AUDITORS' LIABILITY IN THE UNITED STATES- BEYOND BEING RESPONSIBLE TO THE CLIENTS

Sulaiman Abdussamad*

Abstract

The liability of auditors in the United States, as in most common law jurisdictions, is traditionally based on contract between the auditors and their clients. However, over time, the scope of liability has expanded to include third parties, such as investors, creditors, and regulatory bodies. This article examines the laws, rules and judicial pronouncements that shape auditors' liability beyond the auditors and the client whom had a contractual relationship. It explores landmark American judicial precedents, including cases like Ultramares Corp v Touche, Credit Alliance Corp v Arthur Andersen & Co, and Bily v Arthur Young & Co, to illustrate how the courts shift and adapt the law in balancing auditors' accountability, not forgetting concerns over an open-ended liability. The article analyses the doctrines of privity, near-privity, and the foreseeability standard used by the courts to determine auditors' liability. Auditors' embracing and applying these doctrines ultimately determines their audit risk level, even as they leverage them in undertaking business opportunities and challenges in high-risk audits. Furthermore, it considers the policy rationale behind limiting or expanding third-party claims, including deterrence, fairness, and the potential to overwhelm the auditing profession. The article concludes by advocating for a liability framework that protects the investing public's interest without exposing auditors to floodgates risks that will eventually undermine their viability in light of the recent corporate collapses like Enron and Arthur Anderson that provoked the recent global financial crisis.

Keywords: *Auditor Liability, Privity, Foreseeability, Restatement, United States*

1.0 Introduction

Auditors' liability is based mainly on contracts with their clients under common and statutory law. When an auditor is set to work for a client, a contract of employment is created, usually called an engagement letter. Auditors' liability under a contract is governed by the terms set out by the parties in the engagement letter. However, some necessary terms may be implied by law in appropriate circumstances. Implied terms include inter alia, a term that a contracting party will exercise due skill and care in performing what he agrees to do.[1] Inclusive in these terms is the requirement by the courts that parties in a contract must abide by the "strictures of good faith and fair dealing." This entails that "neither party shall do anything that will have the effect of

* LLB, BL, LLM, PhD, Senior Lecturer, Fac. of Law, Baze University, Abuja, Nigeria.+234 9027782888 samadlx@yahoo.com.

[1] Ngai X-W, *Recovery of Pure Economic Loss in Construction Industry* (MSc thesis, Universiti Teknologi Malaysia 2007), 24 https://eprints.utm.my/5974/… accessed 22 April 2025.

destroying or injuring the right of the other party to receive the fruits of the contract."[2] When the auditor fails to execute with regards to the engagement letter, the auditor is said to be in breach. Breach of contractual terms naturally comes with consequences in damages. Damages are monetary compensation employed by courts to bring the injured party as nearly as possible to the same position as if the contract had been performed. These "consequences can and frequently do include pure economic loss."[3] However, in a breach-of-contract action, the plaintiff must first establish before the court that there is an existing contractual relationship between him and the defendant. This contractual relationship is known in law as privity. Privity signifies that the parties are bound by the contract to each other and owe each other a duty to perform under the contract terms. Parties outside the contract do not have *a locus* to sue under the contract.

When the plaintiff is the client for whom the audit was done, it is relatively straightforward to determine whether the auditor is liable or not. However, when the party complaining is a third party who relies on an inaccurate audit report, then the determination of liability becomes more complicated and treacherous. Common law courts had constantly denied remedy to 'strangers' under contract law and tort, perhaps because tort as an equitable remedy must follow the law, as symbolised by the maxim, "equity follows the law."

1.2 Contract and Tort Overlap: The Doctrine of Privity

It is trite that contractual remedies under common law were originally a preserve solely of parties that had furnished consideration. But more often than not, common law courts had found a veritable instrument of justice in tort law to fill the vacuum left by the rigid requirement of consideration in contract. Yet, there remain some borderline cases, even though the two are said to perform separate functions.[4] Tort law protects existing wealth or health, while future gains fall within the purview of contract law. As observed by Weir, 'contract is productive, [while] tort is protective'.[5] Since physical losses are presumed to affect present wealth, they are compensated in tort. On the contrary, when the loss is non-physical, it would be denied except when contractually agreed.[6]

[2] *Anthony's Pier Four, Inc. v HBC Assocs.*, 411 Mass. 451 (SJC 1991)
[3] (n 1) 22. Pure economic loss is a loss to one's finances that does not affect his body or physical property.
[4] ibid
[5] B Markesinis and S Deakin, *Markesinis and Deakin's Tort Law* (6th edn, Clarendon Press 2008) 19.
[6] (n 1) 22.

It is further argued that a contract looks to the future and creates expectations that the law seeks to protect. Tort law, on the contrary, creates no future obligations. Its duty of care standard is not deliberately derived from the parties' will but imposed from outside by reference to societal norms. Therefore, remedies in tort are not designed for frustrated expectancies but for a sustained loss. However, put broadly, this does not always hold good. Professor Atiyah, for example, noted that damages for personal injuries that are typical of tort often include an important element of compensation for lost expectations, i.e., the expectation to earn a living in the way that the injuries prevented.[7] In addition, tort and contract may overlap in that the same wrong may concurrently be a breach of contract and a breach of duty, constituting a tort.[8] Courts viewed tort and contract remedies as mutually exclusive during their development.[9] It has been submitted that when there is a contract, it may be raised to negate the possibility of an action in tort. As observed by Lord Scarman in *Tai Hing Cotton Mill Ltd. v Liu Chong Hing Bank Ltd*[10] as follows:

> Their Lordships do not believe that there is anything to the advantage of the law's development in searching for a liability in tort where the parties are in a contractual relationship. This is particularly so in a commercial relationship. Though it is possible as a matter of legal semantics to conduct an analysis of the rights and duties inherent in some contractual relationships including that of banker and customer either as a matter of contract law when the question will be what, if any, terms are to be implied or as a matter of tort law when the task will be to identify a duty arising from the proximity and character of the relationship between the parties, their Lordships believe it to be correct in principle and necessary for the avoidance of confusion in the law to adhere to the contractual analysis: on principle because it is a relationship in which the parties have, subject to a few exceptions, the right to determine their obligations to each other, and for the avoidance of confusion because different consequences do follow according to whether liability arises from contract or tort, e.g. in the limitation of action.[11]

Notwithstanding the above, the courts still allow claimants to choose whether to sue in contract or tort. Moreover, some liabilities are inherently concurrent, especially in relationships with professionals like solicitors, accountants, and doctors. However, as seen above, the doctrine of privity reigns supreme in third-party liability actions. The doctrine of privity was first established

[7] PS Atiyah, *The Rise and Fall of Freedom of Contract* (Clarendon Press 1979) 762–63
[8] Cases of product defects reflect this situation.
[9] *Bean v Wade* (1885) 2 Times Law Reports 157, 158-9
[10] [1986] AC 80
[11] ibid 107.

in the 1842 English case of *Winterbottom v Wright*.[12] In this case, the plaintiff, a mail coach driver on contract, was injured when the coach collapsed. He sued the coach's repairer, who had a maintenance contract with the coach's owner, for negligence. The court held in "favour of the defendant, stating that there was no privity of contract between the plaintiff and defendant; therefore, no duty flowed to the plaintiff, and no liability existed."[13] The court reasoned that holding the defendant liable outside the realm of contract could open a Pandora's Box of liability:

> 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 operations 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.[14]

In other words, the law assumes that parties in a contract acquire duties and liability from the contract and shields them from liability outside the contract.[15] Therefore, any liability for negligence is to be determined under the principles of the law of contract and is only enforceable by the contracting parties. This principle was reinforced in the case of *Seaver v Ransom* as follows:[16]

> The general rule, both in law and equity was that privity between a plaintiff and a defendant is necessary to the maintenance of an action on contract. The consideration must be furnished by the party to whom the promise was made. The contract cannot be enforced against the third party, and therefore it cannot be enforced by him.[17]

While it is trite that an independent audit is primarily meant to inform the client about the fvinancial health of the company and how well it is performing in its accounting functions, it also serves as an independent source of information from which third parties evaluate their potential

[12] (1842) 152 ER 402
[13] JK Grubbs and JR Ethridge, 'Auditor Negligence Liability to Third Parties Revisited' (2007) 10 *Journal of Legal, Ethical and Regulatory Issues* 75, 79
[14] *Winterbottom v Wright* (1842) 10 M&W 109, 152 ER 402
[15] AF Garrison, 'Common Law Malpractice Liability of Accountants to Third Parties' (1987) 44 *Wash & Lee L Rev* 95, 188 http://scholarlycommons.law.wlu.edu/wlulr/vol44/iss1/101 accessed 12 March 2025.
[16] (1918) 224 NY 233
[17] This decision followed the precedent for applying the doctrine of privity created by the United States Supreme Court's decision in *Savings Bank v Ward* [100 U.S. 195 (1879)]. The case involved an action by a bank that lent money for real estate purchases based on a title report prepared by the defendant's lawyer. The court denied the claim, citing with approval the classic English case of *Winterbottom v Wright* [152 Eng. Rep. 402 (Ex. 1842) for the fear of the "absurd consequences" of indeterminate liability that would ensue if such a plea were to be allowed.

risks.[18] Septimus asserted that the accountant might have no contract with the third party, but his findings influence their decisions and conduct,[19] and thereby make them the obvious victims of a poorly conducted audit.[20] These persons, according to the American Institute of Certified Public Accountants (AICPA),[21] apart from the client, are "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."[22] Moreover, it can be safely asserted that in today's information economy, the public uses independent audits more to evaluate a company's financial stability than by company officers for internal management. The United States Supreme Court judicially recognised this fact in *United States v Arthur Young & Co.*[23] in no equivocal terms. Chief Justice Warren Burger expounded:

> 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 maintains total independence from the client at all times and requires complete fidelity to the public trust.[24]

Notwithstanding the above recognition, the auditor's liability to third parties with no contractual privity remains unsettled. Many persons who suffer loss from the auditor's negligence may still be denied a remedy.[25] With no recourse under contract, third parties who felt that they had been misled by negligent auditing readily sought recourse in the tort of negligence. Unfortunately, the line of judgments regarding auditors' liability in the United States found mere negligence insufficient to warrant recovery for damages from auditors for performing their professional responsibilities.[26]

[18] SJ Septimus, 'Accountants' Liability for Negligence—A Contemporary Approach for a Modern Profession' (1979) 48 *Fordham L Rev* 401, 407 https://ir.lawnet.fordham.edu/flr/vol48/iss3/6/ accessed 10 March 2025.
[19] ibid 407.
[20] JA Siliciano, 'Negligent Accounting and the Limits of Instrumental Tort Reform' (1988) 86 *Mich L Rev* 1929, 342 https://repository.law.umich.edu/mlr/vol86/iss8/4/ accessed 10 March 2025.
[21] American Institute of Certified Public Accountants, *Audit and Accounting Guide: State and Local Governments* (2024 edn, AICPA 2024).
[22] ibid
[23] (1984) 465 U.S. 805
[24] ibid 817.
[25] (n 19) 408.
[26] CR Baker and D Prentice, 'The Origins of Auditor Liability to Third Parties under United States Common Law' (2008) 13 *Accounting History* 163, 164 https://doi.org/10.1177/1032373207088177 accessed 20 March 2025.

As forebears of common law tradition, the United States' courts also kept liability for negligence between parties in privity.

With no duty from the auditor in the absence of privity, the only recourse left for aggrieved third parties was litigation for fraud.[27] However, fraud is also difficult to prove because a higher degree of proof is typically required. Since there is no such thing as an accidental or negligent fraud in law, plaintiffs in a fraud claim must show evidence of intent to deceive on the auditor's part.[28] Thus, the plaintiff has to establish that the auditor knew the audit was in error and did not believe in its contents when submitting the audit report. Swan J elucidated this requirement in the case of *O'Connor v Ludlam:*[29]

> Fraud may be established by showing a false representation has been made either knowingly, or without belief in its truth, or in reckless disregard of whether it be true or false... If they did have that honest belief, whether reasonably or unreasonably, they are not liable. If they did not have an honest belief in the truth, of their statements, they are liable... Further, if the audit made was so superficial as to be only a pretended audit and not a real audit, then the element of knowledge of falsity of their representation is present, and they may be held liable.[30]

For the reason that the greater evidentiary burden they encounter in claims brought under fraud, third-party plaintiffs are drawn more to the tort of negligence as a more viable medium to recover their losses. However, the courts continue to cling to the mindset that negligence per se cannot ground an action for recovery of damages, as reiterated by the Pennsylvania Supreme Court in the case of *Landell v Lybrand*.[31] The case concerns a suit brought against a certified public accounting firm by a third party that had relied on the financial statements they certified. The plaintiff alleged that the financial statements were misleading and relied on them to make his investment. He also charged that the auditors were negligent in performing their duties and, consequently, liable for the loss he sustained. The court found for the accountants, stating the following:

[27] Fraudulent representation by auditors is generally actionable without the necessity of privity.
[28] (n 27) 168, this requirement can also be met by establishing that the audit report was recklessly made with utmost disregard for truth or falsity.
[29] 92 F. 2d 50 (2d Cir. 1937)
[30] ibid 54. Intention to deceive is referred to as scienter in the American legal parlance. "Scienter", on the other hand, has been judicially defined as the "mental state embracing intent to deceive, manipulate, or defraud." See *Ernst & Ernst v Hochfelder,* 425 U.S. 185 (1976) 194.
[31] (1919) 264 PA 406

> There was no contractual relationship between the plaintiff and defendants, and if there is any liability from them to him, it must arise out of some breach of duty, for there is no averment that they made the report with intent to deceive him. The averment in the statement of claim is that the defendants were careless and negligent in making their report, but the plaintiff was a stranger to them and to it, and, as no duly rested upon them to him, they cannot be guilty of any negligence of which he can complain.[32]

Accordingly, the court drew a line of difference between intent to deceive, a necessary ingredient to sustain an action for fraud, and a breach of duty which arises out of contract.[33] The court reasoned that for the plaintiff to prevail, he must show a relationship of privity with the auditor, such that the auditor has a duty imposed by law to act with care towards him. In the absence of such a duty and without proof of fraud, the court concluded that mere negligence does not suffice, even if the plaintiff suffers damage.[34]

With time, the courts began questioning the privity doctrine's rationale. The courts have consistently sidestepped it in negligent acts resulting in physical injury. One such instance was the *locus classicus* of *Heaven v Pender*.[35] In that case, the plaintiff, a painter employed by a painting contractor, was injured when a stage erected by a dock owner collapsed. In an action for damages by the painter, the dock owner cited the principle of *Winterbottom v Wright,*[36] and contended that he owed no duty of care to the painter because his contract was with the ship owner, not the painter. The Court of Appeal, in reversing the Divisional Court and allowing the appeal, observed in a renowned passage by Brett, MR, as follows:

> Whenever one person is by circumstances placed in such a position with regard to another that everyone of ordinary sense who did think would at once recognize that if he did not use ordinary care and skill in his own conduct with regard to those circumstances he would cause danger of injury to the person or property of the other, a duty arises to use ordinary care and skill to avoid such danger.[37]

The first assault on the "citadel of privity" could be traced back to the *Savings Bank v Ward* case.[38] Although the *ratio decidendi* of the case was notorious for importing the privity rule into the U.S.,

[32] ibid

[33] Ordinary negligence means a lack of reasonable care in performing accounting duties. Reasonable implies using the knowledge, skill, and judgment usually possessed by practitioners in similar practice circumstances.

[34] (n 27) 169.

[35] 1883) 11 QBD 503

[36] (1842) 152 ER 402

[37] (1883) 11 QBD 503, 509

[38] 100 U.S. 195 (1879)

in the same judgment, the U.S. Supreme Court made exceptions to privity in "imminently dangerous" acts and in cases involving articles that were inherently dangerous and likely to "put human life in imminent danger."[39] The Supreme Court of Wisconsin put this reasoning into practice in *Smith v Atco Co.,*[40] where the court stated:

> We deem that the time has come for this court to flatly declare that in a tort action for negligence against a manufacturer, or supplier, whether or not privity exists is wholly immaterial. The question of liability should be approached from the standpoint of the standard of care to be exercised by the reasonably prudent person in the shoes of the defendant manufacturer or supplier. Such an approach will eliminate any necessity of determining whether a particular product is "inherently dangerous."[41]

But it was Judge Cardozo's insightful judgment in *Macpherson v Buick Motors Co.,*[42] that finally opened the courthouse doors to persons claiming negligent injury as a separate cause of action. Although liability for negligence that results in physical injury to a person or property soon became a settled law in the United States, the courts have been reluctant to extend this liability to cases of pure economic loss, like negligent misstatements by auditors.

3.0 Liability to Third Parties in the United States

3.1 The Shift Away From Privity: A Historical Perspective

The history of accountant liability in the United States has two crucial periods. In the first period, which coincided with the build-up to the Industrial Revolution and extended through the 1950s, liability restrictions by courts made it almost impossible for third parties to recover their loss for a negligently performed audit. This is unsurprising because a liability restrictive rule was adopted as a general policy for that period. At the onset of the Industrial Revolution, the general concern was that "infant" businesses and manufacturers should not be overburdened with liability.[43] To protect these businesses and manufacturers, the courts devised privity to limit their liability to those who contracted them. As a matter of policy, the courts favoured industrial growth, and the possibility that manufacturers might be forced into bankruptcy outweighed any moral concern to

[39] ibid
[40] (1959) 6 Wis. 2d 371
[41] ibid 383.
[42] (1916) 217 NY 382
[43] (n 19) 412.

compensate every injured consumer.[44] As Friedman argues, "if railroads and enterprises generally had to pay for all damage done 'by accident,' lawsuits could drain them of their economic blood."[45] Consequently, the courts generally held that there should be no interference with the industrialisation process and, where possible, "to limit damages to some moderate measure."[46]

The second period of auditor liability history began in the 1950s, when industrial growth had already taken hold. With the consolidation of the Industrial Revolution, the policy of protecting manufacturers against litigation also diminished.[47] As twentieth-century manufacturing became more sophisticated, consumer safety emerged as a factor to consider when designing a product.[48] Accordingly, the policy consideration in law that defines the court's stance on liability shifted to protecting consumers whose lives were affected by the vast industrial complex.[49] As Septimus points out, "the desire to provide this protection was so great that the new form of liability for unsafe products was a liability without fault, imposed in the form of a warranty implied by law in the sale of goods."[50] In the same sense, Baker and Prentice argue that "changes in legal liability through time have often occurred in response to social and economic conflicts" affecting societies:[51] As William L. Prosser, in his classic tort treatise, observed, "perhaps more than any other branch of the law, the law of torts is a battleground of social theory." Although torts are sometimes perceived as a system of immutable rules, tort remedies are inevitably contested and contestable socio-legal terrain. Our review of the historical waxing and waning of rights and remedies demonstrates that torts have never been and can never be value-neutral. As Mannheim reminded us, all law reflects social and economic interests.[52]

Moreover, the dynamics of the twentieth century were far different from what informed the privity doctrine. As Anderson argues,[53] it was inevitable that this rule of law, formulated before the

---

[44] ibid
[45] (n 27) 167.
[46] ibid
[47] (n 19) 412.
[48] ibid
[49] ibid
[50] ibid. These legislations that had begun as some form of warranty clauses were widely embraced, almost across the board, by all countries. In the case of the U.S., it was incorporated into the *Uniform Commercial Code* (UCC) Article 2, Section 2-314 (1999).
[51] (n 27)
[52] ibid
[53] AP Anderson, 'Accountants' Liability to Third Parties for an Audit' (1968) 52 *Marq L Rev* 158, 161 https://scholarship.law.marquette.edu/mulr/vol52/iss1/8 accessed 20 March 2025

Industrial Revolution, would become subject to exceptions and limitations as the twentieth century was ushered in. Hence, the courts, faced with the necessity to extend the scope of tort law to the needs of the time, did not defraud. They rightly responded by expanding the reach of tort law to embrace new classes of plaintiffs and categories of actions.[54] This revolutionary expansion of liability for negligence under common law is best understood by examining the instrumental reasoning used by courts as a tool for social engineering, as noted by Siliciano:[55]

> In justifying the expansion of liability rules, courts seldom rely primarily on the need to correct some perceived injustice visited on an individual plaintiff by the alleged tortfeasor. Reform instead is frequently defended as a means of furthering broader policy goals, such as creating incentives to encourage risk creators to take optimal levels of care or allocating the costs of accidents to parties better able to shoulder such losses.[56]

In *MacPherson v Buick Motor Co*.,[57] for example, the buyer of a car with a defective wheel brought an action in negligence against the car manufacturer, even though the wheel was built by another party who had a contract with the manufacturer. Cardozo J, went against the then-established legal precedents and enlarged the scope of recovery for negligence to the next level by holding the manufacturer liable. Before this case, an exception to privity was admitted only when the products involved were "inherently dangerous", but Cardozo J broadened the exception to privity to include dangerous products if negligently made. In allowing recovery for the plaintiff, the learned Judge held that a car, when negligently built, was hazardous to the ultimate user. Cardozo's insightful dictum is presented below:

> If the nature of a thing is such that it is reasonably certain to place life and limb in peril when negligently made, it is then a thing of danger. If to the element of danger there is added the knowledge that the thing will be used by persons other than the purchaser, and used without new tests, then, irrespective of contract, the manufacturer of this thing of danger is under a duty to make it carefully.[58]

Six years later, the same Cardozo J imposed liability for economic loss in the first case involving recovering damages for economic loss, *Glanzer v Shepard*.[59] In this case, the seller of beans

[54] DB Dobbs, *The Law of Torts* (West Group 2000) 168.
[55] (n 21)
[56] ibid
[57] (1916) 217 NY 382, legal precedents had previously prevented consumers from recovery of damages unless they bought directly from the manufacturer.
[58] ibid
[59] (N.Y. 1922) 135 N.E. 275

contracted a weigher to certify the weight of the beans. The weigher's certificate, which forms the basis of the contract between the buyer and the seller, was overstated. The buyer instituted this action, asserting negligence on the part of the weigher. Even though the court recognised that the plaintiff was not a party to the contract, it reasoned that the plaintiff was the primary beneficiary of the contract; hence, the weigher owed a duty of care to him. Cardozo J went on to elucidate the concept of 'primary benefit' as follows:

> [T]he plaintiff's use of the certificates was not an indirect or collateral consequence of the action of the weighers.... It was... the end and aim of the transaction.... The defendants held themselves out to the public as skilled and careful in their calling.... In such circumstances, assumption of the task of weighing was the assumption of a duty to weigh carefully for the benefit of all whose conduct was to be governed.[60]

Under this analysis, although there was no contract between the weigher and the buyer because the "end and aim" of the transaction was to provide a service to the buyer, the weigher was held liable. The fact that the contract was not between the plaintiff-buyer and the defendant-weigher was of no consequence if the relationship between the plaintiff and the contracting parties is as close as in this case. The buyer, therefore, can maintain an action against the weigher either for negligent service performance or as a third-party beneficiary of the weigher's contract with the seller. Here, recovery is premised on the relationship between the plaintiff and the parties in contract, an apparent triumph of practical substance over legal form: "equity looks to the substance rather than to the form", as the maxim goes.

3.2 The Return of Privity

The departure from the restrictive notion of privity marked by these cases and the new era of liability-expanding theory of negligence they heralded met with a brick wall in the case of *Ultramares Corp. v Touch, Niven & Co.,*[61] where privity was re-established. Cardozo J declined the opportunity presented by this case to expand tort liability for economic loss. He refused to extend the foreseeability principle of *MacPherson* to financial loss caused by an auditor's neglect, and he also limited *Glanzer's* 'end and aim' concept to cases in which there was a connection between the plaintiff and the defendant that was the "equivalent of privity".[62] In this case, the

[60] ibid 275-276.
[61] (1931) 255 NY 170
[62] ibid 446.

creditor of *Fred Stern & Co.* brought an action against the accounting firm *Touch, Niven & Co.*, which audited the accounts of its then-bankrupt debtor. The creditor claimed it suffered a loss due to reliance on erroneous information in the debtor's financial statement, which the defendants audited. The plaintiff, citing numerous discrepancies in the audit report, argued that the defendants had been negligent and fraudulent in performing the audit.

The Court of Appeal found that the accountants were only guilty of negligence, but because of the lack of a specific contract between the plaintiff and the defendant, no duty of care was owed to the plaintiff. Therefore, no liability ensued on the accountants' part. Cardozo J referred to *Glanzer* in his judgment and distinguished it from *Ultramares*. He reasoned that in *Glanzer*, the plaintiff was not one out of many who may have been recipients of the certificate, but it was the purpose of the contract in the first place. The only foreseen user was the plaintiff, whereas in *Ultramares*, the plaintiff was one of many foreseeable users. Cardozo J held that an accountant could only be liable to the person who hired him. Meanwhile, in terms of privity, it is pertinent to point out that Cardozo did not restrict accountant liability along traditional privity of contract lines or foreclose recovery for those specific persons the auditor knew were recipients who would rely on the information. However, liability will ensue if the auditor's actions constituted fraudulent misrepresentation. The court went on to discuss how the act of fraud might be inferred from a negligent act:

> Our holding does not emancipate accountants from the consequences of fraud. It does not relieve them if their audit has been so negligent as to justify a finding that they had no genuine belief in its adequacy, for this again is fraud. It does no more than say that if less than this is proved, if there has been neither reckless misstatement nor insincere profession of an opinion, but only honest blunder, the ensuing liability for negligence is one that is bounded by the contract, and is to be enforced between the parties by whom the contract has been made. We doubt whether the average business man receiving a certificate without paying for it, and receiving it merely as one among a multitude of possible investors, would look for anything more…[63]

Cardozo J thought that allowing third parties to recover would place an undue burden on the auditor and concluded that:

> To creditors and investors to whom [Stern] exhibited the certificate, the defendants owed a like duty to make it without fraud, since there was notice in the circumstances of its making that the employer did not intend to keep it to himself .... A different question

[63] ibid 188.

> develops when we ask whether they owed a duty to these to make it without negligence. If liability for negligence exists, a thoughtless slip or blunder, the failure to 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.[64]

The policies stated in *Ultramares* set the standard for accountant liability for the next third century. The doctrine outlined in *Ultramares* supports the finding that accountants are not liable to an indeterminate class of individuals who may rely upon the accountant's negligent audit, even if they suffer loss.[65] Over the years, *Ultramares* has been cited in innumerable cases as the landmark decision protecting auditors from third-party suits.[66] The privity doctrine, as articulated in *Ultramares* and extended in *Credit Alliance*, still commands a good following in the United States. Some federal courts apply it,[67] and at least four of the nine states that adopted it have promulgated it into law.[68]

4.0 The Reasonable Foreseeability Standard

For several decades, faithfulness to the privity or near privity doctrine has kept tort law at bay by maintaining accountant liability within the spheres of the law of contract, admitting recovery only where there is privity or a third-party beneficiary relationship.[69] In some cases, there is a 'conduct linking' element.[70] However, by mid-1900, the same forces of progress that forced a retreat from *Winterbottom v. Wright* began questioning the *Ultramares'* position's wisdom.[71] According to Feinman, the series of challenges these forces mounted resulted in many jurisdictions moving

[64] ibid 180.
[65] DF Greene, R Alfonse, RA Petrocine, and CR Fitzpatrick, 'Holding Accountants Accountable: The Liability of Accountants to Third Parties' (2003) 15 *Employee Responsibilities and Rights Journal* 25
[66] BA Daly and JM Gibson, 'The Delineation of Accountants' Legal Liability to Third Parties: Bily and Beyond' (1994) 68 *St John's L Rev* 620
[67] S Vick, 'Bily v Arthur Young & Co: Auditor Liability and Third Party Claims' (1993) 45 *Stanford Law Review* 1234, 1348.
[68] ibid1347.
[69] ER Fencl, 'Rebuilding the Citadel: State Legislative Responses to Accountant Non-Privity Suits' (1989) 67 *Washington University Law Quarterly* 866.
[70] Jay M Feinman, 'Liability of Accountants for Negligent Auditing: Doctrine, Policy, and Ideology' (2003) 31 *Florida State University Law Review* 17.
[71] AP Anderson, 'Accountants' Liability to Third Parties for an Audit' (1968) 52 *Marquette Law Review* 161 http://scholarship.law.marquette.edu/mulr/vol52/iss1/8 accessed 25 March 2025

away from the privity rule in significant respects.[72] One of such cases where similar sentiment was re-echoed was *Carter v. Yardly & Co.,*[73] as reproduced below:

> The time has come for us to recognize that asserted general rule no longer exists. In principle it was unsound. It tended to produce unjust results. It has been abandoned by the great weight of authority elsewhere. We now abandon it in this commonwealth.[74]

The courts then treated these cases as ordinary negligence cases and applied a rule of liability for foreseeable harm, as with defective products. They used this standard to extend an auditor's liability to all those whom the auditor should reasonably foresee as receiving and relying on the audited statement. Liability no longer depends on the accountant's knowledge of the users or the intended class of users of his or her work/product.[75] The most celebrated case on foreseeability in accountant liability is the New Jersey Supreme Court case of *Rosenblum, Inc. v. Adler*.[76] The facts of the case mirrored *Ultramares*. A public accountant again negligently failed to uncover serious errors in the financial statement of another ailing company, this time Giant Stores Corporation. In the wake of the company's bankruptcy, the third-party plaintiff sued the accounting firm for losses suffered as a result of reliance on the firm's audit. The firm defended on privity grounds that the plaintiffs were strangers to the contract between the accounting firm and the audited company. Still, the plaintiffs countered with the analogical argument of audit-as-product. The court took the bait this time, affirming the plaintiffs' grounds. The court argued that since injury resulting from negligent misrepresentation in product defects is generally actionable without regard to privity, there is no basis on which to bar a claim of ordinary negligence for a similar lack of privity.

The New Jersey Supreme Court found on behalf of the plaintiff that the use of financial statements for purposes such as securities offering and corporate acquisitions was foreseen or foreseeable by the defendants, and therefore, they were liable. Moreover, defendants were aware of the merger negotiations. Still, the court found that liability does not depend on the accountant's knowledge of the users or the intended class of users of the report. All that was necessary for imposition of

[72] (n 71) 17.
[73] 319 Mass 92, 64 NE2d 693 (Mass 1946)
[74] ibid 700.
[75] FD Greene, AR Petrocine and RC FitzPatrick, 'Holding Accountants Accountable: The Liability of Accountants to Third Parties' (2003) 15 *Employee Responsibilities and Rights Journal* 23, 27.
[76] 93 NJ 324, 461 A2d 138 (NJ 1983)

liability was that the client, Giant Stores Corporation, used the report for a proper business purpose in the course of which a third party justifiably and foreseeably relied on the report.[77] The Supreme Court of Wisconsin followed *Rosenblum* quickly with its decision in *Citizens State Bank v Timm, Schmidt & Co*.[78] The foreseeability rule enjoyed wide acceptance and was supported by some commentators, who argued that it served important policy objectives such as deterrence and cost spreading.[79] Despite this, only a handful of states, such as New Jersey, Wisconsin, and Mississippi, base recovery for negligence solely on this rule.[80]

5.0 The Restatement Standard

Another way of considering an auditor's duty of care to third parties under common law is the Restatement of Torts approach. A notion of liability to third parties was proposed and incorporated into the Restatement (Second) of Torts, section 552, as a standard for accountant liability. The courts adopted Section 552 as an alternative to the rigid requirement of the *Ultramares* standard and its progeny.[81] By application of the provision of section 522, an auditor does not need to know the specific identity of the lender to be liable to a third-party lender. It would be sufficient if his client informed him that the purpose of the audit is to help obtain a loan. As held, for example, in *Rusch Factors, Inc. v. Levin*,[82] the first case to apply the Restatement standard. The facts of the *Rusch Factors* are as follows: a corporation applied for financing from the plaintiff. The plaintiff requested audited financial statements of the debtor to measure the debtor's financial position. The debtor then engaged the defendant accounting firm, whose audited financial statements "represented the [debtor] to be solvent by a substantial amount. The corporation was insolvent."[83] The court held that although the auditors did not know the plaintiffs, they knew that the audit was meant to help obtain a loan. Hence, they were held liable. The case of *Ryan v Kanne* closely followed the Rusch case,[84] a Supreme Court of Iowa decision also adopted the Restatement standard. In this case, the defendants were employed by a company to prepare a balance sheet to obtain a loan. The balance sheet they prepared showed that the company was solvent when it was

[77] (77) 331.
[78] 113 Wis 2d 376, 335 NW2d 361 (Wis 1983)
[79] (n 68) 1349.
[80] ibid 1348.
[81] JW Zisa, 'Guarding the Guardians: Expanding Auditor Negligence Liability to Third-Party Users of Financial Information' (1989) 11 *Campbell Law Review* 139.
[82] 284 F Supp 85 (D RI 1968).
[83] ibid 86.
[84] 170 N.W.2d 395 (Iowa 1969)

insolvent. In embracing the restatement standard, the court held that the purpose of the defendants' employment was enough to make them liable irrespective of the fact that they did not know the plaintiff.

In adopting this standard, the American Law Institute (ALI) took cognisance of the concern expressed by Cardozo J in *Ultramares.* It reasoned that the foreseeable proposition, where virtually any third party can sue the auditor, could potentially ruin the profession.[85] This prospect, they argued, would lead to a reduction in audit services, which would restrict the flow of information "upon which the operation of the economy rests."[86] Although the *Restatement of Torts* does not constitute US law, it has been adopted by the overwhelming majority of states. The Restatement rule is preferred by its adherents for prescribing a middle-ground between the restrictive privity approach and a possible unlimited liability facilitated by the foreseeability doctrine.

The leading case articulating the application of section 552 is the case of *Bily v Arthur Young & Co*.,[87] where the California Supreme Court overturned the state's prior adoption of the reasonable foreseeability rule in *International Mortgage Co. v John Butler Accountancy Corp*.[88] The *Bily* case arose from the failure of the Osborne Computer Corporation. In early 1983, certain plaintiffs provided direct loans to Osborne or standby letters of credit to secure bank loans. The loans were to have served as short-term financing until Osborne completed an initial public offering. The public offering never occurred, and Osborne filed for bankruptcy in 1983. *Bily* is significant because the court's rejection of the foreseeable user doctrine represents a policy shift away from protecting the rights and expectations of investors, lenders, and the public in favour of a policy that shields accountants from liability to many non-clients. The same decision was reached in the case of *McCamish, Martin, Brown & Loeffler v. F.E. Appling Interests*,[89]where the court applied the Restatement rule for negligent misrepresentation against attorneys, and stated that, "a section 552 cause of action is available only when an attorney transfers information to a known party for a known purpose."[90] In another case, *Tara Capital Partners L.L.P. v. Deloitte & Touche, L.L.P*,[91]

---

[85] Restatement (Second) of Torts section 522, Comment h.
[86] ibid
[87] (n 77)
[88] 177 Cal. App. 3d 806, 223 Cal. Rptr. 218 (1986)
[89] 42 Tex. Sup. Ct. J. 597, 991 S.W.2d 787 (Tex. 1999)
[90] J K Grubbs and J R Ethridge, 'Auditor Negligence Liability to Third Parties Revisited' (2007) 10 *Journal of Legal, Ethical and Regulatory Issues* 75, 86 PDXSCHOLAR+9 accessed 21 March 2025.
[91] WL 1119947 (Tex. App. - Dallas May 20, 2004

the Court of Appeals of Texas in Dallas held that the plaintiffs in this case were not members of an identifiable limited group that auditors were aware of and intended to influence.[92]

The merit of the Restatement rule lies in a middle ground it represented between a closed-door standard of privity and the opened-ended liability of the foreseeability rule. The courts have generally found the privity-based stance of *Ultramares* to be too protective of the public accountants who know the result of their audit will be used to influence specific third parties.[93] At the same time, the foreseeability of the *Rosenblum* is regarded too open-ended to permit accountants reasonably to predict and manage their liability exposure. Restatement standard "balances, more so than other standards, the need to hold public accountants to a standard that accounts for their contemporary role in the financial world with the need to protect them from a liability that unreasonably exceeds the bounds of their real undertaking."[94]

6.0 Conclusion

Auditors' liability to third parties has significantly evolved, as the need to hold auditors accountable and protect them from liability exposure has been recognised. The courts have had to move back and forth between the narrow reach of privity doctrines and the broader coverage of the foreseeability test, from *Ultramares v Touche* to *Credit Alliance v Arthur Andersen.* Since common law applies at the state level, some jurisdictions still maintain limitations on third-party claims. In contrast, others have more inclusive approaches, recognising auditors' crucial role in modern economies. By shifting to foreseeability of harm and misrepresentation under negligence, the courts have duly acknowledged society's demand and expectation of the auditor's responsibility beyond his immediate clients. However, the demand for audit quality must be juxtaposed with defined legal standards to prevent a burden that would unduly overburden the profession. Nonetheless, with the strength and continued growth of the accounting profession and the varied services they provide, which sometimes conflict with their auditing role, litigants are bound to stretch the limits of auditors' liability.

[92] (n 91) 85.
[93] (n 20) 349.
[94] ibid