Pace Law Review

Volume 13
Issue 2 *Fall 1993*

Article 14

September 1993

Security Pacific Business Credit, Inc. v. Peat Marwick Main & Co.: Just in Case You Had Any Doubts - There Is No Tort of Negligent Misrepresentation in New York

Richard D. Holahan Jr.

Recommended Citation
Richard D. Holahan Jr., *Security Pacific Business Credit, Inc. v. Peat Marwick Main & Co.: Just in Case You Had Any Doubts - There Is No Tort of Negligent Misrepresentation in New York*, 13 Pace L. Rev. 763 (1993)
DOI: https://doi.org/10.58948/2331-3528.1538
Available at: https://digitalcommons.pace.edu/plr/vol13/iss2/14

Note

Security Pacific Business Credit, Inc. v. Peat Marwick Main & Co.: Just in Case You Had Any Doubts — There Is No Tort of Negligent Misrepresentation in New York

"[S]ticks and stones can break my bones, but words will never hurt me."[1]

"We are now asked to say that a like liability attaches to the circulation of a thought or a release of the explosive power resident in words."[2]

I. Introduction

The old stereotype of an accountant? You know it. That five-foot-two, physically unfit individual, bespectacled, at all times wielding a trusty calculator and clad in that stylish pocket protector. Geeky? Yes. Boring? Perhaps. Combative? Absolutely not. Well, it may be time for that old stereotype to die.

It is no secret that the most recent recession[3] crippled many enterprises and forced them to seek the protection of bankruptcy.[4] Creditors, investors, and shareholders alike, reeling

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1. *Quoted in* Harry H. Wellington, *On Freedom of Expression*, 88 YALE L.J. 1105, 1106 (1979).

2. Ultramares Corp. v. Touche, 255 N.Y. 170, 181, 174 N.E. 441, 445 (1931).

3. Despite the United States economy's continued anemic performance, the dating committee of the National Bureau of Economic Research, an official panel of economists that charts business cycles, has reported that the recession, which began in July 1990, officially ended in March 1991. Robert D. Hershey, Jr., *This Just In: Recession Ended 21 Months Ago*, N.Y. TIMES, Dec. 23, 1992, at D1.

4. The total number of bankruptcies filed under the Bankruptcy Reform Act of 1978 (including those filed under chapters 7, 9, 11 and 12) totalled 360,329 and 367,866 in

from behemoth losses have, in droves, turned to the auditors[5] of these fallen enterprises seeking recompense.[6] The response of the accountants? A far cry from the conventional stereotype. The accounting profession has engaged in the battle and is fighting tooth and nail to reform the current liability structure of this country.[7]

The primary nemesis of the profession is joint and several liability, a liability system that renders an accountant liable for a plaintiff's damages,[8] *in toto*, regardless of the degree to which

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1981 and 1982 respectively. In 1989, this number had skyrocketed to 642,993. BUREAU OF THE CENSUS, U.S. DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 538 (111th ed. 1991) (Table No. 884).

5. The terms "auditor" and "accountant" will be used interchangeably throughout this Note. Because the courts use the term "accountant" when discussing the cause of action for negligent misrepresentation, i.e., accountants' liability for negligent misrepresentation, this Note will predominantly use this term. It should be noted, however, that these terms do have distinct meanings. An accountant is a person engaged in audit, tax or management advisory services. Auditors constitute a subset of accountants; their role is to examine financial statements in order to determine whether they are presented fairly, and in accordance with established accounting standards. *See* Willis W. Hagen II, *Accountants' Common Law Negligence Liability to Third Parties*, 1988 COLUM. BUS. L. REV. 181, 181-82 n.4.

6. On August 31, 1992, the six largest accounting firms in the country, Arthur Andersen & Company, Coopers & Lybrand, Deloitte & Touche, Ernst & Young, KPMG Peat Marwick, and Price Waterhouse (known collectively as the "Big Six"), issued a position paper estimating that the accounting profession as a whole currently faces claims totaling approximately $30 billion. THE LIABILITY CRISIS IN THE UNITED STATES: IMPACT ON THE ACCOUNTING PROFESSION, *reprinted in* J. ACCT., Nov. 1992, at 19, 19 [hereinafter THE LIABILITY CRISIS]. In 1991, the Big Six expended $477 million on litigation, amounting to nine percent of their domestic auditing and accounting revenues. *Id.* at 20. The American Institute of Certified Public Accountants (AICPA), the governing body of the accounting profession, has reported that claims asserted against firms other than the Big Six rose by two-thirds from 1987 to 1991. AICPA BOARD ENDORSEMENT, *reprinted in* J. ACCT., Nov. 1992, at 18, 18. Approximately 25 years ago, one commentator noted that, "[s]uits against accountants by persons other than their clients have been almost uniformly unsuccessful." Note, *Accountants' Liabilities for False and Misleading Financial Statements*, 67 COLUM. L. REV. 1437, 1437 (1967). Times have certainly changed.

7. In an unprecedented step, the ordinarily fiercely competitive Big Six have joined forces in this call for litigation reform. *See* THE LIABILITY CRISIS, *supra* note 6, at 23. In an effort to impact impending federal legislation, the AICPA's political action committee, the Effective Legislation Committee (ELC), has stepped-up efforts to lobby the U.S. Congress. William Sternberg, *Cooked Books*, THE ATLANTIC MONTHLY, Jan. 1992, at 20, 35. Contributions by the ELC have increased from $20,300 in the 1981-82 election cycle to $912,159 in 1987-88 cycle. *Id.* In addition, the ELC gave $1,087,044 during 1989-90 to important members of Congress sitting on key banking, tax, and commerce committees. *Id.*

8. THE LIABILITY CRISIS, *supra* note 6, at 19.

that accountant's culpability contributed to those damages.[9] The profession strenuously argues that:

> In practical terms this means that, even with no evidence of culpability, a company's independent auditors are almost certain to be named in any action filed against that company alleging financial fraud for no reason other than the auditors' perceived deep pockets or because they are the only potential defendant that is still solvent.[10]

The result of this, the profession contends, is that numerous accountants are forced to settle even the most baseless of claims.[11]

To remedy this inequity, the accounting profession has argued that joint and several liability should be discarded on both the state and federal levels.[12] In its place, the profession has argued for the adoption of a "proportionate liability system,"[13]

9. Where multiple wrongdoers act either concurrently or successively to cause a single, indivisible injury, comparative negligence statutes allow a jury to allocate the percentage of fault that each joint tortfeasor has contributed to a victim's damages. Mike Steenson, *Recent Legislative Responses to the Rule of Joint and Several Liability*, 23 TORT INS. L.J. 482, 482 (1988). Joint and several liability, however, allows that victim to recover all of his damages from any one of the tortfeasors, regardless of the fact that the tortfeasor held entirely liable may only have minimally contributed to causing those damages. W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 67, at 475 (5th ed. 1984). Although the tortfeasor who pays more than his allocated share may generally seek contribution from another tortfeasor, it is not unusual that the deficient tortfeasor is unable to satisfy his proportionate share of the judgment. *See id.* at 476-77.

The policy justifications advanced for joint and several liability are that of compensation and deterrence. Nancy L. Manzer, Comment, *1986 Tort Reform Legislation: A Systematic Evaluation of Caps on Damages and Limitations on Joint and Several Liability*, 73 CORNELL L. REV. 628, 644, 648 (1988). The compensation argument is that the joint tortfeasor, who is after all a wrongdoer, should bear the risk of a co-tortfeasor's insolvency, not the innocent victim. *Id.* at 644. The deterrence justification is that the prospect of complete liability provides an added disincentive for the would-be joint tortfeasor. *Id.* at 648. In the late 1980s, as a part of the tort reform effort, several states either modified or completely discarded joint and several liability. *Id.* at 628, 636. Many state legislatures concluded that the comparative negligence rule in conjunction with the joint and several liability rule was inequitable to many defendants. *Id.* at 636.

10. THE LIABILITY CRISIS, *supra* note 6, at 19.

11. *Id.* at 20. THE LIABILITY CRISIS position paper points to several factors that coalesce to make a coerced settlement inevitable: the prospect of being held accountable for all the plaintiff's damages even though the accountant is only minimally responsible; the fact that very often a settlement is cheaper than the legal fees connected with fighting the claim; and finally, the inability of the accountant to obtain recompense for the legal fees incurred as a result of fighting a baseless claim. *Id.*

12. *Id.* at 23.

13. *Id.* Proportionate liability is a synonym for several liability. *See* KEETON, *supra*

which would limit an accountant's liability to the portion of damages that the fact-finder determines the accountant has caused.[14] This system, the profession asserts, "would help restore balance and equity to the liability system by discouraging specious suits and giving blameless defendants the incentive to prove their cases in court rather than settle."[15]

Critics of this effort contend that the litigation against accountants is, by and large, a justified product of substandard audits.[16] These antagonists point out that over two-thirds of the current litigation against accountants is a product of the savings and loan ("S&L") debacle.[17] They also point to the studies of the causes of the S&L debacle showing that, in several cases, accountants "sacrificed traditional values of the accounting profession — conservatism, skepticism, objectivity, and independence — and either 'looked the other way' in order to retain S&L auditing business, or deliberately participated in and benefited from the pillaging of S&L's."[18]

Last summer, in the midst of this controversy, the New York Court of Appeals issued its latest decision regarding the scope of accountants' liability[19] to third parties for negligent

note 9, § 67, at 475.

14. THE LIABILITY CRISIS, *supra* note 6, at 23.

15. *Id.*

16. *See* sources cited *infra* notes 17-18.

17. Thomas McCarroll, *Who's Counting?*, TIME, Apr. 13, 1992, at 48. From 1980 to 1988, over 500 S&L associations failed throughout the United States, more than three times the number of those that had failed in the previous 45 years combined. S. REP. No. 19, 101st Cong., 1st Sess. 2 (1989).

18. Jan S. Blaising, Note, *Are the Accountants Accountable? Auditor Liability in the Savings and Loan Crisis*, 25 IND. L. REV. 475, 511 (1991). In California, 28 of the 30 S&L institutions involved in this scandal received a clean audit opinion the year before they became insolvent. Sternberg, *supra* note 7, at 20. Furthermore, a Government Accounting Office study of 11 Texas S&L failures found that in six cases the audits were conducted in "an inadequate or unprofessional manner." U.S. GEN. ACCOUNTING OFFICE, PUB. NO. AFMD-89-45, CPA AUDIT QUALITY: FAILURES OF CPA AUDITS TO IDENTIFY AND REPORT SIGNIFICANT SAVINGS AND LOAN PROBLEMS 2 (1989). As a result, the Federal Deposit Insurance Corporation, as well as the Resolution Trust Corporation, have initiated a spate of litigation against the auditors of failed S&L's. *See* Samuel J. Winer & Kenneth B. Winer, *Accountants' Liability for Audits of Savings & Loan Associations*, 646 A.L.I.-A.B.A. COURSE OF STUDY 157, 159 (1991).

19. This Note deals primarily with the claim of negligent misrepresentation asserted against accountants. It should be pointed out, however, that the principles articulated in this context have import beyond this profession. *See, e.g.*, Prudential Ins. Co. of Am. v. Dewey Ballantine, Bushby, Palmer & Wood, 80 N.Y.2d 377, 605 N.E.2d 318, 590

misrepresentation[20] in *Security Pacific Business Credit, Inc. v.*

N.Y.S.2d 831 (1992) (negligent misrepresentation asserted against attorneys); Ossining Union Free Sch. Dist. v. Anderson LaRocca Anderson, 73 N.Y.2d 417, 539 N.E.2d 91, 541 N.Y.S.2d 335 (1989) (negligent misrepresentation asserted against architects and consulting engineers); Wells v. Shearson Lehman/Am. Express, Inc., 72 N.Y.2d 11, 526 N.E.2d 8, 530 N.Y.S.2d 517 (1988) (negligent misrepresentation asserted against financial advisors); Board of Managers of Astor Terrace Condominium v. Schuman, Lichtenstein, Claman & Efron, 183 A.D.2d 488, 583 N.Y.S.2d 398 (1st Dep't 1992) (negligent misrepresentation asserted against engineering and design professionals); Kidd v. Havens, 171 A.D.2d 336, 577 N.Y.S.2d 989 (4th Dep't 1991) (negligent misrepresentation asserted against title company); Belgo Asian Diamond Cy. v. European Am. Bank & Trust Co., 168 A.D.2d 345, 562 N.Y.S.2d 668 (lst Dep't 1990) (negligent misrepresentation asserted against bank).

20. According to the Second Restatement of Torts, negligent misrepresentation occurs when:

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

RESTATEMENT (SECOND) OF TORTS § 552 (1977). This core definition is useful for introductory purposes; however, the Restatement provisions as to the scope of liability to nonprivies for negligent misrepresentation is one of three basic methodologies currently used. *See* discussion *infra* sections C and D of part II.

Negligent misrepresentation is a state common law action; so too is its sibling, fraudulent misrepresentation. *See, e.g.,* Ultramares Corp. v. Touche, 255 N.Y. 170, 174 N.E. 441 (1931) (discussing both causes of action). Section 526 of the Second Restatement of Torts provides that a misrepresentation is fraudulent if the maker: "(a) knows or believes that the matter is not as he represents it to be, (b) does not have the confidence in the accuracy of his representation that he states or implies, or (c) knows that he does not have the basis for his representation that he states or implies." RESTATEMENT (SECOND) OF TORTS § 526 (1977). In contrast to the disparity prevalent among jurisdictions with negligent misrepresentation, *see infra* notes 88-90 and accompanying text, there is general consensus across the country that a nonprivy party may successfully assert a cause of action against the maker of a fraudulent misrepresentation.

In addition, accountants may be subject to liability under various federal securities laws as a result of material misstatements in the financial statements they have audited. Under the Securities Act of 1933, ch. 38, § 11(a), 48 Stat. 74, 82 (1933), 15 U.S.C. § 77k(a) (1988), an accountant can be held liable to those who rely on a materially misleading audit report contained in a registered offering or prospectus. *Id.* Section 10(b) of the Securities Exchange Act of 1934, in combination with Rule 10b-5 of the Securities and Exchange Commission's regulations, exposes auditors of publicly held companies to liability to a third party, if that party can show scienter or intent to defraud. Securities Exchange Act of 1934, ch. 404, § 10(b), 48 Stat. 881, 891 (1934), 15 U.S.C. § 78j(b) (1988); 17 C.F.R. § 240.10b-5 (1992). In certain circumstances, an auditor may also be exposed to criminal liability under the Racketeer Influenced and Corrupt Organizations (RICO) Act of 1970. Pub. L. No. 91-452, §§ 901-904, 84 Stat. 922, 941-48 (1970), 18 U.S.C. §§ 1961-1968 (1988). *See generally* Richard P. Swanson, *Theories of Liability,* 708 A.L.I.-A.B.A. COURSE OF STUDY 1 (1992) (discussing securities law claims against

Peat Marwick Main & Co.[21] On this occasion, the court was faced with the question of whether the creditor of a bankrupt retailer, which relied on the retailer's materially misleading financial statements, could sustain a cause of action against the retailer's public accountant for allegedly negligently auditing those statements.[22]

In reinstating the trial court's summary judgment in favor of the accounting firm, the court concluded that the elements established in an earlier New York Court of Appeals' decision, *Credit Alliance Corp. v. Arthur Andersen & Co.*,[23] had not been satisfied.[24] The elements of *Credit Alliance*, if met, purport to demonstrate that the relationship between the third-party plaintiff and a defendant-accountant is tenable enough to support liability; a relationship that the Court of Appeals had previously defined as one "sufficiently approaching privity."[25] The role of the New York Court of Appeals in this area of the law,[26] and of

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accountants).

21. 79 N.Y.2d 695, 597 N.E.2d 1080, 586 N.Y.S.2d 87 (1992). *See* discussion *infra* part III.

22. *Id.* at 698, 597 N.E.2d at 1081, 586 N.Y.S.2d at 88.

23. 65 N.Y.2d 536, 483 N.E.2d 110, 493 N.Y.S.2d 435 (1985). *See infra* notes 133-53 and accompanying text.

24. *Security Pacific*, 79 N.Y.2d at 699, 597 N.E.2d at 1081, 586 N.Y.S.2d at 88.

25. *Credit Alliance*, 65 N.Y.2d at 553, 483 N.E.2d at 119, 493 N.Y.S.2d at 444. "Privity" in this context refers to privity of contract; the concept that those not a party to a contract have no right to sue for a breach of it. *See infra* note 64. Historically, privity was applied strictly; thus, unless a plaintiff could show that he was a party to a contract that caused him injury, he could not sue for negligence. *See* Winterbottom v. Wright, 152 Eng. Rep. 402, 405 (Ex. 1842). The relationship "sufficiently approaching privity" represents a juridical retreat from this strict interpretation. *See infra* note 64. It is a recognition that there are third parties, not signatories to a contract, to whom the promisee may owe a duty. *See Credit Alliance*, 65 N.Y.2d at 553, 483 N.E.2d at 119, 493 N.Y.S.2d at 444.

26. The New York Court of Appeals was one of the first courts to loosen the strictures of the privity doctrine, *see infra* note 64, and promulgated ground-breaking opinions in this area of the law. *See, e.g.*, Glanzer v. Shepard, 233 N.Y. 236, 135 N.E. 275 (1922) (*see infra* note 64 for further discussion); MacPherson v. Buick Motor Co., 217 N.Y. 382, 111 N.E. 1050 (1916) (allowing a personal injury suit against the manufacturer of defective chattel despite the plaintiff's lack of privity with the manufacturer); Lawrence v. Fox, 20 N.Y. 268 (1859) (*see infra* note 64 for further discussion). The privity doctrine has had a pervasive impact on the scope of accountants' liability for negligent misrepresentation; thus, the Court of Appeals had a significant impact on this cause of action before it even evolved. *See infra* note 64.

In addition, in *Ultramares*, the Court of Appeals, speaking through Chief Judge Cardozo, undertook the first significant analysis of an accountant's liability to a non-

New York itself as the recognized commercial capital of this nation,[27] truly makes *Security Pacific* a case of seminal importance.

Part II of this Note will begin with a discussion of the accountant's role in the business community. In order to fully assess the negligent misrepresentation cause of action as it applies to accountants, it is essential to understand the accountant's role as it is perceived by the accounting profession itself, others in the business community, and the courts. Part II also discusses the nature of an audit, the performance that typically spawns the negligent misrepresentation claim against an accountant. An understanding of the audit function is also imperative in adjudging the negligent misrepresentation cause of action as it applies to accountants.

Part II will continue with an analysis of the negligent misrepresentation cause of action. This analysis will be conducted with a focus on New York law. Preliminarily, the case law leading up to *Security Pacific* will be surveyed. The contract principles that were applied to negligent misrepresentation as it first evolved will be reviewed. The tort principles that have more recently been applied to negligent misrepresentation will also be analyzed. Finally, Part II will conclude with a consideration of whether a tort of negligent misrepresentation was developing in New York. If this was so, *Security Pacific* has conclusively abro-

client for negligent misrepresentation. *See* Albert G. Besser, *Privity? — An Obsolete Approach to the Liability of Accountants to Third Parties*, 7 SETON HALL L. REV. 507, 510 (1976). More recently, the Court of Appeals left another indelible mark on this area of the law with Credit Alliance Corp. v. Arthur Andersen & Co., 65 N.Y.2d 536, 483 N.E.2d 110, 493 N.Y.S.2d 435 (1985). One commentator has pointed out that, "[t]he opinions of the courts in New York, the state of origin of *Ultramares* and *Glanzer*, require closer attention because they frequently are cited in opinions of other jurisdictions, particularly in cases of first impression." R. James Gormley, *The Foreseen, The Foreseeable, and Beyond — Accountants' Liability to Nonclients*, 14 SETON HALL L. REV. 528, 536 (1984).

27. *See* Ehrlich-Bober & Co. v. University of Houston, 49 N.Y.2d 574, 581, 427 N.Y.S.2d 604, 608, 404 N.E.2d 726, 730 (1980) (commenting that New York has a "recognized interest in maintaining and fostering its undisputed status as the pre-eminent commercial and financial nerve center of the Nation and the world") (citing Bache & Co. v. International Controls Corp., 339 F. Supp. 341 (S.D.N.Y. 1972) and International Planning, Ltd. v. Daystrom, Inc., 24 N.Y.2d 372, 248 N.E.2d 576, 300 N.Y.S.2d 817 (1969)); *see also* United States v. Russel, 582 F. Supp. 660, 664 (S.D.N.Y. 1984) (referring to New York as "the commercial center of the United States (and perhaps the world) . . .").

gated it. *Security Pacific*'s dictate rings loud and clear: There is no tort of negligent misrepresentation in New York.

Part III will discuss *Security Pacific*, in detail, with a view toward its potential implications. Part IV of this Note will argue that the New York Court of Appeals' limitation of accountants' liability for negligent misrepresentation to the domain of contract law is a clear signal that the New York Legislature should take action. Tort liability in this area of the law is needed; however, only the legislature can draw boundaries that provide an equitable result for the injured third parties involved without imposing an onerous financial burden on accountants.

The New York Legislature should render negligent accountants liable to all reasonably foreseeable parties who legitimately rely on their audit work. In doing so, the legislature should also use the tools it has available to combat the exposure of accountants to inordinate liability. As the accounting profession itself points out, the premier factor causing this exposure is joint and several liability. This Note will focus on the use of this suggested legislative tool for limiting accountants' liability. Part IV will argue that the current joint and several liability system in New York should be eliminated and replaced with one that only holds accountants liable for their negligence, not the negligence of others.[28]

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28. The New York Legislature has adopted the comparative negligence doctrine. N.Y. Civ. Prac. L. & R. § 1411 (McKinney 1976). However, the legislature has only partially abrogated the joint and several liability rule. In 1986, the legislature enacted Civil Practice Law and Rules (CPLR) article 16, which states in part:

> [W]hen a verdict or decision in an action or claim for personal injury is determined in favor of a claimant in an action involving two or more tortfeasors jointly liable . . . and the liability of a defendant is found to be fifty percent or less of the total liability assigned to all persons liable, the liability of such defendant to the claimant for non-economic loss shall not exceed that defendant's equitable share determined in accordance with the relative culpability of each person causing or contributing to the total liability for non-economic loss . . . .

Id. § 1601 (McKinney Supp. 1993). This modification, however, has no impact on accountants' liability; the common law rule of joint and several liability remains in this context for two reasons. First, actions brought by third parties against accountants are not "personal injury" actions. *See* Becker v. Elm Air Conditioning Corp., 143 A.D.2d 965, 966, 533 N.Y.S.2d 605, 606 (2d Dep't 1988). Second, these actions always involve economic loss. As the practice commentaries to CPLR § 1600 point out, "[a]s to purely economic losses, the old law continues in full force—all defendants are jointly and severally liable to the plaintiff." N.Y. Civ. Prac. L. & R. § 1600 practice commentaries at 200 (McKinney Supp. 1993).

II. Background

A. *The Accountant's Role in the Current Business Environment*

Fifty years ago, when the accounting profession was in its infancy, an accountant's mission in conducting an audit was to assess management's stewardship of the business.[29] "[T]he accountant's primary duties included assisting management in identifying problematic situations such as inferior accounting procedures, employee theft and fraud, unintentional mistakes and undiscovered shortages."[30] Over the years, as the accounting profession developed more advanced procedures for conducting audits, this mission was transformed.[31] Currently, the accounting profession itself, as well as several courts and commentators, perceive the contemporary role of an audit in an entirely different light.[32] Today, in most cases, an audit is requested because a third party, such as the Securities and Exchange Commission[33] or a potential lender, requires independent verification that a business's financial statements,[34] taken as a whole, are presented

29. Judah Septimus, *Accountants' Liability for Negligence — A Contemporary Approach for a Modern Profession*, 48 FORDHAM L. REV. 401, 404-05 (1979).

30. Brian K. Kirby & Thomas L. Davies, *Accountant Liability: New Exposure for an Old Profession*, 36 S.D. L. REV. 574, 577 (1991).

31. Kirby & Davies, *supra* note 30, at 577; Septimus, *supra* note 29, at 401-08.

32. *See generally* Kirby & Davies, *supra* note 30, at 576-78.

33. The Securities Exchange Act of 1934, ch. 404, § 13, 48 Stat. 881, 894 (1934), 15 U.S.C. § 78m(a)(2) (1988), requires public companies to file with the Commission "annual reports, certified . . . by independent public accountants, and such quarterly reports, as the Commission may prescribe." *Id.*

34. The financial statements of a company are generally composed of four documents: a Balance Sheet, an Income Statement, a Statement of Retained Earnings, and a Statement of Cash Flows. The function of each is as follows:

1. *Balance Sheet* - presents a "snap-shot" view of the assets, liabilities, and equity of an enterprise at a particular moment in time, generally as of the last day in a company's operating period.
2. *Income Statement* - summarizes the results of an enterprise's operating activities over the course of the operating period. It generally reports sales, cost of goods sold, operating expenses, gains or losses and the bottom line net income or loss.
3. *Statement of Retained Earnings* - reports the events that have occurred during the operating period which impact the cumulative earnings of the enterprise. These events include: net income or loss, payment of dividends, and any adjustments of income from previous operating periods. This information can be reported in a separate statement or can be included on the income statement.

fairly.[35]

The accounting profession has issued several pronouncements that recognize this new role. These pronouncements emphasize that an auditor no longer serves solely the client, but also third parties who rely on the auditor's work. First among these is the American Institute of Certified Public Accountants' (AICPA's) professional standards, which state:

> A distinguishing mark of a profession is acceptance of its responsibility to the public. The accounting profession's public consists of clients, credit grantors, governments, employers, investors, the business and financial community, and others who rely on the objectivity and integrity of certified public accountants to maintain the orderly functioning of commerce. This reliance imposes a public interest responsibility on certified public accountants.[36]

In addition, the Financial Accounting Standards Board, a body created by the accounting profession to establish acceptable accounting principles and financial reporting standards, has commented:

> The effectiveness of individuals, enterprises, markets, and government in allocating scarce resources among competing uses is enhanced if those who make economic decisions have information that reflects the relative standing and performance of business enterprises to assist them in evaluating alternative courses of action and the expected returns, costs, and risks of each . . . . Independent auditors commonly examine or review financial statements . . . and those who use that information often view an independent auditor's opinion as enhancing the reliability or credibility of the information.[37]

Recently, the AICPA reiterated that "the audit provides investors, bankers, creditors, and others with reasonable assurance

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4. *Statement of Cash Flows* - reports the activities that constitute sources and uses of cash during the operating period. The sources and uses of cash are organized into three categories: operating, financing, and investing activities. This statement also reconciles these activities to net income or loss by detailing certain non-cash items (i.e., depreciation).

See generally DOUGLAS R. CARMICHAEL ET AL., ACCOUNTANTS' HANDBOOK (7th ed. 1991).

35. DAVID N. RICCHIUTE, ACCOUNTING CONCEPTS AND STANDARDS 6 (1982).

36. AICPA, 2 PROF. STAND. (CCH) ET § 53.01 (1988).

37. 2 FINANCIAL ACCOUNTING STANDARDS BOARD, ORIGINAL PRONOUNCEMENTS, ACCOUNTING STANDARDS AS OF JUNE 1, 1992, at 695-710 (1992).

that the financial statements are free of material misstatement."[38]

As the accounting profession acknowledges, various members of the business community rely on the auditor's work in making crucial business decisions.[39] These members include creditors such as banks, suppliers and vendors, and investors such as individuals, mutual funds, and venture capitalists.[40] One commentator has noted that "a variety of third parties may rely on financial statements to evaluate the client for credit-worthiness, investment potential, or any other purpose that may affect a decision to contract with the client."[41]

Courts have also evaluated the accountant's role in the contemporary business setting. First and foremost is the Supreme Court of the United States, which has commented:

> 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.[42]

The New Jersey Supreme Court has also concluded that "[t]he auditor's function has expanded from that of a watchdog for management to an independent evaluator of the adequacy and fairness of financial statements issued by [the company's] management to stockholders, creditors, and others."[43] The Wisconsin Supreme Court has added: "If relying third parties, such as creditors, are not allowed to recover, the cost of credit to the

38. AICPA, UNDERSTANDING AUDITS AND THE AUDITOR'S REPORT, A GUIDE FOR FINANCIAL STATEMENT USERS 36 (1989).

39. John W. Bagby & John C. Ruhnka, *The Controversy Over Third Party Rights: Toward More Predictable Parameters of Auditor Liability*, 22 GA. L. REV. 149, 149 (1987).

40. *See* John A. Siliciano, *Negligent Accounting and the Limits of Instrumental Tort Reform*, 86 MICH. L. REV. 1929, 1932 (1988).

41. Bagby & Ruhnka, *supra* note 39, at 149.

42. United States v. Arthur Young & Co., 465 U.S. 805, 817-18 (1984).

43. H. Rosenblum, Inc. v. Adler, 461 A.2d 138, 149 (N.J. 1983).

general public will increase because creditors will either have to absorb the costs of bad loans made in reliance on faulty information or hire independent accountants to verify the information received."[44]

More recently, the California Supreme Court has commented, "audits of financial statements and the resulting audit reports are very frequently (if not universally) used by businesses to establish the financial credibility of their enterprises in the perceptions of outside persons, e.g., . . . [those] who extend credit to an enterprise or make risk-oriented decisions based on its economic viability."[45] In short, the auditor's assurance that an enterprise's financial condition is reported fairly plays an essential role in the facilitation of commercial intercourse.

B. *The Audit Function*

Audit services constitute a major portion of the work that accountants offer to their clients.[46] A typical audit is conducted by a Certified Public Accountant[47] (CPA), and involves an examination of a client's books and records in order to determine

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44. Citizens State Bank v. Timm, Schmidt & Co., 335 N.W.2d 361, 365 (Wis. 1983).

45. Bily v. Arthur Young & Co., 834 P.2d 745, 751 (Cal. 1992)

46. Other services that accountants can provide to their clients are compilation, tax, and management advisory (consulting) services. A recent breakdown of Big Six revenues has revealed the following:

	PERCENTAGE OF REVENUES		
FIRM	Auditing	Tax	Management Consulting
Arthur Andersen	35%	21%	44%
Ernst & Young	53%	25%	22%
Deloitte & Touche	57%	23%	20%
KPMG Peat Marwick	53%	27%	20%
Coopers & Lybrand	56%	19%	25%
Price Waterhouse	48%	28%	24%

BOWMAN'S ACCOUNTING REPORT, *cited in* Rahul Jacob, *Can You Trust That Audit?*, FORTUNE, Nov. 18, 1991, at 191.

47. The most common barometer of competence in the accounting profession is the license to practice as a CPA. CARMICHAEL, *supra* note 34, at 2-5. Although there is disparity from state to state as to the prerequisites for this license, generally a candidate must: satisfy certain educational criteria, for example, obtain a college degree and complete a certain number of accounting courses; pass the Uniform CPA Examination; and have a certain number of years experience in public accounting. *Id.* at 2-6. In addition, after the license is issued, most states require that licensees obtain a minimum number "continuing professional education" credits. *Id.*

whether they are stated in accordance with Generally Accepted Accounting Principles (GAAP).[48] The standard of care governing the CPA's conduct over the course of the audit is promulgated by the AICPA through a body of rules referred to as Generally Accepted Auditing Standards (GAAS).[49] The results of the audit examination are communicated to the company's management through an independent audit opinion.[50]

It is imperative to note that an audit is not a guarantee of the accuracy of financial statements; the costs of obtaining such assurance would be exorbitant.[51] Invariably, practical considera-

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48. GAAP constitute "[t]he standards and conventions that guide accountants in the preparation of financial statements . . . . These principles are [derived from] . . . practices sanctioned by the American Institute of Certified Public Accountants. GAAP may also include certain practices that are widely followed or commonly advocated in the accounting literature." RALPH ESTES, DICTIONARY OF ACCOUNTING 60 (2d ed. 1985).

49. An audit conducted in accordance with GAAS involves six phases. The auditor must:

1. Plan the audit and make an initial assessment of what work is required to be done. This plan remains flexible and must be modified if the engagement so requires. The plan, and subsequent modifications are recorded on the "Audit Program," which serves as a checklist for the work that must be completed over the course of the audit.
2. Make a preliminary evaluation of the client's internal control structure.
3. Perform compliance testing to assess the adequacy of the client's internal control structure. By doing this the auditor determines whether this structure can be relied on.
4. Adjust the Audit Program to reflect the reliability of the amount of substantive work that is needed based on the strength of the client's internal control structure.
5. Perform the substantive work, and
6. Issue an opinion, *see infra* note 50, based on the results of the work performed.

See JERRY D. SULLIVAN ET AL., MONTGOMERY'S AUDITING 183-84 (10th ed. 1985); *see also* Willis W. Hagen II, *Certified Public Accountant's Liability for Malpractice: Effect of Compliance with GAAP and GAAS*, 13 J. CONTEMP. L. 65, 67-68 (1987).

50. There are four types of reports that an auditor can issue after the audit examination. The first is the prized "unqualified" or "clean" opinion; stating that the financial statements are a fair representation of the financial position of the enterprise and are presented in accordance with GAAP. The second, a "qualified" opinion, is issued when an aspect of the financial statements are not presented in accordance with GAAP, or when there are material uncertainties that could impact the presentation of the financial statements. The third type of report is an "adverse" opinion, which is tantamount to a rejection of the fairness of the presentation. This occurs when the financial statements seriously depart from GAAP. In the final report, a "disclaimer of opinion," the auditor is unable to register an opinion concerning the presentation of the client's financial statements due to significant inadequacies in the client's financial reporting system. AICPA, 1 PROF. STAND. (CCH) AU § 150.01 (1982).

51. See Hagen, *supra* note 5, at 209. Professor Hagen has pointed out that "[t]he

tions forbid an examination of every transaction a business has consummated.[52] Accordingly, the auditor chooses a sample of transactions to be reviewed and, in most audits, great reliance is placed on a business's internal control system.[53] In sum, an audit provides *reasonable* assurance that the financial statements, taken as a whole, are presented fairly.

C. *Negligent Misrepresentation Under Contract Principles*

The New York Court of Appeals' landmark decision in *Ultramares Corp. v. Touche*,[54] established the first governing principles for measuring accountants' liability to third parties for negligent misrepresentation.[55] Although negligent misrepresentation is typically thought of as a creature of tort law,[56] the court, speaking through Chief Judge Cardozo, applied what have evolved today as contract-law principles to this cause of action.[57]

The defendant-accountant in *Ultramares* was hired to prepare and certify the balance sheet of a business engaged in the importation of rubber.[58] At no time, before or during its audit work, was the defendant aware that the plaintiff, a lender of the

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certification of financial statements does not guarantee that the financial statements are free from all defects, but rather is an opinion that the financial statements present fairly the financial position, income from operations, and changes in financial position in accordance with generally accepted accounting principles." *Id.*

52. Thomas L. Gossman, *The Fallacy of Expanding Accountants' Liability*, 1988 COLUM. BUS. L. REV. 213, 234.

53. *Id.*; Hagen, *supra* note 49, at 68.

54. 255 N.Y. 170, 174 N.E. 441 (1931).

55. *See id.* at 179-89, 174 N.E. at 444-48; Besser, *supra* note 26, at 510.

56. *See supra* note 20.

57. *See infra* notes 79-86 and accompanying text. This is not to say, however, that the negligent misrepresentation cause of action does not contain elements of tort law; but these elements go to the determination of whether an accountant has breached the contract with his client. In accepting an engagement, an accountant implicitly promises to use due care in the exercise of his professional judgment. Security Pac. Business Credit, Inc. v. Peat Marwick Main & Co., 79 N.Y.2d 695, 702, 597 N.E.2d 1080, 1083, 586 N.Y.S.2d 87, 90 (1992); Iselin & Co. v. Mann Judd Landeau, 71 N.Y.2d 420, 425, 522 N.E.2d 21, 23, 527 N.Y.S.2d 176, 178 (1988). Assessing whether this promise has been broken requires a court to determine whether an accountant has conformed to the standard of care that would be used by an ordinarily prudent accountant — in essence a tort law negligence analysis. If the accountant is found negligent, there has been a breach of contract. However, under *Ultramares*, once a breach of contract is determined, the scope of the liability is measured solely through the application of contract law principles. *Ultramares*, 255 N.Y. at 182, 174 N.E. at 445.

58. *Ultramares*, 255 N.Y. at 173, 174 N.E. at 442.

importer, would rely on its audit.[59] After finishing its audit work, the defendant issued its certificate to the importer verifying it had positive net worth; in turn, as a condition for certain loans, the importer provided the certificate to the plaintiff.[60] Nine months later, the importer declared bankruptcy.[61] Soon thereafter, the plaintiff brought suit claiming that it had relied on the certificate in extending credit to the importer and that the defendant's negligent audit had caused its loss.[62]

Although the court concluded that the defendant had in fact conducted its audit in a negligent manner, it nevertheless dismissed the plaintiff's negligence claim because of the plaintiff's lack of privity with the defendant.[63] Chief Judge Cardozo noted that "[t]he assault upon the citadel of privity is proceeding in these days apace,"[64] but halted the assault in *Ul-*

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59. *Id.* Although the defendant knew that in the "usual course of business" the importer would exhibit the certified balance sheet to "banks, creditors, stockholders, purchasers or sellers," the defendant was unaware that the particular plaintiff would rely on its audit. *Id.* at 173-74, 174 N.E. at 442.

60. *Id.* at 174-75, 174 N.E. at 442-43.

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

62. *Id.*

63. *Id.*

64. *Id.* at 180, 174 N.E. at 445. "Privity" refers to the nexus between parties to a contract. *Id.*; 4 ARTHUR L. CORBIN, CORBIN ON CONTRACTS § 778 (1951); *see also* Ralph Wolff & Sons v. New Zealand Ins. Co., 58 S.W.2d 623, 624-25 (Ky. Ct. App. 1933). The "citadel of privity" is a metaphor for a doctrine fundamental to old common law: a third person, not a party to a contract, has no right to sue for a breach of it. KEETON, *supra* note 9, § 93, at 669. The foundation of the citadel is found in the landmark English case, Winterbottom v. Wright, 152 Eng. Rep. 402 (Ex. 1842). In *Winterbottom*, a mail company and Wright entered into a contract, in which Wright promised to keep a certain mailcoach in good repair. *Id.* at 402-03. When the mailcoach subsequently collapsed, its driver, who was injured in the accident, brought suit against Wright. *Id.* at 403. The Court of Exchequer denied recovery reasoning:

> There is no privity of contract between these parties; and if the plaintiff can sue, every passenger, or even any person passing along the road, who was injured by the upsetting of the coach, might bring a similar action. Unless we confine the operation of such contracts as this to the parties who entered into them, the most absurd and outrageous consequences, to which I can see no limit, would ensue.

Id. at 405. The rule that evolved from this case was that a third-party, nonprivy could not recover in negligence for either personal or economic injury. KEETON, *supra* note 9, § 93, at 668-69. The "assault" on the doctrine of privity began in New York with Lawrence v. Fox, 20 N.Y. 268 (1859). In that case, Holly loaned Fox $300 in consideration of Fox's promise to pay Lawrence. *Id.* at 269. When Fox refused to pay, Lawrence brought suit. *Id.* The Court of Appeals allowed Lawrence to sustain his suit and in doing so stated:

> "[U]pon the principle of law *long recognized and clearly established*, that when

tramares.[65] In his oft-quoted passage, he cited the unique attributes of the accounting profession that justified the maintenance of the privity barrier:

> If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences.[66]

In distinguishing *Ultramares* from an earlier decision he also authored, *Glanzer v. Shepard*,[67] Chief Judge Cardozo revealed his use of contract-law principles. In *Glanzer*, the plaintiff purchased beans, the price of which was to be determined by the defendant, who was a public weigher hired by the seller.[68] The defendant weighed the beans as contracted and issued a certificate to both the plaintiff and the seller verifying the weight and referencing both parties.[69] After the plaintiff had paid for the beans relying upon this certificate, he discovered that the weight cited was overstated.[70] Ultimately, the plaintiff

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> one person, for a valuable consideration, engages with another, by a simple contract, to do some act for the benefit of a third, the latter, who would enjoy the benefit of the act, may maintain an action for the breach of such engagement; that it does not rest upon the ground of any actual or supposed relationship between the parties as some of the earlier cases would seem to indicate, but upon the broader and more satisfactory basis, that the law operating on the act of the parties creates the duty, establishes a privity, and implies the promise and obligation on which the action is founded."

Id. at 272 (quoting Brewer v. Dyer, 61 Mass. (7 Cush.) 337, 340-41 (1853)). The assault continued in MacPherson v. Buick Motor Co., 217 N.Y. 382, 111 N.E. 1050 (1916), where Judge Cardozo, writing for the New York Court of Appeals, obviated the requirement of privity where a negligent breach of contract resulted in personal injuries. *Id.* at 389-94, 111 N.E. at 1053-55. However, in claims involving solely economic injury, remnants of the citadel remain. KEETON, *supra* note 9, § 97, at 690. Indeed, negligent misrepresentation is one such remnant. *Ultramares*, 255 N.Y. at 179, 174 N.E. at 445.

65. *See Ultramares*, 255 N.Y. at 185, 174 N.E. at 447 (concluding that "nothing in our previous decisions commits us to a holding of liability for negligence in the circumstances of the case at hand . . . .").

66. *Id.* at 179-80, 174 N.E. at 444.

67. 233 N.Y. 236, 135 N.E. 275 (1922).

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

69. *Id.* at 238, 135 N.E. at 275.

70. *Id.*

brought a negligent misrepresentation claim against the weigher seeking to recover the amount overpaid.[71] Despite the plaintiff's lack of privity, the court allowed the claim to stand.[72]

Chief Judge Cardozo reasoned that in *Glanzer*, the nexus between the plaintiff-purchaser and defendant-weigher was tenable enough to support liability.[73] In *Glanzer*, the defendant-weigher was aware of the "end and aim of the transaction"[74] and knew his services would be relied upon by the nonprivy party.[75] Although the seller was the promisee, he was so only in name because the contract was in essence for the benefit of the buyer.[76] Although Chief Judge Cardozo analyzed *Glanzer* in terms of duty, he recognized that the same result could have been reached by the use of contract-law principles.[77] In distinguishing *Ultramares*, he reasoned that "the service was primarily for the benefit of [the importer], a convenient instrumentality for use in the development of the business, and only incidentally or collaterally for the use of those to whom [the importer] and his associates might exhibit it thereafter."[78]

The fledgling contract principles referred to in *Ultramares* have evolved into a distinct species of contract law.[79] These principles form the basis for what is referred to today as third-party beneficiary law.[80] Section 302 of the Second Restatement

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71. *Id.*

72. *Id.* at 242, 135 N.E. at 277.

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

74. *Id.* at 182, 174 N.E. at 445 (quoting *Glanzer*, 233 N.Y. at 238-39, 135 N.E. at 275).

75. In *Ultramares*, Chief Judge Cardozo reasoned that:

> [In *Glanzer*,][t]he bond was so close as to approach that of privity, if not completely one with it. Not so in the case at hand. No one would be likely to urge that there was a contractual relation, or even one approaching it, at the root of any duty that was owing from the defendants now before us to the indeterminate class of persons who, presently or in the future might deal with the [importer] in reliance on the audit. In a word, the service rendered by the defendant in Glanzer v. Shepard was primarily for the information of a third person, in effect, if not in name, a party to the contract, and only incidentally for that of the formal promisee.

Id. at 182-83, 174 N.E. at 446.

76. *Id.*

77. *Id.* at 182, 174 N.E. at 445.

78. *Id.* at 183, 174 N.E. at 446.

79. *See* CORBIN, *supra* note 64, § 772.

80. *Id.*

of Contracts segregates third-party beneficiaries into two categories: intended and incidental.[81] It provides:

> [A] beneficiary of a promise is an intended beneficiary if recognition of a right to performance in the beneficiary is appropriate to effectuate the intention of the parties and either
>
> (a) the performance of the promise will satisfy an obligation of the promisee to pay money to the beneficiary; or
>
> (b) the circumstances indicate that the promisee intends to give the beneficiary the benefit of the promised performance.[82]

Section 302 defines an incidental beneficiary in a residual manner: "An incidental beneficiary is a beneficiary who is not an intended beneficiary."[83] If a plaintiff is able to show that it is an intended beneficiary of a contract, the plaintiff has standing to sue.[84] Conversely, if a court deems the plaintiff to be simply an incidental beneficiary, the plaintiff's suit cannot be sustained.[85]

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81. RESTATEMENT (SECOND) OF CONTRACTS § 302 (1979). In Fourth Ocean Putnam Corp. v. Interstate Wrecking Co., 66 N.Y.2d 38, 485 N.E.2d 208, 495 N.Y.S.2d 1 (1985), the Court of Appeals adopted the Restatement's intended and incidental third-party beneficiary distinction. *Id.* at 44, 495 N.E.2d at 212, 495 N.Y.S.2d at 5 ("We think that the Restatement formulations state the essence of the prior holdings of this court . . . .").

82. RESTATEMENT (SECOND) OF CONTRACTS § 302(1) (1979).

83. *Id.* § 302(2).

84. *Id.* § 304 (stating that "[a] promise in a contract creates a duty in the promisor to any intended beneficiary to perform the promise, and the intended beneficiary may enforce the duty."). The seminal third-party beneficiary case in New York standing for this proposition is Seaver v. Ransom, 224 N.Y. 233, 120 N.E. 639 (1918). In *Seaver*, a dying testatrix desired to leave a remainder interest in real property to her favorite niece. *Id.* at 235, 120 N.E. at 639. Due to her impending death, the testatrix signed a will, which did not provide for this devise, on the condition that her husband promise to leave the niece enough in his will to "make up the difference." *Id.* at 235-36, 120 N.E. at 639-40. When the husband died, it was discovered that he made no such provision in his will. *Id.* at 236, 120 N.E. at 640. The niece brought suit against his estate, and despite her lack of privity to the contract between the testatrix and her husband, the Court of Appeals sustained her claim. *Id.* at 239, 120 N.E. at 642. In doing so, the court noted the legal principle that when a contract is made for the direct benefit of a third party, that party may sue for a breach of it. *Id.* at 237-38, 120 N.E. at 641.

85. RESTATEMENT (SECOND) OF CONTRACTS § 315 (providing that "[an] incidental beneficiary acquires by virtue of the promise no right against the promisor or the promisee."). Strauss v. Belle Realty Co., 98 A.D.2d 424, 469 N.Y.S.2d 948 (2d Dep't 1983), is a good example of an incidental third-party beneficiary case. That case arose out of the infamous blackout of 1977. The plaintiff was a tenant in an apartment building to which the defendant had contracted to supply power. *Id.* at 424, 469 N.Y.S.2d at 949. The plaintiff brought suit after falling down the basement stairs of the building in the dark-

The principles of *Ultramares* and *Glanzer* may be restated in the contemporary parlance of the Restatement. In *Glanzer*, the plaintiff-purchaser was able to show that it was an intended third-party beneficiary because the circumstances indicated that the seller (promisee) intended to give the plaintiff-purchaser (beneficiary) the benefit of its contracted performance. In *Ultramares*, however, the plaintiff-lender was deemed only an incidental beneficiary because the circumstances did not indicate that the importer (promisee) had intended that the benefit of its performance would inure to it.[86]

D. *Negligent Misrepresentation Under Tort Principles*

Although initially adopted and endorsed across the country,[87] the strict privity standard imposed by *Ultramares* [herein-

ness. *Id.* In dismissing the plaintiff's claim, the court held that:

> "An incidental beneficiary is a third party who may derive benefit from the performance of a contract though he is neither the promisee nor the one to whom performance is to be rendered." . . . The contract must evince a discernible intent to allow recovery for the specific damages to the third party that result from a breach thereof before a cause of action is stated. . . . Plaintiff has failed to carry his burden of demonstrating that he has an enforceable right. He offers nothing to show that [the defendant and the building owner] intended to allow him to recover for the damages resulting from his entrance into the darkened common areas.

Id. at 426-27, 469 N.Y.S.2d at 950 (quoting Airco Alloys Div. v. Niagara Mohawk Power Corp., 76 A.D.2d 68, 79, 430 N.Y.S.2d 179, 185-86 (4th Dep't 1980)) (citations omitted).

86. *See supra* text accompanying note 82. The comparison of the rule of *Ultramares* and *Glanzer* to the third-party beneficiary rule of contract law is not a novel approach. In discussing the symmetry of these theories one commentator explained:

> Under the equivalence of privity requirement of *Ultramares-Glanzer*, an accountant will be liable for negligence only to those parties who are in a "contractual relationship or its equivalent" with the accountant. This rule, in effect, limits the scope of an accountant's negligence liability to the parties which would have a right to a remedy under ordinary contract law. The absence of privity . . . generally precludes a right to recover on a contract. One exception is a third party beneficiary contract, where a noncontracting party can enforce the contract if the contracting parties intended to confer directly a benefit upon the third party. Similarly, under the principles of *Ultramares-Glanzer*, a noncontracting party cannot recover for the negligence of an accountant unless the "end and aim of the transaction" was for the specific purpose of benefiting that particular third party.

Hagen, *supra* note 5, at 195-96.

87. *See* Hagen, *supra* note 5, at 184 (stating in 1988 that "the holding of *Ultramares* was the prevailing principle of law for almost forty years . . . ."); *see also* Besser, *supra* note 26, at 516 (commenting in 1976 that "[f]or over thirty years *Ultramares* and its progeny raised the shield of privity . . . .").

after the "Privity Approach"] has recently lost some of its vitality.[88] Currently, there are two other methodologies used to measure an accountant's liability to a nonclient — the Restatement of Torts Approach[89] [hereinafter the "Restatement Approach"] and the Foreseeability Approach.[90] Both of these approaches apply tort principles to the negligent misrepresentation cause of action.[91]

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88. *See* Besser, *supra* note 26, at 541 (exulting, "*Ultramares* is on the wane, and rightly so!"); *see also* Hagen, *supra* note 5, at 184. In addition to New York, the following jurisdictions have adopted or retained the privity approach by common law, statute, or both: Alabama: Colonial Bank v. Ridley & Schweigert, 551 So. 2d 390 (Ala. 1989); Arkansas: ARK. CODE ANN. § 16-114-302 (Michie Supp. 1991); Colorado: Stephens Indus. v. Haskins and Sells, 438 F.2d 357 (10th Cir. 1971) (applying Colorado law); Delaware: Guardian Constr. Co. v. Tetra Tech Richardson, Inc., 583 A.2d 1378 (Del. 1990); Illinois: ILL. COMP. STAT. ANN. ch. 225, § 450/30.1 (Michie 1993); Kansas: KAN. STAT. ANN. § 1-402 (1991); Nebraska: Citizens Nat'l Bank v. Kennedy & Coe, 441 N.W.2d 180 (Neb. 1989); Pennsylvania: Landell v. Lybrand, 107 A. 783 (Pa. 1919).

89. RESTATEMENT (SECOND) OF TORTS § 552 (1977). At least 17 states have adopted the Restatement of Torts' more expansive approach to liability: California: Bily v. Arthur Young & Co., 834 P.2d 745 (Cal. 1992); Florida: First Florida Bank v. Max Mitchell & Co., 558 So. 2d 9 (Fla. 1990); Georgia: Badische Corp. v. Caylor, 356 S.E.2d 198 (Ga. 1987); Iowa: Pahre v. Auditor of State, 422 N.W.2d 178 (Iowa 1988); Kentucky: Ingram Indus. v. Nowicki, 527 F. Supp. 683 (E.D. Ky. 1981) (applying Kentucky law); Louisiana: First Nat'l Bank of Commerce v. Monco Agency, Inc., 911 F.2d 1053 (5th Cir. 1990) (applying Louisiana law); Michigan: Law Offices of Lawrence J. Stockler, P.C. v. Rose, 436 N.W.2d 70 (Mich. Ct. App. 1989), *leave to appeal denied*, 450 N.W.2d 270 (Mich. 1990); Minnesota: Bonhiver v. Graff, 248 N.W.2d 291 (Minn. 1976); Missouri: Lindner Fund v. Abney, 770 S.W.2d 437 (Mo. Ct. App. 1989); New Hampshire: Spherex, Inc. v. Alexander Grant & Co., 451 A.2d 1308 (N.H. 1982); North Dakota: Bunge Corp. v. Eide, 372 F. Supp. 1058 (D.N.D. 1974) (applying North Dakota law); Ohio: Haddon View Inv. Co. v. Coopers & Lybrand, 436 N.E.2d 212 (Ohio 1982); Rhode Island: Rusch Factors, Inc. v. Levin, 284 F. Supp. 85 (D.R.I. 1968) (applying Rhode Island law); Tennessee: Bethlehem Steel Corp. v. Ernst & Whinney, 822 S.W.2d 592 (Tenn. 1991); Texas: Shatterproof Glass Corp. v. James, 466 S.W.2d 873 (Tex. Civ. App. 1971); Washington: Haberman v. Washington Pub. Power Supply Sys., 744 P.2d 1032 (Wash. 1987), *modified*, 750 P.2d 254 (Wash. 1988); West Virginia: First Nat'l Bank v. Crawford, 386 S.E.2d 310 (W. Va. 1989).

90. Three states currently adhere to the foreseeability standard: Mississippi: Touche Ross & Co. v. Commercial Union Ins. Co., 514 So. 2d 315 (Miss. 1987); New Jersey: H. Rosenblum, Inc. v. Adler, 444 A.2d 66 (N.J. Super. Ct. App. Div. 1982), *aff'd in part, rev'd in part*, 461 A.2d 138 (N.J. 1983); Wisconsin: Citizens State Bank v. Timm, Schmidt & Co., 335 N.W.2d 361 (Wis. 1983).

91. The difference between tort and contract liability has been summarized as follows:

> Tort obligations are in general obligations that are imposed by law — apart from and independent of promises made and therefore apart from the manifested intention of the parties — to avoid injury to others. By injury here is meant simply the interference with the individual's interest or an interest of some other legal

The Restatement Approach is derived from Section 552 of the Second Restatement of Torts, which provides that liability for one who negligently supplies information to another is limited to loss suffered:

(a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it; and

(b) through reliance upon it in a transaction that he intends the information to influence or knows that the recipient so intends or in a substantially similar transaction.[92]

The Restatement has been interpreted to expand potential liability to a particular party or group of parties actually foreseen to have relied on the financial statements.[93]

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entity that is deemed worthy of legal protection.

KEETON, *supra* note 9, § 92, at 655. The Restatement and Foreseeability Approaches expose an accountant to liability from third parties to whom the accountant has not specifically assumed a duty to make reparation. The classification of the negligent misrepresentation cause of action as a tort action as opposed to a contract action has significant implications beyond academic tidiness; by characterizing the action as a tort, courts have widely expanded the pool of viable third-party plaintiffs, which has resulted in drastically increased liability exposure for accountants.

92. RESTATEMENT (SECOND) OF TORTS § 552 (1977).

93. *See* Kirby & Davies, *supra* note 30, at 584. The illustrations to comment (h) of section 552 help to elucidate the Restatement Approach. Illustration number five poses the following hypothetical:

> A is negotiating with X Bank for a credit of $50,000. The Bank requires an audit by independent public accountants. A employs B & Company, a firm of accountants, to make the audit, telling them that the purpose of the audit is to meet the requirements of X Bank in connection with a credit of $50,000. B & Company agree to make the audit, with the express understanding that it is for transmission to X Bank only. X Bank fails, and A, without any further communication with B & Company, submits its financial statements accompanied by B & Company's opinion to Y Bank, which in reliance upon it extends a credit of $50,000 to A. The audit is so carelessly made as to result in an unqualified favorable opinion on financial statements that materially misstate the financial position to A, and in consequence Y Bank suffers pecuniary loss through its extension of credit.

RESTATEMENT (SECOND) OF TORTS § 552 cmt. h, illus. 5 (1977).

Based on these facts, the Restatement reaches the conclusion that "B & Company is not liable to Y Bank." Conversely, the Restatement provides that the accountant would be subject to liability if in the above hypothetical: "nothing is said about supplying the information for the guidance of X Bank only . . . ." And "A merely informs B & Company that he expects to negotiate a bank loan, for $50,000," and that he "requires the audit for the purpose of the loan, and has X Bank in mind." *Id.* § 552 cmt. h, illus. 5 (1977).

The Foreseeability Approach, on the other hand, applies the traditional precepts of tort law to the negligent misrepresentation cause of action. In essence, the formulation of this approach is that: "When the independent auditor furnishes an opinion . . . he has a duty to all those whom that auditor should reasonably foresee as recipients from the company of the statements for its proper business purposes, provided that the recipients rely on the statements pursuant to those business purposes."[94]

Both the courts and the commentators who have endorsed one of these tort approaches have consistently pointed to the policy reasons justifying their positions.[95] The proponents of the Foreseeability Approach argue vigorously that the nature of an audit has changed since *Ultramares*; that audits are no longer for the sole benefit of management, but are predominantly for the benefit of third parties.[96] The endorsers of this standard also contend that the increased liability exposure of the accounting profession is not onerous because accountants are able to deflect the increased risk.[97] Two vehicles facilitate this deflection: the availability of insurance; and the ability of accountants to raise their fees to cover the inevitable increases in liability premiums.[98]

The proponents of the Foreseeability Approach also point out that by extending accountants' potential exposure, the courts are creating a significant impetus for accountants to be

94. H. Rosenblum, Inc. v. Adler, 461 A.2d 138, 153 (N.J. 1983).

95. *See* sources cited *infra* notes 96-116.

96. *See* Howard B. Weiner, *Common Law Liability of the Certified Public Accountant for Negligent Misrepresentation*, 20 SAN DIEGO L. REV. 233, 250 (1983) (noting that "[a]s to the function of the audit itself there has indeed been a considerable change since 1931 in the relationship between accounting firms and third persons."). *See* discussion *supra* part II.A.

97. *Adler*, 461 A.2d at 151. The New Jersey Supreme Court determined that:

> Independent auditors have apparently been able to obtain liability insurance covering these risks or otherwise to satisfy their financial obligations. We have no reason to believe that they may not purchase malpractice insurance policies that cover their negligent acts leading to misstatements relied upon by persons who receive the audit from the company pursuant to a proper business purpose.

Id.

98. Hagen, *supra* note 5, at 207-08. Professor Hagen argues that "the accounting profession can include the cost of their malpractice insurance in their billing rates, thereby apportioning the cost of the risk of liability based on the amount of audit work necessary to prevent misleading financial statements." *Id.*

more careful and are thereby aiding in the heightened accuracy of financial disclosure.[99] The critics of the Foreseeability Approach are many.[100] These antagonists contend that the supporters' efforts to dismiss the risk of inordinate liability are misguided.[101] The opponents assert that malpractice insurance is hardly a panacea for the massive liability exposure that the Foreseeability Approach invokes.[102]

The endorsers of the Restatement Approach also point to several policy justifications for their position. This approach is put forward as a prudent compromise between the extremes of the Privity and Foreseeability Approaches.[103] The advocates of this position extract arguments from both sides.[104] In imposing the rigid privity barrier, they would agree that the courts are needlessly insulating accountants from liability.[105] However, the Restatement Approach proponents also agree that there is a need to limit the potentiality of liability wholly inordinate from the gravity of the wrong.[106] Thus, they contend that this approach offers the best of both worlds.[107] Critics of the Restate-

99. Citizens State Bank v. Timm, Schmidt & Co., 335 N.W.2d 361, 365 (Wis. 1983). In adopting the Foreseeability Approach, the Wisconsin Supreme Court held that: "Unless liability is imposed, third parties who rely upon the accuracy of the financial statements will not be protected. Unless an accountant can be held liable to a relying third party, this negligence will go undeterred." *Id.*

100. *See, e.g.*, Siliciano, *supra* note 40; Gormley, *supra* note 26; Stephen M. Lazare, Note, H. Rosenblum, Inc. v. Adler: *A Foreseeably Unreasonable Extension of an Auditor's Legal Duty*, 48 ALB. L. REV. 876 (1984).

101. *See generally*, sources cited *infra* note 109-18.

102. *See infra* notes 109-18 and accompanying text.

103. Bily v. Arthur Young & Co., 834 P.2d 745, 759 (Cal. 1992).

104. *Id.* at 769. The California Supreme Court recently adopted the Restatement Approach because the Restatement "attempts to define a narrow and circumscribed class of persons to whom or for whom representations are made. . . . The Restatement rule thus appears to be a sensible and moderate approach to the potential consequences of imposing unlimited negligence liability . . . ." *Id.*

105. *Id.*

106. *Id.* at 767. In rebuking the Foreseeability Approach, the California Supreme Court commented:

> In our judgment, a foreseeability rule applied in this context inevitably produces large numbers of expensive and complex lawsuits of questionable merit as scores of investors and lenders seek to recoup business losses . . . . [In adopting the Restatement Approach], we seek to deter careless audit reporting while avoiding the specter of a level of liability that is morally and economically excessive.

Id.

107. *See, e.g.*, First Nat'l Bank v. Crawford, 386 S.E.2d 310, 311-12 (W. Va. 1989) (rejecting both the Foreseeability and Privity Approaches and adopting the "middle

ment Approach methodology maintain it is founded on capricious line-drawing, and offers accountants little notice as to whom they can be held liable.[108]

The proponents for retaining the *Ultramares* Privity Approach retort that the policy considerations endorsed by the Foreseeability and Restatement Approach advocates are fallacious.[109] The Privity Approach endorsers generally acknowledge that the accountants' work is used more by third parties, but contend that this is an illogical basis for jettisoning the privity barrier.[110] The central underlying policy reason behind the erection of the privity barrier — to protect accountants from indeterminate liability — is still very relevant.[111] Accountants, they argue, are still at risk of being subjected to inordinate liability as a result of a single, good-faith mistake.[112] Indeed, the fact that more third parties are relying on accountants' work only exacerbates this risk.[113] In addition, the Privity Approach advocates maintain that accountants are not able to deflect this risk. They point to empirical data showing: the meteoric rise in insurance premiums,[114] the high percentage of accounting firms operating without insurance,[115] and the recent failure of two large account-

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ground" offered by the Restatement).

108. Wiener, *supra* note 96, at 252. Judge Wiener used comment (h) of the Restatement, *see supra* note 93, to illustrate the fortuity of the Restatement Approach:

> Where A negotiates with X bank for $50,000 credit and the bank requires an audit by independent public accountants, the accountants will be liable only to X bank for a negligent misrepresentation. If fortuitously, A had decided to go to Y bank for credit, the accounting firm would not be liable. The placing of liability on the fortuitousness of whether the name of the bank is disclosed or whether a class of lending institutions were known to the accounting firm may be a comfortable line to be drawn by those preparing the Restatement, but it does not appear to rest upon sound analytical considerations.

Id.

109. *See* Lazare, *supra* note 100, at 914.

110. *See* Gossman, *supra* note 52, at 232.

111. *See, e.g., id.* at 239; *see also supra* text accompanying note 66.

112. Lazare, *supra* note 100, at 902.

113. *Id.*

114. Studies indicate that between 1984 and 1987, accounting malpractice insurance premiums for some firms increased by five-fold. Robert Mednick, *Accountants' Liability: Coping With the Stampede to the Courtroom*, J. ACCT., Sept. 1987, at 118.

115. In a recent Board Endorsement, the AICPA reported that 40% of firms other than the Big Six are conducting business without malpractice insurance. *See* AICPA BOARD ENDORSEMENT, *supra* note 6, at 18.

ing firms.[116]

Finally, the Privity Approach advocates contend that the argument that the courts will encourage more careful accounting is specious; the inherent limitations in an audit make this so.[117] An audit requires several judgment decisions that make it a form of "art," rather than any scientific process. Under this argument, the accountant, based on his or her experience and knowledge, will make the same decisions as to the amount and course of the work.[118]

E. *The Emergence of the Tort of Negligent Misrepresentation in New York?*

In New York, the first courts to follow *Ultramares* strictly applied its contract principles.[119] However, the language of the Court of Appeals' opinion in *White v. Guarente*[120] suggested that New York might begin to follow the nationwide trend of reducing the rigors of *Ultramares*.[121]

In *White*, the defendant, Arthur Andersen & Co., a national accounting firm, was retained by Guarente-Harrington Associates, a limited partnership, to perform audit and tax services.[122] The plaintiff was one of the limited partners of Guarente-Harrington Associates.[123] The plaintiff's claim alleged that Andersen had negligently issued its auditor's report by failing to notify him that the general partners had withdrawn funds from their

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116. *See* THE LIABILITY CRISIS, *supra* note 6, at 21. In 1990, the seventh-largest accounting firm in the country, Laventhol & Horwath, buckled due to financial decay. In 1992, Pannell Kerr Foster, another large accounting firm sold off approximately 90% of its offices. *Id.*

117. *See* Gossman, *supra* note 52, at 233-34.

118. *Id.* Professor Gossman argues that:

> As with many other professional services, auditing involves as much art as science. An auditor is forced to make many decisions, and to adjust audit procedure to meet the circumstances of each audit. . . . The proper accounting treatment of some matters may not be settled, some of the basic data upon which an auditor must rely are not as a practical matter verifiable, and an auditor is not required to investigate every supporting document, but must rely on sampling.

Id.

119. *See* Besser, *supra* note 26, at 508.

120. 43 N.Y.2d 356, 372 N.E.2d 315, 401 N.Y.S.2d 474 (1977).

121. *See supra* notes 88-90 and accompanying text.

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

123. *Id.* at 358-59, 372 N.E.2d at 317, 401 N.Y.S.2d at 476.

capital accounts in violation of the partnership agreement.[124]

In allowing the claim to stand, the court commented that "this plaintiff seeks redress, not as a mere member of the public, but as one of a settled and particularized class among the members of which the report would be circulated . . . ."[125] It further noted that, "the accountant must have been aware that a limited partner would necessarily rely on [Andersen's work]."[126] Thus, rather than focusing on the plaintiff's status as a surrogate for the formal promisee, the court in *White* injected aspects of foreseeability into the calculus of "the relationship approaching privity."[127] If the language of *White* is taken at face value,[128] the court, in extending an accountant's liability to a limited class of persons foreseen to rely on the audit opinion, would have taken the first step toward applying tort law principles to the negligent misrepresentation cause of action.

More specifically, the reasoning of *White* seemed to em-

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124. *Id.* at 360, 372 N.E.2d 317-18, 401 N.Y.S.2d at 476-77.

125. *Id.* at 363, 401 N.E.2d at 320, 401 N.Y.S.2d at 479.

126. *Id.* at 361, 401 N.E.2d at 319, 401 N.Y.S.2d at 478.

127. *Id.* The interesting aspect of *White* is that the court could have decided the case on more restrictive grounds. Since the plaintiffs were limited partners, they could have been considered actual privies to the contract between Andersen and the limited partnership. *See* Credit Alliance Corp. v. Arthur Anderson & Co., 65 N.Y.2d at 550 n.9, 483 N.E.2d at 117 n.9, 493 N.Y.S.2d at 442 n.9 (1985); Aeronca, Inc. v. Gorin, 561 F. Supp. 370, 378 (S.D.N.Y. 1983); *see also* Calamari v. Grace, 98 A.D.2d 74, 81-82, 469 N.Y.S.2d 942, 946-47 (2d Dep't 1983). Instead, the court's opinion is replete with expansive language characterizing the plaintiffs as "a known group" and not "a faceless or unresolved class of persons." *White*, 43 N.Y.2d at 361, 327 N.E.2d at 318, 401 N.Y.S.2d at 477. Moreover, the court quoted Hochfelder v. Ernst, 503 F.2d 1100, 1107 (7th Cir. 1975), *rev'd on other grounds*, 425 U.S. 185 (1976), with seeming approval:

> The courts in diminishing the impact of *Ultramares* have not only embraced the rule of *Glanzer* — liability to a foreseen plaintiff — but have extended an accountant's liability for negligence to those who, although not themselves foreseen, are members of a limited class whose reliance on the financial statements is specifically foreseen.

White, 43 N.Y.2d at 362, 372 N.E.2d at 319, 401 N.Y.S.2d at 474. The *White* court continued, "here, plaintiff was a member of a limited class whose reliance on the audit and returns was, or at least should have been, specifically foreseen." *Id.*

128. The fact that the court could have relied on alternative grounds to reach its holding in *White*, does not make the expansive language relied on dicta. Dicta constitutes "[s]tatements and comments in an opinion concerning some rule of law or legal proposition not necessarily involved nor essential to determination of the case in hand . . . ." BLACK'S LAW DICTIONARY 454 (6th ed. 1990) (citing Wheeler v. Wilken, 58 P.2d 1223, 1226 (Colo. 1936)). Since the tort-like language was the only grounds relied upon, clearly, it is essential to the case.

brace the methodology of the Restatement Approach. Both *White* and the Restatement refer to the pool of viable plaintiffs as a limited class of persons foreseen to rely upon an accountant's audit work.[129] While not expressly repudiating the principles articulated in *Ultramares* and *Glanzer*, the import of the court's reasoning in *White* could certainly have been interpreted as modifying the holdings of those cases *sub silentio*.[130] In subsequent factual scenarios, the lower courts of New York were significantly divided as to whether the contract principles in *Ultramares* should be retained, or whether the tort principles implied in *White* should be adopted.[131] The only thing that can be said with certainty about *White* is that it created more questions than it answered.[132]

In 1985, the New York Court of Appeals issued another landmark decision in this area of the law, *Credit Alliance Corp. v. Arthur Andersen & Co.*[133] In *Credit Alliance*, the plaintiff, a financial services company, provided financing to L.B. Smith,

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129. *See supra* note 93 and accompanying text.

130. Although the language of *White* refers to viable third-party plaintiffs as those actually foreseen, the opinion cites *Ultramares* and *Glanzer* with approval. *White*, 43 N.Y.2d at 360-62, 372 N.E.2d at 318-19, 401 N.Y.S.2d at 477-78.

131. *See, e.g.*, Credit Alliance Corp. v. Arthur Andersen & Co., 101 A.D.2d 231, 235, 476 N.Y.S.2d 539, 542 (1st Dep't 1984), *rev'd*, 65 N.Y.2d 536, 483 N.E.2d 110, 493 N.Y.S.2d 435 (1985) ("The plaintiffs are members of a limited group to whom defendant would owe a duty and to whom defendant knew or should have known their audit would be delivered, and relied upon."); Baer v. Broder, 106 Misc. 2d 929, 934, 436 N.Y.S.2d 693, 696 (Sup. Ct. Suffolk County 1981), *aff'd on other grounds*, 86 A.D.2d 881, 447 N.Y.S.2d 538 (2d Dep't 1982) ("Plaintiff was not a member of a faceless or indeterminate class of persons . . . and is not for that reason precluded from instituting this [negligent misrepresentation] action") (citing Gordon v. Holt, 65 A.D.2d 344, 349, 412 N.Y.S.2d 534 (4th Dep't 1979)); Estate of Douglas, 104 Misc. 2d 430, 433, 428 N.Y.S.2d 558, 560-61 (Sur. Ct. N.Y. Co. 1980) ("More significantly, the Court of Appeals in *White v. Guarente*, [citation omitted] expressly extended the liability of accountants beyond privity, distinguishing the case which is generally regarded as the keystone of the privity requirement, *Ultramares* [citation omitted]").

132. One prescient commentator, in discussing the potential of *White*, envisioned a factual scenario practically identical to *Security Pacific* as exposing the accountant to liability:

> For example, the long-term creditors of a corporation often require periodic audits by an independent accountant as a condition to a loan. In those situations, the modern accountant should know that the company's audited financial statements will be relied on by the creditors, that are composed of a definable and limited class.

Septimus, *supra* note 29, at 420.

133. 65 N.Y.2d 536, 483 N.E.2d 110, 493 N.Y.S.2d 435 (1985).

Inc. ("Smith") on various occasions.[134] The extensions of credit were preconditioned on the receipt of audited financial statements that were examined by the defendant, Arthur Andersen & Co. ("Andersen").[135] The financial statements were provided to the plaintiff by Smith.[136]

Soon after, Smith filed for bankruptcy, defaulting on several million dollars of loans.[137] The plaintiff brought suit against Andersen alleging that both statements had materially overstated Smith's financial well-being.[138] The plaintiff's complaint alleged, *inter alia*, negligent misrepresentation on the part of Andersen.[139] The complaint also alleged that Andersen "knew, should have known or was on notice" that the financial statements were being used by Smith to induce lenders to extend credit.[140]

In summarily dismissing the plaintiff's claim, the court outlined three criteria that it concluded would establish an adequate basis for imposing liability on an accountant to a nonclient for negligent misrepresentation:

> 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 accountants' understanding of that party or parties' reliance.[141]

In applying the newly articulated criteria, the court concluded that the plaintiff had failed to allege the particular purpose requirement (criterion number one) or the prerequisite linking conduct (criterion number three) on the part of the accountant.[142] In assessing the complaint it noted:

134. *Id.* at 541-42, 483 N.E.2d at 111, 493 N.Y.S.2d at 436.
135. *Id.* at 541, 483 N.E.2d at 111, 493 N.Y.S.2d at 436.
136. *Id.*
137. *Id.* at 542, 483 N.E.2d at 112, 493 N.Y.S.2d at 437.
138. *Id.*, 483 N.E.2d at 111-12, 493 N.Y.S.2d at 436-37.
139. *Id.*, 483 N.E.2d at 112, 493 N.Y.S.2d at 437.
140. *Id.*
141. *Id.* at 551, 483 N.E.2d at 118, 493 N.Y.S.2d at 443.
142. *Id.* at 553-54, 483 N.E.2d at 119, 493 N.Y.S.2d at 444-45.

> [N]o claim is made that Andersen was being employed to prepare the reports with that particular purpose in mind [to induce the plaintiffs to extend credit]. Moreover, there is no allegation that Andersen had any direct dealings with plaintiffs, had specifically agreed with Smith to prepare the report for plaintiffs' use or according to plaintiffs' requirements, or had specifically agreed with Smith to provide plaintiffs with a copy or actually did so. Indeed, there is simply no allegation of any word or action on the part of Andersen directed to plaintiffs, or anything contained in Andersen's retainer agreement with Smith which provided the necessary link between them.[143]

In contrast, the court deemed the facts alleged in *European American Bank and Trust Co. v. Strauhs & Kaye*,[144] the companion case to *Credit Alliance*, sufficient to establish the requisite nexus between the accountant and nonclient.[145] In *European American*, the plaintiff made a series of loans to Majestic Electro Industries, Inc. ("Majestic").[146] Throughout their affiliation, the plaintiff relied on Majestic's interim and year-end financial statements, prepared and audited by the defendant, to determine the amount of money it was willing to lend.[147] Approximately three years later, when Majestic defaulted on one of these loans, the plaintiff discovered that Majestic's financial statements for the prior years had materially overstated the company's solvency.[148] Soon thereafter, the plaintiff brought suit alleging, *inter alia*, negligent misrepresentation.[149]

The plaintiff alleged that the defendant had multiple and "direct oral and written communication[s]" with the plaintiff during the audit work.[150] Additionally, the plaintiff alleged that it had discussed Majestic's financial position with the defendant in face-to-face meetings.[151] Furthermore, the plaintiff contended that the defendant made representations to it concerning the

143. *Id.*
144. 65 N.Y.2d 536, 483 N.E.2d 110, 493 N.Y.S.2d 435 (1985).
145. *Credit Alliance*, 65 N.Y.2d at 554, 483 N.E.2d at 120, 493 N.Y.S.2d at 445.
146. *Id.* at 543, 483 N.E.2d at 112-13, 493 N.Y.S.2d at 437-38.
147. *Id.*, 483 N.E.2d at 113, 493 N.Y.S.2d at 438.
148. *Id.* at 544, 483 N.E.2d at 113, 493 N.Y.S.2d at 438.
149. *Id.* at 544-45, 483 N.E.2d at 113, 493 N.Y.S.2d at 438-39.
150. *Id.* at 544, 483 N.E.2d at 113, 493 N.Y.S.2d at 438.
151. *Id.*

value of Majestic's assets.[152] These facts led the court to conclude that the defendant "was well aware that a primary, if not exclusive, end and aim of auditing its client, Majestic Electro, was to provide [the plaintiff] with the financial information it required."[153]

The more explicit criteria of *Credit Alliance* provided excellent black letter law, but did not clear up all of the confusion left by *White*.[154] The court stated that *Credit Alliance* did "not represent a departure from the principles articulated in Ultramares, Glanzer and White."[155] However, as pointed out previously, the principles articulated in *Ultramares* and *Glanzer* could be interpreted as inconsistent with those promulgated in *White*.[156]

Thus, the unanswered question in *White* remained after *Credit Alliance*: Is there a tort of negligent misrepresentation in New York?[157] The continued confusion resulted, in part, from the juxtaposition of *Credit Alliance* and *European American*. *Credit Alliance* presented the court with a plaintiff that did not

152. *Id.* at 545, 483 N.E.2d at 113, 493 N.Y.S.2d at 439.

153. *Id.* at 554, 483 N.E.2d at 120, 493 N.Y.S.2d at 445.

154. As one commentator has pointed out, "there has been some confusion over how *Ultramares* and *Credit Alliance* should be applied in specific cases." Swanson, *supra* note 20, at 23.

155. *Credit Alliance*, 65 N.Y.2d at 551, 483 N.E.2d at 118, 493 N.Y.S.2d 443.

156. *See supra* notes 125-32 and accompanying text.

157. Following *Credit Alliance*, the Court of Appeals heard two cases dealing with claims by nonclients of negligent misrepresentation against accountants. William Iselin & Co. v. Mann Judd Landau, 71 N.Y.2d 420, 522 N.E.2d 21, 527 N.Y.S.2d 176 (1988); Westpac Banking Corp. v. Deschamps, 66 N.Y.2d 16, 484 N.E.2d 1351, 494 N.Y.S.2d 848 (1985). Neither of these cases presented the court with a closer relationship than that between the nonclient and accountant in *Credit Alliance*. Such a relationship could have presented the court with an opportunity to answer this question. *See* discussion *infra* part III.

In *Westpac*, the complaint did not even allege that the accountants knew their audit report would be shown to plaintiff, or that the accountants had directed any word or action toward the plaintiff. *Westpac*, 66 N.Y.2d at 19, 484 N.E.2d at 1353, 494 N.Y.S.2d at 1353. Thus, the relationship between the plaintiff and defendant in *Westpac* was perhaps even more tenuous than in *Credit Alliance*. In *Credit Alliance*, the plaintiff at least alleged that the defendant knew that the reports would be shown to it. *Credit Alliance*, 65 N.Y.2d at 542, 483 N.E.2d at 112, 493 N.Y.S.2d at 437. Similarly, in *Mann Judd*, the plaintiff introduced "[n]o evidence in admissible form" that showed the accounting partnership's awareness of the plaintiff's reliance. *Mann Judd*, 71 N.Y.2d at 427, 522 N.E.2d at 24, 527 N.Y.S.2d at 179. Thus, *Mann Judd* also presented the same weak relationship found in *Credit Alliance*.

allege any direct contact or communication with the defendant-accountant. Additionally, in *Credit Alliance*, the plaintiff failed to allege any act on the part of Andersen directed toward it.[158] Thus, the relationship between the parties was attenuated.

The strong link between the parties in *European American*, on the other hand, presented the court with a plaintiff that was an intended third-party beneficiary — a viable plaintiff under the *Ultramares* standard previously embraced by the court.[159] This is evidenced by the extensive communications between the accountant and the third-party plaintiff, making the facts of *European American* on par with those in *Glanzer v. Shepard*.[160]

The three *Credit Alliance* criteria provided no instruction for cases in between the extremes of *Credit Alliance* and *European American*. However, the criteria could have been read as adopting a methodology similar to the Restatement Approach.[161] The first two *Credit Alliance* criteria — the particular purpose and reliance requirements — are consonant with the Restatement formulation.[162] Under the Restatement, the accountant must be aware that the audit is being conducted to induce the nonclient's reliance in connection with a particular purpose.[163] Additionally, under the Restatement, the third party must rely on the audit in the furtherance of that particular purpose.[164]

The third criterion — the linking conduct requirement — presented an additional element not required under

158. *See supra* text accompanying note 143.

159. *See supra* notes 79-86. As mentioned previously, the court concluded that the defendant-accountant in *European American*, "was well aware that a primary, if not the exclusive, end and aim of auditing its client, Majestic Electro, was to provide [the plaintiff] with the financial information required." *Credit Alliance*, 65 N.Y.2d at 553, 483 N.E.2d at 119, 493 N.Y.S.2d at 444. This relationship makes the plaintiff in *European American* an intended third-party beneficiary because the "circumstances indicate[d] that the promisee [client] intend[ed] to give the beneficiary [plaintiff] the benefit of the promised performance." RESTATEMENT (SECOND) OF CONTRACTS § 302(1)(b); *supra* text accompanying note 82.

160. *See supra* text accompanying notes 67-72, 144-53.

161. RESTATEMENT (SECOND) OF TORTS § 552 (1977); *see supra* notes 92-93 and accompanying text for further discussion.

162. Bily v. Arthur Young & Co., 834 P.2d 745, 755 (Cal. 1992). In discussing the *Credit Alliance* criteria, the California Supreme Court commented that "the first two elements of the rule (and the New York court's decision in White v. Guarente) are functionally similar to Restatement Second of Torts section 552 . . . ." *Id.* (citations omitted).

163. *See supra* text accompanying notes 92-93.

164. *See supra* text accompanying notes 92-93.

the Restatement compilation. This requirement of *Credit Alliance* clearly cut back on some of the expansive language of *White*, which seemed to embrace an approach identical to that of the Restatement.[165] However, the language the court used in defining the third criterion seemed to indicate that the *Credit Alliance* approach and the Restatement Approach would not significantly differ. As written, this criterion did not require the significant linking conduct found in *European American*, but only "some conduct on the part of the accountants linking them to [the third party, and] evinc[ing] the accountants' understanding of that party or parties' reliance."[166]

III. Security Pacific Business Credit, Inc. v. Peat Marwick Main & Co.

A. *Facts, Procedural History, and Holding*

Top Brass Enterprises, Inc. ("Top Brass"), a publicly owned company engaged in the retailing business, hired accounting firm, Main Hurdman,[167] to audit its financial statements and issue an independent audit opinion thereon for fiscal years ended 1983, 1984, and 1985.[168] In addition to rendering audit services, during 1983, Main Hurdman also aided Top Brass in its negotiations for a $20 million line of credit.[169] One of the several lenders involved in these negotiations was the plaintiff, Security Pacific Business Credit, Inc. ("SPBC").[170] SPBC alleged that it had in-

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165. *See supra* text accompanying notes 127-30.

166. *Credit Alliance*, 65 N.Y.2d at 551, 483 N.E.2d at 118, 493 N.Y.S.2d at 443. The *Credit Alliance* court itself implied that, except for the linking conduct requirement, the new criteria it set out would parallel the Restatement Approach:

> A greater number [of courts] appear to have adopted a rule requiring that the reliant party or his limited class be either known or actually foreseen by the accountants. Inasmuch as this . . . rule, deriving from the Restatement (Second) of Torts § 552, does not include an additional requirement for conduct on the part of the accountant linking them to the noncontractual party or parties, we decline to adopt it.

Id. at 553 n.11, 483 N.E.2d at 119 n.11, 493 N.Y.S.2d at 444 n.11 (citations omitted).

167. Main Hurdman was succeeded by Peat Marwick & Co. *Security Pacific*, 79 N.Y.2d 695, 698, 597 N.E.2d 1080, 1081, 586 N.Y.S.2d 87, 88 (1992).

168. *Id.* at 699, 597 N.E.2d at 1081, 586 N.Y.S.2d at 88.

169. *Id.*

170. *Id.* According to the court, these negotiations were immaterial to the case "because the heart of this lawsuit between SPBC and Peat Marwick relate[d] solely to Main Hurdman's 1984 audit opinion prepared for Top Brass." *Id.*, 597 N.E.2d at 1081-82, 586

formed Main Hurdman that it would be relying on its audit reports in considering Top Brass's credit application.[171] Ultimately, however, SPBC's offer for the $20 million line of credit was not accepted by Top Brass.[172]

In 1984, Top Brass entered the credit market again, this time seeking a $50 million line of credit.[173] SPBC made another proposal to provide this line of credit, which was to be secured by Top Brass's accounts receivable.[174] Although SPBC conducted its own examination of Top Brass's accounts receivable, it advised Top Brass that final approval of the line of credit would be conditioned on Main Hurdman's audit opinion.[175] After its field work, Main Hurdman supplied Top Brass with preliminary financial statements; Top Brass in turn supplied them to SPBC.[176]

SPBC alleged that upon receiving these financial statements, its vice president telephoned Main Hurdman's audit engagement partner and informed him that SPBC would be relying on the audit report.[177] SPBC also contended that, during this conversation, Main Hurdman made representations con-

N.Y.S.2d at 88-89.

171. *Id.*, 597 N.E.2d at 1081, 586 N.Y.S.2d at 88.

172. *Id.*

173. *Id.*, 597 N.E.2d at 1082, 586 N.Y.S.2d at 89.

174. *Id.* at 700, 597 N.E.2d at 1082, 586 N.Y.S.2d at 89.

175. *Id.* at 699-700, 597 N.E.2d at 1082, 586 N.Y.S.2d at 89. At this time, SPBC did not contact Main Hurdman to inform them of their intended reliance on their audit work or seek any of Main Hurdman's work as to the propriety of Top Brass's accounts receivable. *Id.* at 700, 597 N.E.2d at 1082, 586 N.Y.S.2d at 89.

176. *Id.* Main Hurdman's audit engagement letter (which is essentially the signed writing between an auditor and his client evidencing the audit contract) did not refer to SPBC or the line of credit. *Id.* However, the notes to the preliminary financial statements prepared by Main Hurdman noted that Top Brass was negotiating a new line of credit. *Id.* In addition, Main Hurdman's subsequent events memo (which documents an auditor's work in assessing whether any major events have occurred after its field work, but prior to the release of the audit opinion, that require disclosure in the financial statements) stated that Top Brass was negotiating for a line of credit with Security Pacific and/or another lender. *Id.* The minutes of Top Brass's June 30, 1984 Board of Directors meeting also discussed the impending negotiations for the line of credit. *Id.*

177. *Id.* at 701, 597 N.E.2d at 1082, 586 N.Y.S.2d at 89. SPBC alleged that this call was made at the suggestion of Top Brass's officers. *Id.* at 700, 597 N.E.2d at 1082, 586 N.Y.S.2d at 89. SPBC also alleged in its complaint that this call was made prior to the date of Main Hurdman's audit opinion, September 12, 1984. *Id.* Although Main Hurdman's audit partner did not remember the call, Main Hurdman conceded that it was made for the purposes of its motion for summary judgment. *Id.*

cerning the financial statements, and informed SPBC that the audit opinion would be a clean one.[178] After receiving a copy of the finalized financial statements and an unqualified audit opinion from Top Brass, SPBC granted the $50 million line of credit.[179]

Top Brass's 1985 financial statements, also audited by Main Hurdman, disclosed that thirty percent of its accounts receivable were uncollectible, a development which if discovered in the prior year, would have caused Top Brass to report a significant net loss.[180] Ultimately, in 1986, Top Brass declared bankruptcy.[181] Shortly thereafter, SPBC sued the defendant, Peat Marwick, the successor to Main Hurdman, alleging that the 1984 unqualified opinion negligently reported Top Brass's financial position, and that Main Hurdman was aware of SPBC's reliance on it.[182]

In New York Supreme Court, Peat Marwick moved for and was granted a dismissal of the complaint.[183] The First Department of the Appellate Division voted 3 to 2 to reverse and denied the defendant's motion for summary judgment, but granted leave to appeal.[184] The First Department concluded:

> Applying the criteria of *Credit Alliance*, the defendant knew the purpose of the financial reports and quite possibly that the plaintiff was relying on them. To the extent that there are any gaps, the plaintiff is entitled to further pre-trial discovery before there can be any consideration of a motion for summary judgment.[185]

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178. *Id.* at 701, 597 N.E.2d at 1082, 586 N.Y.S.2d at 89. SPBC's vice president also alleged that Main Hurdman assured him that the net income figure would not change, that Top Brass's reserves were adequate, and that Main Hurdman had not discovered anything that SPBC should be aware of in lending Top Brass money. *Id.* at 700-01, 597 N.E.2d at 1082, 586 N.Y.S.2d at 89.

179. *Id.* at 701, 597 N.E.2d at 1083, 586 N.Y.S.2d at 90.

180. *Id.*

181. *Id.*

182. *Id.* at 702, 597 N.E.2d at 1083, 586 N.Y.S.2d at 90.

183. *Security Pac. Business Credit, Inc. v. Peat Marwick Main & Co.*, No. 1034/90 (Sup. Ct. New York County Sept. 5, 1990) (Saxe, J.).

184. *Security Pac. Business Credit, Inc. v. Peat Marwick Main & Co.*, 165 A.D.2d 622, 569 N.Y.S.2d 57 (1st Dep't 1991), *rev'd*, 79 N.Y.2d 695, 597 N.E.2d 1080, 596 N.Y.S.2d 87 (1992).

185. *Id.* at 625, 569 N.Y.S.2d at 59. The dissent agreed with the majority that further discovery might disclose that Main Hurdman knew of the particular purpose for their audit, and that it was aware that SPBC intended to rely on it — the first two

On appeal, the Court of Appeals held that SPBC had failed to allege facts, which if taken as true, would establish that the criteria set out in *Credit Alliance* had been met.[186] Thus, the court concluded that SPBC had "failed to demonstrate the existence of a relationship between itself and defendant's predecessor accounting firm [was one] 'sufficiently approaching privity' . . . ."[187] Accordingly, it reversed the First Department's judgment, and reinstated the Supreme Court's summary judgment ruling.[188]

B. *The Reasoning of the Majority*

In reinstating the summary judgment in favor of Main Hurdman, the court determined that the evidence SPBC adduced did not establish that all three elements of *Credit Alliance* had been met.[189] Specifically, the court noted that SPBC had failed to allege facts that would demonstrate that Main Hurdman was aware that one of the particular purposes of their audit was to aid SPBC in securing the line of credit (the first *Credit Alliance* criterion), or that there was linking conduct on the part of Main Hurdman that evinced its understanding of SPBC's reliance (the third *Credit Alliance* criterion).[190]

Credit Alliance criteria. *Id.* at 626-27, 569 N.Y.S.2d at 60 (Carro, J., dissenting). However, the dissent contended that SPBC had failed to adequately allege the third *Credit Alliance* criterion — the linking conduct requirement — because it adduced no evidence that Main Hurdman had any "direct dealings" with SPBC, except for the telephone call. *Id.* at 627, 569 N.Y.S.2d at 60-61. "[T]here is no evidence of any 'word or action' on the part of the defendant directed to plaintiff, or anything in defendant's retainer agreement with Top Brass, which provided the necessary link between them." *Id.* at 627, 569 N.Y.S.2d at 61 (quoting Credit Alliance Corp. v. Arthur Andersen & Co., 65 N.Y.2d 536, 553-54, 483 N.E.2d 110, 119, 493 N.Y.S.2d 435, 444-45 (1985) and citing Westpac Banking Corp. v. Deschamps, 66 N.Y.2d 16, 19, 484 N.E.2d 1351, 1353, 494 N.Y.S.2d 848, 850 (1985)).

186. *Security Pacific*, 79 N.Y.2d at 699, 597 N.E.2d at 1081, 586 N.Y.S.2d at 88.

187. *Id.* (quoting *Credit Alliance*, 65 N.Y.2d at 553, 483 N.E.2d at 119, 493 N.Y.S.2d at 444).

188. *Id.* at 708, 597 N.E.2d at 1087, 586 N.Y.S.2d at 94.

189. *Id.* at 704, 597 N.E.2d at 1085, 586 N.Y.S.2d at 92. *See supra* text accompanying note 141.

190. *Security Pacific*, 79 N.Y.2d at 705-07, 597 N.E.2d at 1085-86, 586 N.Y.S.2d at 92-93. The court commented:

> [T]he record indicates that the primary, if not exclusive, end and aim of the Main Hurdman audit was for use in Top Brass's audit report as required by Federal law for a publicly held company. While Main Hurdman knew the identity of the spe-

In concluding that SPBC had failed to allege facts that would establish that the first *Credit Alliance* criterion had been met, the court commented that:

> [T]here is no evidence that Main Hurdman shaped its 1984 audit opinion to meet any needs of SPBC. Neither is there any claim or proof that Main Hurdman directly supplied SPBC with a copy of the audit report or opinion or ever agreed to do so. . . . Similarly, the audit engagement letter between Top Brass and Main Hurdman does not mention SPBC or provide or suggest the necessary link to SPBC. To be sure also, there is no claim that Main Hurdman was aware that "*a primary, if not the exclusive, end and aim* of auditing its client . . . [Top Brass] was to provide . . . [SPBC] with the financial information it required."[191]

The court also added that SPBC tendered no evidence that Main Hurdman was hired to prepare its audit opinion "for the purpose of inducing SPBC to extend credit to Top Brass," or that Main Hurdman ever specifically agreed to prepare its audit opinion "for SPBC's use or according to SPBC's requirements."[192] As to SPBC's failure with regard to the third criterion, the court reasoned that if a lender could satisfy the linking conduct requirement by simply telephoning its debtor's auditor, the lender would be receiving an insurance policy on its loan for the bargain price of a telephone call.[193] The court concluded that "[t]his plainly is not what *Credit Alliance* and its related precedents effected."[194] The court also deemed SPBC's evidence con-

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> cific party, SPBC, the complaint and supporting documents fail to allege or demonstrate Main Hurdman's awareness of any other "particular purpose" for their services, or conduct on the part of Main Hurdman creating an "unmistakable relationship" with SPBC.

Id. at 707, 597 N.E.2d at 1086, 586 N.Y.S.2d at 93.

191. *Id.* at 706-07, 597 N.E.2d at 1086, 586 N.Y.S.2d at 93 (emphasis in original) (citations omitted) (quoting *Credit Alliance*, 65 N.Y.2d 536, 554, 483 N.E.2d 110, 120, 493 N.Y.S.2d 435, 445 (1985)).

192. *Id.* at 706, 597 N.E.2d at 1086, 586 N.Y.S.2d at 93.

193. *Id.* The court opined that Main Hurdman's audit engagement partner's responses to SPBC's questions about the propriety of Top Brass's financial statements during the telephone call were limited to "generalities," and did not satisfy the linking conduct requirement of the *Credit Alliance* test. *Id.* at 705, 597 N.E.2d at 1085, 586 N.Y.S.2d at 92.

194. *Id.* at 706, 597 N.E.2d at 1085, 586 N.Y.S.2d at 92. Earlier in its opinion, the court contrasted SPBC's relationship with Main Hurdman with that between the plaintiff and defendant in *European American*: "There [in *European American*], the ac-

cerning Main Hurdman's negotiations with it in 1983 for the $20 million line of credit insignificant in determining whether Peat Marwick could be held liable for Main Hurdman's 1984 audit.[195]

In closing, the court characterized Main Hurdman's audit work as being a "convenient instrumentality" for use in the development of Top Brass's business.[196] The financial statements based on this work, it concluded, were only "incidentally" or "collaterally" for the use of those to whom Top Brass might exhibit them.[197]

C. *The Lone Dissenter*

The dissenting opinion by Judge Hancock contended that, for the purposes of a motion for summary judgment, SPBC had made a sufficient showing that all of the *Credit Alliance* criteria were met.[198] Judge Hancock began his dissent by accusing the court of announcing a new rule to govern accountants' liability for negligent misrepresentation.[199] He first argued that only the third of the *Credit Alliance* criteria — the linking conduct requirement — was really at issue, and that in the final analysis, all of the criteria had been met.[200] Significant to his reasoning was the fact that the court was reviewing a motion for summary judgment.[201] Accordingly, SPBC did not have to "prove the 'linking conduct,' only demonstrate a triable issue of fact."[202]

Judge Hancock argued that the first and second *Credit Alliance* criteria — the particular purpose and reliance require-

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countants had multiple, direct and substantive communications and personal meetings with the relying lender during the entire course of the lending relationship. Here, SPBC's claimed relationship to Main Hurdman, 'sufficiently approaching privity', rises or falls essentially on the single unsolicited phone call." *Id.* at 705, 597 N.E.2d at 1085, 586 N.Y.S.2d at 92.

195. *Id.* at 707, 597 N.E.2d at 1086, 586 N.Y.S.2d at 93-94.

196. *Id.* at 708, 597 N.E.2d at 1087, 586 N.Y.S.2d at 94.

197. *Id.* (quoting Ultramares Corp. v. Touche, 255 N.Y. 170, 183, 174 N.E. 441, 446 (1931) and citing Glanzer v. Shepard, 233 N.Y. 236, 135 N.E. 275 (1922)).

198. *Id.* at 714-17, 597 N.E.2d at 1090-93, 586 N.Y.S.2d at 97-100 (Hancock, J., dissenting).

199. *Id.* at 708, 597 N.E.2d at 1087, 586 N.Y.S.2d at 94.

200. *Id.* at 709, 597 N.E.2d at 1088, 586 N.Y.S.2d at 95.

201. *Id.*

202. *Id.* (citing Sillman v. Twentieth Century-Fox Film Corp., 3 N.Y.2d 395, 404, 144 N.E.2d 387, 392, 165 N.Y.S.2d 498, 504 (1957)).

ments—were undisputed.[203] The telephone conversation between the engagement partner of Main Hurdman and SPBC's vice president established that Main Hurdman knew, "that the audit was to be used for the credit negotiations and that SPBC would rely on its audit report."[204]

Judge Hancock chided the majority for suggesting that New York law clearly showed that the contact between Main Hurdman and SPBC was not sufficient to satisfy the linking conduct requirement of *Credit Alliance*.[205] No New York decision, Judge Hancock pointed out, had ever articulated what conduct was sufficient to satisfy this criterion.[206] Judge Hancock further commented that:

> The language of the *Credit Alliance* opinion suggests that what is called for is an evidentiary showing of some communication or contacts demonstrating the accountant's awareness of the third party's reliance. Indeed, this is how other courts have read *Credit Alliance*. As one court put it, the requirement is "that the accountants manifest conduct underscoring their understanding of a particular nonclient's reliance upon their work product."[207]

According to Judge Hancock, several of the facts alleged represented the requisite 'linking conduct': the telephone conversation between SPBC's vice president and Main Hurdman's audit engagement partner; Main Hurdman's final engagement memo referencing the plaintiff as a potential lender; and the prior negotiations in which Main Hurdman was involved.[208]

In the second half of his dissent, Judge Hancock defined the

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203. *Id.*

204. *Id.* at 714, 597 N.E.2d at 1091, 586 N.Y.S.2d at 98.

205. *Id.* at 715, 597 N.E.2d at 1091-92, 586 N.Y.S.2d at 98-99.

206. *Id.*, 597 N.E.2d at 1091, 586 N.Y.S.2d at 98.

207. *Id.* (quoting First Nat'l Bank of Commerce v. Monco Agency, Inc., 911 F.2d 1053, 1059 (5th Cir. 1990)).

208. *Id.* at 715, 597 N.E.2d at 1092, 586 N.Y.S.2d at 99. Judge Hancock also quoted Huang v. Sentinel Govt. Sec., 709 F. Supp. 1290, 1298 (S.D.N.Y. 1989), which stated that the test for whether the third criterion was met "is not . . . formal direct communication, but rather some link of the 'defendant to plaintiff which evinces defendant's understanding of plaintiff's reliance.'" *Security Pacific*, 79 N.Y.2d at 715, 597 N.E.2d at 1091, 586 N.Y.S.2d at 98. Judge Hancock added that "[i]f, as the language of *Credit Alliance* indicates, what is required is a demonstration of some conduct evincing or underscoring the accountant's knowledge of the reliance, then it seems self-evident that there is enough to withstand summary judgment here." *Id.*, 597 N.E.2d at 1092, 586 N.Y.S.2d at 99.

new rule that he contended the majority adopted for measuring accountants' liability for negligent misrepresentation.[209] This rule, he argued, was a regression to the stringent privity requirements established by *Ultramares* and *Glanzer*.[210] Two aspects of the majority opinion convinced him that this was so. First, the majority's insistence that the inducement of SPBC's reliance on the financial statements was not the exclusive "end and aim" of Main Hurdman's audit.[211] Second, the majority's requirement that Main Hurdman's linking conduct establish an "unmistakable relationship" with SPBC.[212]

Commenting on the first aspect of the majority's opinion, Judge Hancock noted that in *Ultramares* and *Glanzer*, "[f]or all intents and purposes, plaintiff's relationship must have been that of a third-party beneficiary to the contract for the accountants' services."[213] He further asserted that the court's holding in *White v. Guarente* reduced the rigors of *Ultramares* to require that the inducement of the plaintiff's reliance only be "one of the ends and aims" that is specifically foreseen by the accountant.[214]

Under this reasoning, by requiring that SPBC's reliance be "*the* end and aim" of Main Hurdman's audit, the majority re-erected the privity restrictions of *Ultramares*.[215] As to the second aspect, Judge Hancock maintained that the examples provided by the court of the conduct that would demonstrate an "unmistakable relationship," established that something more than conduct evincing the accountant's understanding of the plaintiff's reliance would be the new standard.[216]

Judge Hancock concluded his dissent by arguing that the record showed that the first two *Credit Alliance* criteria had

209. *Id.* at 717-19, 597 N.E.2d at 1092-93, 586 N.Y.S.2d at 100-01.

210. *Id.* The majority retorted that the law of New York had never deviated from *Ultramares* and contended that its opinion in this case was consonant with the principle established in *Ultramares* and followed by its progeny. *Security Pacific*, 79 N.Y.2d at 707-08, 597 N.E.2d at 1087, 586 N.Y.S.2d at 94.

211. *Id.* at 708, 717, 597 N.E.2d at 1087, 1093, 586 N.Y.S.2d at 94, 100 (Hancock, J., dissenting).

212. *Id.*

213. *Id.* at 718, 597 N.E.2d at 1093, 587 N.Y.S.2d at 100.

214. *Id.* at 719, 597 N.E.2d at 1094, 587 N.Y.S.2d at 101 (emphasis removed).

215. *Id.* (emphasis added in quotation).

216. *Id.* at 718-19, 597 N.E.2d at 1093-94, 587 N.Y.S.2d at 100-01.

been met.[217] He further argued that the evidence adduced by SPBC also raised a triable issue of fact as to whether the third criterion had been met.[218]

IV. Analysis

A. *Security Pacific: All Doubts Resolved — There is No Tort of Negligent Misrepresentation in New York*

The question raised by *White v. Guarente*[219] and left open by *Credit Alliance Corp. v. Arthur Andersen & Co.*[220] is answered in *Security Pacific Business Credit, Inc. v. Peat Marwick Main & Co.*:[221] There is no tort of negligent misrepresentation in New York.

Security Pacific is more than just a dispute between the majority and the dissent about the quantum of evidence necessary to survive a motion for summary judgment. The two opinions used different standards in approaching the negligent misrepresentation cause of action. The majority interpreted *Credit Alliance* as calling for an application of the contract principles of *Ultramares Corp. v. Touche*.[222] The dissent, on the other hand, interpreted *Credit Alliance* as requiring a methodology similar to that of the Restatement Approach.[223]

The majority's application of the first and third *Credit Alliance* criteria demonstrate its strict use of the principles of *Ultramares*. In dismissing SPBC's evidence with regard to the first criterion — the particular purpose requirement — the court concluded that SPBC had failed to allege that: "Main Hurdman shaped its 1984 audit opinion to meet any needs of SPBC";[224] or that Main Hurdman "directly supplied SPBC with a copy of the

217. *Id.* at 720, 597 N.E.2d at 1094, 586 N.Y.S.2d at 101.

218. *Id.*

219. 43 N.Y.2d 356, 372 N.E.2d 315, 401 N.Y.S.2d 474 (1977); *see supra* notes 120-32 and accompanying text.

220. 65 N.Y.2d 536, 483 N.E.2d 110, 493 N.Y.S.2d 435 (1985); *see supra* notes 133-53 and accompanying text.

221. 79 N.Y.2d 695, 597 N.E.2d 1080, 586 N.Y.S.2d 87 (1992).

222. *See supra* notes 79-86 and accompanying text.

223. *See supra* notes 192-93 and accompanying text.

224. *Security Pacific*, 79 N.Y.2d at 706, 597 N.E.2d at 1086, 586 N.Y.S.2d at 93; *see supra* text accompanying note 191.

audit report or opinion";[225] or that Main Hurdman ever specifically agreed to prepare its audit opinion "for SPBC's use or according to SPBC's requirements."[226] However, if SPBC adduced evidence such as this, it would have alleged facts that would make it an intended third-party beneficiary to the audit contract between Top Brass and Main Hurdman.[227]

All of these scenarios, independently or taken together, bespeak a relationship that would satisfy section 302 of the Second Restatement of Contracts.[228] In each, "the circumstances [would] indicate that the promisee [client] intend[ed] to give the beneficiary [third party] the benefit of the promised performance."[229] In situations where an accountant shapes the audit for a third-party plaintiff's purposes, directly supplies that plaintiff with the audit report, or tailors the audit opinion to meet that plaintiff's needs, the plaintiff's reliance is the primary or sole

225. *Security Pacific*, 79 N.Y.2d at 706, 597 N.E.2d at 1086, 586 N.Y.S.2d at 93; *see supra* text accompanying note 191.

226. *Security Pacific*, 79 N.Y.2d at 706, 597 N.E.2d at 1086, 586 N.Y.S.2d at 93; *see supra* text accompanying note 191. The court derived all of these scenarios directly from *Credit Alliance. Credit Alliance*, 65 N.Y.2d at 553-54, 483 N.E.2d at 119, 493 N.Y.S.2d at 444-45; *see supra* text accompanying note 191. The facts of each purportedly bear indicia that demonstrate the particular purpose requirement has been met (at least for the purposes of a motion for summary judgment). However, in enumerating these scenarios, the *Security Pacific* court significantly omitted one scenario proffered by the *Credit Alliance* court, which under a consistent analysis, should equally show that the particular purpose requirement has been met. The *Credit Alliance* court stated:

> Moreover, *there is no allegation that Andersen [the accountant] had any direct dealings with plaintiffs*, had specifically agreed with Smith [the client] to prepare the report for the plaintiffs' use or according to plaintiffs' requirements, or had specifically agreed with Smith to provide plaintiffs with a copy or actually did so.

Credit Alliance, 65 N.Y.2d at 553, 483 N.E.2d at 119, 493 N.Y.S.2d at 444 (emphasis added). Thus, it seems that the *Credit Alliance* court envisaged that the direct dealings between the accountant and nonclient in *Security Pacific* could be sufficient to satisfy the particular purpose requirement.

227. *See supra* notes 81-85 and accompanying text.

228. RESTATEMENT (SECOND) OF CONTRACTS § 302 (1979); *see supra* notes 81-85 and accompanying text.

229. RESTATEMENT (SECOND) OF CONTRACTS § 302 (1979); *see supra* text accompanying note 82. As in Seaver v. Ransom, 224 N.Y. 233, 237-38, 120 N.E. 639, 641 (1918), which held in favor of an intended beneficiary of a will who was not named in the will reasoning that a third party can sue for breach of a contract made for his direct benefit, *see supra* note 84, in each of these scenarios the audit contract would be made for the direct benefit of the nonclient, and under third-party beneficiary contract principles, the nonclient would be permitted to sue for a breach of it. *Id.*

"end and aim" of the audit under *Glanzer v. Shepard.*[230]

The court admonished that these situations were presented as "nonexclusive types of activity," which would establish that the *Credit Alliance* criteria had been met.[231] This caution, however, in no way offers a more expansive reading of the opinion. While these scenarios may not be the only way to satisfy *Credit Alliance*, the clear import of the court's reasoning is that the connection between the third party and the accountant must be *as extensive* as in all of these situations.

The court's reading of the third *Credit Alliance* criterion — the linking conduct requirement — further displays its strict use of the principles of *Ultramares*. The court concluded that SPBC's allegations as to Main Hurdman's conduct did not demonstrate an "unmistakable relationship" between the two parties.[232] It eschewed SPBC's evidence regarding Main Hurdman's prior negotiations with it, as well as Main Hurdman's representations to SPBC during the telephone call.[233]

230. 233 N.Y. 236, 135 N.E. 275 (1922); *see supra* notes 67-78 and accompanying text. Thus, as in *Glanzer* where the seller was the formal promisee but the contract was for the benefit of the buyer, *see supra* text accompanying note 76, under *Security Pacific* even though the audit client is the formal promisee, the contract must be for the specific benefit of the nonclient in order for the nonclient to be a viable plaintiff.

231. *Security Pacific*, 79 N.Y.2d at 707, 597 N.E.2d at 1086-87, 586 N.Y.S.2d at 93-94.

232. *Id.*

233. *See supra* notes 169-79 and accompanying text. None of the cases that the Court of Appeals heard following *Credit Alliance* refined the precise requirements of the linking conduct element of the test. *See, e.g.*, William Iselin & Co., Inc. v. Landau, 71 N.Y.2d 420, 522 N.E.2d 21, 527 N.Y.S.2d 176 (1988); Westpac Banking Corp. v. Deschamps, 66 N.Y.2d 16, 484 N.E.2d 1351, 494 N.Y.S.2d 848 (1985); *see supra* note 157. However, the conduct of Main Hurdman in *Security Pacific* satisfies the plain language the Court of Appeals used in *Credit Alliance*. The third criterion calls for "*some* conduct on the part of the accountants linking them to [the nonclient], which evinces the accountants' understanding of [the nonclient's] reliance." *Credit Alliance*, 65 N.Y.2d at 551, 483 N.E.2d at 118, 493 N.Y.S.2d at 443 (emphasis added); *see supra* text accompanying notes 141-43 and accompanying text. Main Hurdman's previous negotiations with SPBC, a major potential lender of the client, in which Main Hurdman gained an understanding that the lender would condition its loan on the receipt of audited financial statements, *see supra* text accompanying notes 169-79, as well as Main Hurdman's representations directly to SPBC over the telephone concerning Top Brass's financial statements, *see supra* text accompanying note 178, surely qualifies as "some conduct" linking Main Hurdman with SPBC, evincing Main Hurdman's understanding of SPBC's reliance.

By contrast, the court put its imprimatur on the factual scenario in *European Bank & Trust Co. v. Strauhs & Kaye*,[234] where the contact between the accountant and nonclient was "multiple, direct and substantive."[235] By quantifying the communications and contacts that the third party must have with the accountant, the court construed the third *Credit Alliance* criterion as calling for conduct that would establish the audit "was primarily for the information of a third person, in effect, if not in name, a party to the contract, and only incidentally for that of the formal promisee."[236] When an accountant has multiple, direct, and substantive communications and contacts with a third party, it is clear that the client has intended the benefit of the audit to inure to the third party and that the third party's reliance is the primary or sole "end and aim" of the audit.[237]

In sum, the practical significance of *Security Pacific* is that in New York, in order for a nonclient to successfully assert negligent misrepresentation against an accountant, it must show that it is a third-party beneficiary to the audit contract.[238] Under *Security Pacific*, the bounds of the negligent misrepresentation cause of action are coterminous with those of contract law.

If the dissent had commanded a majority vote in *Security Pacific*, the tort of negligent misrepresentation would have been born. In arguing that the first and second criteria — the particular purpose and reliance requirements — were met, Judge

234. 65 N.Y.2d 536, 483 N.E.2d 110, 493 N.Y.S.2d 435 (1985); *see supra* notes 144-53 and accompanying text.

235. *See supra* note 194.

236. *Ultramares*, 255 N.Y. at 83, 174 N.E. at 446; *see supra* note 75.

237. *Glanzer*, 233 N.Y. 236, 135 N.E. 275 (1922); *see supra* notes 67-78 and accompanying text. In one sense the court's analysis in *Security Pacific* could be interpreted as even more restrictive than that in *Glanzer*. In *Glanzer*, Judge Cardozo wrote:

> Constantly the bounds of duty are enlarged by knowledge of prospective use. We must view the act [of the negligent misrepresentation] in its setting, which will include the implications and the promptings of usage and fair dealing. The casual response, made in mere friendliness or courtesy may not stand on the same plane . . . as the deliberate certificate . . . intended to sway conduct.

Id. at 240, 135 N.E. at 276. The setting in which Main Hurdman and SPBC dealt shows that Main Hurdman's representations were a far cry from "casual." Indeed, the prior negotiations in which Main Hurdman participated, and Main Hurdman's responses concerning Top Brass's financial statements during a telephone call were more akin to the deliberate certificate in *Glanzer*, which was "intended to sway conduct."

238. *See supra* notes 228-37 and accompanying text.

Hancock commented that Main Hurdman knew "that the audit was to be used for the credit negotiations and that SPBC would rely on its audit report."[239] Under this standard, it would seem that if the accountant was aware that one of the reasons why the audit was being conducted was to induce the plaintiff's reliance for a particular purpose (such as a loan), and if the plaintiff so relied, the first two *Credit Alliance* criteria would be met.[240] This construction of *Credit Alliance* would have made the law of New York parallel to section 552 of the Second Restatement of Torts.[241] The Restatement Approach, as mentioned previously, expands an accountant's liability to any nonclient or limited group of nonclients actually foreseen to be relying on the audited financial statements.[242]

Under Judge Hancock's analysis, the criteria of *Credit Alliance* would only diverge from the Restatement Approach with regard to the third *Credit Alliance* criterion — the requirement of linking conduct.[243] However, his interpretation of this requirement makes this divergence minimal. According to Judge Hancock, the linking conduct requirement is satisfied by "an evidentiary showing of some communication or contacts demonstrating the accountant's awareness of the third party's reliance."[244]

239. *Security Pacific*, 79 N.Y.2d at 714, 597 N.E.2d at 1091, 586 N.Y.S.2d at 98 (Hancock, J., dissenting).

240. Judge Hancock's standard would be more expansive than the court's. Judge Hancock would not require that the audit's "end and aim" be for the nonclient's benefit, *Cf. Glanzer*, 233 N.Y. at 238-39, 135 N.E. at 275, but would allow certain incidental beneficiaries to recover. *See supra* text accompanying notes 213-14. As in Strauss v. Belle Realty Co., 98 A.D.2d 424, 469 N.Y.S.2d 948 (2d Dep't 1983), *see supra* note 85, nonclients that the accountant is aware will rely on the audit "derive benefit from the performance of [the audit contract] though [the nonclient] is neither the promisee nor the one whom performance is to be rendered . . . ." *Id.* at 426-27, 469 N.Y.S.2d at 950 (citations omitted).

241. RESTATEMENT (SECOND) OF TORTS § 552 (1977); *see supra* notes 92-93 and accompanying text.

242. RESTATEMENT (SECOND) OF TORTS § 552 (1977); *see supra* notes 92-93 and accompanying text.

243. *See supra* notes 205-08 and accompanying text.

244. *Security Pacific*, 79 N.Y.2d at 715, 597 N.E.2d at 1091, 586 N.Y.S at 98 (Hancock, J., dissenting); *see supra* text accompanying note 207. Judge Hancock's interpretation of the linking conduct element finds strong support in the plain language of *Credit Alliance*, which requires only "*some* conduct on the part of the accountants linking them" to the nonclient. *Credit Alliance*, 65 N.Y.2d at 551, 483 N.E.2d at 118, 493 N.Y.S.2d at 443 (emphasis added).

Thus, under this standard, any act directed toward the nonclient, tending to show the accountant's understanding of the nonclient's reliance, would satisfy the third prong of the test. Admittedly, this requirement creates a slightly higher standard than the Restatement Approach, because under the latter methodology the accountant can be held liable without directing any conduct toward the nonclient.[245] However, Judge Hancock's approach would still constitute a tort theory.

Any act by an accountant directed toward a nonclient, would not "indicate the assumption of a duty to make reparation if the benefit [a 'non-negligent' audit] is lost,"[246] and would certainly not confer intended third-party beneficiary status on the nonclient.[247] Accordingly, Judge Hancock's interpretation of *Credit Alliance* would have created an "obligation that [is] imposed by law — apart from and independent of promises made and therefore apart from the manifested intention of the parties. . . ."[248] An obligation of this nature is classified as a tort obligation.[249]

B. *The Contract Principles Utilized in Security Pacific Ignore the Contemporary Role of the Audit in the Business Community.*

When an accountant undertakes the auditing function, he is well aware why he is being retained — some third party has required that the accountant's client obtain independent verification of its financial statements.[250] It is very rare indeed that an

245. *See supra* notes 92-93 and accompanying text.

246. Airco Alloys Div., Airco Inc. v. Niagara Mohawk Power Corp., 76 A.D.2d 68, 79, 430 N.Y.S.2d 179, 185 (4th Dep't 1980); *see supra* note 85.

247. RESTATEMENT (SECOND) OF CONTRACTS § 302(1) (1979); *see supra* notes 81-85 and accompanying text. As in Strauss v. Belle Realty Co., 98 A.D.2d 424, 469 N.Y.S.2d 948 (1983); *see supra* note 85, the nonclient in this scenario would be an incidental beneficiary to the audit contract because the nonclient would "derive benefit from the performance of a contract though [it] is neither the promisee nor the one whom performance is to be rendered . . . ." *Strauss*, 98 A.D.2d at 426-27, 469 N.Y.S.2d at 950 (citations omitted). Additionally, a minor act by the accountant directed to the nonclient would not "show that [the accountant] intended to allow [the nonclient] to recover for the damages resulting from [the breach of contract]." *Id.* at 426-427, 469 N.Y.S.2d at 950.

248. KEETON, *supra* note 9, § 92 at 655; *see supra* note 64 for further discussion.

249. *See supra* notes 87-91 and accompanying text.

250. *See supra* notes 33-35 and accompanying text.

audit is conducted primarily for benefit of management.[251] After all, in a vast majority of businesses, management is comprised of business experts, who are intricately involved with their company's operations on a daily basis, year-round.[252] Plainly, management would not need to hire independent auditors, who only conduct their field work for one or two months, to learn about their business.[253]

The accounting profession,[254] several commentators,[255] as well as several courts,[256] recognize that the contemporary role of the audit is to benefit third parties such as investors, lenders, and shareholders.[257] Although these parties are often not third-party beneficiaries to the audit contract, their reliance on the audited financial statements is justified and reasonable. Indeed, such reliance is integral to uninhibited commercial intercourse.[258] The contract principles utilized in *Security Pacific* wrongly foreclose these parties from relief.[259] By restricting the scope of the negligent misrepresentation cause of action to the domain of contract law, the court has undermined the justified reliance of these third parties, and at least to some extent, may have stagnated the free flow of commerce.

In assessing Main Hurdman's audit of Top Brass, the Court of Appeals characterized Main Hurdman's audit work as merely a "convenient instrumentality"[260] for use in Top Brass's busi-

251. *See supra* notes 29-45 and accompanying text.

252. The goal of the audit is no longer to assess management's stewardship of the business. *See supra* notes 32-35. As the accounting profession recognizes, the contemporary role of the audit is to provide "investors, bankers, creditors, and others with reasonable assurance that the financial statements are free of material misstatement." AICPA, *supra* note 38, at 36.

253. *See supra* notes 46-53 and accompanying text. An audit is only intended to provide reasonable assurance that a client's financial statements are presented fairly. *See supra* text accompanying notes 51-53. Accordingly, in most audits, the accountant only reviews a sample of transactions that have occurred over the audit period. *See supra* text accompanying note 52. It is for this reason that management is often more familiar with the intricacies of the enterprise's daily operations.

254. *See supra* notes 36-38 and accompanying text.

255. *See supra* notes 39-41 and accompanying text.

256. *See supra* notes 42-45 and accompanying text.

257. *See supra* notes 29-45 and accompanying text.

258. *See supra* notes 29-45 and accompanying text.

259. *See supra* notes 189-97 and accompanying text.

260. *Security Pacific*, 79 N.Y.2d at 707, 597 N.E.2d at 1086, 586 N.Y.S.2d at 94.

ness, and only "incidentally"[261] or "collaterally"[262] for the use of third parties.[263] A closer analysis of the contemporary role of the audit exposes this characterization as patently erroneous. One of the *primary* reasons why Main Hurdman was retained to audit Top Brass's financial statements was to offer third parties such as SPBC reasonable assurance that Top Brass's financial statements were not materially misstated.

C. *The New York Legislature Should Take Action.*

The predominance of policy questions[264] involved in this intractable area of the law makes the courts an ill-equipped body to provide an equitable resolution of the proper scope of accountants' liability for negligent misrepresentation.[265] In New York's tripartite governmental framework, the legislature was intended to be the premiere policy-making body, not the judiciary.[266] Only the legislature has the ability to conduct detailed studies, hold hearings, and fully hear arguments from all parties effected.[267]

Security Pacific is paradigmatic of a court's failure in this

261. *Id.*

262. *Id.*

263. *Id.*

264. *See supra* notes 95-118 and accompanying text.

265. The Court of Appeals itself has contemplated legislative action in this area of the law. As far back as *Ultramares*, in discussing whether the duty to third parties for negligent misrepresentation should be commensurate with that of fraudulent misrepresentation, Chief Judge Cardozo reasoned that "[a] change so revolutionary, if expedient, must be wrought by legislation." *Ultramares*, 255 N.Y at 187, 174 N.E. at 447.

In *Security Pacific*, the majority, in criticizing the dissent, stated that, "[w]e have declined to adopt the broad-brush transformation of the liability formula espoused by the dissenting opinion, because such an extension of liability formula to noncontracting parties is 'unwise as a matter of policy . . . or, at the least, a matter for legislative rather than judicial reform.'" *Security Pacific*, 79 N.Y.2d at 708, 597 N.E.2d at 1087, 586 N.Y.S.2d at 94 (quoting Ossining Union Free Sch. Dist. v. Anderson LaRocca Anderson, 73 N.Y.2d 417, 425, 539 N.E.2d 91, 95, 541 N.Y.S.2d 335, 339 (1989) and citing *Credit Alliance*, 65 N.Y.2d 536, 553 n.11, 483 N.E.2d 110, 119 n.11, 493 N.Y.S.2d 435, 444 n.11 (1985)).

266. *See* N.Y. CONST. art. 3, § 1 (vesting legislative power in the legislature). For a discussion of the limits of judicial policy making in New York, see 20 N.Y. JUR. 2D *Constitutional Law* § 161 (1982) and cases cited therein.

267. *See* N.Y. CONST. art. 3, § 1 (vesting legislative power in the legislature); *In re* Joint Legislative Committee, 285 N.Y. 1, 32 N.E.2d 769 (1941) (legislative power authorizes investigations into matters of public welfare).

regard. The three juridical approaches that were available to the Court of Appeals all offer a flawed outcome. The Foreseeability Approach, by creating liability to all parties who are reasonably foreseeable to rely on an accountant's work, certainly runs the risk of imposing inordinate liability on accountants.[268] As the current statistics show, Chief Judge Cardozo's statements concerning "a liability in an indeterminate amount for an indeterminate time to an indeterminate class"[269] were prophetic. There are unique attributes about the profession of accounting, which make it particularly susceptible to excessive liability.[270] As mentioned previously, a great number of third parties rely on the audited financial statements in making crucial business decisions.[271] Accordingly, when the audited financial statements are materially misstated, painting a rosier picture than reality, a large number of third parties can be adversely affected. A "naked" foreseeability analysis exposes accountants to suits from these third parties, whether or not the audit was conducted negligently.[272]

The Restatement Approach, on the other hand, offers the fortuitous result of making only those third parties who are actually foreseen competent plaintiffs.[273] The facts of *Security Pacific* are illustrative. Under the Restatement Approach, by simply making itself known to the defendant, Main Hurdman, the plaintiff, SPBC, could have transformed itself into a viable plaintiff.[274] In addition, although more expansive than the Privity Approach,[275] the Restatement methodology is still inconsistent with the contemporary role of the audit.[276] A variety of third parties, not actually foreseen but reasonably foreseeable,

268. *See supra* text accompanying note 94.

269. *Ultramares Corp. v. Touche*, 255 N.Y. 170, 179-80, 174 N.E. 441, 444 (1931).

270. *See supra* text accompanying notes 8-10.

271. *See supra* notes 33-45 and accompanying text.

272. *See supra* note 94. The mere fact that financial statements are materially misstated does not necessarily mean that an accountant has been negligent. The purpose of most audits is to provide *reasonable* assurance that the financial statement are free from material misstatement. *See supra* text accompanying notes 51-53. Thus, it is possible that an audit could be conducted in accordance with Generally Accepted Audit Standards, but the financial statements would still be materially misstated.

273. *See supra* notes 92-93 and accompanying text.

274. *See supra* notes 92-93 and accompanying text.

275. *See supra* notes 87-103 and accompanying text.

276. *See supra* notes 32-35, 92-93 and accompanying text.

may legitimately rely on audited financial statements in making crucial business decisions.[277] Indeed, in many cases the reason the audit is conducted is not for any one specifically foreseen party or parties, but for reasonably foreseeable third parties.[278]

Despite the two unsatisfactory approaches available, the Court of Appeals chose an even more inequitable standard — the Privity Approach.[279] By utilizing this approach and circumscribing the scope of liability in negligent misrepresentation to the domain of contract law,[280] the court has foreclosed relief to many more third parties who legitimately rely on accountants' work.[281]

The New York Legislature has the ability to craft tort liability in such a fashion as to avoid the inadequacies of the three judicial options available. Four state legislatures, Arkansas,[282] Illinois,[283] Kansas[284] and Utah,[285] have enacted legislation to govern accountants' liability to nonclients for negligent misrepresentation; however, these measures are, in essence, codifications of the Privity Approach.[286] This Note proposes an altogether different approach.

The legislature should act to craft a tort of negligent misrepresentation. Tort liability in this area of the law is a necessity. If it is reasonably foreseeable that a third party would receive a copy of a client's financial statements and rely on the accountant's audit work, the accountant should be held liable to the third party for injury caused by the accountant's negligence.[287] Inevitably, these third parties are the reason the audit was conducted in the first place.[288] This standard comports with the contemporary function of the audit, and offers recompense

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277. *See supra* notes 29-45 and accompanying text.

278. *See supra* notes 29-45 and accompanying text.

279. *See supra* notes 54-86 and accompanying text.

280. *See supra* notes 79-85 and accompanying text.

281. *See supra* notes 29-45 and accompanying text.

282. ARK. CODE ANN. § 16-114-302 (Michie Supp. 1989); *see supra* note 88.

283. ILL. COMP. STAT. ANN. ch. 225, § 450/30.1 (Michie 1993); *see supra* note 88.

284. KAN. STAT. ANN. § 1-402 (Supp. 1989); *see supra* note 88.

285. UTAH CODE ANN. § 58-26-12 (1990); *see supra* note 88.

286. *See* Joey D. Duke, *Accountant's Liability to Third Parties for Negligent Misrepresentation: Should There be a Uniform Standard*, 14 AM. J. TRIAL ADVOC. 133, 139 (1990).

287. *See supra* text accompanying note 94.

288. *See supra* notes 29-45 and accompanying text.

to those who legitimately rely on accountants' work, but who cannot establish that they are third-party beneficiaries.[289]

However, as the current liability statistics show,[290] this proposal will assuredly expose accountants to inordinate liability unless the legislature also adopts substantive and procedural "brakes" to protect accountants.[291] As the accounting profession itself points out, the primary factor causing exposure to exorbitant liability is joint and several liability.[292] The New York Legislature should eliminate this system as it applies to accountants.

In the accountant-third party scenario, joint and several liability works as a device for injustice. The unique status of accountants in third-party suits alleging negligent misrepresentation bolsters the argument for the elimination of joint and several liability in this context.[293] Inevitably, the primary reason

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289. *See supra* notes 29-45 and accompanying text.

290. *See supra* notes 112-16 and accompanying text.

291. Although the focus of the argument in this section concerns the abrogation of joint and several liability, other safeguards can also facilitate the protection of accountants from excessive liability and should be investigated. For instance, shareholders' derivative suits present an analogous context to the one at hand. Both there and here, there is a grave risk that the plaintiff will use the judicial process to extort a settlement out of a "deep pocket" defendant. *See* THE LIABILITY CRISIS, *supra* note 6, at 20. The legislature has remedied this risk in shareholder derivative suits by requiring plaintiffs to post a bond and pay attorneys fees if the suit is unsuccessful. N.Y. BUS. CORP. LAW § 627 (McKinney 1961). Similarly, in the accountant-third party context, plaintiffs asserting suits of negligent misrepresentation could be required to post bond, and to pay attorneys' fees if they lose.

292. *See supra* note 6 and accompanying text.

293. In the accountant-third party context, particularly in New York, the policy reasons that would justify the maintenance of joint and several liability are wholly inapplicable. The first policy reason proffered in support of joint and several liability is that of compensation. *See supra* note 9. The joint tortfeasor, who has collaborated in causing an injury, should bear the risk of a co-defendant's insolvency, not the innocent victim. *See supra* note 9. However, under *Security Pacific*, the various third parties who rely on the audit, but who would only be classified as incidental third-party beneficiaries to the audit contract, are completely denied recovery. *See supra* notes 222-238 and accompanying text. By expanding accountants' liability to those third parties who are reasonably foreseeable but simultaneously limiting these parties' recovery to the percentage of damages that the accountant caused, this proposal facilitates, rather than frustrates, the compensation objective.

The second policy reason justifying joint and several liability — that the prospect of total liability will greater deter the would-be joint tortfeasor's negligent conduct — is equally inapplicable in the accountant-third party scenario in New York. *Supra* note 9. Here again, under *Security Pacific*, accountants can not be held liable to nonclients who

that an accountant is sued, or joined to the third party's claim, is because the client is unable to satisfy the judgment, often times due to insolvency.[294] Unlike other contexts, where a joint tortfeasor *may* not be able to obtain contribution from a joint tortfeasor, in this context, it is *essentially guaranteed* that the accountant will not be able to obtain contribution.[295]

In the overwhelming majority of audits, an accountant relies upon management's competence and integrity.[296] The preparation of fairly stated financial statements is management's responsibility.[297] Thus, if there has been a material misstatement in the financial statements, a portion of the fault is necessarily allocable to the company's negligence or lack of integrity. Of course, the company's demise, the impetus for the third-party suit, will preclude the accountant from obtaining contribution for this portion of the damages caused. Consequently, in claims by nonclients against accountants, joint and several liability is inequitable because it essentially guarantees that accountants will pay a greater proportion of the damages than they have caused.

VII. Conclusion

Security Pacific Business Credit, Inc. v. Peat Marwick Main & Co.'s dictate is manifest — There is no tort of negligent misrepresentation in New York. The New York Court of Appeals has restricted the boundaries of the negligent misrepresentation cause of action to that of third-party beneficiary princi-

are only incidental third-party beneficiaries to the audit contract. *See supra* notes 186-93 and accompanying text. Thus, with regard to these plaintiffs, under current New York law, there is no incentive for the accountant to refrain from engaging in negligent conduct. By giving these plaintiffs standing to sue, but limiting their judgments to the proportion of damages that the accountant has caused, the New York Legislature would enhance the deterrence factor, not undermine it.

294. *See supra* note 10 and accompanying text.

295. *See supra* notes 9-12 and accompanying text. The proposal of a different liability system for accountants is consistent with Chief Judge Cardozo's initial explanation of the unique attributes of the accounting profession, which would expose an accountant to "liability in an indeterminate amount for an indeterminate time to an indeterminate class." *Ultramares Corp. v. Touche*, 255 N.Y. 170, 179-80, 174 N.E. 441, 444 (1931); *see supra* text accompanying note 66.

296. *See supra* notes 51-53 and accompanying text.

297. *See supra* notes 51-53.

ples under contract law. These contract principles are incompatible with the role of the audit in the modern business community. The New York Court of Appeals' holding in *Security Pacific* denies third parties who legitimately and detrimentally rely on accountants' negligent audit work the relief they deserve.

Incidents such as the S&L debacle, have left the public questioning the role of accountants in the modern financial community. *Security Pacific* can do nothing else but exacerbate this uncertainty. In essence, the case is another reminder to third parties, such as creditors, investors and shareholders, that although the audited financial statements they rely on to make important business decisions may be negligently misstated, they are without protection of the law.

Security Pacific is a clear signal that the legislature of New York should act. The New York legislature has the resources to offer these third parties recompense, but only where recompense is due. By expanding liability for negligent misrepresentation to all reasonably foreseeable third parties, while simultaneously excising joint and several liability, the legislature could provide an equitable result for both the accountants and third parties involved. It is time for New York to take the lead in this area of the law again. This time, however, through the legislature.

Richard D. Holahan, Jr.