policy factors suggested by the court.[10]

I. The Case

A. The Facts

In March 1979, John P. Butler Accountancy Corp. (Butler) issued unqualified reports based on audited financial statements for the year ending December 31, 1978, to Westside Mortgage, Inc. (Westside).[11] Fifty-seven percent of Westside's stated net worth was attributable to a secured promissory note.[12] The note was worthless due to a prior foreclosure of a senior lien on the real property securing the loan.[13] Without the promissory note as an asset, Westside did not qualify to do business in Federal Housing Administration (FHA) insured loans.[14] At the time of the audit, Butler was aware of the minimum net worth requirement for participation in FHA business.[15]

In late 1979, Westside gave International Mortgage Company (IMC) copies of the audited financial statements.[16] IMC allegedly relied on these statements in entering into contracts with Westside to do business in FHA loans.[17] Butler had no knowledge of IMC at the time of the audit, nor was Butler aware of IMC's receipt of and reliance upon Westside's financial statements.[18] IMC did not contact Butler to verify that the financial statements presented fairly the financial position and results of operation of Westside.[19] After entering into a series of

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7. *International Mortgage Co.*, 177 Cal. App. 3d at 820, 223 Cal. Rptr. at 227.
8. *See infra* notes 11-51 and accompanying text.
9. *See infra* notes 52-104 and accompanying text.
10. *See infra* notes 105-134 and accompanying text.
11. *International Mortgage Co.*, 177 Cal. App. 3d at 809, 223 Cal. Rptr. at 219.
12. *Id.* at 810, 223 Cal. Rptr. at 219.
13. *Id.* at 809, 223 Cal. Rptr. at 219.
14. *Id.* at 810, 223 Cal. Rptr. at 219. A minimum net worth of $100,000 is required to participate in FHA business. 24 C.F.R. §§ 203.3-203.5 (1985).
15. *International Mortgage Co.*, 177 Cal. App. 3d at 810, 223 Cal. Rptr. at 219.
16. *Id.* at 809, 223 Cal. Rptr. at 219.
17. *Id.* at 810, 223 Cal. Rptr. at 220.
18. *Id.*
19. *Id.*

contracts to sell government loans to IMC, Westside failed to deliver the trust deeds to IMC, resulting in alleged damages of $475,293.[20] Westside issued a promissory note to IMC for the $475,293, but defaulted after paying only $40,000.[21] IMC sued Butler for damages,[22] alleging negligence and negligent misrepresentation.[23] The trial court granted Butler's motion for summary judgment based on the traditional rule that a Certified Public Accountant (CPA) owes no duty of care to a third party who was not specifically known to the accountant as an intended recipient of the audited financial statements.[24] IMC appealed the trial court's decision.[25]

B. *The Opinion*

The California Court of Appeal reversed, holding that an independent auditor owes a duty of care to reasonably foreseeable statement users who rely on unqualified reports issued on audited financial statements.[26] Beginning with a review of Justice Cardozo's seminal opinion in *Ultramares Corp. v. Touche*,[27] the *International Mortgage Co.* court noted that the application of the duty doctrine to the accounting profession has been unique.[28] Under the *Ultramares* rule, accountants have been shielded from liability for negligence in the audit of financial statements and issuance of unqualified audit reports, except to those in privity with the accountant.[29] The California Court of Appeal referred to the fact that even as *Ultramares* was being accepted, the tide of precedent had already begun to move against the privity rule.[30] Although the erosion of the privity rule continued as to other professionals, accountants remained untouched by the trend.[31]

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20. *Id.* at 810, 223 Cal. Rptr. at 219.
21. *Id.* at 810, 223 Cal. Rptr. at 220.
22. *Id.* Only IMC's claim against Butler was before the court on this appeal. *Id.* at 810 n.1, 223 Cal. Rptr. at 220 n.1. However, IMC also sued Westside under the same theories. *Id.* at 810, 223 Cal. Rptr. at 220.
23. *Id.* at 810, 223 Cal. Rptr. at 220.
24. *Id.*
25. *Id.*
26. *Id.* at 820-21, 223 Cal. Rptr. at 227.
27. 255 N.Y. 170, 174 N.E. 441 (1931). *See infra* notes 59-67 and accompanying text (discussion of *Ultramares*).
28. *International Mortgage Co.*, 177 Cal. App. 3d at 811, 223 Cal. Rptr. at 220.
29. *Ultramares*, 255 N.Y. at 180, 174 N.E. at 444; *International Mortgage Co.*, 177 Cal. App. 3d at 811, 223 Cal. Rptr. at 220.
30. *International Mortgage Co.*, 177 Cal. App. 3d at 812, 223 Cal. Rptr. at 221. *See infra* note 47 (list of professions subject to foreseeability standard in California).
31. *International Mortgage Co.*, 177 Cal. App. 3d at 812, 223 Cal. Rptr. at 221.

Reasoning by analogy, the *International Mortgage Co.* court traced the history of attorney liability in California.[32] Although attorneys were traditionally beneficiaries of the privity rule,[33] the California Supreme Court rejected this rule in favor of a balancing test developed in *Biakanja v. Irving*.[34] The *Biakanja* balancing test was held applicable to attorneys in *Lucas v. Hamm*.[35] The demise of the privity requirement for lawyers in California was completed in *Heyer v. Flaig*,[36] when the California Supreme Court held attorneys to a level of care consistent with their position of trust and knowledge.[37] The court stated that public policy requires attorneys to act in accordance with the foreseeability standard, to protect adequately the rights and interests of persons affected by the actions of the attorneys.[38]

Similarly, the *International Mortgage Co.* court emphasized the public role of accountants.[39] Dubbed "public watchdogs" by the

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32. *Id.* at 812-14, 223 Cal. Rptr. at 221-22.

33. *Id.* In National Savings Bank v. Ward, 100 U.S. 195, 200 (1880), the United States, Supreme Court held "[b]eyond all doubt, the general rule is that the obligation of the attorney is to his client and not to a third party. . . ." California soon followed, adopting the privity rule followed by the *National Savings Bank* Court in Buckley v. Gray, 110 Cal. 339, 42 P. 900 (1895). *Buckley* was expressly overruled in Biakanja v. Irving, 49 Cal. 2d 647, 651, 320 P.2d 16, 19 (1958) and in Lucas v. Hamm, 56 Cal. 2d 583, 588, 364 P.2d 685, 687, 15 Cal. Rptr. 821, 823 (1964).

34. *International Mortgage Co.*, 177 Cal. App. 3d at 813, 223 Cal. Rptr. at 221-22. *See Biakanja*, 49 Cal. 2d 647, 320 P.2d 16 (action for damages against notary public for drawing invalid will). The *Biakanja* factors include the extent to which the transaction was intended to affect the plaintiff, the foreseeability of harm to the plaintiff, the degree of certainty that the plaintiff suffered injury, the closeness of the connection between the defendant's conduct and the injury suffered, the moral blame attached to the defendant's conduct, and the policy of preventing future harm. *Id.* at 650, 320 P.2d at 19.

35. 56 Cal. 2d 583, 364 P.2d 685, 15 Cal. Rptr. 821 (1961). In *Lucas*, the defendant attorney was retained to prepare a client's will and subsequent codicils. The instruments designated plaintiffs as beneficiaries of a trust. The instruments violated the rule against perpetuities and were thus invalid. As a result of the attorney's negligence, plaintiffs were deprived of the trust intended for them. Instead, plaintiffs were forced to settle with the testator's blood relatives for a sum $75,000 less than they would have received in the absence of defendant's negligence. *Id.* at 586-87, 364 P.2d at 686-87, 15 Cal. Rptr. at 822-23. The court held that an attorney is liable to foreseeable third parties for injuries caused by the attorney's negligence. The court ruled, however, that drafting a will that violated the rule against perpetuities was not negligent, due to the complex nature of the law. *Id.* at 592, 364 P.2d at 690, 15 Cal. Rptr. at 826. *See* CAL. CIV. CODE § 715.2 (West 1982) (rule against perpetuities; vesting of interest in property).

36. 70 Cal. 2d 223, 449 P.2d 161, 74 Cal. Rptr. 225 (1969). In *Heyer*, the testatrix engaged the defendant attorney to prepare a will leaving the testatrix's entire estate to her two daughters, plaintiffs. At the same time, the testatrix informed the defendant of her ensuing marriage. The defendant negligently failed to mention the testatrix's new husband in the will, thus entitling him to a portion of the estate as a posttestamentary spouse. CAL. PROB. CODE §§ 6560-6562 (West Supp. 1986). The court adopted the rationale of *Lucas*, holding that an intended beneficiary of a will acquires a right of action against a negligent attorney. *Heyer*, 70 Cal. 2d at 225, 449 P.2d at 162, 74 Cal. Rptr. at 226.

37. *Heyer*, 70 Cal. 2d at 228-29, 449 P.2d at 164-65, 74 Cal. Rptr. at 228-29.

38. *Id.*

39. International Mortgage Co. v. John P. Butler Accountancy Corp., 177 Cal. App. 3d

United States Supreme Court,[40] accountants have assumed a role of public trust and responsibility that extends beyond the auditor-client relationship.[41] This role requires that the accountant maintain complete independence from the client and report on the client's financial position and results of operation objectively.[42] The California Court of Appeal was careful to point out that the accountant does not guarantee that the client's financial statements are completely true and without fault.[43] Instead, the accountant's certification merely warrants that the statements fairly present the financial position of the firm in accordance with Generally Accepted Accounting Principles (GAAP), as codified by the American Institute of Certified Public Accountants (AICPA).[44]

The *International Mortgage Co.* court also noted that the risk of loss is more appropriately placed upon the accounting profession than the innocent consumer.[45] The accounting profession, according to the court, is able to pass the risk to its clients and the ultimate consuming

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806, 817, 223 Cal. Rptr. 218, 224. An independent auditor is employed to analyze a client's financial status and make public the findings in accordance with recognized accounting principles. This undertaking is imbued with considerations of public trust. The accountant must realize the finished product will be relied upon by creditors, stockholders, investors, lenders, or anyone else involved in the financial concerns of the audited client. *Id. See also* AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, PROFESSIONAL STANDARDS, CODE OF PROFESSIONAL ETHICS (CCH) ET § 51.04 (1978) [hereinafter cited as AICPA] (emphasizing accountant's role of responsibility to the public).

40. United States v. Arthur Young & Co., 465 U.S. 805 (1984). Chief Justice Burger described the role of the independent auditor as follows:

> An independent certified public accountant performs a different role. By certifying the public reports that collectively depict a corporation's financial status, 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. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust. To insulate from disclosure a certified public accountant's interpretations of the client's financial statements would be to ignore the significance of the accountant's role as a disinterested analyst charged with public obligations.

Id. at 817-18.

41. *Id.* at 818.

42. *Id.*

43. *International Mortgage Co.*, 177 Cal. App. 3d at 817, 223 Cal. Rptr. at 225.

44. *Id.* The professional standards of the AICPA express the auditor's function as follows: "The objective of the ordinary examination of financial statements by the independent auditor is the expression of an opinion on the fairness with which they present financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles." AICPA, *supra* note 39, § 110.01, at 61. The AICPA has promulgated reporting standards which govern the preparation of financial statements. The standards require that the report specifically state that the financial statements are in accordance with generally accepted accounting principles, and further provide an expression of an opinion or reasons why no opinion can be given as to the adequacy of the reports. *Id.* vol. A, § 150.02, at 81-82.

45. *International Mortgage Co.*, 177 Cal. App. 3d at 821, 223 Cal. Rptr. at 227.

public through the cost of accounting services and insurance.[46] As a general proposition, the *International Mortgage Co.* court held that the same standard should govern the imposition of negligence liability, regardless of the defendant's profession.[47]

The California Court of Appeal cited with approval the recent holdings of the New Jersey and Wisconsin Supreme Courts,[48] which extended the foreseeability standard of negligence liability to accountants.[49] The *International Mortgage Co.* court concluded that society is better served by holding accountants to a foreseeability standard.[50] The foreseeability standard provides financial disincentive for negligent conduct and will heighten the profession's use of cautionary techniques.[51]

II. Legal Background

A. *History of Accountant Liability to Third Parties for Negligence*

Liability of accountants to third parties can be traced back to 1919.[52] In *Landell v. Lybrand*,[53] the plaintiff, relying upon an accountant's

46. *Id. But see infra* notes 108-18 and accompanying text (discussion of ability of accountants to bear risk of loss).

47. *International Mortgage Co.*, 177 Cal. App. 3d at 818-19, 223 Cal. Rptr. at 225-26. *See, e.g.*, MacPherson v. Buick Motor Co., 217 N.Y. 382, 390, 111 N.E. 1050, 1053 (1916) (car manufacturers); Molien v. Kaiser Found. Hosps., 27 Cal. 3d 916, 923, 616 P.2d 813, 817, 167 Cal. Rptr. 831, 835 (1980) (physicians); J'Aire Corp. v. Gregory, 24 Cal. 3d 799, 804-05, 598 P.2d 60, 63, 157 Cal. Rptr. 407, 409 (1979) (general contractors); Tarasoff v. Regents of Univ. of Calif., 17 Cal. 3d 425, 434-35, 551 P.2d 334, 342-43, 131 Cal. Rptr. 14, 22-23 (1976) (psychiatrists); Greenman v. Yuba Power Products, Inc., 59 Cal. 2d 57, 62, 377 P.2d 897, 900, 27 Cal. Rptr. 697, 700 (1963) (tool manufacturers); Lucas v. Hamm, 56 Cal. 2d 583, 589, 364 P.2d 685, 688, 15 Cal. Rptr. 821, 824 (1961) (attorneys); Biakanja v. Irving, 49 Cal. 2d 647, 651, 320 P.2d 16, 19 (1958) (notaries public); Huber, Hunt & Nichols, Inc. v. Moore, 67 Cal. App. 3d 278, 301, 136 Cal. Rptr. 603, 617 (1977) (architects); M. Miller Co. v. Dames & Moore, 198 Cal. App. 2d 305, 308, 18 Cal. Rptr. 13, 15 (1961) (engineers).

48. Rosenblum v. Adler, 93 N.J. 324, 352, 461 A.2d 138, 153 (1983); Citizens State Bank v. Timm, Schmidt & Co., 113 Wis. 2d 376, 385-86, 335 N.W.2d 361, 365-66 (1983).

49. *International Mortgage Co.*, 177 Cal. App. 3d at 819, 223 Cal. Rptr. at 226.

50. *Id.* at 820, 223 Cal. Rptr. at 227.

51. *Id.*

52. Note, *Public Accountants and Attorneys: Negligence and the Third Party*, 47 Notre Dame Law. 588, 596-600 (1972) (analysis of former scope of accountant liability to third parties). *See also* Note, Rosenblum, Inc. v. Adler: *CPAs Liable at Common Law to Certain Reasonably Foreseeable Third Parties Who Detrimentally Rely on Negligently Audited Financial Statements*, 70 Cornell L. Rev. 335 (1985) [hereinafter cited as Note, *Rosenblum v. Adler*] (review of historical background of accountant liability to third parties through *Rosenblum v. Adler*); Levitin, *Accountants' Scope of Liability for Defective Financial Reports*, 15 Hastings L.J. 436 (1964) (discussing the scope of accountant liability); Hawkins, *Professional Negligence Liability of Public Accountants*, 12 Vand. L. Rev. 797 (1959) (analysis of how concepts of professional negligence are applied to accountants).

53. 264 Pa. 406, 107 A. 783 (1919).

report, purchased stock in a company. However, the company's financial statements were in error, and negligent auditing by the accountant led to an incorrect opinion on the financial statements. The stock was in fact valueless. Since no contract existed between the parties and fraud was not proven, the court held that the accountant owed no duty to the plaintiffs.[54]

The *Landell* rationale, however, was questioned by the New York decision of *Glanzer v. Shepard.*[55] Although *Glanzer* involved the liability of public weighers, the circumstances are analogous to those in accountant liability cases. In *Glanzer*, the plaintiffs purchased beans. The total price was to be determined on the basis of weight sheets certified by public weighers. When the plaintiffs discovered that the recorded weight was erroneous, they sued the weighers for overpayment.[56] The court found that the plaintiffs' use of the certificates was the "end and aim" of the transaction.[57] Notwithstanding the theory of *Landell*, the New York court held the public weigher liable for negligence when reliance on the certified statements by third persons was foreseeable.[58]

The New York court defined the liability of accountants to third parties in *Ultramares v. Touche.*[59] In *Ultramares*, Fred Stern and Company employed an accounting firm to conduct an annual audit.[60] The accountants negligently failed to detect Stern's overvaluation of the company's assets.[61] The plaintiff, who loaned money to Stern in reliance upon the audited balance sheet, successfully sued the accountants on the theory of negligence.[62] On appeal, however, the appellate court reversed the decision of the lower court on the negligence action.[63] The appellate court reasoned that holding accountants liable for negligence to parties not in privity of contract would "expose accountants

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54. *Id.* at 406, 107 A. at 783. This was nothing more than a restatement of the rule established in Winterbottom v. Wright, 152 Eng. Rep. 402 (Ex. 1842). In *Winterbottom*, the court held that the breach of a contract to keep a mailcoach in repair could not give rise to a cause of action by a passenger in the coach who was injured when it collapsed. *Id.* at 405. The court stated that "[u]nless we confine the operation of such contracts as this to the parties who enter into them, the most absurd and outrageous consequences, to which I can see no limit, would ensue." *Id.*

55. 233 N.Y. 236, 135 N.E. 275 (1922).

56. *Id.* at 237-38, 135 N.E. at 275.

57. *Id.* at 238-39, 135 N.E. at 275.

58. *Id.* at 238-39, 135 N.E. at 275-76.

59. 255 N.Y. 170, 174 N.E. 441 (1931).

60. *Id.* at 173, 174 N.E. at 442.

61. *Id.* at 176, 174 N.E. at 443.

62. Id.

63. Id. at 193, 174 N.E. at 450.

to a liability in an indeterminate amount for an indeterminate time to an indeterminate class."[64]

Rather than overrule *Glanzer*, Justice Cardozo merely distinguished it on the facts.[65] Although the service in *Glanzer* was rendered primarily for the plaintiffs' benefit, the plaintiff in *Ultramares* was only an incidental beneficiary of the accountant's services.[66] Later courts ignored this distinction and interpreted *Ultramares* as holding that accountants owe no duty to persons not in privity of contract.[67]

In *Investment Corp. v. Buchman*,[68] for example, the plaintiff desired to purchase a large block of stock in the Belcher-Young Company. One condition of the purchase was that Belcher would provide the plaintiff with certified financial statements. The accountants retained to audit the statements allegedly knew that the plaintiff would rely on the information in deciding whether to buy the stock or rescind the contract.[69] The Florida Supreme Court held that the accountants owed no duty to the plaintiffs because, though known to the defendants, the plaintiffs were not in privity of contract with the defendants.[70] The court recognized that there were policy arguments in favor of

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64. *Id.* at 179, 174 N.E. at 444. Even as accountants' liability was limited by requiring privity before a duty could be found, the court recognized such a holding was against the flow of common law. Justice Cardozo observed "[t]he assault upon the citadel of privity is proceeding in these days apace." *Id.* at 180, 174 N.E. at 445.

65. *Id.* at 183, 174 N.E. at 446. For a discussion of the distinction drawn by Justice Cardozo, see Wiener, *Common Law Liability of the Certified Public Accountant for Negligent Misrepresentation,* 20 SAN DIEGO L. REV. 233, 242-44 (1980). The *International Mortgage Co.* court rejected the accountant's argument that the "end and aim" analysis of *Glanzer* was applied in *Ultramares* and should also be applied in this case. International Mortgage Co. v. John P. Butler Accountancy Corp., 177 Cal. App. 3d 806, 814-16, 223 Cal. Rptr. 218, 222-24.

66. *Ultramares*, 255 N.Y. at 183, 174 N.E. at 446.

67. *See generally* C.I.T. Fin. Corp. v. Glover, 224 F.2d 44, 46 (2d Cir. 1955) (to establish liability for negligence, jury must find that financial reports were made for "primary benefit" of plaintiff); O'Conner v. Ludlam, 92 F.2d 50, 53 (2d Cir. 1937) (strict adherence to rule of *Ultramares* that accountants are not liable for ordinary negligence in the absence of privity of contract); State St. Trust Co. v. Ernst, 278 N.Y. 104, 111, 15 N.E.2d 416, 418 (1938) (in absence of contractual relationship, accountants not liable for ordinary negligence even though aware of possible use of reports by company to obtain credit); Duro Sportswear, Inc. v. Cogen, 131 N.Y.S.2d 20, 24 (1954), *aff'd.*, 285 App. Div. 867, 137 N.Y.S.2d 829 (1955) (in absence of privity of contract, fraud must be shown for plaintiff to recover). The inaccurate interpretation of *Ultramares* has been applied in cases factually similar to *Glanzer* in which a negligent misrepresentation was relied upon by a known third party for a specific transaction. Candler v. Crane, Christmas & Co., [1951] 2 K.B. 164, 183-84. *See* Seavey, Candler v. Crane, Christmas & Co.—*Negligent Misrepresentation by Accountants,* 67 LAW Q. REV. 466 (1951) (criticizing *Candler*).

68. 208 So. 2d 291 (Fla. Dist. Ct. App. 1968).

69. *Id.* at 292. *See* Note, *Accountant's Liability to Third Parties for Negligence,* 23 U. MIAMI L. REV. 256 (1968) (discussing *Investment Corp.* in depth).

70. *Investment Corp.*, 208 So. 2d at 294 (citing Sickler v. Indian River Abstract & Guar. Co., 142 Fla. 528, 195 So. 195, 198 (1940)).

both parties, but felt bound by precedent to apply the privity rule.[71]

As the social role of accountants changed, dissatisfaction with the privity limitation intensified.[72] Many jurisdictions adopted the rule of the *Restatement (Second) of Torts*, which essentially represents a compromise between the privity rule and the foreseeability rule.[73] The *Restatement* provides that accountants owe a duty of care to known or intended third party users of financial statements and to third persons who are members of a known or intended *class* of users of financial statements.[74]

An early decision adopting the *Restatement* approach was *Rusch Factors, Inc. v. Levin*.[75] A Rhode Island corporation hired an accountant to audit financial statements for the purpose of obtaining a loan from the plaintiff. On the basis of the financial statements, the plaintiff lent more than $337,000 to the corporation. After the corporation went into receivership, the plaintiff brought a tort action against the accountant.[76] The federal district court held that the accountant was liable in negligence for careless financial misrepresentations relied upon by actually foreseen and limited classes of persons.[77] Reasoning that the burden of malpractice was more appropriately placed on the accountant than on an innocent plaintiff,[78] the court noted the accountant is in a better position than the plaintiff to spread the risk of loss to consumers.[79] Finally, the court speculated that the *Restatement* rule would encourage the improvement of cautionary techniques used by the accounting profession.[80]

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71. *Investment Corp.*, 208 So. 2d at 295-96. The court relied on Sickler v. Indian River Abstracts & Guar. Co., 142 Fla. 528, 195 So. 195 (1940) (abstractor not liable to persons with whom there is no privity of contract), and State St. Trust Co. v. Ernst, 278 N.Y. at 104, 15 N.E.2d 416 (1938) (interpreting *Ultramares* as meaning an accountant could not be liable for ordinary negligence in the absence of a contractual relationship).

72. Comment, Rosenblum v. Adler: *The New Jersey Supreme Court Expands Accountants' Liability*, 37 RUTGERS L. REV. 161, 167 (1984).

73. RESTATEMENT (SECOND) OF TORTS § 552 (1977). *See, e.g.*, Rusch Factors, Inc. v. Levin, 284 F. Supp. 85, 90, 92-93 (D.R.I. 1968) (accountants liable to third party they knew would rely on audited financial statements); Ryan v. Kanne, 170 N.W.2d 395, 401-03 (Iowa 1969) (accountants liable to third party they knew would rely on accounts payable information); Shatterproof Glass Corp. v. James, 466 S.W.2d 873, 876 (Tex. Civ. App. 1971) (duty of care owed to creditor to whom accountant knew audit would be given).

74. RESTATEMENT (SECOND) OF TORTS § 552 (1977). Several illustrations pertaining to public accountants are found in the comments to § 552.

75. 284 F. Supp. 85 (D.R.I. 1968).

76. *Id.* at 86-87.

77. *Id.* at 92-93.

78. *Id.* at 91.

79. *Id.*

80. *Id.*

The Iowa Supreme Court was the next court to adopt the *Restatement* approach. In *Ryan v. Kanne*,[81] an accounting firm brought an action to recover auditing fees despite the fact that the defendants' financial statements had been negligently audited.[82] The accountants were hired, at the insistence of one of the defendants' creditors, to audit financial statements with particular attention to accounts payable. Further, the accountants were advised of both the purpose of the audit and the possibility that the defendants' business would be taken over. In auditing the financial statements, the accountants failed to discover several errors. A reaudit performed by another firm disclosed a discrepancy in accounts payable of over $33,000.[83] The Iowa Supreme Court, in ruling on a defendant's counterclaim for negligence, rejected the strict rule of *Ultramares* and applied the analysis of *Levin* to hold the accountants liable to a limited class of foreseeable plaintiffs.[84] The *Ryan* court did not determine whether the rule of liability should be relaxed to extend to all foreseeable persons who may rely on the reports, but reasoned that lack of privity of contract is not a valid defense when the accountant is aware that third parties will rely on the financial statements.[85]

B. Recent Trend in Accountant Liability to Third Parties

Labeling the *Restatement* rule a "compromise position"[86] grounded on a "social fallacy,"[87] commentators urged the adoption of a general foreseeability standard for accountant liability.[88] Taking issue with the *Ultramares/Restatement* fear that expanded liability would bring financial ruin to the accounting profession, these commentators pointed both to the ready availability of malpractice insurance and to the

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81. 170 N.W.2d 395 (Iowa 1969).
82. *Id.* at 396, 401.
83. *Id.* at 397-99.
84. *Id.* at 401.
85. *Id.* at 403.
86. Besser, *Privity?—An Obsolete Approach to the Liability of Accountants to Third Parties*, 7 SETON HALL L. REV. 507, 527 (1976) (*Restatement* position allows accountants to escape liability by showing no knowledge of intended recipients).
87. Wiener, *supra* note 65, at 259 (reasons in support of *Ultramares* and *Restatement* position provide no persuasive rationale for treating accountants differently from other potential defendants).
88. Besser, *supra* note 86; Wiener, *supra* note 65. *But see* Comment, *Auditors' Third Party Liability: An Ill-Considered Extension of Law*, 46 WASH. L. REV. 675, 676 (1971) (expanded liability will probably result in injury to the auditing profession); Comment, *Accountants' Liability to the Third Party and Public Policy: A Calabresi Approach*, 39 SW. L.J. 689, 690 (1985) (imposition of accountant liability to all foreseeable persons for negligence is not economically or legally justifiable) [hereinafter cited as Comment, *A Calabresi Approach*].

continued economic viability of the accounting profession despite exposure to expanded liability under federal securities law and the *Restatement*.[89] Finally, in 1983, the supreme courts of two states held accountants to a general foreseeability standard.[90]

In *Rosenblum v. Adler*,[91] an accounting firm negligently audited the financial statements of a publicly held corporation. Relying on the financial statements, the plaintiffs acquired stock in the corporation in conjunction with the sale of their business to the corporation.[92] The stock proved to be worthless.[93] In holding the accountants liable for the plaintiffs' losses, the New Jersey Supreme Court reasoned that whether or not the accountants actually knew of the plaintiffs, it was reasonably foreseeable that the financial statements would be used in connection with the corporation's business transactions.[94]

Similarly, in *Citizens State Bank v. Timm, Schmidt & Co.*,[95] an accounting firm audited financial statements for Clintonville Fire Apparatus, Incorporated (CFA).[96] After reviewing the financial statements, the plaintiffs extended loans to CFA.[97] During a subsequent audit, the accounting firm's employees discovered material errors in the financial statements.[98] After these errors were corrected, all of CFA's creditors were notified, and the plaintiffs called in all loans made to CFA.[99] As a result, CFA went into receivership. The plaintiffs filed suit against the accounting firm seeking the amount due on the loans.[100] Affirming the decision of the lower court, the appellate court concluded that even if the *Restatement* was the law in Wisconsin, Citizens Bank was not within the limited class protected by the provisions of the *Restatement*.[101] The Wisconsin Supreme Court reversed, holding the *Restatement*'s limited scope to be too

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89. *See* Comment, *supra* note 72, at 168. *See also* Comment, *Auditors' Responsibility for Misrepresentation: Inadequate Protection for Users of Financial Statements,* 44 WASH. L. REV. 139, 151 (1968); Wiener, *supra* note 65, at 250; Besser, *supra* note 86, at 534-37.

90. Rosenblum v. Adler, 93 N.J. 324, 461 A.2d 138 (1983); Citizens State Bank v. Timm, Schmidt & Co., 113 Wis. 2d 376, 335 N.W.2d 361 (1983).

91. 93 N.J. 324, 461 A.2d 138 (1983).

92. *Id.* at 329, 461 A.2d at 140-41.

93. *Id.* at 329, 461 A.2d at 141.

94. *Id.* at 355, 461 A.2d at 154.

95. 113 Wis. 2d 376, 335 N.W.2d 361 (1983).

96. *Id.* at 378, 335 N.W.2d at 362.

97. *Id.*

98. *Id.*

99. *Id.*

100. *Id.* at 379, 335 N.W.2d at 362.

101. *Id.* at 382, 335 N.W.2d at 364.

restrictive and inconsistent with Wisconsin negligence law making a tortfeasor liable for all foreseeable consequences of his acts.[102]

The rationale of both courts was nearly identical to that of *Levin*.[103] *Rosenblum* and *Citizens*, however, rejected the limited nature of the *Restatement* in favor of liability to all foreseeable plaintiffs. The California Court of Appeal in *International Mortgage Co.* relied on the same rationale to hold accountants to the foreseeability standard. Like New Jersey and Wisconsin, the California court rejected the *Restatement* view in favor of the foreseeability standard, finding the protectionist rule of *Ultramares* and the limited liability imposed under the *Restatement* inconsistent with California's negligence law.[104]

III. Legal Ramifications

International Mortgage Co. extends the liability of accountants to third parties who reasonably and foreseeably rely on the accountant's audited statements.[105] The expansion of liability is based on several policy considerations, including appropriate placement of risk, cost spreading, and deterrence.[106] The *International Mortgage Co.* court, however, failed to consider adequately the effects of the holding on the accounting profession and society in general.[107]

Under the new law announced in *International Mortgage Co.*, accountants will bear the full risk of loss for negligence in the preparation and issuance of unqualified financial statements.[108] Imposition of this burden is based on the assumption that the accounting

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102. *Id.* at 386, 335 N.W.2d at 366.

103. *See supra* notes 75-80 and accompanying text (discussion of *Levin*).

104. International Mortgage Co. v. John P. Butler Accountancy Corp., 177 Cal. App. 3d 806, 819-20, 223 Cal. Rptr. 218, 226-27. *But see* Credit Alliance Corp. v. Arthur Andersen & Co., 493 N.Y.S.2d 435, 483 N.E.2d 110 (1985), in which the New York Court of Appeals deferred to the *Ultramares* standard. The court held that to maintain an action against an accountant, a plaintiff must be either in privity with the accountant or meet the following prerequisites: (1) the accountant must have been aware that the financial reports were to be used for a particular purpose; (2) the accountant must have known that the client intended that a known party would rely on the reports in furtherance of that purpose; and (3) the accountant must have done something linking him or her to that party which evinces the accountant's understanding of that party's reliance. *Id.* at 443, 483 N.E.2d at 118.

105. *International Mortgage Co.*, 177 Cal. App. 3d at 812, 818, 223 Cal. Rptr. at 221, 225-26.

106. *Id.* at 820, 223 Cal. Rptr. at 227.

107. *See* Comment, *A Calabresi Approach, supra* note 88, at 690.

108. *International Mortgage Co.*, 177 Cal. App. 3d at 820, 223 Cal. Rptr. at 227. Often the accountant is only secondarily liable, since the accountant relies on management. When a business fails, however, the accountant is seen as the deep pocket and the only one available to reimburse the plaintiff for the resulting losses. Collins, *Minimizing Risk for CPAs is Focus of AICPA Conference,* 161 J. Acct., July 1986, at 52.

profession will be able to pass the risk to its clients and the ultimate consuming public through insurance and the increased cost of accountant services.[109] The validity of this assumption is questionable, however,[110] since the cost of liability insurance has become prohibitive.[111] The smaller accounting firms are being hit the hardest, since litigation will usually be limited to cases involving commercial transactions that do not fall under the securities laws.[112] Those cases generally involve smaller businesses dealing with smaller accounting firms.[113] Of the nearly one dozen insurance companies which formerly offered liability insurance for smaller accounting firms, only three companies still offer coverage.[114] Strict adherence to the foreseeability standard may result in insurance becoming completely unavailable to small accounting firms.

Due to the increased cost of insurance, all accounting firms may be forced to increase fees substantially.[115] An increase in fees will make it more difficult for smaller companies to afford the audited financial statements needed to solicit and transact business.[116] Furthermore, as a result of the unavailability or prohibitive cost of insurance, many accounting firms may simply withdraw from the audit market altogether. The exodus of smaller accounting firms will further narrow the choices of smaller companies needing audited statements.[117] Perhaps this limitation of choice will result in an increasing willingness by lenders and other third parties dealing with

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109. Galen, *Litigation Blitz Hits Accountants,* 8 NAT'L L.J. No. 40, 1 (1986).

110. *Id.* at 26. Due largely to the increase in litigation, small and medium sized accounting firms are experiencing an insurance shortage which may force many of them out of the market. *Id.*

111. *See id.*; Continuing Education of the Bar, *Accountants Owe a Duty of Care to Foreseeable Plaintiffs,* CAL. BUS. L. RPTR. 239 (May 1986) [hereinafter cited as *Accountants Owe Duty*]; Collins, *supra* note 108, at 52; Note, *Rosenblum v. Adler, supra* note 52, at 350-54.

112. Galen, *supra* note 109, at 26 (cases not governed by securities laws generally involve medium amounts of money and are between smaller businesses and smaller accounting firms).

113. *Id.*

114. *See id.* Of those firms offering liability insurance to small companies, one has stopped writing policies for individual accountants and anticipates ending its group policy plan for the California Society of CPAs. For those companies still offering liability insurance to smaller firms, premiums and deductibles have skyrocketed while maximum coverage has plummeted. Larger firms have also indicated that similar insurance problems are affecting them; "[j]udgments and settlements of lawsuits involving accountants have been huge, . . . $180,000,000 for the 8 larger CPA firms since 1980, and insurance for all firms has become limited and prohibitively expensive." Collins, *supra* note 108, at 52.

115. *Accountants Owe Duty, supra* note 111, at 240.

116. *Id.*

117. *See supra* note 108.

nonpublic entities to rely on reports prepared in engagements of lesser scope than an audit.[118]

Indeed, accountants may begin to issue audited reports that contain disclaimer language[119] to shield themselves from liability under the foreseeability rule.[120] Auditors may also attempt to protect themselves by the use of an express limitation upon the persons or class of persons who may rely on the audit.[121] If limitation provisions and disclaimers effectively limit the liability of accountants, *International Mortgage Co.* may reduce the accountant's incentive to conduct full scope audits.[122] Paradoxically, the policy of encouraging more thorough audits by placing the risk of loss on accountants may be entirely thwarted by the probable reaction to the extension of liability in *International Mortgage Co.*

An examination of the results of the application of the foreseeability standard to other professionals provides some insight as to what the future may hold for the accounting profession. For example, the application of the foreseeability rule to the medical profession caused a tremendous increase in the cost of malpractice insurance. This increase in turn threatened the quality and quantity of available medical services.[123] In response to these dangers, the Medical Injury Compensation Reform Act (MICRA) was enacted in 1975.[124] Among

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118. *Accountants Owe Duty, supra* note 111, at 240. Engagements of lesser scope are the compilation or review of financial statements. A compilation of financial statements consists of presenting in the form of financial statements information that is the representation of management without the accountant undertaking to express any assurance on the statements. A review of financial statements occurs when the accountant performs an inquiry and analytical procedure that provides the accountant with a reasonable basis for expressing limited assurance that there are no material modifications that should be made to the statements in order for them to be in conformity with generally accepted accounting principles. American Institute of Certified Public Accountants, *Professional Standards*, AR § 100, Compilation and Review of Financial Statements (SSARS No. 1 1978).

119. *See* Rosenblum v. Adler, 93 N.J. at 351, 461 A.2d at 152; Comment, *supra* note 72, at 189-90.

120. *Rosenblum*, 93 N.J. at 351, 461 A.2d at 152; Comment, *supra* note 72, at 189-90.

121. *See* Comment, *supra* note 72, at 189-90.

122. *Id.* (the universal availability of the disclaimer device would substantially undercut the policy goals advanced by the adoption of the broad foreseeability rule); Solomon, Ultramares *Revisited: A Modern Study of Accountants' Liability to the Public*, 18 DE PAUL L. REV. 56, 83 (1968) (the widespread use of disclaimers of opinion as a device for avoiding liability would not produce a satisfactory solution, but would only further compound problems due to its consequences on the credit standing of the client and its ultimate destruction of the accountant's very purpose for existence); Besser, *supra* note 86, at 541 (the use of disclaimers is permissible, although an accountant cannot disclaim liability for all negligent representations in the report). *See* C.I.T. Fin. Corp. v. Glover, 224 F.2d 44, 46 (2d Cir. 1955) (effect of a disclaimer should ultimately be a question for the jury).

123. Proclamation by the Governor, 1975 Cal. Stat. at 3947.

124. *Id.* ch. 1, at 3949 (2d Extra. Sess.). *See also Review of Selected 1975 California Legislation*, 7 PAC. L.J. 544 (1976) (review of MICRA amendments).

the provisions in MICRA is a statute of limitations requirement that all actions for negligence be commenced within three years of the date of the injury or one year after the date the injury was or should have been discovered, whichever occurs first,[125] and a $250,000 ceiling on recovery for noneconomic damages.[126]

Similarly, real estate brokers became liable under the foreseeability standard in 1984.[127] The initial impact was devastating, resulting in dramatic increases in the cost of insurance and general confusion about the duty owed to buyers.[128] In response to the immediate movement for protective legislation, remedial legislation was passed in 1985.[129] Among the statutory provisions passed was a detailed description of the standard of care required of the real estate broker, a description of the precise scope of inspection required, a two-year statute of limitations for breach of duty actions, and the imposition of a duty of reasonable care on the buyer to protect himself through diligent attention and observation.[130]

The effect of *International Mortgage Co.* on the accounting profession will be manifested to some degree in the area of liability insurance, causing an impact on the availability and affordability of coverage.[131] The long-term effects, as yet, remain uncertain. Concern within the profession that the extension of the foreseeability standard may result in the diminished ability of the accounting profession to certify financial statements is justified. The smaller firms are especially concerned because of the importance of the audit to the livelihood of the small accounting firm. The countervailing consideration, however, is that allowing accountants to operate under a lenient liability standard or shielded from liability by broad disclaimers does little to promote cautionary operating techniques.[132] The California Court of Appeal has clearly stated that accountants must join the ranks of other professionals and face liability for negligence under the foreseeability standard.[133] In light of the effect the strict

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125. CAL. CIV. PROC. CODE § 340.5 (West 1982).
126. CAL. CIV. CODE § 3333.2 (West Supp. 1986).
127. Easton v. Strassburger, 152 Cal. App. 3d 90, 199 Cal. Rptr. 383 (1984).
128. 1985 Cal. Stat. ch. 223, sec. 4, at ___(imprecision of terms in *Easton* and absence of comprehensive declaration of duties, standards, and exceptions has caused modification of insurance coverage for real estate licensees and caused confusion as to manner of performing duty ascribed by court).
129. 1985 Cal. Stat. ch. 223, at ___(enacting CAL. CIV. CODE § 2079 (West Supp. 1987)).
130. CAL. CIV. CODE §§ 2079.2-2079.5 (West 1987).
131. *See supra* notes 108-14 and accompanying text.
132. *See supra* notes 115-22 and accompanying text.
133. *International Mortgage Co.*, 177 Cal. App. 3d at 820, 223 Cal. Rptr. at 227.

foreseeability standard has had on other professions,[134] the probability is high that the accounting profession will soon approach the legislature to seek a reprive from a deluge of litigation.

CONCLUSION

In *International Mortgage Co.*, the California Court of Appeal held that the accounting profession is subject to the same judicial criteria governing other professionals in the area of liability to third parties for negligence. *International Mortgage Co.* did not place a limit on the extension of the foreseeability standard. The *International Mortgage Co.* court based its holding on three policy factors: (1) appropriate placement of risk on accountants rather than innocent plaintiffs; (2) the ability of the accounting profession to better spread this risk to its clients and the ultimate consuming public; and (3) general considerations of deterrence. Unfortunately, the court failed to consider thoroughly the implications of the expansion of liability.

First, the court rather unrealisitically failed to recognize that liability insurance is available only at a very high cost. The ability of accountants to spread the risk of loss is therefore diminished. Indeed, the ability of smaller accounting firms to continue in business may be jeopardized. Second, the prospect of expanded liability may encourage accounting firms to adopt devices such as provisions limiting reliance and disclaimers qualifying audit reports in order to restrict potential liability. Thus, the deterrence aspect of *International Mortgage Co.* may be thwarted. Legislative relief appears to be the only solution to the dramatic increase in litigation that will surely arise as a result of the extension of the foreseeability standard to accountants.

Ann Simmons

134. *See supra* notes 123-30 and accompanying text.