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INTRODUCTION

In recent years, there has been a trend toward increased legal liability of certified public accountants, particularly in the audit role.[1] This recent development in auditor liability law is significant to both lawyers and accountants.[2] The premise of this article is the evaluation of a series of important court decisions from the perspectives of the accounting and legal professions, and an attempt to forge shared views of the reasons for and

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1 The "Big Six" accounting firms reported to the Securities and Exchange Commissions that their collective total costs for legal judgments, settlements, and costs were $367 million, $487 million, and $783 million for 1990, 1991, and 1992 respectively. SAINT PAUL PIONEER PRESS, Nov. 1993, at 41. The nation's seventh largest accounting firm went bankrupt at the end of the 1980's due to malpractice judgments, settlements, and costs. *Id.* at 42. But *see* Kimberly Reeves, *Accountants Call for Tort Reform to Limit Damages and Liability*, HOUSTON BUS. J. 52 (1993) (stating that almost ninety percent of the total costs were from settled cases).

Claims against small firms during the 1980's and into the 1990's are different. Most of the smaller firms are insured under the AICPA's malpractice insurance plan. During the years from 1982 to 1992, the number of claims ranged between five and seven percent of the total number of policies covered by the plan. The total number of policies fluctuated much more significantly from a starting figure in 1982 of 10,865, to a high of 15,553 in 1985, to a low of 9,441 in 1990, and ended in 1992 with 10,352. Furthermore, approximately 24.2% of the total number of claims arose from audit engagements which accounted for 32% of the claim dollars paid. Hence, audits ran a close second to tax engagements (25.6%) and ahead of review engagements (19.6%) as a potential source of malpractice claims, *Here's How Florida Stacks Up*, FLORIDA CPA TODAY, Nov. 1993, at 10. *See infra* note 14 [discussing comparative (by firm size) increases in malpractice insurance costs over the same period~.

See Emily Couric, *The Tangled Web*, 79 A.B.A.J. 65 (1993) (noting that all of the largest malpractice claims against attorneys have occurred in the last seven years, including fourteen settlements of $20 million or more). *But see* David M. Trubek, et. al., *The Costs ofency of litigation must use as a baseline, the number of opportunities to use the courts). See also infra* note 161.

2 MARC J. EPSTEIN & ALBERT D. SPALDING, THE ACCOUNTANT'S GUIDE TO LEGAL LIABILITY AND ETHICS (1993)(suggesting that recent increases in malpractice claims against accountants places the entire profession at risk). *See* Couric, *supra* note 1 (discussing the increase in legal malpractice as following the wave of lawsuits against other professionals and finding a direct link between the increase in third party lawsuits against accountants and the subsequent increase of such non-client lawsuits against lawyers).

significance of the outcome of these decisions.[3] This article focuses on common law auditor liability decisions of the state courts of last resort made since 1980.[4]

The cases in this study were selected for many reasons. First, all decisions involve lawsuits filed against auditors that reached at least one state appellate court since 1980. These cases involve the common law legal standard of auditor liability.[5] Second, this standard of liability is primarily developed by the states' appellate courts, predominantly by the states' "supreme" courts.[6] Finally, this study focuses on state supreme courts' decisions because of their importance as precedent.[7] Courts and

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[3] Gary Lawson and Tamara Mattison, *A Tale of Two Professions: The Third-Party Liability of Accountants and Attorneys for Negligent Misrepresentation*, 52 OHIO ST. L.J. 1309 (1991) (written by two authors when one was an attorney and the other a Certified Public Accountant). This article does not cite secondary sources written about auditor liability where the authors belong to only one profession, or those in which one or more of the authors is both a lawyer and an accountant because it is very difficult for one person to bring the perspectives and interests of each profession to the analysis of auditor liability. *See infra* note 161 and accompanying text (discussing the need for cooperative efforts between accountants and lawyers).

[4] *See infra* notes 21-22 and accompanying text. The cases in this study were selected by use of the WESTLAW legal data base. The WESTLAW system purports to identify all the reported decisions with respect to a subject matter heading. The subject researched was "Accountants". The search performed was a "Key Number Search". Key numbers are organized to focus on specific issues within a subject, and again purport to identify all reported cases which contain a discussion of the specific sub-topic. In this study, the Key Numbers studied under the heading "Accountants" were Keys 8-11. Specific sub-topics of these keys include "duties and liabilities" (#8), "duties and liabilities to third persons" (#9), "Actions" (#10), and "Damages" (#11). The final search of these key numbers for this study was completed at the end of September 1994. Only those cases located under these key numbers which contained evidence that an audit or its equivalent was the accounting engagement that became the basis of the plaintiff's claim were included in the study.

[5] The authors decided to exclude from this study all decisions made by the federal trial and appeal courts because when these courts sit in diversity and decide important common law development issues, they certify the question to the state supreme court. *See* Badische Corp. v. Caylor, 356 S.E.2d 198 (Ga. 1987).

[6] A few states such as New York and Kentucky do not title their highest court as the "supreme court," this article will use "Supreme Court(s)" to refer to all states highest court(s).

[7] Lawrence Baum & Bradley C. Canon, *State Supreme Courts as Activists: New Doctrines in the Law of Torts*, STATE SUPREME COURTS: POLICYMAKERS IN THE FEDERAL SYSTEM, 83 (M. Porter & G. Tarr eds., 1982) (discussing an empirical study of state supreme courts that concluded that the creation and greater authority given to intermediate state appellate courts freed the state supreme courts to be more selective in the cases they hear, and hence play an even greater role in policymaking). *See also,* Robert A. Kagan et al., *The Business of State Supreme Courts, 1870-1970*, 30 STANFORD L. REV. 121, 142-145 (1977); Note, *Courting Reversal: The Supervisory Role of State Supreme Courts*, 87 YALE L.J. 1191 (1978); Mary C. Porter & G. Alan Taar, Introduction to STATE SUPREME COURTS: POLICYMAKERS in the FEDERAL SYSTEM (Mary C. Porter & G. Alan Tarr eds., 1982); and Robert F. Williams, *State Constitutional Law Processes*, 24 WM. & MARY L. REV. 169, 207 (1983). See also, Security Pacific

commentators have acknowledged this superior precedential role of state supreme courts' decisions.[8] However, some accounting and legal literature has treated all court decisions as being fungible.[9]

A total of thirty-three state supreme court decisions, made by twenty-two state supreme courts, will be evaluated with respect to accounting and legal professions' perspectives.[10] In addition, a total of sixteen state intermediate appellate opinions, representing five new states, and client plaintiff cases from Florida will be analyzed.[11] This article evaluates and identifies those jurisdictions which decided at least a majority of their decisions in favor of auditors, and those which decided at least a majority of their decisions in favor of plaintiffs.[12]

The accounting and legal professions examine these cases from different perspectives. Auditors look to the significance and difficulty of the work performed by the accountants.[13] A second key accounting perspective is that

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Business Credit, Inc. v. Peat Marwick Main & Co., 597 N.E.2d 1080, 1087 (N.Y., 1992), a case in this study, for a state supreme court's view of the relative insignificance of lower federal court opinions as precedent with respect to a state substantive law doctrine crafted by a state supreme court.

[8] Lincoln Grain, Inc. v. Coopers & Lybrand, 345 N.W.2d 300, 309 (Neb. 1984). See Courting Reversal, supra note 7 at 1191 (ns. 1 and 2 and authority cited therein), and at 1202 (suggesting that at least as measured by likelihood of reversal by the state's highest court, the precedent value of intermediate appellate and trial court decisions were fungible).

[9] Joey D. Duke, *Accountant's Liability to Third Parties for Negligent Misrepresentation: Should There Be a Uniform Standard*, 14 AM. J. TRIAL. ADVOC. 133 (1990) (giving equal status to a California intermediate decision in establishing the standard of care that audit firms owe third parties as the decisions of the New York Court of Appeals); Mark H. Fink, *Third-Party Liability of Public Accountants*, 71 MICH. BUS. J. 1286, 1287 (1992). *See also* Annotation, *Liability of Public Accountant to Third Parties*, 46 A.L.R.3d 979, 1005 (1972)and Annotation, *Accountant's Malpractice Liability to Clients*, 92 A.L.R.3d 396 (1979). (Both providing an example that legal precedent is fungible at all levels).
See KENT E. ST. PIERRE, AUDITOR RISK AND LEGAL LIABILITY, 25-27 (1982)(providing an example of an accounting publication that treats precedent as being fungible).

[10] *See infra* notes 21, and 35-37 and accompanying text. It was not always clear in evaluating cases for inclusion in this study, even when the appellate court asserted that an audit was involved in the lawsuit, that an audit engagement was material to the asserted claim, *see, e.g.*, Mid-American Bank & Trust Co. v. Harrison, 851 S.W.2d 563, 563-64 (Mo. Ct. App. 1993). These somewhat doubtful cases were nevertheless included in the study. *See also* discussion infra note 129.

[11] *See infra* note 38.

[12] *See infra* notes 49-54 and accompanying text.

[13] In a recent survey, most of the 2000 responding accounting firms identified keeping up with regulations and standards as their greatest current professional challenge, *Standards Overload #1 Problem*, 16 PUBLIC ACCOUNTING REPORT 21, 1(Nov. 1992). HBJ Miller "GAAP Guide or 1993 identifies several levels of self-regulation sources that a competent auditor must know and apply: Generally Accepted Auditing Standards ["GAAS"~; Statements on Auditing Standard; Audit Interpretations (A.I.) of "GAAS"; Statements on Quality Control Standards (SQCS); Industry Audit Guides; Statements of Positions of The Auditing Standards Division (clarifying Industry Audit Guides); the Code of Professional Responsibility;

most auditors are keenly aware that the cost of their malpractice insurance has significantly increased since 1980, which is primarily attributable to the increased possibility that a lawsuit could be filed against them for alleged failure to properly perform an audit engagement.[14]

The legal community, on the other hand, views case law from a different perspective. Lawyers view complex issues such as the proper auditor liability standard as one of interest identification, evaluation, and accommodation.[15] They are interested in the legal standards that treat similar interests in the same manner, especially when the interests being compared include those of members of the legal profession.[16] One of the concerns with auditor liability

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and Notices to Practitioners. The Guide indicates that with the exception of the Notice to Practitioners, these other self-regulation sources are "authoritative" as they have been approved by the American Institute of Certified Public Accountants (AICPA).

In addition, an audit engagement requires that the audit firm keep abreast of and apply Generally Accepted Accounting Principles (GAAP) to the financial activity of the client for the period in question, and report on whether the client's actions are in conformity with GAAP. A GAAS standard (SAS 52), for example, makes direct reference to GAAP, and identifies for auditors and directs them to follow a hierarchy of GAAP standards. *See* also Epstein and Spaulding, *supra* note 2, at 125 (identifying the complexity and resulting difficulty for auditors with respect to this intricate self-regulation scheme).

The depth of auditor self-regulation standards is in sharp contrast to the scant self-regulation standards for the legal profession with respect to providing authoritative guidance on the quality of lawyering. *But see* discussion *infra* note 69.

[14] Since the mid 1980's liability insurance costs for the "Big Six" accounting firms have increased tenfold. For other large firms of fifty or more CPAs, costs have increased threefold, and for smaller firms, they have doubled. Robert Mednick, *Liability Crisis Update*, 8 NEW ACCOUNTANT, Nov./Dec. 1992, at 30. *See also CPA Insurance Soars as Claims Take-Off*, v.16 #15, Aug. 1992, at 2-3 and *For the Record: "Big Six Respond to the Liability Crisis*, 6 ACCOUNTING TODAY, Sept. 1992, at 3.

With respect to the parallel escalation in lawyer malpractice insurance costs during the 1980's, *see* Couric, *supra* note 1 (asserting without reference to sources that legal malpractice premiums increased at an annual rate of one hundred to three hundred percent during the mid-1980's).

[15] In *Estin v. Estin*, 334 U.S. 541, 545 (1948), Justice Douglas quoted (from *In re Tache*, 37 S.E.C. 629, 671 (1957) that "...few areas of the law are in black or white. The grays are dominant and even among them the shades are innumerable. For the eternal problem of the law is one of making accommodations between conflicting interests." One of the decisions studied herein evaluated the role of the auditor as an "arbiter, interpreter, and umpire among all of the varied interests" who use the audit firms' work product. H. Rosenblum Inc. v. Adler, 461 A.2d 138, 150 (N.J. 1983).

[16] "Formal Justice" requires equal application of principles and institutions to classes defined by them. JOHN RAWLS, A THEORY OF JUSTICE, 58 (1971). Section 299A of the RESTATEMENT (SECOND) OF TORTS provides that all professionals are required to adhere to the same general standard: to perform professional services with the same training, knowledge, and skill as that possessed by members of that profession in good standing. Constance F. Fain, *5 Professional Liability*, PERSONAL INJURY: ACTIONS, DEFENSES, DAMAGES, at 48 (1991). *But see supra* note 13 (providing a reason why the auditor's burden under this general standard may be significantly more onerous.

decisions is whether malpractice standards for auditors are the same as malpractice standards for lawyers and other professionals.[17]

Part one of this study restates how auditors fared in the state supreme courts and selected state intermediate courts from 1980-1994, and then explores reasons for these outcomes suggested by the accounting and legal literature.[18] In Part two, there is a return to the key accounting and legal professions' perspectives discussed in the proceeding paragraphs.[19] This part identifies lessons that the accounting and legal communities may draw from these decisions. The article concludes by identifying future research questions concerning auditor common law liability, including those questions most likely to be of continuing significance to accountants and lawyers in the twenty-first century.[20]

Part One - Auditor Liability: Restating And Explaining The Outcomes of State Supreme Courts And Selected Intermediate State Court Decisions 1980-1994

A. Outcome Restatement

Twenty-two state supreme courts made thirty-three auditor common law liability decisions during the period 1980-94.[21] There have been more state

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17 *See infra* notes 139-40 and accompanying text.

18 *See infra* notes 21-110 and accompanying text.

19 *See infra* notes 111-140 and accompanying text.

20 *See infra* notes 141-161 and accompanying text.

21 Colonial Bank of Ala. v. Ridley & Schweigert, 551 So. 2d 390 (Ala. 1989) (audit firm wins against third party plaintiff); Blumberg v. Touche Ross & Co., 514 So. 2d 922 (Ala. 1987) (client wins against audit firm); Bily v. Arthur Young & Co., 834 P.2d 745 (Cal. 1992) (audit firm wins against third party); First Fla. Bank v. Max Mitchell & Co., 558 So. 2d 9 (Fla. 1990) (third party plaintiff wins against auditor); Badische Corp. v. Caylor, 356 S.E.2d 198 (Ga. 1987) (auditor wins against third party plaintiff); Idaho Bank & Trust Co. v. First Bankcorp of Idaho, 772 P.2d 720 (Idaho 1989) (auditor wins against third party plaintiff); Eldred v. McGladrey, Hendrickson & Pullen, 468 N.W.2d 218 (Iowa 1991) (audit firm wins against third party); Pahre v. Auditor of State, 422 N.W.2d 178 (Iowa 1988) (auditor wins against third party plaintiff); Brueck v. Krings, 638 P.2d 904 (Kan. 1982) (auditor wins against third party plaintiff); Jenson v. Touche Ross & Co., 335 N.W.2d 720 (Minn. 1983) (auditor wins against third party plaintiff); Touche Ross & Co. v. Commercial Union Ins. Co., 514 So. 2d 315 (Miss. 1987) (auditor wins against third party plaintiff); Thayer v. Hicks, 793 P.2d 784 (Mont. 1990) (third party wins against audit firm); St. Paul Fire & Marine Ins. Co. v. Touche Ross & Co., 452 N.W.2d 746 (Neb. 1990) (third party wins against audit firm); Lincoln Grain, Inc. v. Coopers & Lybrand, 345 N.W.2d 300 (Neb. 1984) (client wins against auditor); Demetracopoulos v. Wilson, 640 A.2d 279 (N.H. 1994) (audit firm wins against third party); Levine v. Wiss & Co., 478 A.2d 397 (N.J. 1984) (client wins against auditor); H. Rosenblum Inc. v. Adler, 461 A.2d 138 (N.J. 1983) (third party plaintiff wins against auditor); Security Pac. Bus. Credit, Inc. v. Peat

supreme court decisions with respect to auditor liability in this period than during the first eighty years of the twentieth century.[22] State supreme courts

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Marwick Main & Co., 597 N.E.2d 1080 (N.Y. 1992) (audit firm wins against third party); Westpac Banking Corp. v. Deschamps, 484 N.E.2d 1351 (N.Y. 1985) (auditor wins against third party plaintiff); Credit Alliance Corp. v. Arto., 483 N.E.2d 110 (N.Y. 1985) (auditor wins against third party plaintiff); European American Bank & Trust Co. v. Strauhs & Kaye, Etc., 483 N.E.2d 110 (N.Y., 1985)(separate case consolidated for appeal with Credit Alliance, decided same day with Credit Alliance, hence with same citation, but with a different result - third party plaintiff wins against auditor); Raritan River Steel Co. v. Cherry, 367 S.E.2d 609 (N.C. 1988) (third party plaintiff wins against auditor); Grant Thorton v. Windsor House, Inc., 566 N.E.2d 1220 (Ohio 1991) (audit firm wins against third party, but this time third party was the entity audited. Client was state government agency, paying for audits to scrutinize entity compliance with government payment regulations); Investors Reit One v. Jacobs, 546 N.E.2d 206 (Ohio 1989) (client wins on two causes of action, but auditor wins on other cause of action); Haddon View Inv. Co. v. Coopers & Lybrand, 436 N.E.2d 212 (Ohio 1982) (third party plaintiff wins against auditor); United States Nat'l Bank of Or. v. Fought, 630 P.2d 337 (Or. 1981) (third party plaintiff wins against auditor); First Nat'l Bank of Minneapolis v. Kehn Ranch, Inc., 394 N.W.2d 709 (S.D. 1986) (auditor wins against third party plaintiff); Bethlehem Steel Corp. v. Ernst & Whinney, 822 S.W.2d 592 (Tenn. 1991) (third party wins against audit firm); Ward v. Ernst & Young, 435 S.E.2d 628 (Va. 1993) (third party plaintiff wins against audit firm); Seaward Int'l, Inc. v. Price Waterhouse, 391 S.E.2d 283 (Va. 1990) (audit firm wins against client); First Nat'l Bank of Bluefield v.Crawford, 386 S.E.2d 310 (W. Va. 1989) (third party plaintiff wins against auditor); Imark Indus., Inc. v. Arthur Young & Co., 436 N.W.2d 311 (Wis. 1989) (third party plaintiff wins against auditor); Citizens State Bank v. Timm., Schmidt & Co., 335 N.W.2d 361 (Wis. 1983) (third party plaintiff wins against auditor).

[22] The bases for selecting these pre-1980 audit liability cases is explained, supra note 4. Flagg v. Seng, 60 P.2d 1004 (Cal. Ct. App. 1936) (audit firm wins against client); Canaveral Capital Corp. v. Bruce, 214 So. 2d 505 (3d DCA 1968) (audit firm wins against third party); Dantzler Lumber & Export Co. v. Columbia Casualty Co., 156 So. 116 (Fla. 1934); Cereal Byproducts Co. v. Hall, 132 N.E.2d 27 (Ill. App. Ct. 1956) (client wins against audit firm); Ryan v. Kanne, 170 N.W.2d 395 (Iowa 1969) (third party plaintiff wins against audit firm); Board of County Comm'r of Allen County v. Baker, 102 P.2d 1006 (Kan. 1940) (client wins against audit firm); Ronaldson v. Moss Watkins Inc., 127 So. 467 (La. App. 1930) (client wins against audit firm); Gammel v. Ernst & Ernst, 72 N.W.2d 364 (Minn. 1954) (client wins against audit firm); City of East Grand Folks v. Steele; 141 NW 181 (Minn. 1913) (client wins against audit firm); Fidelity & Deposit Co. of Md. v. Atherton, 144 P.2d 157 (N. M. 1943) (audit firm wins against client); 1136 Tenants Corp. v. Max Rothenberg & Co., 36 A. D. 2d 804, 319 N.Y.S.2d 1007, *aff'd.* 281 N.E.2d 846 (App. Div. 1971) (client wins against audit firm); Duro Sportswear Inc. v Cogen, 131 N.Y.S.2d 20, 132 N.Y.S.2d 51, *aff'd.* 285 A. D. 867, 137 N.Y.S.2d 829 (1954) (audit firm wins against client); National Sur. Corp. v. Lybrand, 256 A. D. 226, 9 N.Y.S.2d 554 (App. Div. 1939) (client wins against audit firm); State St. Trust Co. v. Ernst, 16 N.E.2d 851 (N.Y. 1938) (audit firm wins against third party); Ultramares Corp. v. Touche, 174 N.E. 441 (N.Y. 1931) (audit firm wins against third party); Craig v. Anyon, 212 A. D. 55, 208 N.Y.S.2d 259, *aff'd.* 152 N.E. 431 (A. D. 1925) (client wins against audit firm); Beardsley v. Ernst, 191 N.E. 808 (Ohio Ct. App. 1934) (audit firm wins against third party); Landell v. Lybrand, 107 A. 783 (Pa. 1919) (audit firm wins against third party); Delmar Vineyard v. Timmons, 486 S.W.2d 914 (Tenn. Ct. App. 1972) (audit firm wins against client); Shatterproof Glass Cov. App. 1971) (third party plaintiff wins against audit firm); American Indem. Co. v. Ernst & Ernst, 106 S.W.2d 763 (Tex. Civ. App. 1937) (audit firm wins against third party).

See also Kagan, et. al. State Supreme Courts, supra note 7, at 142, documenting the one hundred year trend of common law tort doctrine cases becoming in ever increasing percentage of the decisions of state

rendered only one favorable decision to an audit firm during the period from 1980 through 1994, where the firm was being sued by its own client.[23] However, such courts rendered favorable decisions to the auditors' clients in four decisions during this same period.[24]

State supreme courts rendered decisions, during the period 1980-94, favorable to auditors in fifteen decisions when a third party was the plaintiff.[25] State supreme courts rendered decisions favorable to third party plaintiffs in thirteen decisions during this period.[26] Overall state supreme courts rendered decisions between 1980-94 favorable to auditors in sixteen decisions, and favorable to plaintiffs in seventeen decisions.

The state supreme courts of Alabama[27], Iowa[28], Nebraska[29], New Jersey[30], New York[31], Ohio[32], Virginia[33], and Wisconsin[34] have made multiple

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supreme courts; and Id. at 145, specifically noting that despite their prominence, a combination of products liability and all forms of malpractice cases had increased from only .5 to 1.6 percent of all state supreme court decisions when 1920-50 decisions were compared to 1955-70 decisions.

[23] *Seaward Int'l, Inc.*, 391 S.E.2d 283.

[24] *Blumberg*, 514 So. 2d 922; *Lincoln Grain, Inc.*, 345 N.W.2d 300; *Levine*, 478 A.2d 397; *Investors Reit One*, 546 N.E.2d 206 (decision favorable to plaintiffs on two causes of action, while favorable to defendant auditor on only one cause of action).

[25] *Colonial Bank of Ala.*, 551 So. 2d at 390; *Bily*, 834 P.2d 745; *Badische Corp.*, 356 S.E.2d at 198; *Idaho Bank & Trust Co.*, 772 P.2d 720; *Eldred*, 468 N.W.2d 218; *Pahre*, 422 N.W.2d 178; *Brueck*, 638 P.2d 904; *Jenson*, 335 N.W.2d 720; *Touche Ross & Co.*, 514 So. 2d 315; *Demetracopoulos*, 640 A.2d 279; *Security Pac. Bus. Credit, Inc.*, 597 N.E.2d 1080; *Westpac Banking Corp*, 484 N.E.2d 1351; *Credit Alliance Corp.*, 483 N.E.2d 110; *Grant Thorton*, 566 N.E.2d 1220; *First Nat'l Bank of Minneapolis.*, 394 N.W.2d 709.

[26] *First Fla. Bank*, 558 So. 2d 9; *Thayer*, 793 P.2d 784; *St. Paul Fire & Marine Ins. Co.*, 452 N.W.2d 746; *H. Rosenblum Inc.*, 461 A.2d 138; *European American Bank & Trust Co., v. Strauhs & Kaye, Etc.*, 483 N.E.2d 110 (N.Y., 1985)(separate case consolidated for appeal with Credit Alliance, decided same day with Credit Alliance, hence with same citation, but with a different result - third party plaintiff wins against auditor); *Raritan River Steel Co.*, 367 S.E.2d 609; *Haddon View Inv. Co.*, 436 N.E.2d 212; *United States Nat'l Bank of Or.*, 630 P.2d 337; *Bethlehem Steel Corp.*, 822 S.W.2d 592; *Ward*, 435 S.E.2d 628; *First Nat'l Bank of Bluefield*, 386 S.E.2d 310; *Imark Indus., Inc.*, 436 N.W.2d 311; *Citizens State Bank*, 335 N.W.2d 361.

[27] *Colonial Bank of Ala.*, 551 So. 2d 390; and *Blumberg*, 514 So. 2d 922.

[28] *Eldred*, 468 N.W.2d 218; *Pahre*, 422 N.W.2d 178.

[29] *St. Paul Fire & Marine Ins. Co.*, 452 N.W.2d 746; *Lincoln Grain, Inc.*, 345 N.W.2d 300.

[30] *Levine*, 478 A.2d 397; and *H. Rosenblum Inc.*, 461 A.2d 138.

[31] *Security Pac. Bus. Credit, Inc.*, 597 N.E.2d 1080; *Westpac Banking Corp.*, 484 N.E.2d 1351; *Credit Alliance Corp.*, 483 N.E.2d 110; *European American Bank & Trust Co., v. Strauhs & Kaye, Etc.*, 483 N.E.2d 110 (separate case consolidated for appeal with Credit Alliance, decided same day with Credit Alliance, hence with same citation, but with a different result - third party plaintiff wins against auditor)

[32] *Grant Thorton*, 566 N.E.2d 1220; *Investors Reit One*, 546 N.E.2d 206; and *Haddon View Inv. Co.*, 436 N.E.2d 212.

[33] *Ward*, 435 S.E.2d 628; *Seaward Int'l, Inc.*, 391 S.E.2d 283.

[34] *Imark Indus., Inc.*, 436 N.W.2d 311; and *Citizens State Bank*, 335 N.W.2d 361

decisions. Ten state supreme courts rendered favorable decisions to the defendant auditor in their decisions between 1980-94, or at least in a majority of their auditor liability decisions of this recent period.[35] Ten state supreme courts rendered a decision favorable to the plaintiff in their only decision between 1980-94 or at least in a majority of their auditor liability decisions of this period.[36] The remaining two state supreme courts each made two decisions: one favorable to the auditor, and the other favorable to the plaintiff.[37]

Five additional states, whose state supreme courts made no auditor liability decisions during the period 1980-94, and Florida, whose state supreme court made no client/plaintiff decisions during this period, had state intermediate appellate court(s) make a total of sixteen such decisions.[38]

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[35] Bily v. Arthur Young, 834 P.2d 745 (Cal. 1992); Badische Corp. v. Caylor, 356 S.E.2d 198 (Ga. 1987); Idaho Bank & Trust Co. v. First Bankcorp. of Idaho, 772 P.2d 720 (Idaho 1989); Eldred v. McGladrey, 468 N.W.2d 218 (Iowa 1991); Pahre v. Auditor of State, 422 N.W.2d 178 (Iowa 1988); Brueck v. Krings, 638 P.2d 904 (Kan. 1982); Jenson v. Touche Ross & Co., 335 N.W.2d 720 (Minn. 1983); Touche Ross & Co. v. Commercial Union Ins. Co., 514 So. 2d 315 (Miss. 1987); Demetracopoulos v. Wilson, 640 A.2d 279 (N.H. 1994); Security Pac. Bus. Credit, Inc. v. Peat Marwick Main & Co., 597 N.E.2d 1080 (N.Y. 1992)(audit firm wins against third party); Westpac Banking Corp. v. Deschamps, 484 N.E.2d 1351, (N.Y. 1985)(audit firm wins against third party); Credit Alliance Corp. v. Arthur Anderson, 483 N.E.2d 110 (N.Y. 1985)(audit firm wins against third party); European American Bank & Trust Co. v. Strauhs & Kaye, Etc., 483 N.E.2d 110 (separate case consolidated for appeal with Credit Alliance, decided same day with Credit Alliance, hence with same citation, but with a different result - third party plaintiff wins against auditor); First Nat'l Bank of Minneapolis v. Kehn Ranch, Inc., 394 N.W.2d 709 (S.D. 1986).

[36] First Fla. Bank v. Max Mitchell & Co., 558 So. 2d 9 (Fla. 1990); Thayer v. Hicks, 793 P.2d 784 (Mont. 1990); St. Paul Fire & Marine Ins. Co. v. Touche Ross & Co., 452 N.W.2d 746 (Neb. 1990); Lincoln Grain, Inc. v. Coopers & Lybrand, 345 N.W.2d 300 (Neb. 1984); Levine v. Wiss & Co., 478 A.2d 397 (N.J. 1984); H. Rosenblum Inc. v. Adler, 461 A.2d 138 (N.J. 1983); Raritan River Steel Co. v. Cherry, 367 S.E.2d 609 (N.C. 1988); Grant Thorton v. Windsor House, Inc., 566 N.E.2d 1220 (Ohio 1991)(audit firm wins against third party); Investors Reit One v. Jacobs, 546 N.E.2d 206 (Ohio 1989)(client wins against audit firm); Haddon View Inv. Co. v. Coopers & Lybrand, 436 N.E.2d 212 (Ohio 1982)(third party wins against audit firm); United States Nat'l Bank of Or. v. Fought, 630 P.2d 337 (Or. 1981); Bethlehem Steel Corp. v. Ernst & Whinney, 822 S.W.2d 592 (Tenn. 1991); First Nat'l Bank of Bluefield v. Crawford, 386 S.E.2d 310 (W. Va. 1989); Imark Indus., Inc. v. Arthur Young & Co., 436 N.W.2d 311 (Wis. 1989); Citizens State Bank v. Timm, Schmidt & Co., 335 N.W.2d 361 (Wis. 1983).

[37] Colonial Bank of Ala. v. Ridley & Schweigert, 551 So. 2d 390 (Ala. 1989) (auditor wins against third party plaintiff); Blumberg v. Touche Ross & Co., 514 So. 2d 922 (Ala. 1987) (client wins against firm); Ward v. Ernst & Young, 435 S.E.2d 628 (Va. 1993) (third party plaintiff wins against firm); Seaward Int'l Inc. v. Price Waterhouse, 391 S.E.2d 283 (Va. 1990) (audit firm wins against client).

[38] Hydroculture Inc. v. Coopers & Lybrand, 848 P. 2d 856 (Ariz. Ct. App. 1992); Coopers & Lybrand v. Trustees of the Archdiocese of Miami, 536 So. 2d 278 (Fla. 3d DCA 1989); Devco Premium Fin. Co. v. North River Ins. Co., 450 So. 2d 1216 (Fla. 1st DCA 1984); Holland v. Arthur Anderson, 571 N.E.2d 777 (Ill. App. Ct. 1991), (formerly 127 Ill. App.3d 854, (Ill. App. Ct. 19bbs, 539 N.E.2d 877 (Ill. App. Ct. 1989); Huls v. Clifton, Gunderson & Co., 535 N.E.2d 72 (Ill. App. Ct. 1989); Brumley v. Touche

Decisions favorable to auditors were made in ten of these intermediate opinions, while six decisions were favorable to plaintiffs.[39] Categorizing the outcomes of the intermediate appellate decisions by jurisdiction, results in three jurisdictions rendering a majority of their decisions favorable to the auditors, one jurisdiction where the decisions were favorable to the plaintiffs, while the Illinois and Texas intermediate appellate courts each made four decisions - two favorable decisions to auditors and two favorable to plaintiffs.[40]

Clients as plaintiffs did not fare as well in the intermediate appellate courts as they did in the state supreme courts. In nine of the cases, from five jurisdictions, clients were the plaintiffs.[41] Five of the client-as-plaintiff decisions, from four jurisdictions, were favorable to the auditors.[42] In the other four decisions, from four jurisdictions, the decisions were favorable to

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Ross & Co., 487 N.E.2d 641 (Ill. App. Ct. 1985); Local 1064 v. Ernst & Young, 516 N.W.2d 492 (Mich. Ct. App. 1994); Harper v. Inkster Pub. Schs., 404 N.W.2d 776 (Mich. Ct. App. 1987); Jaffe v. Harris, 338 N.W.2d 228 (Mich. Ct. App. 1983); Mid-American Bank & Trust Co. v. Harrison, 851 S.W.2d 563 (Mo. Ct. App. 1993); Lindner Fund v. Abney, 770 S.W.2d 437 (Mo. Ct. App. 1989); Brown v. KPMG Peat Marwick, 856 S.W.2d 742 (Tex. Ct. App. 1993); University Nat'l Bank v. Ernst & Whinney, 773 S.W.2d 707 (Tex. Ct. App. 1989); Greenstein, Logan & Co. v. Burgess Mrktg. Inc., 744 S.W.2d 170 (Tex. Ct. App. 1987); Blue Bell Inc. v. Peat Marwick, Mitchell, 715 S.W.2d 408 (Tex. Ct. App. 1986).

[39] *Coopers & Lybrand*, 536 So. 2d at 278 (auditor wins against a client's surrogate - trustee in bankruptcy); *Devco Premium Fin. Co.*, 456 So. 2d at 1216 (auditor wins against client); *Holland*, 571 N.E.2d at 777 (audit firm wins second appeal because of the inability of client's successor in interests, the trustee in bankruptcy, to prove that the damage to the client was caused by the wrongdoing of the auditors). *Huls*, 535 N.E.2d at 72 (auditor wins against third party plaintiff); *Harper*, 404 N.W.2d at 776 (auditor wins against third party plaintiff); *Jaffe*, 338 N.W.2d at 228 (auditors win against client partnership); *Mid-American Bank & Trust Co.*, 851 S.W.2d at 563 (audit firm wins against third party plaintiff); *Lindner Fund*, 770 S.W.2d at 437 (auditors win against third party plaintiff); *Brown*, 856 S.W.2d at 742 (audit firm wins against third party plaintiff); *University Nat'l Bank*, 773 S.W.2d at 707 (auditor wins against client). The six decisions favorable to plaintiffs were: *Hydroculture Inc.*, 848 P.2d at 856 (Ariz. Ct. App. 1992) (client wins against audit firm); *First Nat'l Bank*, 539 N.E.2d at 877 (client wins against auditor); *Brumley*, 487 N.E.2d at 641 (third party plaintiff wins against auditor); *Local 1064*, 516 N.W.2d at 492 (client wins against audit firm); *Greenstein, Logan & Co.*, 744 S.W.2d at 170 (client wins against auditor); *Blue Bell Inc.*, 715 S.W.2d at 408 (third party plaintiff wins against auditor).

[40] Florida, Michigan, and Missouri were the three jurisdictions which rendered at least a majority of their intermediate appellate decisions in favor of auditors, while Arizona rendered a decision favorable to plaintiffs. The cases are identified by outcome supra, note 39.

[41] *Hydroculture Inc.*, 848 P.2d at 856; *Coopers & Lybrand*, 536 So. 2d at 278; *Devco Premium Finance Co.*, 450 So. 2d at 216; *Holland*, 571 N.E.2d at 777; *First Nat'l. Bank*, 539 N.E.2d at 877; *Local 1064*, 516 N.W.2d at 492; *Jaffe*, 338 N.W.2d at 228; *University Nat'l Bank*, 773 S.W.2d at 707; *Greenstein, Logan & Co.*, 744 S.W.2d at 170.

[42] *Coopers & Lybrand*, 536 So. 2d at 278; *Devco Premium Finance Co.*, 456 So. 2d at 1216; *Holland*, 571 N.E.2d at 777; *Jaffe*, 338 N.W.2d at 228; *University Nat'l Bank*, 773 S.W.2d at 707.

the clients.[43] When the client as plaintiff state supreme court and intermediate state appellate court cases are combined, court holdings were favorable to auditors in six decisions, whereas appellate courts holdings were favorable to clients in eight decisions.[44]

Similar to client plaintiffs, third party plaintiffs fared worse in state intermediate appellate courts than they did in state supreme courts. In seven of the cases, involving four jurisdictions, third parties were the plaintiffs.[45] The holdings in five cases, from four jurisdictions, were favorable to auditors, whereas there were two decisions from two jurisdictions favorable to the third party plaintiffs.[46] When the third party as plaintiff state supreme court and intermediate appellate court cases are combined, court holdings were favorable to auditors in twenty decisions and favorable to third party plaintiffs in fifteen decisions.[47]

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[43] *Hydroculture Inc.*, 848 P.2d at 856; *First Nat'l Bank*, 539 N.E.2d at 877; *Local 1064*, 516 N.W.2d at 492; *Greenstein, Logan & Co.*, 744 S.W.2d at 170.

[44] *Coopers & Lybrand*, 536 So. 2d at 278; *Devco Premium Finance Co.*, 456 So. 2d at 1216; *Holland*, 571 N.E.2d at 777; *Jaffe*, 338 N.W.2d at 228; *University Nat'l Bank*, 773 S.W.2d at 707; and Seaward Int'l Inc. v. Price Waterhouse, 391 S.E.2d 283 (Va. 1990). Blumberg v. Touche Ross & Co., 514 So. 2d 922 (Ala. 1987); *Hydroculture Inc.*, 848 P.2d at 856; *First Nat'l Bank*, 539 N.E.2d at 877; *Local* 1064, 516 N.W.2d at 492; Lincoln Grain Inc. v. Coopers & Lybrand, 345 N.W.2d 300 (Neb. 1984); Levine v. Wiss & Co., 478 A.2d 397 (N.J. 1984); Investors Reit One v. Jacobs, 546 N.E.2d 206 (Ohio 1989) (auditor prevails in one cause of action out of three); *Greenstein, Logan & Co.*, 744 S.W.2d at 170 (Tex. Ct. App. 1987).

[45] Huls v. Clifton, Gunderson & Co., 535 N.E.2d 72 (Ill. App. Ct. 1989); Brumley, 487 N.E.2d at 641; *Harper v. Inkster Pub. Schs.*, 404 N.W.2d 776 (Mich. Ct. App. 1987); Mid-American Bank & Trust Co. v. Harrison, 851 S.W.2d 563 (Mo. Ct. App. 1993); Lindner Fund v. Abney, 770 S.W.2d 437 (Mo. Ct. App. 1989); Brown v. KPMG Peat Marwick, 856 S.W.2d 742 (Tex. Ct. App. 1993); Blue Bell Inc. v. Peat Marwick Mitchell, 715 S.W.2d 408 (Tex. Ct. App. 1986).

[46] *Huls*, 535 N.E.2d at 72; *Harper*, 404 N.W.2d at 776; *Mid-American Bank & Trust Co.*, 851 S.W.2d at 563; *Lindner Fund*, 770 S.W.2d at 437, *Brown*, 856 S.W.2d at 742. Brumley, 487 N.E.2d at 641; and *Blue Bell Inc.*, 715 S.W.2d at 408.

[47] Colonial Bank of Ala. v. Ridley & Schweigert, 551 So. 2d 390 (Ala. 1989); Bily v. Arthur Young, 834 P.2d 745 (Cal. 1992); Badische Corp. v. Caylor, 356 S.E.2d 198 (Ga. 1987); Idaho Bank & Trust Co. v. First Bankcorp. of Idaho, 772 P.2d 720 (Idaho 1989); *Huls* , 535 N.E.2d at 72; Eldred v. McGladrey, 468 N.W.2d 218 (Iowa 1991); Pahre v. Auditor of State, 422 N.W.2d 178 (Iowa 1988); Brueck v. Krings, 638 P.2d 904 (Kan. 1982); *Harper*, 404 N.W.2d at 776; Jenson v. Touche Ross & Co., 335 N.W.2d 720 (Minn. 1983); Touche Ross & Co. v. Commercial Union Ins. Co., 514 So. 2d 315 (Miss. 1987); *Mid-American Bank & Trust Co.*, 851 S.W.2d at 563; *Lindner Fund*, 770 S.W.2d at 437; Demetracopoulos v. Wilson, 640 A.2d 279 (N.H. 1994); Security Pac. Bus. Credit, Inc. v. Peat Marwick Main & Co., 597 N.E.2d 1080 (N.Y. 1992); Westpac Banking Corp. v. Deschamps, 484 N.E.2d 1351 (N.Y. 1985); Credit Alliance Corp. v. Arthur Anderson, 483 N.E.2d 110 (N.Y. 1985); Grant Thorton v. Windsor House, Inc., 566 N.E.2d 1220 (Ohio 1991); First Nat'l Bank of Minneapolis v. Kehn Ranch, Inc., 394 N.W.2d 709 (S.D. 1986); and *Brown*, 856 S.W.2d at 742. The fifteen decisions favorable to third party plaintiffs were: *First Fla. Bank v. Max Mitchell & Co.*, 558 So. 2d 9 (Fla. 1990); *Brumley*, 487 N.E.2d at 641; Thayer v. Hicks, 793 P.2d 784 (Mont. 1990); St. Paul Fire & Marine Ins. Co. v. Touche Ross & Co.,

When the outcomes of all of the cases in this study are categorized, twenty-six holdings are favorable to the defendant auditors and twenty-three holdings are favorable to the plaintiffs.[48] Twelve jurisdictions made a majority of their decisions in favor of auditors; eleven states made a majority of their decisions in favor of plaintiffs; and four states made an equal number of decisions favorable to both auditors and plaintiffs.[49]

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452 N.W.2d 746 (Neb. 1990); H. Rosenblum Inc. v. Adler, 461 A.2d 138 (N.J. 1983); *European American Bank & Trust Co., v. Strauhs & Kaye, Etc.*, 483 N.E.2d 110 (N.Y., 1985)(separate case consolidated for appeal with Credit Alliance, decided same day with Credit Alliance, hence with same citation, but with a different result - third party plaintiff wins against auditor); Raritan River Steel Co. v. Cherry, 367 S.E.2d 609 (N.C. 1988); Haddon View Inv. Co. v. Coopers & Lybrand, 436 N.E.2d 212 (Ohio 1982); United States Nat'l Bank of Or. v. Fought, 630 P.2d 337 (Or. 1981); Bethlehem Steel Corp. v. Ernst & Whinney, 822 S.W.2d 592 (Tenn. 1991); Blue Bell Inc. v. Peat Marwick, Mitchell, 715 S.W.2d 408 (Tex. Ct. App. 1986); Ward v. Ernst & Young, 435 S.E.2d 628 (Va. 1993); First Nat'l Bank of Bluefield v. Crawford, 386 S.E.2d 310 (W. Va. 1989); Imark Indus. Inc. v. Arthur Young & Co., 436 N.W.2d 311 (Wis. 1989); Citizens State Bank v. Timm, Schmidt & Co., 335 N.W.2d 361 (Wis. 1983).

[48] *Colonial Bank of Ala.*, 551 So. 2d at; *Bily*, 834 P.2d at 745; *Coopers & Lybrand*, 536 So. 2d at 278; *Devco Premium Finance Co.*, 456 So. 2d at 1216; Badische Corp. v. Caylor, 356 S.E.2d 198 (Ga. 1987); *Idaho Bank & Trust Co.*, 772 P.2d at 770; *Holland*, 571 N.E.2d at 777; *Huls*, 535 N.E.2d at 72; *Eldred*, 468 N.W.2d at 218; *Pahre*, 422 N.W.2d at 178; *Brueck*, 638 P.2d at 904; *Harper*, 404 N.W.2d at 776; *Jaffe*, 338 N.W.2d at 228; *Jenson*, 335 N.W.2d at 720; *Touche Ross & Co.*, 514 So. 2d at 315; *Mid-American Bank & Trust Co.*, 851 S.W.2d at 563; Lindner Fund, 770 S.W.2d at 437; *Demetracopoulos*, 640 A.2d at 279; *Security Pac. Bus. Credit, Inc.*, 597 N.E.2d at 1080; *Westpac Banking Corp.*, 484 N.E.2d at 1351; *Credit Alliance Corp.*, 483 N.E.2d at 110; *Grant Thorton*, 566 N.E.2d at 1220; *First Nat'l Bank of Minneapolis*, 394 N.W.2d at 709; *Brown*, 856 S.W.2d at 742; *University Nat'l Bank*, 773 S.W.2d at 707; and *Seaward Int'l, Inc.*, 391 S.E.2d at 283. The twenty-three decisions favorable to plaintiffs were: *Blumberg*, 514 So. 2d at 922; *Hydroculture Inc.*, 848 P.2d at 856; *First Fla. Bank*, 558 So. 2d at 9; *First Nat'l Bank*, 539 N.E.2d at 877; *Brumley*, 487 N.E.2d at 641; *Local 1064*, 516 N.W.2d at 492; *Thayer*, 793 P.2d at 784; *St. Paul Fire & Marine Ins. Co.*, 452 N.W.2d at 746; *Lincoln Grain, Inc.*, 345 N.W.2d at 300; *Levine*, 478 A.2d at 397; *H. Rosenblum Inc.*, 461 A.2d at 138; *European American Bank & Trust Co., v. Strauhs & Kaye, Etc.*, 483 N.E.2d at 110(separate case consolidated for appeal with Credit Alliance, decided same day with Credit Alliance, hence with same citation, but with a different result - third party plaintiff wins against auditor); *Raritan River Steel Co.*, 367 S.E.2d at 609; *Investors Reit One*, 546 N.E.2d at 206; *Haddon View Inv. Co.*, 436 N.E.2d at 212; *United States Nat'l Bank of Or.*, 630 P.2d at 337; *Bethlehem Steel Corp.*, 822 S.W.2d at 592; *Greenstein, Logan & Co.*, 744 S.W.2d at 170; *Blue Bell Inc.*, 715 S.W.2d at 408; *Ward*, 435 S.E.2d at 628; *First Nat'l Bank of Bluefield*, 386 S.E.2d at 310; *Imark Indus. Inc.*, 436 N.W.2d at 311; *Citizens State Bank*, 335 N.W.2d at 361.

[49] The twelve jurisdictions making at least a majority of its 1980-94 appellate decisions in favor of auditors were (unless specifically indicated decisions are those of the state supreme court): California, Georgia, Idaho, Iowa, Kansas, Michigan (intermediate appellate decisions), Minnesota, Mississippi, Missouri (intermediate appellate opinions), New York, New Hampshire, and South Dakota. *See supra* notes 35 and 40 and accompanying text for list of cases by jurisdictional outcome.

Florida intermediate appellate courts made two decisions in client/plaintiff cases, both in favor of the audit firm. But because the Florida Supreme Court in a decision involving a third party made a decision favorable to that plaintiff, it is misleading to count Florida twice, and on both side of this overall jurisdiction/state count.

B. The Outcomes: Perspectives on "Favorable" and on the Case and Jurisdictional Alignment

In deciding whether a decision was "favorable" to the auditor or the plaintiff in this study, the analysis began by focusing on the "appeal posture" of the case. The concept of appeal posture used to guide the reported findings included examining the decision of the state supreme court in light of whether the auditor or plaintiff received a favorable trial decision, and how that trial outcome was changed, if at all, by the intermediate state appellate court.[50] Appeal posture included the identification of the specific "grounds for error" argued to the appellate court by one or both sides of these cases, and which alleged errors were found to be error by the appeals court.[51]

The eleven jurisdictions making at least a majority of its 1980-94 appellate decisions in favor of plaintiffs were: Arizona, Florida (state supreme court's only decision was in favor of third party plaintiff), Montana, Nebraska, New Jersey, North Carolina, Ohio, Oregon, Tennessee, West Virginia, and Wisconsin. *See supra* notes 36,40 and accompanying text for list of cases by jurisdictional outcome. The four states with an equal number of decisions favoring audit firms and plaintiffs were: Alabama, Illinois (intermediate appellate opinions), Texas (intermediate appellate opinions), and Virginia. *See supra* notes 33, 36 and accompanying text for list of cases by jurisdictional outcome.

[50] *See Courting Reversal, supra* note 7, at 1196-97 (identifying a set of variables by which to measure success on appeal); *See* Stanton Wheeler, et. al., *Do The Haves Come Out Ahead? Winning and Losing in State Supreme Courts, 1870-1970*, 21 LAW & SOC. REV. 403, 406 (1987)(Empirical study documenting and asserting the general tendency of state appeals courts to affirm lower courts. In the one-hundred year period of the study, the sixteen state supreme courts studied affirmed in approximately sixty percent (60%) of the cases they collectively reviewed). The controversial nature of auditor liability standards and their application is demonstrated by the fact that in the thirty-three auditor malpractice decisions by state supreme courts reviewed in this study, the twenty-two courts reversed in approximately two-thirds of the cases.

See, e.g., Investors Reit One, 546 N.E.2d at 206 (providing an example of the difficulty of characterizing a decision as favorable because two causes of action were decided in favor of the plaintiff and one was decided favorably for the defendant).; *See, e.g., Ward*, 435 S.E.2d at 630 (providing another example of the difficulty of characterization as the court ruled in favor of the audit firm concerning the controversial third party duty issue, but reversed the lower court rejection of the possibility that this plaintiff could recover on a third party beneficiary contract claim).

[51] *See Courting Reversal, supra* note 7, at 1207-09 (evaluating with three gross variables [constitutional, substantive, procedural issues~ whether the nature of the issue on appeal affected the overall results in the more than 5000 state supreme court decisions (1870-1970) evaluated in the study. Finding that the mere presence of a constitutional issue did not significantly impact the probability that the studied state supreme courts would reverse, but that there was more likelihood that these state supreme courts would reverse a purely procedural issue rather than a substantive issue. In the forty-nine auditor malpractice cases in this study, none of the appeals were based significantly on constitutional issues, approximately fifteen percent of the appeals focused on application of the statute of limitations and other procedural issues, and in the remaining cases the primary point of contention between the parties on appeal

"Favorable" was also determined by evaluating the significant facts found by appellate courts, and the influence these facts had on the court's decision.[52] "Favorable" was also defined by examining which legal doctrines each party requested the court to accept.[53] Moreover, "favorable" was defined by examining which auditor or plaintiff interests were protected or subordinated by the appellate court decisions.[54]

It is important to use such a multiple-factor evaluation in determining if a decision is "favorable" to auditors or to plaintiffs. In assessing the impact on interests, for example, only one of the state supreme court studied and only one of the selected state court intermediate opinions included an affirmance of a money award against a defendant auditor.[55] Auditors who were involved in cases that were eventually appealed and heard in state appellate courts by the plaintiff and/or the auditor had their litigation costs significantly increased by the lengthy appellate process.[56] However, only two of these defendant auditors had to pay the plaintiff, after several years, at least at the end of round one (in a few cases round two) of the state appellate process.[57]

The greatest significance of these outcomes for both the accounting and legal professions is the close split in the outcomes of the decisions. This near split, a twenty-six to twenty-three difference, and a slight twelve-eleven-three edge for auditors when the cases are aligned by jurisdictions, is an example of a pattern of what commentators have called the "diffusion" of a significant

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was substantive doctrine. In a substantial majority of the procedural cases, the appellate court reversed, and because the appropriate substantive doctrine was highly controversial during this decade, see infra notes 77-105 and accompanying text, reversal occurred in a majority of these cases.

[52] For well known discussions of the identification of legally significant facts by appellate courts, and their influence on the appeal outcome, *see* KARL N. LLEWELLYN, THE BRAMBLE BUSH: ON OUR LAW AND ITS STUDY, 42-52, 58-69 (1960), and RUGGERO J. ALDISERT, LOGIC FOR LAWYERS - A GUIDE TO CLEAR LEGAL THINKING, 226-229 (1989). For a good example, of the impact of the identification of a legally significant fact on the outcome of one of the auditor malpractice appeals evaluated in this study, see discussion infra, notes 118-122 and accompanying text.

[53] *See infra* notes 102-04, 109 and accompanying text.

[54] *See supra* note 15 and accompanying text, with respect to the reason why "interest analysis" was a component of the assessment of "favorable."

[55] Thayer v. Hicks, 793 P.2d. 784 (Mont. 1990) (the court upheld the basic damage award of over $300,000 against the audit firm, but remanded because of improper award of prejudgment interests). *See also* Greenstein, Logan & Co. v. Burgess Marketing Inc., 744 S.W.2d 170 (Tex. Ct. App. 1987) (client wins and appellate court affirms three million dollar judgment against auditor).

[56] *See, e.g.*, Blumberg v. Touche Ross & Co., 514 So. 2d 922 (Ala. 1987) (parties conduct discovery for several years). *See* Trubek, et. al, *supra* note 1, at 91 (discussing the costs of civil litigation and finding that the overwhelming proportion of litigation costs were the lawyers' fees).

[57] *See supra* note 55, and accompanying text.

change in a common law doctrine.[58] It serves as a signal to both professions that state appellate courts have not yet reached a consensus on what is the current proper accommodation of the conflicting interests presented by a client lawsuit against an auditor, but even more particularly a suit by a third party. The remainder of this section identifies and evaluates auditor and lawyer perspectives that might account for this lack of consensus, and hence the close split in the outcomes of these cases.

C. Auditor Perspective - Client Solvency & Case Outcomes

The solvency of the client is a factor that the accounting profession has identified as significant as to whether a lawsuit will be filed against an auditor, especially by a third party non-client - the consensus is that client insolvency prompts lawsuits against auditors.[59] The cases that have reached the state supreme courts and selected state intermediate appellate courts support this view. In only five of the third party plaintiff cases (35 of the 49 cases in the study), where evidence of solvency/insolvency appeared in the case report, did that evidence warrant concluding that the client was still solvent.[60] This study

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[58] Porter and Tarr, *supra* note 7, at xxi. For a survey of the various patterns of "diffusion" of "tort reform" doctrines, see Baum and Canon, supra note 7 (authors document that the state supreme courts since World War II have generally made all kinds of classes of defendants more vulnerable to successful tort litigation).

[59] C. Scott Smith, *Deep Pockets*, INTERNATIONAL ACCOUNTING BULLETIN, May 1992, at 2. *See supra* note 1.

[60] In *Harper v. Inkster Public Schools.*, 404 N.W.2d 776, 777 (Mich. Ct. App. 1987), and *Demetracopoulos v. Wilson*, 640 A.2d 279, 281-82 (N.H. 1994), the third party plaintiff was the business manager of the audit firm's client, it was clear that the client school district and non-profit corporation remained solvent/viable. In *Brown v. KPMG Peat Marwick*, 856 S.W. 2d 742, 743-44 (Tex. Ct. App. 1993) limited partners filed a counterclaim against its managing partner (who had originally filed the declaratory lawsuit) and other defendants, including the audit firm. The managing partner, a corporation, was apparently still solvent at the time of the litigation. In *Grant Thorton v. Windsor House, Inc.*, 566 N.E.2d 1220, 1223 (Ohio 1991), the client was a solvent state government agency, the Ohio Department of Public Welfare. In *St. Paul Fire & Marine Insurance. Co. v. Touche Ross & Co.*, 452 N.W.2d 746, 749 (Neb. 1990), the client's solvency at the time of trial wasn't as clear. The insurance company alleged in its petition that it was the surety on the debts of the audit firm's client, and that it "would be" damaged in excess of ten million dollars. The Nebraska Supreme Court interpreted that allegation to mean that sometime in the future the plaintiff would suffer an injury. Hence the allegation suggest that at some point in the future, but not now, the audit firm's client would be unable to pay its debts.

Evidence was present in other cases: Colonial Bank of Ala. v. Ridley & Schweigert, 551 So. 2d 390 (Ala. 1989) (client defaulted on loan to third party plaintiff and filed for bankruptcy); Bily v. Arthur Young, 834 P.2d 745, 748 (Cal. 1992) (client filed for bankruptcy prior to filing of lawsuit); First Fla. Bank v. Max Mitchell, & Co., 558 So. 2d 9, 11 (Fla. 1990) (auditor's client defaulted on repayment of $500,000 line of credit to this plaintiff); Badische Corp. v. Caylor, 356 S.E.2d 198, 199 (Ga. 1987) (auditor's client filed

has documented, however, that the insolvency of the client was not a good predictor of the outcome of these third party cases when they reached the state appellate courts. This is evident by the twenty to fifteen edge in the auditors' favor.[61]

It is also true that in about half of the lawsuits where the clients were plaintiffs, the clients were either insolvent or at least in serious financial

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for bankruptcy); Idaho Bank & Trust Co. v. First Bankcorp of Idaho, 772 P.2d 720, 721 (Idaho 1989) (auditor's client placed in receivership); Huls v. Clifton, Gunderson & Co., 535 N.E.2d 72, 76 (Ill. App. Ct. 1989) (third party plaintiff purchased auditor's client); Brumley v. Touche Ross & Co., 487 N.E. 2d 641 (Ill. App. Ct. 1985) (third party plaintiff purchased auditor's client); Eldred v. McGladrey, 468 N.W.2d s client in bankruptcy proceedings); Pahre v. Auditor of State, 422 N.W.2d 178 (Iowa 1988) (auditor's client insolvent); Brueck v. Krings, 638 P.2d 904 (Kan. 1982) (auditor's client, a savings and loan, collapsed); Jenson v. Touche Ross & Co., 335 N.W.2d 720, 723 (Minn. 1983) (auditor's client survived long enough to pay part of judgment based on same facts in a separate litigation, but then filed for bankruptcy); Touche Ross & Co. v. Commercial Union Ins. Co., 514 So. 2d 315 (Miss. 1987) (auditor's client, a bank, declared insolvent); Lindner Fund v. Abney, 770 S.W.2d 437 (Mo. Ct. App. 1989) (no indication of client's on-going solvency); Thayer v. Hicks, 793 P.2d 784, 787, 793-994 (Mont. 1990) (audit firm's client insolvent, but substantial evidence presented at trial that the client was insolvent at the time of the audit that gave rise to the litigation, and the audit firm failed to identify that insolvency); H. Rosenblum Inc. v. Adler, 461 A.2d 138, 141 (N.J. 1983) (auditor's client purchased plaintiff's company principally by giving the plaintiff stock which subsequently proved worthless when the client filed for bankruptcy shortly after the merger); Security Pac. Bus. Credit Inc. v. Peat Marwick Main & Co., 597 N.E.2d 1080, 1083 (N.Y. 1992) (audit firm's client filed for bankruptcy); Westpac Banking Corp. v. Deschamps, N.E.2d 1351 (N.Y. 1985) (auditor's client "collapsed"); Credit Alliance Corp. v. Arthur Anderson, 483 N.E.2d 110, 112 (N.Y. 1985) (auditor's client filed for bankruptcy after defaulting on millions of dollars in loans made to it by plaintiffs); European American Bank & Trust Co. v. Strauhs & Kaye, Etc., 483 N.E. 2d 110, 113 (N.Y., 1985)(auditor's client filed for bankruptcy between the time the complaint was first filed and the filing of the motion for summary judgment by the defendant auditor); Raritan River Steel Co. v. Cherry, 367 S.E.2d 609, 612 (N.C. 1988) (auditor's client owed plaintiff an excess of $2,000,000 which it apparently failed to pay); Haddon View Inv. Co. v. Coopers & Lybrand, 436 N.E.2d 212, 213 (Ohio 1982) (auditor's clients collapsed); United States Nat'l Bank of Or. v. Fought, 630 P.2d 337, 339 (Or. 1981) (auditor's client defaulted on over $1,000,000 in loans made to it by the plaintiff); First Nat'l Bank of Minneapolis v. Kehn Ranch, Inc., 394 N.W.2d 709 (S.D. 1986) (auditor's client filed for bankruptcy); Bethlehem Steel Corp. v. Ernst & Whinney, 822 S.W.2d 592, 593 (Tenn. 1991) (auditor's client insolvent); Blue Bell Inc. v. Peat Marwick Mitchell, 715 S.W.2d 408, 410 (Tex. Ct. App. 1986) (auditor's client insolvent); Ward v. Ernst & Young, 435 S.E.2d 628, 629 (Va. 1993) (third party plaintiff was sole stockholder of audient which was in the process of being purchased by another company); First Nat'l Bank of Bluefield v. Crawford, 386 S.E.2d 310 (W. Va. 1989) (auditor's client made loan from plaintiff bank that it apparently failed to completely repay); Imark Ind. Inc. v. Arthur Young & Co., 436 N.W.2d 311, 314 (Wis. 1989) (auditor's client bankrupt-defaulted on loans made by plaintiff); Citizens State Bank v. Timm, Schmidt & Co., 335 N.W.2d 361, 362 (Wis. 1983) (auditor's client defaulted on loans made by plaintiff, eventually becoming insolvent and was liquidated.)

[61] *See supra* note 47 and accompanying text.

trouble.[62] Yet, six of the fourteen decisions were favorable to the auditors/defendants.[63]

D. Auditor Perspective - Firm Size & Case Outcomes

The size of an auditing firm is a factor that the accounting profession has identified as significant in judging whether a lawsuit will be filed against the auditor. The consensus among commentators is that fewer lawsuits are filed against larger auditing firms.[64] The "Big Six" (previously the "Big Eight") firms, however, were the defendants in over half of the auditor liability cases in this study.[65] Financial resources may account for the disproportionate

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[62] Hydroculture Inc. v. Coopers & Lybrand, 848 P.2d 856, 859 (Ariz. Ct. App. 1992) (client filed for bankruptcy prior to first filing a claim against the audit firm); Blumberg, 514 So. 2d at 924 (client apparently solvent); Coopers & Lybrand v. Trustees of the Archdiocese of Miami, 536 So. 2d 278 (Fla.3d DCA 1989)(client, Archdiocese, solvent); Devco Premium Finance Co. v. North River Ins. Co., 456 So. 2d 1216, 1218 (Fla. 1st DCA 1984) (client liquidated); Holland v. Arthur Anderson, 571 N.E.2d 777 (Ill. App. Ct. 1991) (client, insurance holding company, bankrupt) (formerly 127 Ill. App.3d 854, Ill. App. Ct. 1984); First Nat'l Bank v. Brumleve and Dabbs, 539 N.E.2d 877, 878-70 (Ill. App. Ct. 1989) (client alleged it suffered "huge losses", but apparently still solvent); Local 1064 v. Ernst & Young, 516 N.W.2d 492, 493 (Mich. Ct. App. 1994) (labor union/client loss was limited to amount reflected in higher percentage contribution that state employment agency required-remained on-going entity); Jaffe v. Harris, 338 N.W.2d 228 (Mich. Ct. App. 1983) (Client, book company, apparently remained solvent); Lincoln Grain, Inc. v. Coopers & Lybrand, 345 N.W.2d 300, 304 (Neb. 1984) (client, closed its division, the value of whose assets were in question); Levine v. Wiss & Co., 478 A.2d 397 (N.J. 1984) (client, husband as part of divorcing couple, businesses' apparently remain solvent); Investors Reit One v. Jacobs, 546 N.E.2d 206, 207 (Ohio 1989) (client, investment trusts, lose all of the investments); University Nat'l Bank v. Ernst & Whinney, 773 S.W.2d 707, 709 (Tex. Ct. App. 1989) (client bank despite substantial losses apparently remained solvent); Greenstein, Logan & Co. v. Burgess Marketing Inc. 744 S.W.2d 170, 177 (Tex. Ct. App. 1987) (client bankrupt); Seaward Int'l, Inc. v. Price Waterhouse, 391 S.E.2d 283, 286 (Va. 1990) (despite incurring substantial tax liability, client apparently remained solvent).

[63] *See supra* note 44 and accompanying text.

[64] *But see supra* note 1 (suggesting that the largest accounting firms have borne the financial brunt of the increased litigation against auditing firms). A recent report of the results of a "liability" survey of mid-size and smaller accounting firms stated that the median claim against such firms was $155,000, and slightly less than half said that their firm's exposure to legal liability had increased in the last five (1987-92) years. *See Survey Shows Extent of Members Concern Over Legal Liability*, July 1992, at 1. For a like perception of the trend of filing lawsuits against large law firms see Couric, supra note 1, at 65 (noting that in the last decade large law firms are more frequently the target of malpractice lawsuits, because they are seen as the deep pocket).

[65] *Blumberg*, 514 So. 2d at 922; *Hydroculture Inc.*, 848 P.2d at 856; *Bily*, 834 P.2d at 745; *Coopers & Lybrand*, 536 So. 2d at 278 (Fla. 1st DCA 1989); *Holland*, 571 N.E.2d at 777; Brumley v. Touche Ross, 487 N.E.2d 641 (Ill. App. Ct. 1985); Brueck v. Krings, 638 P.2d 904 (Kan. 1982) (Peat, Marwick, Mitchell & Co. party defendant); *Local 1064*, 516 N.W.2d 492(Mich. Ct. App. 1994); Harper v. Inkster Pub. Schs., 404 N.W.2d 776 (Mich. Ct. App. 1987) (Arthur Anderson & Co. party defendant); *Jaffe*, 338 N.W.2d at 228 (Arthur Young & Co. party defendant); *Jenson*, 335 N.W.2d at 720; *Touche Ross*

representations of the large auditing firms in these cases because they had the finances to appeal the law suit through the legal system.[66] The fact that the defendants were "Big Six" firms did not have a significant impact on the outcomes of these cases. A total of fourteen decisions (including eight state supreme court decisions) were decided in favor of the "Big Six" firms whereas the plaintiffs secured favorable decisions in thirteen cases (including nine state supreme court decisions) when pitted against such firms.[67]

In the remaining decisions, those in which non-"Big Six" firms were the defendants, twelve decisions were favorable to defendant auditors, and ten decisions were favorable to plaintiffs.[68] Thus, "Big Six" firms and non-"Big

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& Co., 514 So.2d at 315; *St. Paul Fire & Marine Ins. Co.*, 452 N.W.2d at 746; *Lincoln Grain, Inc.*, 345 N.W.2d at 300; *H. Rosenblum Inc.*, 461 A.2d at 138 (Touche Ross & Co. party defendant); *Security Pac. Bus. Credit, Inc.*, 597 N.E.2d at 1080; *Credit Alliance Corp.*, 483 N.E.2d at 110; *Investors Reit One*, 546 N.E.2d at 207 (Coopers & Lybrand party defendant); *Haddon View Inv. Co.*, 436 N.E.2d at 212; *First Nat'l Bank of Minneapolis*, 394 N.W.2d at 709 (Touche Ross & Co. party defendant); *Bethlehem Steel Corp.*, 822 S.W.2d at 592; *Brown*, 856 S.W.2d at 743-44; *University Nat'l Bank*, 773 S.W.2d at 707; *Blue Bell Inc.*, 715 S.W.2d at 408; *Ward*, 435 S.E.2d at 628; *Seaward Int'l Inc.*, 391 S.E.2d at 283; *Imark Indus. Inc.*, 436 N.W.2d at 311.

[66] *See supra* note 56 and accompanying text.

[67] The fourteen decisions that favored "Big Six" auditors were: *Bily*, 834 P.2d at 745; *Coopers & Lybrand*, 536 So. 2d at 278; *Holland*, 571 N.E.2d at 777; *Brueck*, 638 P.2d at 904 (Peat, Marwick, Mitchell & Co. party defendant); Harper, 404 N.W.2d at 776 (Arthur Anderson & Co. party defendant); *Jaffe*, 338 N.W.2d at 228 (Arthur Young & Co. party defendant); *Jenson*, 335 N.W.2d at 720; *Touche Ross & Co.*, 514 So. 2d at 315; *Security Pac. Bus. Credit Inc.*, 597 N.E.2d at 1080; *Credit Alliance Corp.*, 483 N.E.2d at 110; and *First Nat'l Bank of Minneapolis*, 394 N.W.2d at 709 (Touche Ross & Co. party defendant); *Brown*, 856 S.W.2d at 742; *University Nat'l Bank*, 773 S.W.2d at 707; and *Seaward Int'l Inc.*, 391 S.E.2d at 283.

The thirteen decisions that were favorable to plaintiffs were: *Blumberg*, 514 So. 2d at 922; *Hydroculture Inc.*, 848 P.2d at 856; *Brumley*, 487 N.E.2d at 641; *Local 1064*, 516 N.W.2d 492; *St. Paul Fire & Marine Ins.* Co., 452 N.W.2d at 746; *Lincoln Grain, Inc.*, 345 N.W.2d at 300; *H. Rosenblum Inc.*, 461 A.2d at 138 (Touche Ross & Co. party defendant); *Investors Reit One*, 546 N.E.2d at 207 (Coopers & Lybrand party defendant); *Haddon View Inv. Co.*, 436 N.E.2d at 212; *Bethlehem Steel Corp.*, 822 S.W.2d at 592; *Blue Bell Inc.*, 715 S.W.2d at 408; *Ward*, 435 S.E.2d at 628, and *Imark Ind. Inc.*, 436 N.W.2d at 311.

[68] The twelve decisions favorable to non-big six audit firms were: *Colonial Bank of Ala.*, 551 So. 2d at 390; *Devco Premium Finance Co.*, 456 So. 2d at 1216; *Badische Corp.*, 356 S.E.2d at 198; *Idaho Bank & Trust Co.*, 772 P.2d at 770; *Huls*, 535 N.E.2d at 72; Eldred, 468 N.W.2d at 218; *Pahre*, 422 N.W.2d at 178; *Mid-American Bank & Trust Co.*, 851 S.W.2d at 563, *Lindner Fund*, 770 S.W.2d at 437; *Demetracopoulos*, 640 A.2d at 279; *Westpac Banking Corp.*, 484 N.E.2d at 1351; and *Grant Thorton*, 566 N.E.2d at 1220.

The ten decisions favorable to plaintiffs when they filed against non-big six firms were: *First Fla. Bank*, 558 So. 2d at 9; *First Nat. Bank*, 539 N.E.2d at 877; *Thayer*, 793 P.2d at 784; *Levine*, 478 A.2d at 397; *European American Bank & Trust Co., v. Strauhs & Kaye, Etc.*, 483 N.E.2d at 110; *Raritan River Steel Co.*, 367 S.E.2d at 609; *United States Nat'l Bank of Or.*, 630 P.2d at 337; *Greenstein, Logan & Co.*, 744 S.W.2d at 170; *First Nat'l Bank of Bluefield*, 386 S.E.2d at 310; *Citizens State Bank*, 335 N.W.2d at 361.

Six" firms fared about the same in these state appellate decisions in which they were the auditor/defendants.

E. Lawyer Perspective - Third Party Plaintiff's Theory of the Case and Case Outcomes

Experienced lawyers recognize that lawsuits filed against auditors are ultimately the result of strategic decisions made by the lawyers for the plaintiff and defendant.[69] The plaintiff's "blue print" is referred to as "the theory(ies) of the case", which this article identifies as the cause(s) of action identified in the plaintiff's complaint.[70]

In the state supreme court decisions and the intermediate appellate court decisions in which a third party plaintiff filed the lawsuit, attorneys for the third party plaintiffs filed complaints which alleged multiple causes of action.[71] In all but one of these cases, the complaint included the claim that

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[69] LEGAL EDUCATION AND PROFESSIONAL DEVELOPMENT - AN EDUCATIONAL CONTINUUM 138 (1992) (listing current fundamental lawyer skills as development, implementation, and continuing reassessment of the planning process); *See also* Roger A. Parkinson, *Better Case Results From Improving Planning and Managing*, 432 PLI/Lit 403 (1992).

[70] *Legal Education and Professional Development, supra* note 69, at 138 (listing among the second set of fundamental lawyer skills as formulating, elaborating, and evaluating legal theories); GEORGE VETTER, SUCCESSFUL CIVIL LITIGATION 21 (1977)
(defining theory of the case as the identification of the most persuasive facts available to convince the jury of the cause of action). The defendant usually answers with defense theories in light of the plaintiff's theory of the case. Peter N. Sheridan, Three Keys To the Successful Defense of Litigation of Precedential Importance: Preparation, Preparation, Preparation, 455 PLI/LIT 9 (1993); Defending the Professional (1982); Defending the Professional, Practicing Law Institute, 1982.

[71] *Colonial Bank of Ala.*, 551 So. 2d at 392 (negligence, wantonness, breach of contract, and fraud/breach of fiduciary warranties); *Bily*, 834 P.2d at 748-49 (fraud, negligent misrepresentation, and "professional negligence"); *First Fla. Bank*, 558 So. 2d at 11 (Fla. 1990) (negligence, gross negligence, and fraud); *Badische Corp.*, 356 S.E.2d at 199 (negligence); *Idaho Bank & Trust Co*, 772 P.2d at 721 (negligence); *Huls*, 535 N.E.2d at 74 (fraudulent concealment, willful misconduct, and fraudulent misrepresentation); *Brumley*, 487 N.E.2d at 642 (negligence); *Eldred*, 468 N.W.2d at 219 (fraudulent, negligent, and innocent misrepresentation); *Pahre*, 422 N.W.2d at 179 (Iowa 1988) (negligence); *Brueck*, 638 P.2d at 907 (negligence, gross negligence, breach of state securities law, and breach of express and implied warranties); *Harper*, 404 N.W.2d at 776 (negligence); *Jenson*, 335 N.W.2d at 724 (negligence, breach of contract, sale of unregistered securities, fraudulent sale of securities, statutory consumer fraud, and statutory false advertising); *Touche Ross & Co.*, 514 So. 2d at 315 (gross negligence); *Mid-American Bank & Trust Co.*, 851 S.W.2d at 564 (breach of contract and negligent misrepresentation); *Lindner Fund*, 770 S.W.2d at 438 (negligence and gross negligence); *Thayer*, 793 P.2d at 786 (negligence and negligent misrepresentation); *St. Paul Fire & Marine Ins. Co.*, 452 N.W.2d at 748 (negligent misrepresentation, negligence); *Demetracopoulos*, 640 A.2d at 281 (intentional interference with contractual relations, negligence, and defamation); *H. Rosenblum Inc.*, 461 A.2d at 141 (negligence, gross negligence, fraudulent misrepresentation, and breach of warranties); *Security Pac. Bus. Credit, Inc.*, 597 N.E.2d at 1081

the auditor had performed negligently and/or had made negligent misrepresentations in the audit report.[72]

In the state supreme court decisions in which negligence and/or negligent misrepresentation was claimed by the third party plaintiff, twelve decisions upheld the possibility that the plaintiff might recover, and fifteen rejected that possibility.[73] The California Supreme Court "split the baby," eliminating the possibility that the plaintiffs could recover on negligence, but preserved the opportunity for negligent misrepresentation recovery.[74]

(negligence); *Westpac Banking Corp.*, 484 N.E.2d at 1352 (negligence and gross negligence); *Credit Alliance Corp.*, 483 N.E.2d at 112 (negligence and fraud); *European American Bank & Trust Co., v. Strauhs & Kaye, Etc.*, 483 N.E.2d 110 (N.Y., 1985)(separate case consolidated for appeal with Credit Alliance, decided same day with Credit Alliance, hence with same citation. negligence and gross negligence); Raritan River Steel Co. v. Cherry, 367 S.E.2d at 611 (negligent misrepresentation and breach of contract); Grant Thorton v. Windsor House, Inc., 566 N.E.2d at 1221 (counterclaims included breach of contract, fraud, libel, malpractice, and negligence); *Haddon View Inv. Co.*, 436 N.E.2d at 213 (professional malpractice, breach of contract, concealment, fraud and deceit); *United States Nat'l Bank of Or.*, 630 P.2d at 338 (fraudulent misrepresentation and a deceit claim); *First Nat'l Bank of Minneapolis*, 394 N.W.2d at 709 (negligence and fraud); *Bethlehem Steel Corp.*, 822 S.W.2d at (Tenn. 1991) (negligence); *Brown*, 856 S.W.2d at 745 (malpractice, negligence, negligence per se, negligent misrepresentation, and gross negligence); *Blue Bell Inc.*, 715 S.W.2d at 410 (negligent misrepresentation, fraud, breach of warranties, and breach of fiduciary duty); *Ward*, 435 S.E.2d at 630 (breach k of Bluefield, 386 S.E.2d at 311 (professional negligence); *Imark Ind. Inc.*, 436 N.W.2d at 313 (negligent misrepresentation); *Citizens State Bank*, 335 N.W.2d at 362 (negligence, reckless preparation of financial statements).

[72] *See supra* note 71. The only decision in which the plaintiff's attorney's theory of the case didn't include negligence or negligent misrepresentation was Huls v. Gunderson, 535 N.E.2d 72, 74 (Ill. App. Ct., 1989) (fraudulent concealment, willful misconduct, and fraudulent misrepresentation).

[73] The possibility of the third party plaintiff succeeding on the negligence cause(s) of action was upheld in the following twelve state supreme court decisions: *First Fla. Bank*, 558 So. 2d 9 (Fla. 1990); *Thayer*, 793 P.2d at 784; *St. Paul Fire & Marine Ins. Co.*, 452 N.W.2d at 746; *H. Rosenblum Inc.*, 461 A.2d at 138; *European Am. Bank & Trust Co.*, 483 N.E.2d at 110; *Raritan River Steel Co.*, 367 S.E.2d at 609; *Haddon View Inv. Co.*, 436 N.E.2d at 212; *United States Nat'l Bank of Or.*, 630 P.2d at; *Bethlehem Steel Corp.*, 822 S.W.2d at 592; *First Nat'l Bank of Bluefield*, 386 S.E.2d at 310; *Imark Indus. Inc.*, 436 N.W.2d at 311; *Citizens State Bank*, 335 N.W.2d at 361.

The state supreme court decisions rejecting the possibility of the third party plaintiff succeeding on the negligence causes of action were: *Colonial Bank of Ala.*, 551 So. 2d at 390; *Badische Corp.*, 356 S.E.2d at 198; *Idaho Bank & Trust Co.*, 772 P.2d at 720; *Eldred*, 468 N.W.2d at 219; *Pahre*, 422 N.W.2d at 178; *Brueck*, 638 P.2d at 904; *Jenson*, 335 N.W.2d at 720; *Touche Ross & Co.*, 514 So. 2d at 315; *Demetracopoulos*, 640 A.2d at 281; *Security Pac. Bus. Credit Inc.*, 597 N.E.2d at 1085; *Westpac Banking Corp.*, 484 N.E.2d at 1351; *Credit Alliance Corp.*, 483 N.E.2d at 110; *Grant Thorton*, 566 N.E.2d at 1222; -26 (showing that the overall favorable outcome count for audit firms versus third parties was 15-13). *See infra* notes 74 and 76 (discussing the two decisions which accounted for the slight outcome difference between the overall favorable outcome count and the outcome split with respect to the negligence claim reported in this note).

[74] *Bily*, 834 P.2d at 767.

The six intermediate appellate decisions in which the third party plaintiff alleged a negligence claim split four to two in favor of the audit firms concerning sanctioning the possibility of recovery on the negligence and/or negligent misrepresentation causes of action.[75] Hence, the split of these appellate courts in deciding the viability of a negligence claim by a third party plaintiff (fifteen decisions sanctioned at least some possibility and nineteen decisions rejected such a possibility) coincides with the same relatively close split in the overall outcomes of these decisions, and may be a significant reason for these courts being so divided, especially if the courts accept or reject the third par reasons.[76]

In twenty-five of these thirty-four decisions, a key issue was identical: the scope of the duty owed by auditors when a third party plaintiff claimed a negligent audit and resulting injury.[77] These state appellate courts arguably

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[75] The two decisions favorable to third party plaintiffs with respect to the negligence claim were: *Brumley*, 487 N.E.2d at 641; and *Blue Bell, Inc.*, 715 S.W.2d at 408. The four decisions favorable to auditors with respect to the negligence claim were: *Harper*, 404 N.W.2d at 776; *Mid-American Bank & Trust Co.*, 851 S.W.2d at 563; *Lindner Fund*, 770 S.W.2d at 437; and *Brown*, 856 S.W. 2d at 742.

[76] The significance of the appellate courts' evaluation of the plaintiff's negligence claim is heightened since that the courts dismissed the other causes of action alleged by the third party plaintiffs. *See supra* note 71 and accompanying text. Fraud causes of action were dismissed in several of these cases. First, there are instances when the plaintiff voluntarily dismissed a fraud cause of action. *See, e.g., First Fla. Bank*, 558 So. 2d at 11 (Fla. 1990). Second, courts dismissed actions by relying on the same scope of the duty owed evaluation. *See, e.g., Colonial Bank of Ala.*, 551 So. 2d at 396; *but see First Fla. Bank*, 558 So. 2d at 14. Third, in decisions such as *Bily v. Arthur Young*, 834 P.2d at 748-749, the court struck down a viable claim of fraud by requiring the plaintiff to prove that the auditing firm intentionally misled the third party by omissions or overt statements made in the report. By requiring this level of culpability, the decision departed sharply from Justice Cardozo's view on the viability of a fraud claim in the seminal *Ultramares v. Touche*, 174 N.E. 441,444(N.Y., 1931). Cardozo ruled that the fraud claim could be pursued by the third party creditor against an auditor without the plaintiff having to prove the same duty nexus, and without proving deliberate deception as long as the plaintiff could prove either assertions of facts without knowledge to support those facts or misstatement of fact reasonably relied upon.

The courts also dismissed contract causes of action. The plaintiffs were unable to convince the juries that the auditing firm and the clients intended that the third party benefit by the audit agreement. *See, e.g., Colonial Bank of Ala.*, 551 So. 2d at 395-96; Grant Thorton, 566 N.E.2d at 1223. However, in *Ward v. Ernst & Young*, the court rejected plaintiff's professional negligence claim and restored his possibility of recovering on a third party beneficiary contract claim. In this case, the third party plaintiff was the sole stockholder of the audit firm's client, and the audit firm allegedly knew that a sale of his stock was pending at the time of the audit. In *Bily v. Arthur Young*, one of two cases where the privity standard was adopted, the California Supreme Court also recognized the possibility of third party recovery on a contract theory, at 767 (n.16). *See also, infra* note 107 and accompanying text.

[77] *Colonial Bank of Ala.*, 551 So. 2d at 392-95; *Bily*, 834 P.2d at 752; *First Fla. Bank*, 558 So. 2d at 12-14; *Badische Corp.*, 356 S.E.2d at 199-200; *Idaho Bank & Trust Co.*, 772 P.2d at 721-22; *Brumley*, 487 N.E.2d at 643-45; *Pahre*, 422 N.W.2d at 179-81; *Harper*, 404 N.W.2d at 777-79; *Touche Ross & Co.*, 514 So. 2d at 318-23; *Mid-American Bank & Trust Co.*, 851 S.W.2d at 564-66; *Lindner Fund*, 770 S.W.2d at 438-39; *Thayer*, 793 P.2d at 786; *Demetracopoulos*, 640 A.2d at 282; *H. Rosenblum Inc.*,

had five options.[78] First, a court could retain or adopt the historical privity standard, which was most notably articulated by Justice Cardozo in *Ultramares v. Touche*.[79] The *Ultramares* opinion provides the most protective standard to auditors by asserting that auditors do not owe a duty to any third party, except for those who pay for such a duty. Other options, which reflect standards which provide progressively less protection for auditors, are the "near privity" standard[80], the "foreseen standard," (as stated in the Restatement)[81], the "reasonably foreseeable" standard[82], and the "reasonably

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461 A.2d at 142-53; *Security Pac. Bus. Credit*, 597 N.E.2d at 1083-84; *Westpac Banking Corp.*, 484 N.E.2d at 1352-53; *Credit Alliance Corp.*, 483 N.E.2d at 114-119; *European Am. Bank & Trust Co.*, 483 N.E.2d at 120; Raritan River Steel Co., 367 S.E.2d at 614-618; *Haddon View Inv. Co.*, 436 N.E.2d at 214-15; *Bethlehem Steel Corp.*, 822 S.W.2d at 92; *Blue Bell Inc.*, 715 S.W.2d at 411-12; *Ward*, 435 S.E.2d at 631-33; *First Nat'l Bank of Bluefield*, 386 S.E.2d at 311-313; *Citizens State Bank*, 335 N.W.2d at 364-66.

The cases in which the scope of the duty standard was not the key issue on appeal were: *Eldred*, 468 N.W.2d at 219 (no proof of reliance on audit firm report by the third party); *Brueck*, 638 P.2d at 904 (selection of appropriate statute of limitations as decisive issue); *Jenson*, 335 N.W.2d at 720 (applicability of statutory causes of action); *St. Paul Fire & Marine Ins. Co.*, 452 N.W.2d at 748-49 (insurance company, surety for audit firm client, failed to properly plead that they had currently suffered damages. Given opportunity to replead by Nebraska Supreme Court); *Grant Thorton*, 566 N.E.2d at 1222 (applicable statute of limitations for accounting malpractice is four years and no use of "discovery" rule); *United States Nat'l Bank of Or.*, 630 P.2d at 337 (elements of cause of actions for misrepresentation and deceit); *First Nat'l Bank of Minneapolis*, 394 N.W.2d at 709 (proof that damages were caused by auditor negligence); *Brown*, 856 S.W.2d at 746-748 ("discovery" accrual date rule doesn't apply to accountant malpractice claims when the plaintiff is a third party by curiously using as a key justification an analysis of the scope of the duty an accountant should owe to a third party); and *Imark Indus. Inc.*, 436 N.W.2d at 311 (auditor reliance and proportioning damages among joint tortfeasors).

[78] But *See supra* note 74 (discussing how California Supreme Court demonstrated that more than one of these standards could be adopted in a single case)

[79] *Ultramares*, 174 N.E. at 444. *See infra* note 84 and accompanying text (discussing the recent judicial reluctance in adopting this standard). *See* Richard Miller, *Public Accountants and Attorneys: Negligence and the Third Party*, 47 NOTRE DAME L. REV. 568 (1972) (providing commentary on the *Ultramares* standard). *See* Weiner, *Common Law Liability of the Certified Public Accountant for Negligent Misrepresentation*, 20 SAN DIEGO L. REV. 233 (1983) (a critical view of the *Ultramares* standard). *See* Kenneth Davis, *Accountant's Liability for Negligently Certifying Financial Reports: The Legacy of Ultramares v. Touche*, 64 N.Y.ST.B.J. 30 (Oct. 1992) (an unfavorable evaluation of *Ultramares* by a New York practitioner).

[80] *See infra* note 87 (identifying jurisdictions whose state appellate courts adopted or retained this standard during the period 1980-94). With respect to recent commentary evaluating most/all of the competing duty standards see: *See* Duke, *supra* note 9; Thomas Shroyer, *Accountants and The Dynamics of Duty*, 13 WM. MITCHELL L. REV. 477, 495-96 (1987) (an evaluation of competing duty standards).

[81] Restatement (Second) of Torts § 552 (1977). *See infra* note 91 (identifying jurisdictions whose state appellate courts adopted or retained this standard during the period 1980-94). With respect to commentary evaluating this standard, *See* Shroyer, supra note 80, at 496-97.

[82] *See infra* note 96(identifying jurisdictions whose state appellate courts adopted this standard during the period 1980-94. With respect to commentary evaluating this standard, *See* Thomas L. Gossman, *IMC v. Butler: A Case For Expanded Professional Liability for Negligent Misrepresentation?*, 26 AM.

foreseeable/policy evaluation" standard based on a weighing of interests.[83]

Only one of twenty-five decisions retained the strict "privity" standard.[84] The California Supreme Court first applied a policy-analysis approach, and this approach resulted in deciding upon the strict "privity" standard for third party negligence, but not negligent misrepresentation claims.[85] Both courts felt that auditors still needed the protection of the privity standard, and that the legitimate interests of potential third party users of the audit could be protected by alternative methods.[86]

Four state supreme courts have adopted or applied the "near privity" duty rule.[87] This standard limits the auditor's duty to situations where the auditor knows a purpose of the audit is to influence a third party, and the auditor directly and voluntarily contacts the eventual third party plaintiff, thereby evidencing an understanding that this third party will rely on the audit report.[88]

BUS. LAW J. 99, 100 (1988)(unfavorable); Shroyer, *supra* note 80 at 497-500; Weiner, *supra* note 79 (favorable).

[83] *See infra* notes 100-101(identifying jurisdictions whose state appellate courts adopted this standard during the period 1980-94, and those incorporating policy/interest analysis as part of their reasonably foreseeable test, and/or that used policy analysis in its reasoning that led to the dismissal of the claim of a particular kind of third party).

[84] Ward v. Ernst & Young, 435 S.E.2d 628, 631-33 (Va. 1993) *See,e.g.,* Ark. Code Ann. s. 17-12-702 (1987) (auditors only liable to those not in privity to whom he sends a copy of a writing sent to a client acknowledging that intent of the audit is to benefit that third party).

[85] *Bily*, 834 P.2d at 767. *See infra* notes 100-101.

[86] *Ward*, 435 S.E.2d at 631-33 (briefly acknowledging that eighteen states had adopted the Restatement standard, and ignoring the rejection of the strict privity standard even in New York, whose Court of Appeals had founded it, and rejecting the possibility of distinguishing accountants duty to third parties from that of other professionals). *But see supra* note 76 (discussing *Ward* which demonstrates that even if a court adheres to the privity standard, facts that satisfy the nexus of the near privity standard, may result in a possible recovery on a third party beneficiary contract theory). *See also* discussion *infra* note 139 and accompanying text. *Bily*, 834 P.2d at 767. (California Supreme Court's adoption of the Restatement Second Standard for Negligent Misrepresentation claims). Because competent future California third party claimants's lawyers will read Bily and plead negligent misrepresentation, this article in its jurisdictional count, identifies California as a jurisdiction adopting the Restatement Second Standard, *see infra* notes 91-95. *See also,* Davis, *supra* note 79, at 35.

[87] Colonial Bank of Ala. v. Ridley & Schweigert, 551 So. 2d 390, 395 (Ala. 1989); Idaho Bank & Trust Co. v. First Bankcorp. of Idaho, 772 P.2d 720, 722 (Idaho 1989); Thayer v. Hicks, 793 P.2d 784, 789 (Mont. 1990) ("modified version" of near privity standard doesn't require specific jury instruction that the audit firm must have voluntarily contacted the specific third party plaintiff). Security Pac. Bus. Credit Inc. v. Peat Marwick Main & Co., 597 N.E.2d 1080, 1083-84 (N.Y. 1992); Westpac Banking Corp. v. Deschamps, 484 N.E.2d 1351, 1352-53 (N.Y. 1985); Credit Alliance Corp. v. Arthur Anderson, 483 N.E.2d 110, 114-119 (N.Y. 1985); European American Bank & Trust Co. v. Strauhs & Kaye, Etc., 483 N.E.2d 110, 120(N.Y., 1985)(separate case consolidated for appeal with Credit Alliance)

[88] Colonial Bank of Ala. v. Ridley & Schweigert, 551 So.2d 390, 394 (Ala. 1989); Idaho Bank & Trust Co. v. First Bankcorp. of Idaho, 772 P.2d 720, 722 (Idaho, 1989); Thayer v. Hicks, 793 P.2d 784, 791 (Mont., 1990) ("modified version" of near privity standard doesn't require specific jury instruction that the

The rationale that most commonly appeared in these decisions for adopting the near privity standard was that this standard was the best way to preserve the policy wisdom of *Ultramares*.[89] In only two of the seven cases, was a third party able to allege facts that could establish that the auditing firm voluntarily contacted it with respect to transmittal of the audit report in order to influence that third party.[90]

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audit firm must have voluntarily contacted the specific third party plaintiff. As long as there is evidence that the audit firm knew, at the time of preparing the audit report, that a purpose of the audit was to influence the specific third party plaintiff with regard to a specific transaction(s), and that the specific third party would be relying on the audit report in doing business with the audit firm's client); Security Pacific Business Credit, Inc. v. Peat Marwick Main & Co., 597 N.E.2d 1080, 1083-84 (N.Y., 1992); Westpac Banking Corp. v. Deschamps (and Seidman & Seidman), 484 N.E.2d 1351, 1352-53 (N.Y., 1985); Credit Alliance v. Arthur Anderson, 483 N.E.2d 110, 118 (N.Y., 1985); European American Bank & Trust Co. v. Strauhs & Kaye, Etc., 483 N.E.2d 110, 120 (N.Y., 1985)(Case reviewed and decided in same opinion as Credit Alliance)

[89] Colonial Bank of Ala. v. Ridley & Schweigert, 551 So.2d 390, 395 (Ala. 1989); Idaho Bank & Trust Co. v. First Bankcorp. of Idaho, 772 P.2d 720 (Idaho, 1989) (no clear rationale expressly stated); Thayer v. Hicks, 793 P.2d 784, 789 (Mont., 1990) (Since under the facts of the case, the outcome would be the same no matter which of the three scope of duty standard was adopted, court found no need to consider adopting more "liberal" standards); Security Pacific Business Credit, Inc. v. Peat Marwick Main & Co., 597 N.E.2d 1080, 1084 (N.Y., 1992); Westpac Banking Corp. v. Deschamps (and Seidman & Seidman), 484 N.E.2d 1351, 1353 (N.Y., 1985); Credit Alliance v. Arthur Anderson, 483 N.E.2d 110, 115-116, and 118 (N.Y., 1985); European American Bank & Trust Co. v. Strauhs & Kaye, Etc., 483 N.E.2d 110, 120 (N.Y., 1985).

[90] In Thayer v. Hicks, 793 P.2d 784, 790 (Mont., 1990), the audit firm met with the third party plaintiff, and knew that a purpose of the audit was to influence this third party to buy the audit firm's client. See supra note 88 for an explanation of why the Montana Supreme Court thought it unnecessary that the jury be expressly instructed on the need for such voluntary direct contact by the audit firm of the specific third party plaintiff. In European American Bank & Trust Co. v. Strauhs & Kaye, Etc., 483 N.E.2d 110, 113 and 120 (N.Y., 1985) the third party plaintiff alleged it was the principal lender to the auditor's client, and that the auditor knew that throughout the period in question, of this relationship and the plaintiff's reliance on the audited financials to make the lending decisions, and that representatives of the plaintiff and the auditing firm met on several occasions to discuss the accuracy of the audit.

In Colonial Bank of Ala. v. Ridley & Schweigert, 551 So.2d 390, 395 (Ala. 1989) (third party plaintiff unable to allege facts to even prove that the audit firm knew at any time that the audit report was to be used to influence a specific third party); Idaho Bank & Trust Co. v. First Bankcorp. of Idaho, 772 P.2d 720, 722 (Idaho, 1989) (case remanded to trial court to apply "Credit Alliance" standard to facts); Security Pacific Business Credit, Inc. v. Peat Marwick Main & Co., 597 N.E.2d 1080, 1085-86 (N.Y., 1992) (audit firm knew that the plaintiff would rely on the audit report, but the plaintiff initiated contact with the audit firm was deemed insufficient to satisfy the third element of Credit Alliance - voluntary contact with the third party plaintiff initiated by the audit firm. This application of the near privity standard by the New York Court of Appeals appears to require that the audit firm must at least by implication assume the risk of liability to a third party before the court will find that the audit firm owed a duty to that third party. Hence this standard may require more proof than that required to establish third party beneficiary contract liability, see discussion, supra note 76); Westpac Banking Corp. v. Deschamps (and Seidman & Seidman) (auditing firm knew that audit was needed to seek a "bridge loan", but didn't know a specific lender, including this

Twelve jurisdictions' state appellate courts, including nine state supreme courts, in thirteen decisions adopted or retained the Restatement Second of Torts, Section 552 "foreseen" third party scope of the auditor's duty standard.[91] This standard extends auditor liability to the class of third parties that the auditor knew were to be supplied with the audited financials for guidance or information, or at least knew that the client intended to supply the audit report and accompanying statements to a limited class of such third parties.[92] The rationale that most frequently appeared in these decisions for

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third party plaintiff would be approached to provide the loan), 484 N.E.2d 1351, 1353 (N.Y., 1985); Credit Alliance v. Arthur Anderson, 483 N.E.2d 110, 119 (N.Y., 1985) (plaintiff creditor failed to allege any "linking facts", or even that the auditor knew at time of undertaking the engagement that purpose of the audit was to influence this plaintiff or any other specific third party).

[91] Bily v. Arthur Young, 834 P.2d 745, 769 (Cal. 1992). *See supra* note 86 (providing an explanation as to why this case is categorized as a Rstmt. case); First Fla. Bank v. Max Mitchell, & Co., 558 So. 2d 9, 14 (Fla. 1990); Badische Corp. v. Caylor, 356 S.E.2d 198, 199-200 (Ga. 1987); Brumley v. Touche Ross, 487 N.E.2d 641, 643 (Ill. App. Ct. 1985).; Pahre v. Auditor of State, 422 N.W.2d 178, 180 (Iowa 1988); Mid-American Bank & Trust Co. v. Harrison, 851 S.W.2d 563, 564-66 (Mo. Ct. App. 1993); Lindner Fund v. Abney, 770 S.W.2d 437, 438-39 (Mo. Ct. App. 1989); Demetracopoulos v. Wilson, 640 A.2d 279, 282 (N.H. 1994); Raritan River Steel Co.v. Cherry 367 S.E.2d 609, 617 (N.C. 1988); Haddon View Inv. Co. v. Coopers & Lybrand, 436 N.E.2d 212, 215 (Ohio 1982); Bethlehem Steel Corp. v. Ernst & Whinney, 822 S.W.2d 592, 595 (Tenn. 1991); Blue Bell Inc. v. Peat Marwick, Mitchell, 715 S.W.2d 408, 411-12 (Tex. Ct. App. 1986); First Nat'l Bank of Bluefield v. Crawford, 386 S.E.2d 310, 313 (W. Va. 1989).

[92] RESTATEMENT (SECOND) Section 552:

Information Negligently Supplied for

The Guidance of Others

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

(2) Except as stated in Subsection (3), the liability stated in Subsection (1) is limited to loss suffered

(a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply 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 know that the recipient so intends or in a substantially similar transaction.

(3) The liability of one who is under a public duty give the information extends to loss suffered by any of the class of persons for whose benefit the duty is created; in any of the transactions in which it is intended to protect them.

Comment "h" to this section made clear that the auditor didn't have to know of the identify of the eventual plaintiff, provided the auditor knew that the purpose of the audit was to influence a specific class of persons. Illustration "5" on the other hand, indicated that if the auditor knew that the audit was intended for a specific person or entity, the scope of the duty extended only to that person. Illustration "10" which also accompanied comment h indicated that if the auditor didn't know that any specific type of entity and/or person was intended to receive and be influenced by the audit, no duty was owed to any third person who received and relied upon it. Hence the restatement, depending on how these comments and illustrations

adopting or retaining the Restatement Second standard was that in today's financial world, the courts and the accounting profession have accepted or should accept that it is fair to impit firm when in fact it knows or should know that the audit will be used to influence this third party/this type of third party.[93]

In applying this standard, all but one of the seven decisions which found in favor of the plaintiff, included allegations and proof by the third party plaintiff that the auditing firm knew in preparing the audit that it was to be used to influence either the plaintiff or a third party like the plaintiff, or came to know of that fact, or knew from their work that the plaintiff was likely to receive such a report.[94] In the six cases in which the appellate court applied this standard and found for the defendant auditor, no such knowledge was alleged, or plaintiff failed to preserve or arguably prove such knowledge.[95]

Three state supreme courts adopted the reasonably foreseeable scope of an auditor's duty to third parties standard.[96] This standard provides potential protection to a broader class of third party plaintiffs: those who the auditor

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are accepted/interpreted, may be viewed as containing multiple scope of the liability to third party standards. For confirmation, see infra note 93, documenting the nuances of the Restatement standard by the decisions in this study.

[93] *Bily*, 834 P.2d at 769 (audit firm on notice with respect to scope of potential third party liability); *First Fla. Bank*, 558 So. 2d at 15-16 (auditors can acquire requisite knowledge after the completion of the audit); *Badische Corp.*, 356 S.E.2d at 200; *Brumley*, 487 N.E.2d at 645 (the influencing of a third party need not be the primary original purpose for the audit); *Pahre*, 422 N.W.2d at 180; *Lindner Fund*, 770 S.W.2d at 438; *Demetracopoulos*, 640 A.2d at 283 (audit report not prepared to benefit third party plaintiff); *Raritan River Steel Co.*, 367 S.E.2d at 617; *Haddon View Inv. Co.*, 436 N.E.2d at 214-215; *Bethlehem Steel Corp.*, 822 S.W.2d at 593.

[94] *First Fla. Bank*, 558 So. 2d at 16 (auditor subsequently came to know of use of the audit to influence the specific plaintiff and reconfirmed its accuracy specifically to the plaintiff); *Brumley*, 487 N.E.2d at 645; *Raritan River Steel Co.*, 367 S.E.2d at 618(allegations sufficient to show that the audit would be used to influence third parties); *Haddon View Inv. Co.*, 436 N.E.2d at 215; *Bethlehem Steel Corp.*, 822 S.W.2d at 593 (giving plaintiff chance to prove that the audit firm at least knew that its report was to be used to influence the type of creditor represented by the plaintiff); *Blue Bell Inc.*, 715 S.W.2d at 413 (auditor knew that plaintiff was an on going trade creditor of the client coupled with the fact that multiple copies of the report were furnished the client); *First Nat'l Bank of Bluefield*, 386 S.E.2d at 311.

[95] *Bily*, 834 P.2d at 774 (one plaintiff failed to cross-appeal from loss and intermediate affirmance of negligent misrepresentation claim); *Badische Corp.*, 356 S.E.2d at 198; *Pahre*, 422 N.W.2d at 181; (auditor's client required by state law to send audit report to state auditor); *Mid-American Bank & Trust Co.*, 851 S.W.2d at 563, 565-66; (third party plaintiff was not within limited group to whom the accounting firm owed a duty); *Lindner Fund*, 770 S.W.2d at 438; *Demetracopoulos*, 640 A.2d at 283; (the audit was not done to influence or benefit this any third party).

[96] Touche Ross & Co. v. Commercial Union Ins. Co., 514 So. 2d 315, 322 (Miss. 1987); H. Rosenblum Inc. v. Adler, 461 A.2d 138, 153 (N.J. 1983); Citizens State Bank v. Timm, Schmidt & Co., 335 N.W.2d 361 (Wis. 1983).

should have anticipated as receivers/users of the audit.[97] A key shared rationale of the courts adopting this standard was the current recognition by the accounting profession, federal and state governments, and the business community that an audit is frequently paid for and then used by clients in order to favorably influence others.[98] In these decisions, the client's surety against defalcations, a company being bought by the auditor's client, and a creditor, all of whom acted in reliance on the audit, were found to arguably be within the class of third parties whose reliance on the audit could have been foreseen by the auditing firm.[99]

Two of these cases, however, held or implied that a direct examination of policy/interest factors could result in a finding that the auditor should not be held liable in the specific case, even if the third party plaintiff was reasonably foreseeable.[100] These observations proved prophetic, when later, the only case in this study which directly used poletermine the scope of an audit firm's duty to a third party, and a second case that began its evaluation with direct policy/interest analysis, both concluded that the audit firm owed no duty in negligence to the third party plaintiffs.[101]

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[97] Touche Ross & Co. v. Comm. Union Ins. Co., 514 So.2d 315, 322 (Miss., 1987); Rosenblaum v. Adler, 461 A.2d 138, 147-153 (N.J., 1983); Citizens State Bank v. Timm, Schmidt & Co., 335 N.W.2d 361, 366 (Wis., 1983).

[98] Touche Ross & Co. v. Comm. Union Ins. Co., 514 So.2d 315, 322 (Miss., 1987); Rosenblaum v. Adler, 461 A.2d 138, 149-150 (N.J., 1983); Citizens State Bank v. Timm, Schmidt & Co., 335 N.W.2d 361, 365 (n.10) (Wis., 1983). A second and third shared rationale relied upon by these courts was that imposing the liability that results from this modern use of audits on auditors is fair - because auditors may respond by reducing the risk of being sued by being more careful in preparing audits - the costs of this greater care can then be passed on to clients and eventually to society; and that auditors can obtain malpractice insurance to pay/help pay specific claims; See Touche Ross & Co. v. Comm. Union Ins. Co., 514 So.2d 315, 322 (Miss., 1987) (citing with approval these justifications as stated in Rosenblum); Rosenblaum v. Adler, 461 A.2d 138, 151, 153 (N.J., 1983); Citizens State Bank v. Timm, Schmidt & Co., 335 N.W.2d 361, 365 (Wis., 1983).

[99] Touche Ross & Co. v. Comm. Union Ins. Co., 514 So.2d 315, 323 (Miss., 1987)(Ultimately, however, Mississippi Supreme Court decided against recovery for this third party plaintiff); Rosenblaum v. Adler, 461 A.2d 138, 155 (N.J., 1983) (audit firm knew in fact of this plaintiff and use of the audit report and financial statements in question, prior to the plaintiffs reliance); Citizens State Bank v. Timm, Schmidt & Co., 335 N.W.2d 361, 367 (Wis., 1983).

[100] *H. Rosenblum Inc.*, 461 A.2d at 147 (by implication); *Citizens State Bank*, 335 N.W.2d at 366 (express holding).

[101] Harper v. Inkster Pub. Schs., 404 N.W.2d 776, 777-79 (Mich. Ct. App. 1987) (using a policy/interest evaluation to hold that the audit firms not liable to key financial personnel of the client on a negligence theory); Bily v. Arthur Young, 834 P.2d 745, 761-67 (Cal. 1992). *See supra* note 85 (discussing the court's conclusion after its policy analysis that the correct standard for negligence claims of third parties generally was the traditional privity standard).

These differences, therefore, in the scope of the duty standard selected by the courts during the period 1980-94, is a significant factor in accounting for the close outcome split of the third party plaintiff auditor liability cases. The twenty-one states split almost symmetrically (1-4-12-3-1) in choosing one of the five standards, well over half chose the middle ground, the Restatement standard. When the privity or near privity standards were used, only two of eight decisions were favorable to the third party plaintiff.[102] When the Restatement Second standard was used, seven decisions were favorable to the third party plaintiff, and six were favorable to the defendant audit firm.[103] When the reasonably foreseeable standard was used, two of three decisions were favorable to the third party plaintiffs.[104] Resorting to a policy evaluation in determining whether a duty was owed to a third party, on the other hand, produced a favorable result for the audit firm in the only case that applied it, and it may not be as unfavorable a standard for auditors as heretofore claimed.[105] Hence, the duty standard selected has significantly, but not conclusively, influenced the court outcome with respect to the viability of negligence claims. When the middle standard is chosen, for example, as one might expect, the outcome is less predictable.

F. Lawyer Perspective - Client/Plaintiff's Theory of the Case and Case Outcomes

Earlier this article reported a close edge favoring plaintiffs in cases in which clients had sued auditors.[106] Unlike third party plaintiff cases, however, it is more difficult to attribute this close split primarily to any obvious patterns in how these courts reacted to aspects of the theories of the case chosen by these client/plaintiffs. Those shared reactions that were observed are identified in the following discussion.

First, clients have a stronger argument than third parties in alleging a contract theory of a case, yet in only eight of fourteen cases was a contract cause of action alleged.[107] In the eight cases where a contract cause of action

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102 *See supra* notes 85-86, and 90.

103 *See supra* notes 94-95.

104 *See supra* note 99.

105 *See supra* note 101 and accompanying text. *See* Thomas Bilek, *Accountant Liability to the Third Party and Public Policy: A Calabrasi Approach*, 39 Sw. L. J. 689, 689-90 (1985) (arguing that interest/policy evaluation disfavors the accountant).

106 *See supra* note 44 and accompanying text.

107 Blumberg v. Touche Ross & Co., 514 So. 2d 922, 923, (Ala. 1987); Holland v. Arthur Anderson, 571 N.E.2d 777, 779 (Ill. App. Ct. 1991); Local 1064 v. Ernst & Young, 516 N.W.2d 492, 493

was alleged, seven clients also alleged a tort theory.[108] The contract theory of the case paid dividends in five cases in which the courts found that the client had a chance to arguably prove the contract claim, because the appellate court sanctioned its survival despite the auditor's raising "tort defenses."[109]

(Mich. Ct. App. 1994); Lincoln Grain Inc. v. Coopers & Lybrand, 345 N.W.2d 300, 303 (Neb. 1984); Levine v. Wiss & Co., 478 A.2d 397 (N.J. 1984); Investors Reit One v. Jacobs, 546 N.E.2d 206, 207 (Ohio 1989); University Nat'l Bank v. Ernst & Whinney, 773 S.W.2d 707, 708 (Tex. Ct. App. 1989); Seaward Int'l Inc. v. Price Waterhouse, 391 S.E.2d 283, 286 (Va. 1990).

In Blumberg v. Touche Ross & Co., 514 So.2d 922, 927 (Ala., 1987, the Alabama Supreme Court relied on contract principles and policies in part based on a finding that the auditing firm expressly promised in its engagement letter to conduct the audit in compliance with GAAS. Even when no express commitment was made by the auditor to adhere to professional standards, a state appellate court held that there was an implied promise to perform the work in accordance with current professional standards; Levine v. Wiss & Co., 478 A.2d 397, 402 (N.J., 1984). *See supra* note 76 (explaining why third party plaintiffs have difficulty successfully claiming breach of contract).

[108] *Blumberg*, 514 So. 2d at 924 (court rejected defendant's claim that plaintiff plead a tort theory for statute of limitations purposes); *Holland*, 571 N.E.2d at 779 (plaintiff alleged common law fraud as well as breach of contract); *Local 1064*, 516 N.W.2d at 493 (client relied solely on contract theory); *Lincoln Grain, Inc.*, 345 N.W.2d at 304-305 (treated claim for purposes of the appeal as sounding in tort, because parties so treated the claim at the trial level, despite plaintiff's original breach of contract allegation); *Levine*, 478 A.2d at 398 (plaintiff alleged negligence as well as breach of agreement and breach of fiduciary duty); *Investors Reit One*, 546 N.E.2d at 207 (fraud and negligence claims as well as breach of contract); *University Nat'l Bank*, 773 S.W.2d at 708 (negligence and contract); *Seaward Int'l Inc.*, 391 S.E.2d at 286 (negligence).

[109] *Blumberg*, 514 So. 2d 924 (defendant's claim that plaintiff plead a tort theory rejected); *Local 1064*, 516 N.W.2d at 495 (rejected audit firm attempt to characterize the claim as malpractice for purpose of identification of the correct statute of limitations); *Levine*, 478 A.2d at 398, 402 (rejecting immunity defense to negligence claim, in part because the capacity in which the accountants acted, made it accurate to characterize them as "creatures of contract")); *Investors Reit One*, 546 N.E.2d at 212 (client's other theories of recovery survive despite the auditor's successful attack on the negligence claim with the appropriate "tort" statute of limitations); *Lincoln Grain Inc.*, 345 N.W.2d at 305-307 (plaintiff appeared capable of proving the contract claim, but chose to argue the claim as a tort claim at trial. The Nebraska Supreme Court still ruled in the client's favor limiting the role of contributory negligence, and also held that the audit firm couldn't argue that a client assumes the risk of a negligent audit).

In the three decisions in which contract was alleged but the ultimate decision was favorable to the defendant auditing firm, the client plaintiff lacked adequate evidence to prove its contract claim. Hence, this left the tort claim susceptible to tort defenses. *Holland*, 571 N.E.2d at 779 (plaintiff failed to identify in the complaint the specific nature of the breach of contract or the economic loss suffered by the plaintiff attributable to that breach. This then left only the tort claim and the appellate court ruled that the defendant's summary judgement motion should be granted when plaintiff failed to raise factual issues to demonstrate how it was damaged by what it characterizes as fraud on the part of its auditors.); *University Nat'l Bank*, 773 S.W.2d at 708 (the defendant had ended its practice of sending an engagement letter in audits. Hence, the content of such a letter, and the bank's response was unavailable as the basis for the contract claim. In addition, deficiencies in defendant's audit work were not the source of the bank's complaint. Instead allegations of the auditing firm's commitment to take on job of pseudo bank examiner was the basis for the contract claim. The court found inadequate proof by bank of such an enforceable commitment. The appeals court upheld the application of comparative negligence doctrine to tort cause of action); *Seaward*

Decisions were favorable to auditors in three of six cases where clients placed reliance only on a tort theory of recovery. These plaintiffs' causes of action succumbed to "tort defense" unless they were able to prove or at least allege a relatively flagrant violation of Generally Accepted Auditing Standards (GAAS) and/or Generally Accepted Accounting Principles (GAAP).[110] In summary, auditors won six of nine decisions when the client did not allege, failed to prove, or did not rely throughout the appeal on a contract claim, and none of the five decisions when such claim was alleged and arguably proven. Hence, the allegation and proof by the client of a contract theory of the case is a factor in accounting for the difference in the outcomes of the client auditor liability cases during the period 1980-94.

Int'l Inc., 391 S.E.2d at 286 (audit firm made express promise in engagement letter to adhere to GAAS. Plaintiff's trial audit expert failed to identify specific auditing standards violated by defendant).

[110] Hydroculture Inc. v. Coopers & Lybrand, 848 P. 2d 856, 860-61 (Ariz. App., 1992) (court rejected audit firm claim that it owed no duty to its client that could be the bases of a negligence claim when the dispute related to the validity of the audit firm's demand that GAAP required the client to remove certain income items from its annual financial statements. Hence trial court committed error in granting summary judgment to audit firm); Coopers & Lybrand v. Trustee of the Archdiocese of Miami, 536 So. 2d 278, 280 (n.1) (Fla. Dist. Ct. App., 1989) (given nature of the audit only true basis for cause of action against auditors was a breach of contract claim, yet plaintiff's pleading apparently alleged only auditor malpractice/negligence. Reliance on only the negligence claim resulted in a comparative negligence finding, coupled with the appellate court ruling that the scope of the damages must be furthered limited by requiring that the plaintiff prove that the damages were not only foreseeable but would in fact have occurred given the breach of the auditor's tort duty; id. at 281-82); Devco Premium Finance v. North River Ins. Co., 456 So.2d 1216, 1217 (Fla. Dist. Ct. App.,1984) (auditor malpractice only cause of action alleged by the plaintiff. Auditing firm may assert defense of comparative negligence when plaintiff's only theory/cause of action is auditor malpractice, but if client had altered claim to breach of contract same defense would have been unavailable to the defendant). In First Nat. Bank v. Brumleve and Dabbs, 539 N.E.2d 877, 880 (Ill. App. Ct., 1989) the client plaintiff alleged only negligence, and survived an attempt for summary judgment by the defendant auditor by alleging multiple facts purporting to document the omissions and errors of the defendant auditor); Jaffe v. Harris, 338 N.W.2d 228, 230 (Mich. Ct. App., 1983) (fraud and malpractice only causes of action alleged by plaintiff-limited partners of client partnership. Malpractice claim is barred by tort/malpractice statute of limitations); In Greenstein, Logan & Co. v. Burgess Marketing, 744 S.W.2d 170, 185-86 (Tx. Ct. App., 1987), the plaintiff alleged only accountant malpractice /negligence. Defendant auditor conceded after the trial failure to comply with GAAS. Plaintiff's verdict for over three million dollars was upheld by intermediate appellate court despite appellate tort defense arguments that the plaintiff was contributory negligent.

Part 2 - The Recent Restatement of Auditor Common Law Liability Decisions: Key Implications for the Accounting and Legal Professions

A. Lessons for Auditors

Earlier we identified two key auditor perspectives about malpractice lawsuits filed against them.[111] One of these concerns was the escalating cost of malpractice insurance.[112] The article has documented that the key decisions of the last decade and one-half, 1980-94, resulted in only two final monetary judgments against auditors.[113] These courts also did not exhibit an attitude that it was proper for the auditor defendants to serve as the "deep pocket."[114] These decisions therefore provide some evidence that the escalation of malpractice insurance rates is not warranted by the outcomes or reasoning of state appellate courts.[115]

The second auditor concern identified earlier in the article was whether the judges recognized the complexity and difficulty of the audit function.[116] The decisions of the state courts of last resort did show some sensitivity to the

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[111] *See supra* notes 13-14 and accompanying text.

[112] *See supra* note 14 and accompanying text.

[113] *See supra* notes 55 and accompanying text.

[114] Bily v. Arthur Young, 834 P.2d 745, 761 (Cal. 1992) (stating that if audit firm faces negligent claims from all foreseeable third parties, its potential liability would be excessive); First Fla. Bank v. Max Mitchell, & Co., 558 So. 2d 9, 16 (Fla. 1990); Eldred v. McGladrey, 468 N.W.2d 218, 220 (Iowa 1991) (expressing concern that auditors not be held liable to an unlimited class of third parties for an indeterminate amount); Touche Ross & Co. v. Commercial Union Ins. Co., 514 So. 2d 315, 322 (Miss. 1987) (auditor firm is not the guarantor of the client's financial statements); Security Pac. Bus. Credit Inc. v. Peat Marwick Main & Co., 597 N.E.2d 1080, 1086 (N.Y. 1992) (holding that the lender can not acquire additional loan protection simply by calling debtor's current audit firm and seeking reassurance that the financial statements are accurate); Raritan River Steel Co. v. Cherry, 367 S.E.2d 609, 616 (N.C. 1988) (standard limiting audit firm's potential liability is warranted because audit firm lacks control over distribution of its report and some of the content contained therein. Imark Indus. Inc. v. Arthur Young & Co., 436 N.W.2d 311, 315 (Wis. 1989) (plaintiff made covenants not to sue two principle officers of the audit firm's client in exchange for their cooperation in the investigation of the audit, which resulted in a decision to sue the audit firm for negligent misrepresentation). It should be noted that this sensitivity was demonstrated by state supreme courts deciding against as well as those deciding the specific case in favor of the audit firm.

[115] *See supra* note 14. *See also* Trubek, *supra* note 1, at 118-119 (questioning how insurance companies, who set the malpractice rates, use the findings that civil defendants who persevere through the trial stage fare better overall with respect to monetary outcome then those who do not).

[116] *See supra* note 13 and accompanying text.

complex nature of an audit engagement.[117] One of the better examples of this sensitivity was a state supreme court holding, that notwithstanding the fact that the third party plaintiff was within the class to whom the auditor owed a duty, such a person must also prove all of the other elements of negligence.[118] One of those elements is actual reliance by the third party plaintiff on the audit.[119] The court held that a plaintiff/creditor can only prove reliance by producing evidence that the audit report was examined prior to extending credit to the auditor's client.[120] This court reasoned that an audit report is interdependent and hence can only be fully understood and justifiably relied upon when considered in the context of the entire report, including any qualifications of the auditor's opinion and any explanatory footnotes included in the statements.[121] The court held that the plaintiff was not reasonable in relying on a secondary source's extraction of only the net worth figure from an audit report.[122]

Although these courts evidenced some sensitivity to the complexity of the audit function, they rarely treated the quality of the auditor's work as a significant issue on appeal.[123] The reason is not expressly indicated in most

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[117] *See, e.g., Bily*, 834 P.2d at 761, 763 (identifying the complexity of the audit as a factor in its decision to limit negligence liability of auditors to third parties) H. Rosenblum Inc. v. Adler, 461 A.2d 138, 147 (N.J. 1983) (stating that "organizations depend upon intricate networks of accountability ... This process of accounting is essential to the proper functioning of society and organizations"); *Harper*, 404 N.W.2d at 778 (noting that audit firm must do more than detect errors it must also provide critical analysis and summary in lay terms); *First Nat'l Bank of Bluefield*, 386 S.E.2d at 313-314 (an audit firm must rely to some degree on the accuracy of client records); *Blue Bell Inc.*, 715 S.W.2d at 416; *Imark Indus. Inc.*, 436 N.W.2d at 319; (cited both auditing standards and audit firm's own audit manual to assert that an audit may require firm to continue to examine open account records until the very end of the field work done in conjunction with the audit).

[118] Raritan River Steel Co. v. Cherry, 367 S.E.2d 609 (N.C. 1988).

[119] *Id.* at 612. See also *Bily*, 834 P.2d at 772 (identifying the need to emphasize that third parties must show reliance on the audit report as an indispensable element of the claim).

[120] *Raritan River Steel Co.*, 367 S.E.2d 609, at 612.

[121] *Id.* at 613.

[122] *Id. See also Eldred*, 468 N.W.2d at 219 (noting that investors who hadn't read the audit firm report can not simply rely on the state who had read the report).

[123] Coopers & Lybrand v. Trustees of the Archdiocese of Miami, 536 So. 2d 278, 282 (Fla. 3rd DCA 1989); Jenson v. Touche Ross & Co., 335 N.W.2d 720, 726 (Minn. 1983) (auditors are required to report contingent liabilities of a client where they involve considerable degree of uncertainty and where an adverse outcome would have material effect on financial statement); Thayer v. Hicks, 793 P.2d 784, 791-92 (Mont. 1990) (audit firm which asserts in engagement letter and audit report that its work was done in conformity with GAAS and GAAP can not defend by asserting that the state accountancy board adopted these standards after the audit in question); Lincoln Grain Inc. v. Coopers & Lybrand, 345 N.W.2d 300, 304-06, and 308-09 (Neb. 1984) (audit firms must independently verify valuations provided by clients, and failure to do so creates the foreseeable risk that future defalcations may occur); Seaward Int'l Inc., v. Price

of courts' observations concerning the procedural history of these cases.[124]

Waterhouse, 391 S.E.2d 283, 286 (Va. 1990) (plaintiff's expert's testimony evaluated to determine if it provided proof that audit firm could have discovered sources to put client's claims in question); *Imark Indus. Inc.*, 436 N.W.2d at 319 (quality of audit work evaluated to aid the appellate court in resolving the issue of allegedly inconsistent jury findings).

Touche Ross & Co. v. Commercial Union Ins. Co., 514 So. 2d 315, 324 (Miss. 1987) (court failed to recognize that a key element of a quality audit is the early assessment of the adequacy of the internal controls of the client) See also *Bily*, 834 P.2d at 748; Devco Premium Finance Co. v. North River Ins. Co., 450 So. 2d 1216, 1219 (Fla. 1st DCA 1984), and Lincoln Grain, Inc. v. Coopers & Lybrand, 345 N.W.2d 300, 304 (Neb. 1984). See Epstein & Spaulding, *supra* note 2, at 21, 134 (demonstrating the significance that self-regulation standards place on the assessment of the adequacy of the client's internal control system for planning and conducting the audit).

Compare John Pickering, *Liability Crisis Goes Global*, ACCOUNTANCY TODAY, Nov. 1992, at 32 (identifying a $832 million dollar lawsuit filed against one of the "Big Six" firms by the subsequently ousted Australian Labor Government in which a CEO had withheld information for years from his board and the audit firm) with Walter P. Schuetze, *Credibility in Question: A Little Backbone Would Cure Legal Crisis*, ACCOUNTANCY TODAY, Dec. 1992, at 10-11 (Chief Accountant for the SEC asserts that among the underlying causes of the increase in litigation against accounting firms is the failure of these firms in many instances to ask clients the tough questions, and make unpopular decisions).

[124] There are two categories of cases in which the appellate court's recitation of the procedural history of the case did provide some basis for inferring why the quality of the audit was not a key appellate issue, despite specific allegations of audit firm malpractice in the plaintiff's pleadings. First, there are those cases in which the case was decided pre-trial or during trial and in turn appealed on a "threshold" procedural issue. Blumberg v. Touche Ross & Co., 514 So. 2d 922, 923 (Ala. 1987) (statute of limitations); Hydroculture Inc. v. Coopers & Lybrand, 848 P.2d 856, 859 (Ariz. Ct. App. 1992) (summary judgment granted accounting firm on client's negligence claim related to the firm's audit work); First Nat'l Bank of Sullivan v. Brumleve and Dabbs, 539 N.E.2d 877 (Ill. App. Ct. 1989) (complaint dismissed pretrial); Brumley v. Touche Ross, 487 N.E.2d 641, 642 (Ill. App. Ct. 1985) (amended complaint dismissed pretrial); Brueck v. Krings, 638 P.2d 904, 905 (Kan. 1982) (statute of limitations); Harper v. Inkster Pub. Schs., 404 N.W.2d 776, 777 (Mich. Ct. App. 1987) (summary dismissal of third party plaintiff's lawsuit on no duty finding); Lindner Fund v. Abney, 770 S.W.2d 437, 438 (Mo. Ct. App. 1989) (pretrial dismissal of plaintiff's claims for failure to state a cause of action); St. Paul Fire & Marine Ins. Co. v. Touche Ross & Co., 452 N.W.2d 746, 748-49 (Neb. 1990) (insurance company, surety for audit firm client, failed to properly plead that they had currently suffered damages).; Levine v. Wiss & Co., 478 A.2d 397, 398 (N.J. 1984) (motion to dismiss granted on grounds of limited immunity); Grant Thorton v. Windsor House, Inc., 566 N.E.2d 1220, 122 (Ohio 1991) (summary judgment granted audit firm on statute of limitations and no intended beneficiary grounds); Brown v. KPMG Peat Marwick, 856 S.W. 2d 742, 743, 745 (Tex. Ct. App. 1993) (summary judgment); Blue Bell Inc. v. Peat Marwick, Mitchell, 715 S.W.2d 408, 410 (Tex. Ct. App. 1986) (pre-trial summary judgment dismissal of plaintiff's complaint); and Ward v. Ernst & Young, 435 S.E.2d 628, 630 (Va. 1993) (trial judge granted defendant audit firm's pre-trial demurrer to breach of contract and professional negligence claims, and dismissed third party beneficiary to contract claim at the end of the plaintiff's trial evidence all on lack of duty/proof of intention to benefit grounds).

Second, cases in which there was evidence that the quality of the audit was contested at trial but eliminated as a key appellate issue: Badische Corp. v. Caylor, 356 S.E.2d 198, 199 (Ga. 1987) (but focusing opinion on scope of duty owed the third party); Pahre v. Auditor of State, 422 N.W.2d 178, 179 (Iowa 1988) (focusing opinion on scope of duty owed the third party); Touche Ross & Co. v. Commercial Union Ins. Co., 514 So. 2d 315, 316-318 (Miss. 1987); H. Rosenblum Inc. v. Adler, 461 A.2d 138, 153 (N.J. 1983) (but focusing opinion on scope of duty owed the third party); Greenstein, Logan & Co. v. Burgess

All that can be fairly said concerning this issue is that either the lawyers for the auditors and the plaintiffs chose not to make it a critical issue, or the trial eliminated the quality of the audit as a critical appellate issue.[125]

There is a third key lesson for auditors from the study of these decisions. Some of these courts have interpreted the standard in a manner that discourages auditors from asking the client to identify the purpose of the audit.[126]

Marketing Inc., 744 S.W.2d 170, 185 (Tex. Ct. App. 1987) (focusing appellate opinion on scope of the damages).

[125] *See supra* note 124 and accompanying text. In the cases in this study, where there was at least trial evidence with respect to the quality of the audit, that evidence provided a basis for the trier of fact to almost always reasonably conclude that the audit was defective - i.e. not completed in accordance with Generally Accepted Auditing Standards (GAAS). See e.g., Coopers & Lybrand v. Trustees of the Archdiocese of Miami, 536 So. 2d 278, 279 (Fla. 3d DCA 1989) (jury found that audit firm negligently prepared audit); *Devco Premium Finance Co.*, 456 So. 2d at 1219; *Pahre*, 422 N.W.2d at 179 (evidence that financial statements prepared by audit firm overstated the financial "health" of the client); *H. Rosenblum Inc.*, 461 A.2d at 153 (reasonable inference that audit had been made carelessly and negligently); University Nat'l Bank v. Ernst & Whinney, 773 S.W.2d 707, 710 (Tex. Ct. App. 1989); Greenstein, Logan & Co., 744 S.W.2d at 185 (audit firm failed to comply with GAAS in conducting the audits in question); *Blue Bell, Inc.*, 715 S.W.2d at 413; *Imark Indus., Inc.*, 436 N.W.2d at 319 (plaintiff presented evidence that audit firm failed to apply proper auditing standards in recognizing as revenue the amount of a disputed change order); Citizens State Bank v. Timm, Schmidt & Co., 335 N.W.2d 361, 363 (Wis. 1983) (plaintiff answers audit firm's motion for summary judgment by submitting affidavit of CPA in which it was concluded that audit firm failed to adhere to GAAS).

[126] Colonial Bank of Ala. v. Ridley & Schweigert, 551 So. 2d 390, 395 (Ala. 1989) (as long as the audit firm doesn't ask purpose it won't learn that it is designed to influence any one or several creditors. As long as creditors remain unspecified they can't be voluntarily contacted by an auditor and hence the audit firm owes them no duty under the near privity standard); First Fla. Bank v. Max Mitchell, & Co., 558 So. 2d 9, 15 (Fla. 1990)(in discussion of the Restatement Second Standard, the court identified and reprinted illustration "10" in the commentary - illustration clearly discourages auditor from asking client about purpose of audit) *Badische Corp.*, 356 S.E.2d at 200 (Ga. 1987) (courts will seek to determine the purpose of the audit in order to determine those third parties who the auditor knew its report was to influence. An auditor who asks no questions about the purpose of the audit, may assume it is only for the use of the client, and then repeat that understanding in the engagement letter).; *Pahre*, 422 N.W.2d at 180, 181 (auditors and their lawyers further discouraged from asking client about purpose of audit when state supreme court further distorts the Restatement standard by limiting class of third parties to those that auditor [rather than client~ expected to influence); Credit Alliance Corp. v. Arthur Anderson, 483 N.E.2d 110, 118 (N.Y. 1985) (near privity standard elements by definition discourage audit firm from asking client purpose of audit); Raritan River Steel Co. v. Cherry, 367 S.E.2d 609, 616 (N.C. 1988) (audit firm liability should be limited to those third parties it knows will rely on their work). See also *Bily*, 834 P.2d at 754, 763, 773 (expressly acknowledging that pre-engagement knowledge by the audit firm that the purpose of the audit is to influence specific third parties is a significant factor meriting possible liability, undercutting for example the need to prove post-audit report contact by such an audit firm with such third parties. Yet, later in the same opinion, the majority asserted that the audit firm may have been unaware of the third party transaction that gave rise to the subsequent third party claim. Further the court stated that if there is inadequate competent evidence that the audit firm knew of possible third parties that the audit report is intended to influence, summary judgment for the audit firm may be appropriate since the firm

Some of these courts have concluded that the audit firm usually does not know the purpose of the audit.[127]

When a court discourages auditors from learning the purpose of an audit, it also leaves judges free to speculate about the purpose of the audit.[128] A few of these courts have even speculated whether the engagement was intended to be an audit.[129] Hence, these courts have reinforced one of the most glaring

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wasn't on notice of the scope of the risk that could result from undertaking the engagement.) *See also* Seaward Int'l, Inc., v. Price Waterhouse, 391 S.E.2d 283, 286 (Va. 1990) (illustrating that even in client/plaintiff cases, critical disputes can arise about the purpose of the audit, and the audit firm who fails to asks and then negotiate with the client with respect to the purpose of the audit, is better served by the legal standard crafted by the appellate court then one who does.)

[127] *Bily*, 834 P.2d at 751 (acknowledging that the purpose of the audit is often to establish the financial credibility of the client with third parties, who will then be more likely to lend or invest in the entity, but also agreed with the presumption that the audit it primarily for internal use of the client); *Raritan River Steel*, 367 S.E.2d at 616 (client may or may not intend to use the audit for other than internal purposes - hence audit firm may have no idea that report may be distributed to others. Hence in fairness audit firm should not be held liable when it is unaware of the use to which its report may be put)

In *Citizens State Bank*, 335 N.W.2d at 367, the president of the audit firm acknowledged that he knew audited statements are used for many purposes, and that it is common for them to be supplied to lenders, creditors, and other persons). In Mid-American Bank & Trust Co. v. Harrison, 851 S.W.2d 563 (Mo. Ct. App. 1993) the accountant stated the purpose of his preparation of annual financial statements of the client was only to influence two specific third parties). In Brown v. KPMG Peat Marwick, 856 S.W. 2d 742, 744-45 (Tx. App., 1993), an express provision of a limited partnership agreement required the annual independent audit and a report to the partners. Yet the court in its analysis of the statute of limitations issue, ignored the fact that this was the only purpose for the audit, and that therefore the limited partners were in fact third party beneficiaries of the audit. *See supra* note 76.

Only a few cases in this study involved situations where the audit firm knew that the purpose of the audit was to conform to statutory and/or regulatory requirements. *See, e.g., Brueck*, 638 P.2d at 906; *Lindner Fund*, 770 S.W.2d at 438; *H. Rosenblum Inc.*, 461 A.2d at 140; *Security Pac. Bus. Credit, Inc.*, 597 N.E.2d at 1086; (publicly held firm primary reason for audit was to satisfy SEC regulations); and *Westpac Banking Corp.*, 484 N.E.2d at 1352.

[128] *Pahre*, 422 N.W.2d at 180 and 181; *H. Rosenblum Inc.*, 461 A.2d at 149; (listing various common purposes for audits, including the influencing of a variety of third parties); *Credit Alliance Corp.*, 483 N.E.2d at 116 (quoting with apparent approval the view of Justice Cardozo expressed more than fifty years earlier in the *Ultramares* decision, that the primary purpose of an audit is for the internal use of the client).

[129] Lincoln Grain, Inc. v. Coopers & Lybrand, 345 N.W.2d 300, 308 (Neb. 1984) (trial judge's instructions characterized the audit as an "opinion audit" without defining "opinion" and without apparently recognizing that all audits result in an "opinion" by the audit firm); *Levine*, 478 A.2d at 398 (appellate court characterized engagement as a binding valuation of a business asset under the appointment of a court, and with the consent of the parties, to a divorce proceeding. Later in the opinion the court describes the accountant's tasks so as to equate the engagement to an audit, Id. at 399.) First Nat'l Bank of Bluefield v. Crawford, 386 S.E.2d 310, 313-314 (W. Va. 1989) (courts have recognized that there may be several kinds of accounting audits - without express citation and without reference to accounting standards identifying and sanctioning notion of several types of audits. Court also failed to infer from its own restatement of the audit firm's understanding of the nature of the engagement that it had undertaken,

omissions in current auditor self-regulation standards: the failure to compel an audit firm to ask the client the purpose of the engagement prior to its agreeing to undertake the work, and to restate those goals in the engagement letter.[130] The early, express identification of the purpose for the audit creates the opportunity for the audit firm and the client to agree upon those third parties to whom the audit will be presented.[131]

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that in fact it was a review and not an audit, see Id. at 314 (n.10)). See also Internt. Mortg. v. Butler Accountancy, 221 Cal. Rptr. 218, 225 (Cal Ct. App., 1986) citing to specific professional audit standards that suggest that when an audit firm has its name associated with reviewed financial statements, it should expressly state the nature of the examination, if any, and the degree of responsibility the audit firm is taking).

[130] Blumberg v. Touche Ross & Co., 514 So. 2d 922, 923 (Ala. 1987) (illustrating an example of an engagement letter making express reference to the purpose of the engagement, but implying that the purpose is for internal client use only). *See also Brueck*, 638 P.2d at 906 (the engagement letter apparently made no reference to the purpose of the audit).

See Annotation, *Liability of Public Accountants to Third Parties*, 46 A.L.R.3d 979, 1001 (1972) (suggesting that audit firms are aware of use of audited reports). *See* Miller *supra* note 12, at 3.07(identifying those pre-engagement steps that an auditor should take to comply with current self-regulation standards. The authors identify the topics to be covered with the client at a pre-engagement conference. No mention is made of asking the client the purpose of the audit. The authors then follow with the standard language to be included in an engagement letter. Again the standard letter omits any reference to the auditor and client having identified the purpose of the audit; id. at 3.07-3.08). *See* Mark F. Murray, *Drafting Accountant Engagement Letters*, PRAC. Law., Dec. 1992, at 61 (discussing drafting engagement letters to reduce the risk of malpractice). Murray suggests that liability can be limited by identifying the expected users of the report. He suggests that the audit firm could state in the engagement letter that it was for client internal use only. *Id.* at 65. If the audit firm has failed to ask the client about the purpose/proposed uses/users of the audit, such an assertion in the engagement letter should not aid in limiting auditor liability.

[131] *Colonial Bank of Ala.*, 551 So. 2d at 393 (reviewing Restatement Second cases and concluding that the Restatement standard works so that the auditor and client can agree on the third parties to be influenced by the audit); *Bily*, 834 P.2d at 767 (acknowledging that the engagement agreement between client and audit firm could specifically identify a particular third party or parties so as to make them third party beneficiaries to the contract); *Badische Corp.*, 356 S.E.2d at 200; Touche Ross & Co. v. Commercial Union Ins. Co., 514 So. 2d 315, 323 (Miss. 1987); *H. Rosenblum Inc.*, 461 A.2d at 152 (qualifying this right to identify and thereby narrow the third parties to be influenced by the audit, to those situations where the audit was of a privately owned company - because federal law and regulations that establish SEC required audits of public companies would not permit such identification and narrowing) *See also* First Nat'l Bank of Minneapolis v. Kehn Ranch, Inc., 394 N.W.2d 709, 713 (S.D. 1986) (purpose of the audit was to comply with express provision in the loan agreement that the debtor hire an audit firm. Hence this creditor could have been identified in the engagement letter, and liability limited to that third person). *See also* Bethlehem Steel Corp. v. Ernst & Whinney, 822 S.W.2d 592, 594 (Tenn. 1991)(where the court expressly stated that the critical point at which to examine the auditor's knowledge of the use of the audit is at the time the audit report is published. This rule would thwart the negotiation point made herein, and ignores the probability that audit planning should be influenced by advance knowledge of the third party/type of third party the audit will be used to influence)

Finally, these cases encourage auditors when drafting opinion letters to consider cautioning even expected users that the passage of time is likely to erode the reliability of the audit.[132]

B. Lessons for Lawyers

This article earlier identified two perspectives that members of the legal profession may have when undertaking a review of the auditor liability cases reviewed in this study.[133] First, most lawyers know that viable legal standards seek to accommodate conflicting interest. This article has documented a close split in the outcome of these decisions attributable in large part to the courts selecting a standard of auditor liability that accommodates both the interests of the accounting profession and that of the type of plaintiffs who filed these lawsuits.[134]

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[132] *First Fla. Bank*, 558 So. 2d at 9 (third party creditor demonstrates recognition of need to examine interim reports); Eldred v. McGladrey, 468 N.W.2d 218, 220-221 (Iowa 1991) (audit firm is not required to update materially correct audit report to reflect changes in the client's financial health it discovers after the audit is completed, which don't materially change the accuracy of the financials for the period covered by the audit); Touche Ross & Co., 514 So. 2d at 324 (audit firm can't be held responsible when loss of plaintiff was principally attributable to criminal fraud which began four months after the completion of the audit); *H. Rosenblum Inc.*, 461 A.2d at 140, 141; (owners of company to be bought out and merged with audit firm's client, demonstrate recognition of need to be reassured that there were no material changes since the financial representations made in the last audited statements). *Raritan River Steel Co.*, 367 S.E.2d at 613 (N.C. 1988) (an audit report represents the auditor's opinion of the accuracy of the client's financial statements at a given period of time).

By the same token, however, cases in the study also recognize the reciprocal principle that an audit firm which discovers evidence after completing the audit that makes the financials it has certified materially inaccurate for the period covered in the statements, is obligated to correct those financials, and/or its accompanying report. *See, e.g.*, Jenson v. Touche Ross & Co., 335 N.W.2d 720, 728 (Minn. 1983); *H. Rosenblum inc.*, 461 A.2d at 140, 155.

The Auditing Practices Board has suggested that the "reliable life" of an audit is one year. Christine Pearse, *Liability: Case Law Accumulates*, 110 ACCOUNTANCY, Nov. 1992, at 114 (citing to a case that held it unreasonable to rely on an audited financials when the audit was already fifteen months old).

More indirect measures of how to determine if audited financials are still reliable come from self-regulation and other authorities. A user of such evidence should examine the quality of the internal control system of the client, consistency of use of Generally Accepted Accounting Principles, viability of the client entity as an on-going concern, and the identification of changes in the use of Generally Accepted Accounting Principles that could materially affect the future financial health of the client entity. *See* Epstein and Spaulding, *supra* note 2, at 134-137 (identifying two recent enactments (Federal Corrupt Practices Act and the Federal Deposit Insurance Corporation Improvement Act) and self-regulation actions (Treadway Commission Reports), which emphasize the significance of the auditor assessment of the internal control system of the entity and requiring reporting on the effectiveness of the internal controls by the entity).

[133] *See supra* notes 15-17 and accompanying text.

[134] *See supra* notes 102-105 and text accompanying those notes and immediately proceeding note

For example, all current standards of legal liability, including the "near-privity" standard, would hold an auditor had a duty to an institutional creditor of the client who paid in whole or in part for that audit.[135] Lawyers for such institutional creditors who study these cases and learn this lesson could recommend that their clients change their lending practices to attempt to insure that they "buy-in" to the audit or an audit update.[136] Most of these standards, on the other hand, would also sanction house counsel for an auditing firm revising opinion letters to carefully spell out the circumstances and duration for which reliance would be warranted by the client and other users of the audit report.[137]

102, and notes 107-110 and accompanying text. *See also* United States v. Arthur Young & Co., 465 U.S. 805, 817-18 (1984) (identifying interest at risk with respect to completion and use of an audit report).

[135] *See supra* notes 86,88-89 and accompanying text.

[136] *Bily*, 834 P.2d at 765, 769 (third parties, whose audit firm is not aware they will rely on audit, can directly contact audit firm and obtain report for own use and benefit); First Fla. Bank v. Max Mitchell & Co., 558 So. 2d 9, 10 (Fla. 1990) (creditor recognized need to examine subsequent interim reports. Once such recognition is demonstrated, a creditor need only offer to pay to expedite the preparation of the interim reports); Huls v. Clifton, Gunderson & Co., 535 N.E.2d 72, 74 (Ill. App. Ct. 1989) (third party plaintiff demonstrated recognition of option of hiring another audit firm to review financials); Pahre v. Auditor of State, 422 N.W.2d 178, 181 (Iowa 1988)(recognizing that third party may pay for work done by professional); Rosenblum v. Adler, 461 A.2d 138, 152 (n. 12) (N.J., 1983)(citing to decision by an Ontario, Canada court which recognized that a third party could recover the costs of paying for a new audit from an audit firm who prepared a negligent audit); Credit Alliance Corp. v. Arthur Anderson, 483 N.E.2d 110, 118 (N.Y. 1985) (citing two earlier decisions, one in which the third party paid for the audit, and another in which the auditor was paid extra by the client for furnishing the report directly to the third party plaintiff); *First Nat'l Bank of Minneapolis*, 394 N.W.2d at 713 (express provision in the loan agreement between the third party creditor and the audit firm's eventual client required the client to have the audit in question done). *See supra* notes 76. *See also Colonial Bank of Ala.*, 551 So. 2d at 395 (illustrating how such a buy-in would alter the outcome of a lawsuit filed on behalf of a "listed creditor").

[137] *First Fla. Bank*, 558 So. 2d at 14 (Fla. 1990); Lincoln Grain, Inc. v. Coopers & *Lybrand*, 345 N.W.2d 300, 307 (Neb. 1984) (sanctioning specific instruction based on apparent disclaimer in the engagement letter that ordinary audit is not a fraud detection audit); *H. Rosenblum Inc.*, 461 A.2d at 152 (a court which adopted the reasonably foreseeable standard of third party liability reasoned that at least commentators had recommended that such liability could be limited by express disclaimers); First Nat'l Bank of Bluefield v. Crawford, 386 S.E.2d 310, 314-315 (W. Va. 1989) (audit firm may make specific disclaimers, the reasonableness of which will be judged by the nature of the engagement it has undertaken. It cannot, however, simply proclaim that its work, given its nature, is unworthy of reliance and it must disclose discovered material flaws in the reports of its clients). *See also supra* note 132 - with regard to reliable life of an audit. *See also* Blumberg v. Touche Ross & Co., 514 So. 2d 922, 923 (Ala. 1987)(providing an example of an auditor's attempt to draft an express disclaimer that did not survive proper evaluation by courts).

Sometimes lawyers and courts have characterized as "disclaimers," statements by audit firms that were in fact admissions that the field work/verification steps contemplated in the audit plan were not executed as planned because the client or the audit firm or both decided that all verification steps need not be completed. *See* Murray *supra* note 130, at 65-66 (advocating consideration of inclusion in engagement

Second, this article suggested that most lawyers would want development of the auditor malpractice standard to be consistent with the evolution of the malpractice standard for lawyers and other professionals.[138] When asked to select a standard for the scope of the duty auditors owe to third parties, a majority of these courts did express a preference for employing the same standard as was employed in lawyer and other professional malpractice cases.[139] Only in a few statute of limitations decisions, where auditors were treated worse or better than lawyers, and in states which chose the privity/near privity standard of auditor liability to third persons, where the standard possibly provided auditors more protection than lawyers, was this preference for the same standards not clearly followed.[140]

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letters of an express disclaimer or client hold harmless clause). Murray doesn't dispute that a disclaimer clause would not excuse an audit firm's failure to comply with current self-regulation standards, especially in light of the fact that the audit report routinely claims that the audit was done in compliance with GAAS. *See also* Epstein and Spaulding *supra* note 2, at 134 (identifying recent self-regulation standards which include disclaimers apparently aimed at users). The difficulty here of course is that such users are not charged with responsibility of knowing these self-regulation standards, and that an audit firm which failed to follow self-regulation standards generally would not necessarily be allowed to shield its liability based on broad "no guarantee" language.

138 *See supra* notes 16-17 and accompanying text.

139 *Blumberg*, 514 So. 2d at 926 (implied, by nature of precedent relied upon); *Bily*, 834 P.2d at 770; Coopers & Lybrand v. Trustees of the Archdiocese of Miami, 536 So. 2d 278, 281 (Fla. 3d DCA 1989); *Pahre*, 422 N.W.2d at 181 (same scope of duty standard for appraisers); Brumley v. Touche Ross, 487 N.E.2d 641, 644 (Ill. App. Ct. 1985) (audit firm duty to third party patterned after lawyer third party liability standard); Jenson v. Touche Ross & Co., 335 N.W.2d 720, 728 (Minn. 1983) (adhering to its rule that professionals can't be held strictly liable); Levine v. Wiss & Co., 478 A.2d 397, 400 (N.J. 1984); Bethlehem Steel Corp. v. Ernst & Whinney, 822 S.W.2d 592, 595 (Tenn. 1991); University Nat'l Bank v. Ernst & Whinney, 773 S.W.2d 707, 710 (Tex. Ct. App. 1989); Blue Bell Inc. v. Peat Marwick, Mitchell, 715 S.W.2d 408, 412-13 (Tex. Ct. App. 1986); Ward v. Ernst & Young, 435 S.E.2d 628, 632-33 (Va. 1993) (adherence to privity standard for all professional malpractice actions); *First Nat'l Bank of Bluefield*, 386 S.E.2d at 313 (selecting the Restatement second rule with respect to an audit firm's liability to third parties,in part, because it is the same standard applied to other professionals); Citizens State Bank v. Timm, Schmidt & Co., 335 N.W.2d 361, 365 (Wis. 1983) (applying the reasonably foreseeable scope of duty standard to auditors, in part because it had been recently decided by the same court that it was the appropriate standard for attorneys) *See* Eric R. Dinallo, *The Peculiar Treatment of Contributory Negligence in Accountant's Liability Cases*, 65 N.Y.U. L. REV. 329, 351 (1990) (commentary advocating similar treatment of auditors with regard to the use of the contributory negligence doctrine in malpractice cases). *See also* Mednick, supra note 14 at 31, demonstrating that even in its drive to seek relief from increased exposure to legal liability, the accounting profession has acknowledged the need for fairness and not privilege for the profession, .

140 Local 1064 v. Ernst & Young, 516 N.W.2d 492, 494-95 (Mich. Ct. App. 1994) (auditors treated not as well as attorneys with respect to the number of years plaintiffs have to file claims. Court rejected application of two year malpractice statute of limitations to auditors on grounds that common law "malpractice" didn't include auditors. Court identifies either three or six year statute of limitations as correct statute for auditors); Investors Reit One v. Jacobs, 546 N.E.2d 206, 211 (Ohio 1989) (auditors treated less

Part 3 - Summary of Key Findings and Future Research Issues

A. Key Findings

This article has "restated" the common law liability decisions of twenty-two state supreme courts and intermediate appellate opinions from five additional states during the period 1980-94. These decisions were then categorized as either favorable to auditors or favorable to the plaintiffs, and then evaluated for their significance to the accounting and legal professions. Several findings have surfaced in this study.

First, there has been a fair amount of common law activity concerning auditor liability. More cases have been decided by these courts in this fifteen year period than in the prior eighty years of the twentieth century.[141] Second, in deciding cases, these courts split almost equally in favor of audit firms and plaintiffs.[142] Most significantly the state supreme courts split evenly, ten making their decision(s) or a majority of their decisions in favor of audit firms, ten in favor of plaintiffs, and two deciding an equal number of cases in favor of audit firms and plaintiffs.[143] Third, despite the substantial increase in the number of such decisions, the outcomes of these cases signal to both professions that these courts' identification, evaluation, and accommodation of the interests at stake in auditor liability disputes is still in flux.[144] Fourth, accounting and legal professions' perspectives were evaluated to account for the close outcome split, and it was concluded that the most significant reason comes from among the perspectives of the legal profession.[145] This perspective was identified as the receptivity of these state supreme and other inter-

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and more favorably than doctors and lawyers in malpractice lawsuits with respect to a statute of limitations defense. Ohio Supreme Court decided general four year rather than one year malpractice statute of limitations is the appropriate statute of limitations for accounting malpractice, but then refused to apply "date of discovery" accrual rule to accountants, after having already ruled that "discovery" rule applies to doctors and lawyers); Grant Thorton v. Windsor House, Inc., 566 N.E.2d 1220, 1222 (Ohio 1991); Brown v. KPMG Peat Marwick, 856 S.W. 2d 742, 747 (Tex.Ct. App. 1993) (audit firm treated better than attorneys potentially with respect to the accrual date of a malpractice action). *See* Travis Dodd, *Accounting Malpractice and Contributory Negligence: Justifying Disparate Treatment Based Upon the Auditor's Unique Role*, 80 GEO. L.J. 909, 930 (1992) (commentary advocating dissimilar treatment of auditors with regard to the use of the contributory and comparative negligence doctrines in malpractice cases).

141 *See supra* notes 21-22 and accompanying text.

142 *See supra* notes 48 and accompanying text.

143 *See supra* notes 35-37 and accompanying text.

144 *See supra* note 58 and accompanying text.

145 *See supra* notes 59-110 and accompanying text.

mediate appellate courts to various "theories of the case", particularly negligence claims for third parties and contract claims for clients as plaintiffs.[146]

The fifth key finding of this article was that the dominant concerns that the accounting profession has with the increased litigation against it were being addressed to some significant degree in the decisions of these most powerful state courts.[147] The outcomes and reasoning of the cases in this study suggest that the accounting profession should have little concern that courts view it as the "deep pocket" when tht; however, the high rate of claims brought against accountants provides a basis for inferring that lawyers for plaintiffs so view audit firms.[148]

In order for the second identified concern of auditors to be better addressed, the attorneys for audit firms and plaintiffs should focus more on the audit firms' compliance with Generally Accepted Auditing and Accounting Standards and Principles in fashioning their "theories of the case and appeal."[149] For example, in preventing litigation and in fashioning their "theories of the case and appeal" in third party plaintiff cases, attorneys should note that these critical state appellate courts show a preference for private ordering to resolve claims against audit firms, and give significance to private ordering that in fact appears in the record in making their decisions.[150] The problem, however, is that these cases reveal little evidence of a systematic resort to such private ordering by audit firms or plaintiffs. Significantly, current accounting self-regulation standards do not require private ordering. In most of these cases, the audit firms did not specifically ask the client about the purpose of the audit, or about whom the audit was specifically intended to influence.[151] There is little evidence in these cases, on the other hand, that users of the audit ever examined its age or inquired as to its useful life, nor do third party complaints seem to systematically express a willingness to "buy-in" to an audit or pay for an update.[152]

When neither side used private ordering, these cases suggest that lawyers for both audit firms and plaintiffs should focus more on the related issues of whether the plaintiff relied in fact on the audit report, and whether that reliance was reasonable.[153] This greater focus on the issues of plaintiff

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146 *See supra* notes 69-110 and accompanying text.

147 *See supra* notes 111-125 and accompanying text.

148 *See supra* notes 113-115 and accompanying text.

149 *See supra* notes 123-125 and accompanying text.

150 *See supra* notes 130-132, and 135-137 and accompanying text.

151 *See supra* notes 130-131 and accompanying text.

152 *See supra* notes 132, 135-137 and accompanying text.

153 *See supra* notes 76-77, 118-122, 131 and accompanying text. The lawyers would turn to the content of the audit report, including any qualifications or reservations contained therein. The focus would be on if, how, and when the audit report was used by this plaintiff, and on the normative role played by the

reliance and the reasonableness of that reliance, rather than on the more "political" scope of duty issue, is far more likely to lead to a search in the record for facts that provide a reasonable accommodation of the interests of the accounting profession and plaintiffs, particularly third party plaintiffs.[154]

The sixth key finding of this article is the identification of the dominant concerns of the legal profession regarding the increased litigation against audit firms in state courts.[155] First, the interests of the audit firms, and by extension law firms, have been reasonably accommodated in these decisions.[156] Second, lawyers and accountants, for the most part, were treated equally in these decisions with respect to malpractice standards and related procedural issues.[157]

B. Future Research Issues

The findings of this article suggest the following will remain important future research issues for both professions. First, will the number of decisions, of state supreme courts, on the common law standard of auditor liability continue at the same accelerated rate as during the 1980-94 period studied in this article? As lawsuits against audit firms continue to be filed, future research might track whether the law of auditor liability remains "in flux" during the last half of the decade of the 1990's and into the first years of the next century.[158] Will (for example) the close split in the outcomes of these state appellate court decisions continue during this period? Will most state supreme courts continue to choose the "middle standard" i.e. of the Restatement Second with respect to the scope of the duty auditors owe third parties? Will the trend towards a uniform malpractice standard for all professionals continue?

Third, research by scholars from both professions should continue to explore if non-big six firms continue to fare roughly as well as big six firms with respect to state appellate court outcomes?[159] What will be the impact on

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audit report in decisions of the type made by this type of plaintiff. *See* Dodd, *supra* note 140, at 920-21 (suggesting that the reliance issue should play a more significant role when clients sue their audit firm).

154 *See supra* notes 86, 89, 93, 98, 100-101(discussing the reasons various courts chose one of the several duty standard options). *See also supra* notes 76-77, 86, 110 (documenting that lawyers for audit firms during this period sometimes argued that the audit firm owed only a duty to the public and concerned third parties when a client sued, and other times argued that the audit firm should have no duty to anyone other than the client when a third party filed the lawsuit).

155 *See supra* notes 133-140 and accompanying text.

156 *See supra* notes 134-137 and accompanying text.

157 *See supra* notes 138-140 and accompanying text.

158 *See supra* notes 58 and accompanying text.

159 *See supra* notes 64-68 and accompanying text.

auditor liability if all concerned parties resort more heavily to private ordering, such as by carefully identifying the purpose of the audit and who therefore is intended to be influenced by the audit and for what period of time? Will an evaluation of the quality of the auditor's work come to play a more significant role in auditor liability litigation during this period?

Finally, future doctrine and empirical research should focus on fostering greater dialogue between the accounting and legal professions.[160] Surveys of the members of both professions about key malpractice issues are rare. Little or no data exists on how often lawyers draft or review audit firm engagement letters for the purpose of reducing the risk of subsequent legal liability. Similarly, detailed data with respect to the costs of malpractice insurance attributable to the filing of lawsuits, the settlement of lawsuits, trial of lawsuits, and appeal of lawsuits are not readily available.[161] Research is needed to assure that the interests of both professions are reasonably accommodated in the future.

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[160] Representatives from the professional committees from national organizations such as the ABA Standing Committee on Lawyer Professional Liability report that the AICPA and the ABA have not taken concerted actions to study the malpractice crisis and the common ground that the professions share with respect to such litigation. In recent years, attorneys and auditors have certainly shared the experience of being jointly sued co-defendants, especially in litigation arising from the savings and loan industry collapse. *See* Diane Cox, *Professionals Defend Themselves*, NAT. L.J., Mar. 1992. On the other hand, there is some perception in the accounting profession that segments of the legal profession are fueling the increased risk that auditors will be sued to further their own self interests. *See* Reeves, *supra* note 1. *See also* Murray *supra* note 130 (noting that attorneys should write or review accountant engagement letters to reduce the risk of subsequent litigation/successful litigation). *See also* Murray, *The Engagement Letter: A Good Defense Measure*, THE PRACTICING CPA, July 92 (same author writing on same topic directed to accounting firms).

[161] For evidence that the ABA and AICPA have cooperated in the past to resolve audit issues of importance to both professions, *see* SAS #12. In a winter of 1993 telephone conversation between the director of the ABA Lawyer Professional Liability Committee and the authors of this article, the director noted the lack of data to support the contention that at least with respect to lawyers there was a malpractice crisis (i.e. a significant increase in the number of lawsuits filed against lawyers over the course of the 1980's and into the 1990's, or a resulting significant impact on the availability and cost of malpractice insurance for lawyers). She also noted the difficulty even the ABA Standing Committee had in collecting systematic data on malpractice claims and insurance coverage and rates. She felt that two of the key reasons for this difficulty were reluctance of a sufficient number of insurance companies to provide comprehensive claims data, and the significant number of lawyers without malpractice insurance. *See supra* note 9 (identifying sources that demonstrate that the accounting profession has done better in collecting such data from its members, and that about forty percent of smae same perception by the legal profession concerning legal malpractice, *see also* Couric, *supra* note 1, at 68.