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Raritan River Steel Co. v. Cherry, Bekaert & (and) Holland: Accountants' Liability to Third Parties for Negligent Misrepresentation

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For more than fifty years public accounting firms have provided a unique financial service by performing annual audits on their clients' financial statements. By rendering an independent, objective evaluation of the statements, the auditor provides reasonable assurance to financial information users such as lending institutions and investors that the financial statements fairly present the financial position of the client.[1] But, in performing audits, public accountants recognize that an "inherent divergence of interests [exists] between management and third persons who will rely upon these statements."[2] While management desires to maximize the profits reflected in the financial statements, third parties seek to control risk by accurately evaluating a company's credit or investment potential. This divergence of interests generates disagreement on the extent and type of financial information that should be presented. The result is third-party decision-makers demanding an impartial evaluation of the client's financial statements.

Increasing complexity in financial transactions "dictate[s] that the general public rely more heavily now than ever before on the work product of the professional accountant."[3] Increased competition for audit clients, however, has resulted in price wars among the big accounting firms, and both commentators and professionals assert that lower accounting fees create pressure on firms to cut corners so that they may remain profitable on each job.[4] Cutting corners may result in a compromise of professional standards[5] and may risk potential lawsuits at a time when the exact scope of accountants' liability to third parties remains unsettled.[6]

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1. *See* CODIFICATION OF ACCOUNTING STANDARDS vol. B, Concept of Professional Ethics No. 7, § 51 (Am. Inst. of Certified Pub. Accountants 1985) [hereinafter ACCOUNTING STANDARDS vol. B] (recognizing that the "public accountant should maintain his integrity and objectivity and . . . be independent of those he serves"); ACCOUNTING STANDARDS vol. A, Statement on Auditing Standards No. 1, § 110 (Am. Inst. of Certified Pub. Accountants 1985) [hereinafter ACCOUNTING STANDARDS vol. A] ("The objective of the ordinary examination of financial statements by the independent auditor is the expression of an opinion on the fairness with which they present the financial position . . . in conformity with generally accepted accounting principles.").

2. H. Rosenblum, Inc. v. Adler, 93 N.J. 324, 347, 461 A.2d 138, 150 (1983).

3. Note, *Negligent Misrepresentation and the Certified Public Accountant: An Overview of Common Law Liability to Third Parties*, 18 SUFFOLK U.L. REV. 431, 431 (1984); *see* United States v. Arthur Young & Co., 465 U.S. 805, 817-18 (1984) (public accountant's role is that of "Public Watchdog"); ACCOUNTING STANDARDS vol B, *supra* note 1, Concept of Professional Ethics No. 2, § 51 ("The reliance of the public . . . impose[s] particular obligations on certified public accountants.").

4. *See, e.g.*, Stevens, *No More White Shoes*, BUS. MONTH, April 1988, at 39, 40.

5. *See id.* at 41.

6. Jurisdictions currently apply one of four tests in evaluating the scope of accountants' liability to third parties for negligent misrepresentation: (1) the traditional privity requirement, (2) a balancing of factors approach, (3) the *Restatement (Second) of Torts* standard, and (4) the simple negligence standard of reasonable foreseeability. *See* Gossman, *An Examination of an Emerging Tort Theory Expanding the Liability of Certified Public Accountants for Negligent Misrepresentation*, 4 COOLEY L. REV. 301 (1987) (critical analysis of various theories of accountant liability); *see also*

In 1931 the New York Court of Appeals held in *Ultramares Corp. v. Touche*[7] that a third party could recover for an accountant's negligence only if she was considered the primary beneficiary of the contract between the auditor and the client.[8] More than fifty years later, most jurisdictions still require some form of privity between the third party and the accountant before imposing liability for negligence.[9] The majority of courts recently addressing the issue have adopted the *Restatement (Second) of Torts* formulation that extends the right of recovery to third parties who are members of a foreseen class of financial statement users.[10] Nevertheless, a pure negligence formula that extends the cause of action to all reasonably foreseeable users has gained increased acceptance from both courts and legal commentators.[11]

In *Raritan River Steel Co. v. Cherry, Beckaert & Holland*[12] the North Carolina Supreme Court addressed the legal sufficiency of third-party creditors' claims of negligent misrepresentation by a public accounting firm that issued an unqualified opinion on the financial statements of a client. The court followed the modern trend and adopted the *Restatement* approach.

This Note examines the factors the court considered in evaluating the legal sufficiency of the creditors' complaints regarding the essential elements of justifiable reliance and duty. The Note also addresses the importance of and problems with establishing the additional element of causation. Finally, the Note reviews the court's rationale for adopting the *Restatement* approach and concludes that both legal reasoning and policy considerations support extending accountants' liability to the more expansive reasonable foreseeability standard.

In *Raritan River*, Intercontinental Metals Corporation ("IMC") engaged defendant, the public accounting firm of Cherry, Beckaert & Holland, to perform an audit of the company's financial statements for the fiscal years ending September 30, 1980 and September 30, 1981.[13] Defendant's audit report expressed an unqualified opinion that IMC's comparative financial statements presented fairly the company's financial position as of September 30, 1981. The

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Note, *supra* note 3, at 431-32 (noting that "[d]ue to this increased reliance [upon the auditor's report], several jurisdictions have expanded accountants' liability for negligent economic injury to third parties").

7. 255 N.Y. 170, 174 N.E. 441 (1931).

8. Courts and commentators refer to the doctrine as the "limited privity rule." *See, e.g.*, Gossman, *supra* note 6, at 302. The *Ultramares* court did recognize a third party's right to recover from an accountant for fraud in the absence of privity. *Ultramares*, 255 N.Y. at 179, 174 N.E. at 444. See *infra* notes 24-27 and accompanying text for facts and discussion of *Ultramares*.

9. Achampong, *Common Law Liability of Accountants for Negligence to Non-Contractual Parties: Recent Developments*, 91 DICK. L. REV. 677, 677 (1985), *reprinted in* 37 DEF. L. REV. 203 (1988); *see, e.g.*, Credit Alliance Corp. v. Arthur Andersen & Co., 65 N.Y.2d 536, 554, 483 N.E.2d 110, 119, 493 N.Y.S.2d 435, 445 (1985); Robertson v. White, 633 F. Supp. 954, 970-71 (W.D. Ark. 1986); Briggs v. Sterner 529 F. Supp. 1155, 1177 (S.D. Iowa 1981).

10. *See* RESTATEMENT (SECOND) OF TORTS § 522 (1977); Gossman, *supra* note 6, at 302 (*Restatement* limits the scope of liability by retaining "as its basis the limits prescribed by contract law").

11. *See* Gossman, *supra* note 6, at 302-03; H. Rosenblum, Inc. v. Adler, 93 N.J. 324, 355-56, 461 A.2d 138, 155-56 (1983). See *infra* notes 41-50 and accompanying text for a discussion of the reasonable foreseeability standard.

12. 322 N.C. 200, 367 S.E.2d 609 (1988).

13. *Id.* at 203, 367 S.E.2d at 611.

audit report also included a statement that the defendant performed the audit in accordance with Generally Accepted Auditing Standards (GAAS).[14] IMC subsequently went bankrupt.

The two plaintiffs, Raritan River Steel Company ("Raritan") and Sidbec-Dosco, Inc. ("Sidbec"), consolidated their actions as creditors of IMC. Both alleged that defendant's negligence in preparing the audit report resulted in an overstatement of IMC's actual net worth in the financial statements. Raritan claimed that it extended more than two million dollars credit on open account for IMC's purchase of raw steel. Raritan obtained IMC's net worth figure from a report published in *Dun & Bradstreet*, and the report cited defendant's audit report as its source of information. Sidbec asserted that it obtained IMC's net worth figure directly from the defendant's report, and it sought damages for the loss of substantial unsecured credit extended to IMC in reliance on the report.

Before addressing the legal sufficiency of the two complaints, the supreme court defined negligent misrepresentation as a tort that "occurs when a party justifiably relies to his detriment on information prepared without reasonable care by one who owed the relying party a duty of care."[15] The court then concluded that "a party cannot show justifiable reliance on information contained in audited financial statements without showing that he relied upon the actual financial statements to obtain this information."[16] Because Raritan pleaded reliance on the *Dun & Bradstreet* report, the court dismissed its complaint.[17] Sidbec pleaded reliance only on the actual audit report and financial statements and, therefore, sufficiently pleaded the element of justifiable reliance.[18]

Next, the court addressed whether Sidbec's complaint adequately established that defendant owed it a duty of care. The court noted four different tests used by other jurisdictions in determining the scope of an accountant's liability to third parties.[19] The court rejected the limited privity rule of *Ultramares* as unduly restrictive and rejected the more expansive negligence standard of reasonable foreseeability as imposing "liability more expansive than an accountant should be expected to bear."[20] The court adopted the *Restatement* formulation and interpreted the standard to extend the right of recovery to any "person, or one of a group of persons, whom the accountant or his client intends the infor-

14. Generally Accepted Auditing Standards concern the auditor's professional qualities and the judgment exercised by him in the performance of his examination and his report. The American Institute of Certified Public Accountants (AICPA) approved and adopted 10 standards with which auditors must comply, and auditing procedures that auditors must perform before rendering an opinion on the financial statements. *See* ACCOUNTING STANDARDS vol. A, *supra* note 1, Statements of Auditing Standards Nos. 1 & 2, § 150.

15. *Raritan River*, 322 N.C. at 206, 367 S.E.2d at 612.

16. *Id.*

17. *Id.* at 207, 367 S.E.2d at 613.

18. *Id.* at 207-08, 367 S.E.2d at 613. The court's distinction is not between two sets of information, but between two sources of information. Although Raritan and Sidbec presumably relied on identical information, only Sidbec, which relied on the actual financial statements, sufficiently pleaded justifiable reliance. *See infra* notes 54-55 and accompanying text.

19. See *supra* note 6 for the enumeration of the four tests. See *infra* notes 24-50 and accompanying text for the comparison and evaluation of the four tests.

20. *Raritan River*, 322 N.C. at 211, 367 S.E.2d at 615.

mation to benefit."[21] If the client holds the requisite intent, "then the accountant must know of his client's intent at the time the accountant audits or prepares the information."[22]

Sidbec's complaint alleged that defendant knew IMC would use the audited financial statements to represent its financial condition and that third parties would extend credit in reliance upon the statements. Applying the *Restatement* test, the court concluded that Sidbec sufficiently alleged that defendant intended or knew IMC intended such information to benefit third-party creditors.[23]

The scope of accountants' liability for negligent misrepresentation was an issue of first impression in North Carolina. The supreme court, therefore, looked not only to the *Restatement,* but also to the extensive case law in other jurisdictions for guidance in formulating a standard of liability.

The scope of accountants' liability to third parties was first addressed in the landmark *Ultramares* case.[24] In *Ultramares* plaintiff creditor, relying upon defendant's report, suffered credit losses when the client company declared bankruptcy.[25] Defendant knew the client intended to use his report in obtaining credit from banks, creditors, or sellers. Nevertheless, the court denied recovery on the plaintiff's negligent misrepresentation claim.

The *Ultramares* court rejected extending accountants' liability to third parties because "if negligence exists, a thoughtless slip or blunder . . . may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class."[26] The court concluded that little justification existed for imposing a duty that would subject a party to such consequences.[27]

Although the assault on the *Ultramares* privity doctrine started in the late 1960s,[28] the requirement of privity survives as the majority rule.[29] Jurisdictions recently adopting the privity rule, however, have applied a contemporary formulation of the privity standard articulated by the New York Court of Appeals in *Credit Alliance Corp. v. Arthur Andersen & Co.*[30] In *Credit Alliance* the court

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21. *Id.* at 210, 367 S.E.2d at 614 (interpreting RESTATEMENT (SECOND) OF TORTS § 552 (1977)). See *infra* notes 33-40 and accompanying text for the background and development of case law concerning the *Restatement.*

22. *Raritan River,* 322 N.C. at 210, 367 S.E.2d at 614.

23. *Id.* at 215-16, 367 S.E.2d at 618.

24. 225 N.Y. 170, 174 N.E. 441 (1931); *see* Note, *supra* note 3, at 436. By the beginning of the twentieth century, "most American courts required privity for the recovery of damages *for both physical and economic injury* allegedly caused by negligent performance of a contract." Note, *supra* note 3, at 435 (emphasis added).

25. *Ultramares,* 255 N.Y. at 175, 174 N.E. at 442.

26. *Id.* at 179, 174 N.E. at 444. The plaintiff did prevail on its fraud claim. Some commentators argue that Justice Cardozo refused to extend liability for negligence to accountants either to protect the "fledgling" accounting industry or because he believed that the plaintiff would prevail on the fraud claim. *See* Achampong, *supra* note 9, at 205 n.14; Note, *supra* note 3, at 436-37 n.32.

27. *Ultramares,* 255 N.Y. at 179, 174 N.E. at 444. The court also noted that such liability for negligence would extend to "other callings" and create one negligence standard with regard to the client and another standard, often stricter, with regard to the public. *Id.* at 188, 174 N.E. at 448.

28. *See* Gossman, *supra* note 6, at 302-03.

29. *See* Gossman, *supra* note 6, at 302 & n.6. For an enumeration of the four current approaches, see *supra* note 6.

30. 65 N.Y.2d 536, 483 N.E.2d 110, 493 N.Y.S.2d 435 (1985); *see, e.g.,* Toro Co. v. Krouse, Kern & Co., 827 F.2d 155, 158-59 (7th Cir. 1987) (applying Indiana law) (insufficient evidence under

dismissed a third party's claim for credit losses allegedly resulting from reliance upon a negligently prepared audit report. The court established a three-pronged test for imposing liability which required that the accountant (1) know of the "particular purpose" for which the plaintiff intends to use statements; (2) know the specific identity of the plaintiff or plaintiffs; and (3) exhibit some conduct "which evinces the accountants' understanding" of the plaintiff's reliance.[31] Although the court's wording differed from that used in the *Ultramares* primary beneficiary test, the court dismissed the plaintiff's complaint by finding that the defendant's conduct failed "to demonstrate the existence of a relationship between the parties sufficiently approaching privity."[32]

The North Carolina Supreme Court in *Raritan River* rejected the limited privity rule and followed the modern trend in electing to adopt the *Restatement* alternative for determining the scope of accountants' liability.[33] The *Restatement* extends the right of recovery for negligent misrepresentation to persons or classes of persons (1) whom either the auditor intended to influence or knew that his client intended to influence with the financial statements, and (2) who relied upon such statements in a transaction that the accountant intended to influence or knew his client intended to influence.[34] Therefore, if the auditor knows the client intends to use the financial statements to negotiate a bank loan but does not know the specific bank, the auditor nevertheless is potentially liable for negligence to any bank with whom the client negotiates and obtains the loan.[35] Courts have applied the *Restatement* formulation to a variety of third-party class members.[36]

In adopting the *Restatement* formulation, jurisdictions have justified the ex-

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Credit Alliance test to show accountant's understanding of plaintiff's actual reliance); Robertson v. White, 633 F. Supp. 1155, 1176-77 (S.D. Iowa 1981) (decided prior to *Credit Alliance* decision, but nevertheless denied liability because defendant lacked actual knowledge regarding particular plaintiff).

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

32. *Id.* at 553, 483 N.E.2d at 119, 493 N.Y.S.2d at 444.

33. *Raritan River*, 322 N.C. at 214, 367 S.E.2d at 617; *see* Achampong, *supra* note 9, at 211; Gossman, *supra* note 6, at 302 n.6. *But cf.* Note, *supra* note 3, at 443 ("In the most recent decisions concerning accountants' liability to third parties, courts have adopted a standard negligence theory of recovery.").

34. RESTATEMENT (SECOND) OF TORTS § 552(2) (1977). The *Restatement* limits liability to losses suffered

> (a) by the person or one of a limited group of persons for whose benefit and guidance [the accountant] intends to supply the information or knows that the [client] intends to supply it; and
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> (b) through reliance upon it in a transaction that [the accountant] intends the information to influence or knows that the [client] so intends . . . .

Id. The known limited group the auditor or client intends to influence is distinct from the "much larger class who might reasonably be expected sooner or later to have access to the information" and foreseeably rely on it. *Id.* § 552 comment h.

35. *See id.* § 552(a) comment h, illustrations 5-7. The *Restatement* extends the right of recovery to the class actually foreseen by the accountant as well as to the person specifically foreseen. *See* Note, *supra* note 3, at 440 & n.50.

36. *See, e.g.*, Badische Corp. v. Caylor, 257 Ga. 131, 356 S.E.2d 198 (1987) (supplier of inventory to client on credit not a member of class of whose reliance defendant was actually aware); Haddon View Inv. Co. v. Coopers & Lybrand, 70 Ohio St. 2d 154, 436 N.E.2d 212 (1982) (accountant could specifically foresee limited partners' reliance on his report performed for the partnership).

pansion of liability by pointing to the present status of the accounting industry. In *Spherex, Inc. v. Alexander Grant & Co.*[37] the court noted that "the sophistication of modern accounting procedures and the accountant's central role in the financing and investment industry are a far cry from the fledgling profession in need of judicial protection that existed at the time of *Ultramares*."[38] According to the court, the *Restatement* approach "harmonize[s] the accountant's contemporary role and his potential liability."[39]

The reasonable foreseeability or "pure" negligence formula represented a third alternative available to North Carolina in establishing a rule of liability. This standard imposes on the accountant liability for negligence to all those whom he "should reasonably foresee as recipients from the company of the statements."[40]

At least one court has rejected the argument that extending accountants' liability to all reasonably foreseeable users would result in financial ruin to the accounting industry. In 1983 the New Jersey Supreme Court, in *H. Rosenblum, Inc. v. Adler*,[41] became the first court to adopt the reasonable foreseeability standard. The court concluded that "the extent of financial exposure has certain built-in limits":[42]

> The plaintiffs would have to establish that they received the audited statements from the company pursuant to a proper company purpose, that they, in accordance with that purpose, relied on the statements and that the misstatements therein were due to the auditor's negligence and were a proximate cause of the plaintiff's damage.[43]

The *Rosenblum* court also espoused two policy arguments supporting the extension of liability. First, the court noted that extending liability shifted the loss from the innocent third party to the negligent defendant.[44] Second, the imposition of a duty to foreseeable users should cause "accounting firms to engage in more thorough reviews."[45]

Similarly, in *International Mortgage Co. v. John P. Butler Accountancy Co.*[46] the California Court of Appeal adopted a standard negligence formula after rejecting arguments that such an expansive test would impose an undue burden on accountants because of their lack of control over the client's records and the ultimate users.[47] In *International Mortgage* plaintiff admitted that de-

37. 122 N.H. 898, 451 A.2d 1308 (1982).

38. *Id.* at 903-04, 451 A.2d at 1311.

39. *Id.* at 904, 451 A.2d at 1312.

40. H. Rosenblum, Inc. v. Adler, 93 N.J. 324, 352, 461 A.2d 138, 153 (1983).

41. 93 N.J. 324, 461 A.2d 138 (1983). The plaintiff in *Rosenblum* acquired stock in defendant's client, a publicly traded corporation, after relying upon the defendant's unqualified audit report. The auditors failed to detect the client's manipulation and falsification of accounting records, and plaintiff's stock subsequently proved worthless. *Id.* at 329, 461 A.2d at 140.

42. *Id.* at 350, 461 A.2d at 152.

43. *Id.*

44. *Id.* at 351, 461 A.2d at 152.

45. *Id.* at 350, 461 A.2d at 152. The court further noted accountants' ability to satisfy their financial obligations in the past and the availability of malpractice insurance. *Id.*

46. 177 Cal. App. 3d 806, 223 Cal. Rptr. 218 (1986).

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

fendant neither knew of him at the time of the audit nor knew plaintiff would rely or was relying on the statements. Nevertheless, the court refused to recognize defendant's undue burden argument and stated:

> The auditor is not guaranteeing the client's records and resulting financial statements are perfect; only that any errors which might exist could not be detected by an audit conducted under GAAS and GAAP. Thus, the auditor's degree of control over the client's records is unimportant; the auditor need only control his or her abilities to apply GAAS and GAAP to a given audit situation.[48]

In addressing the auditor's lack of control over the ultimate users, the court held that the auditor's liability extends "only to those third parties who reasonably and foreseeably rely on the audited statements."[49]

In *Raritan River* the North Carolina Supreme Court had a choice of four standards for assessing an accountant's duty: the privity rule, the *Restatement* rule, the balancing of factors approach, and the reasonable foreseeability standard. Before adopting a standard, however, the court established the requirements for proving the element of justifiable reliance.

The court stated that to prove justifiable reliance, a plaintiff must demonstrate that he relied on information in the "*actual* financial statements."[50] The court cited as authority for its premise the New Jersey Supreme Court's decision in *Rosenblum*.[51] In *Rosenblum* the court, after adopting the expansive foreseeable users standard for determining the scope of liability, limited its holding by declaring that "foreseeable users . . . [must] receive the audited statements *from the business entity for a proper business purpose* to influence a business decision of the user."[52]

In its complaint Raritan pleaded reliance on information contained in a *Dun & Bradstreet* credit report. Although *Dun & Bradstreet* cited defendant's audit report as its source of information, the supreme court dismissed the claim because it failed to allege reliance on the actual audit report. The court noted that no other court had permitted a plaintiff to prevail "without demonstrating that they relied upon the accountant's actual audit opinion."[53] In addition, the court implicitly incorporated *Rosenblum*'s additional requirement that the plaintiff receive the audit report from the client or accountant.[54]

48. *Id.* at 818, 223 Cal. Rptr. at 225.

49. *Id.* at 818, 223 Cal. Rptr. at 225-26.

50. *Raritan River*, 322 N.C. at 206, 367 S.E.2d at 612 (emphasis added).

51. *Id.* (citing H. Rosenblum, Inc. v. Adler, 93 N.J. 324, 352-53, 461 A.2d 138, 153 (1983)).

52. *Rosenblum*, 93 N.J. at 352, 461 A.2d at 153 (emphasis added). The New Jersey court then concluded that "an institutional investor or portfolio manager who does not obtain the audited statements from the company would not come within the stated principle." *Id.* at 352-53, 461 A.2d at 153.

53. *Raritan River*, 322 N.C. at 206, 367 S.E.2d at 613.

54. *Id.* at 206, 367 S.E.2d at 612-13. Although the court cited *Rosenblum* with favor, whether such citation constitutes an express adoption is not completely certain. The *Raritan River* court did not strictly hold that the plaintiff must have received the report from the client or accountant, but only that it must have relied on the actual audited financial statements. However, the court did not address any discrepancies that might have existed between the *Dun & Bradstreet* report and the audit report. Therefore, reliance on the actual audit report is required probably not to bar plaintiffs who

The court expressly stated two reasons for requiring reliance on the actual audit report. First, the audit opinion expresses the accuracy of the client's financial position "at a given period of time."[55] Second, the financial statements "are the representations of management, [and] not the auditor."[56] At first glance, these two considerations do not seem to provide a sound basis for the court's requirement of reliance on the actual audit report. Presumably, if precisely the same information exists in both the *Dun & Bradstreet* report and the audit statements, then no disparity in the information conveyed to the users will exist because the publication has altered neither the opinion's accuracy nor the date or content of the audit report.

In fact, however, the court's rationale is reasonable. Because of the unique nature of an auditor's opinion—valuable for a limited time and based upon representations other than his own—the auditor needs some control over distribution of the audited information. Therefore, the court implied a requirement that the user receive the audit report from the client or accountant to provide the auditor with a mechanism for limiting the scope of his liability by controlling the distribution of his audit report.[57]

A third basis for the court's requirement of reliance on the actual audited financial statements is the indivisible nature of the audit report. The court stated, "Isolated statements in the report, particularly the net worth figure, do not meaningfully stand alone; rather, they are interdependent and can be fully understood and justifiably relied on only when considered in the context of the entire report . . . ."[58] The court recognized that an auditor expresses an opinion on the financial statements taken as a whole, and not on the individual parts.[59] Furthermore, an auditor cannot control which audited information a financial information supplier selects to reproduce for its subscribers. Thus, to permit a third party to recover for losses resulting from reliance on less than the full audit report exposes the accountant to liability greater than his undertaking.[60]

Theoretically, the plaintiff also must prove causation by demonstrating that reliance on specific inaccurate data, as opposed to the entire financial report,

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rely on inaccurate reproductions, but plaintiffs who receive the information from a source other than the client or accountant.

55. *Id.* at 207, 367 S.E.2d at 613.

56. *Id.*

57. *See supra* note 52 and accompanying text. The engagement letter between the auditor and the client sets out the nature, extent, and timing of the auditor's services. The auditor and client also may establish the number of audit report copies and identify any third party recipients. Thus, by controlling the number of parties receiving the audited statements, the auditor can control the potential number of claimants. In addition, the auditor can control the timing of statement distribution and thereby exercise limited control over the time frame in which parties receive the information.

58. *Raritan River*, 322 N.C. at 207, 367 S.E.2d at 613. The court stated that the "entire report" consists of not only the financial statements themselves, but also "any explanatory footnotes included in the statements." *Id.*

59. *See* ACCOUNTING STANDARDS vol. A, *supra* note 1, Statement on Auditing Standards No. 1, § 504 (fourth reporting standard).

60. Even if the audit report and the published information are identical, the other considerations make reliance unjustified. *See supra* notes 53-57 and accompanying text.

caused his damages.[61] Because *Raritan River* only reached the pleading stage, the court never addressed the causation issue other than to acknowledge that plaintiff alleged errors in the financial statements and losses in reliance upon such statements.[62] One commentator has noted that "an examination of past audit cases reveals that more often than not the auditors were held [liable] for the entire amount of plaintiff's loss," because the court never attempted to apportion damages based on causation.[63] Whether North Carolina will follow this trend remains to be determined. However, if courts continue to permit a plaintiff to establish detrimental reliance (*i.e.*, causation) merely by proving errors in the statements and losses from reliance on those statements—rather than reliance on the specific errors in the statements—then the lack of detrimental reliance will cease to exist as a valid defense.[64]

Establishing causation requires not only proving detrimental reliance on the audit report, but also proving that the auditor's errors and omissions were material. If courts fail to assess the materiality of the auditor's misstatements, then any insignificant errors incapable of adversely influencing a user's decision could serve as a foundation for accountants' liability.[65] Presumably, however, because courts require a misstatement of a material fact for fraud claims, the courts likewise will require material misstatements for negligence claims.

The second issue created by the *Raritan River* court's definition of negligent misrepresentation regarded to which third parties the auditor's duty extended. The court first discussed and evaluated other jurisdictions' support and criticism for each alternative.

The court declined to adopt the longstanding *Ultramares* approach, declaring it "unduly restrictive" in light of the "central role independent accountants play in the financial world."[66] The court recognized that audited information increasingly serves as the financial decision-making tool for investors and lenders.[67] Due to the "heavy public reliance on audited information," the *Ultramares* rule undesirably discriminated against otherwise deserving plaintiffs not in "privity or near-privity" with the auditor.[68]

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61. *See* Gossman, *supra* note 6, at 323 (plaintiff must prove reliance on inaccurate data caused his losses).

62. *Raritan River*, 322 N.C. at 203, 367 S.E.2d at 611.

63. Gossman, *supra* note 6, at 323 ("such a result is neither fair nor consistent with legal principles").

64. *See id.*

65. In *Ultramares*, Cardozo's apprehension in abrogating the privity requirement was that "a thoughtless slip or blunder" could create liability. 255 N.Y. 170, 179, 174 N.E. 441, 444 (1931).

66. *Raritan River*, 322 N.C. at 211, 367 S.E.2d at 615.

67. *Id.* The *Raritan River* court's rejection of the *Ultramares* approach accords with the majority of recent decisions in other jurisdictions. *See* Gossman, *supra* note 6, at 302 n.6.

68. *Raritan River*, 322 N.C. at 211, 367 S.E.2d at 615. In addition to the "heavy public reliance" rationale, the court apparently considered most persuasive other courts' arguments that an alternative standard best serves to encourage the accountants to refrain from performing negligent audits at the expense of innocent parties. *See, e.g.*, H. Rosenblum, Inc. v. Adler, 93 N.J. 324, 339, 461 A.2d 138, 145 (1983); Badische Corp. v. Caylor, 257 Ga. 131, 134, 356 S.E.2d 198, 200 (1987). *But see* Gossman, *supra* note 6, at 320-21 ("The assertion that an accountant's duty to the public is such as to give rise to liability to the general public is neither logical nor founded on sound legal principles."); Goldberg, *Accountable Accountants: Is Third-Party Liability Necessary?*, 17 J. LEGAL

The rejection of the "near-privity" rule not only follows the modern trend, but is legally sound. The current *Ultramares* standard extends liability only to the specifically foreseen plaintiff.[69] For example, an auditor might learn that his client intends to use the audit report to procure two separate loans, one from Bank X and one from an anonymous bank. Although extending the auditor's liability to both banks would result in no additional burden to perform his audit with reasonable care, the auditor nonetheless would remain liable for negligent misrepresentation under the "near-privity" rule only to the specifically foreseen Bank X.[70] However, both the *Restatement* rule and the reasonable foreseeability standard would impose liability on the auditor to both banks.

With little discussion, the *Raritan River* court also rejected the *Biakanja v. Irving*[71] balancing test, which the North Carolina Court of Appeals had adopted as the appropriate standard. The court considered the "moral blame" and "policy of preventing future harm" factors incapable of "precise application."[72] In addition, the court noted that the factors added little to the "assessment of whether a defendant violated a particular duty of care."[73] Finally, the court found the balancing test to approximate the "reasonable foreseeability" test, and for reasons stated below, the court refused to adopt such an expansive standard.[74]

The *Raritan River* court concluded that the *Restatement* standard most effectively balanced "the need to hold accountants to a standard that accounts for their contemporary role in the financial world with the need to protect them from liability that unreasonably exceeds the bounds of their real undertaking."[75] In adopting the *Restatement* standard, the court explained its rejection of the "reasonable foreseeability" test. The court examined the analogy made by other jurisdictions between negligent misrepresentation claims and products liability claims.[76] The court rejected the reasonable foreseeability jurisdictions' conclu-

STUD. 295, 300 (1988) (arguing that third parties who desire increased reliability should contract with the auditor for it, because the assertion that increased liability alone provides an incentive for the auditor to exercise greater care is at best dubious).

69. *See supra* text accompanying notes 29-32.

70. *See* ACCOUNTING STANDARDS vol. A, *supra* note 1, Statement of Auditing Standards § 312; *infra* notes 101-02.

71. 49 Cal. 2d 647, 320 P.2d 16 (1958). The *Biakanja* balancing of factors represents a fourth approach to assessing liability to third parties for negligent misrepresentation. However, this approach has received little recognition by courts in assessing accountants' liability. *Biakanja* involved extending a notary public's liability for negligence to a third party based upon balancing factors such as the "extent to which the transaction was intended to affect the plaintiff, the foreseeability of harm to him, [and] the degree of certainty that the plaintiff suffered injury . . . ." *Id.* at 650, 320 P.2d at 19. Only one court, the Missouri Court of Appeals in 1973, has applied this approach to the auditors' situation. *See* Aluma Kraft Mfg. Co. v. Elmer Fox & Co. 493 S.W.2d 378, 383 (Mo. Ct. App. 1973). Ironically, even the California courts have refused to use the *Biakanja* test in assessing accountants' liability. *E.g.*, International Mortgage Co. v. John P. Butler Accountancy Corp., 177 Cal. App. 3d 806, 820, 223 Cal. Rptr. 218, 227 (1986).

72. *Raritan River*, 322 N.C. at 214, 367 S.E.2d at 617.

73. *Id.*

74. *Id*; *see infra* text accompanying notes 75-94.

75. *Raritan River*, 322 N.C. at 214, 367 S.E.2d at 617.

76. *Id.* at 212, 367 S.E.2d at 615-16. The distinction between claims involving economic injury and claims involving physical injury intensified after the New York Court of Appeals' holding that a third party may recover for physical injury resulting from the negligence of a manufacturer not in

sion that public policy does not justify disparate treatment between the two classes of claimants.[77] On the contrary, the court concluded that the analogy highlighted three "significant differences" "[b]etween the production and distribution of an accountant's audit report and the design and manufacture of a product" that justified disparate treatement.[78]

The first "significant difference" concerned the accountant's inability to control the distribution of his report.[79] This lack of distribution control meant the accountant lacked control over his "exposure to liability."[80] Earlier in its opinion, however, the court asserted that a deserving plaintiff must rely on the *actual* audited statements, and thus implied that the plaintiff must receive those statements from the client or accountant.[81] These restrictions raise doubts about the soundness of the court's "lack of distribution control" argument. In addition, as the reasonable foreseeability jurisdictions argue, the "lack of control over ultimate users is *not* prejudicial," because the auditor's liability extends only to reasonably foreseeable users.[82] Thus, courts in these jurisdictions refuse to distinguish between negligent misrepresentation claims against accountants and manufacturers based on the argument that accountants lack control of product distribution.

A second difference between manufacturers and accountants expressed by the court was the auditor's lack of control over the client's records and thus his "lack of control over some of the contents of the statements he assesses."[83] A legitimate concern does exist that innocent or fraudulent misrepresentations by the client to the auditor ultimately may reach the financial statements and subject the accountant to liability.[84] Several courts, however, have correctly noted

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privity with him. *See* MacPherson v. Buick Motor Co., 217 N.Y. 382, 389-90, 111 N.E. 1050, 1054 (1916); *see also* Ultramares Corp. v. Touche, 255 N.Y. 170, 189, 174 N.E. 441, 448 (1931) (third party not in privity with defendant denied recovery for economic injury). *But see* Glanzer v. Shepard, 233 N.Y. 236, 238, 135 N.E. 275, 276 (1922) (permitting recovery for economic injury suffered by purchaser as a result of defendant's negligence in performing on a contract with the seller). Justice Cardozo wrote all three opinions for the New York court.

77. *Raritan River*, 322 N.C. at 212, 367 S.E.2d at 615-16 (citing H. Rosenblum, Inc. v. Adler, 93 N.J. 324, 341, 461 A.2d 138, 147 (1983)).

78. *Id.* at 212, 367 S.E.2d at 616.

79. *Id.* Manufacturers and designers are relatively more capable of controlling the means by which their products enter the stream of commerce. *Id.*

80. *Id.* The court was apparently concerned over the potentially large number of claims resulting from any one particular negligent misrepresentation.

81. *See supra* notes 53, 56-60 and accompanying text. At least one commentator suggests that such requirements will facilitate distribution control because the auditor, before rendering his services, could agree with the client on a particular number of copies for distribution or a fixed group of persons receiving copies. *See* Gossman, *supra* note 6, at 322.

82. International Mortgage Co. v. John P. Butler Accountancy Co., 177 Cal. App. 3d 806, 818, 223 Cal. Rptr. 218, 225-26 (1986) (emphasis added). *But see* Gossman, *supra* note 6, at 322 (questioning whether the foreseeability standard represents any practical restraint on liability, since almost anyone could be foreseen as a "potential reliant person"). One might argue that third parties who fail to comprehend the nature of an audit report do not constitute reasonably foreseeable users. To hold a defendant liable to "misusers" would impose a standard approaching strict liability.

83. *Raritan River*, 322 N.C. at 212-13, 367 S.E.2d at 616.

84. One collateral issue not present in *Raritan River* is the effect of criminal conduct on the part of the client. At least one court has concluded that criminal client conduct subsequent to the auditor's completion of his field work constitutes an intervening cause exonerating the auditor from liability. *See* Touche Ross & Co. v. Commercial Union Ins. Co., 514 So. 2d 315, 324 (Miss. 1987);

that the auditor does not guarantee that the financial statements are perfect.[85] These courts have concluded that the auditor must only perform the audit in accordance with GAAS and thereby preclude responsibility for errors which proper procedures fail to detect.[86] If compliance with GAAS establishes the proper standard of care for accountants, then the auditor's lack of control over the client's records does not materially interfere with performance of the audit in accordance with such standards.

The court found a third "significant difference" between manufacturers' and accountants' respective expectations concerning the use of their product. The court stated that manufacturers desire unknown consumers to use their product; thus, their expectations encompass an undertaking that may subject them to liability to an indefinite class of anonymous users. Accountants, on the other hand, receive no benefit from client distribution of their reports, and, unlike manufacturers, their expectations do not include unidentified users with unidentified purposes.[87] As previously noted, however, the public relies extensively or solely on the auditor's report in making financial decisions.[88] In fact, this longstanding and increasing third-party reliance on the auditor's independent, objective evaluations generates demand for his product.[89]

The court's differentiation between manufacturers and accountants has merit because the auditor is unaware of most "foreseeable" users' identities and, therefore, lacks the ability to adopt appropriate risk allocation methods.[90] The foreseeability jurisdictions, which limit justifiable reliance to foreseeable users with a "proper business purpose," apparently consider that this restriction provides auditors with the information needed for minimizing risk.[91]

The court concluded its assault on the "reasonable foreseeability" standard by expressing concern over the "potential for inordinate liability."[92] The New

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see also H. Rosenblum, Inc. v. Adler, 93 N.J. 324, 344, 461 A.2d 138, 148 (1983) (auditor required to detect illegal or improper acts only if the exercise of "normal professional skill and care" would uncover them).

85. *See, e.g., International Mortgage*, 177 Cal. App. 3d at 818, 223 Cal. Rptr. at 225; *Commercial Union*, 514 So. 2d at 322. *See also* ACCOUNTING STANDARDS vol. A, *supra* note 1, Statement on Auditing Standards No. 1, § 110 (auditor expresses opinion only as to fairness with which clients present their financial position).

86. *See, e.g., International Mortgage*, 177 Cal. App. 3d at 818, 223 Cal. Rptr. at 225. Because the *Raritan River* case proceeded only to the pleading stage, whether North Carolina will construe compliance with GAAS as the standard of care benchmark remains unresolved. *See infra* note 104 and accompanying text.

87. *Raritan River*, 322 N.C. at 213, 367 S.E.2d at 616.

88. *See supra* note 3 and accompanying text.

89. *See* H. Rosenblum, Inc. v. Adler, 93 N.J. 324, 345-46, 461 A.2d 138, 149-50 (1983).

90. *Raritan River*, 322 N.C. at 213, 367 S.E.2d at 616. The court, in fairness to accountants, believed auditors should not be held liable when they are "unaware of the use to which their opinions will be put." *Id.* The court failed, however, to consider whether the *Restatement* standard discourages auditors from probing clients about intended uses of the statements at the risk of increasing their own liability, while nevertheless receiving benefits like increased demand as a result of such undisclosed uses. Furthermore, this disincentive to inquire about the identities and uses of third parties is a detriment to all parties concerned, because knowledge of the identities and uses of third parties allows the auditor more knowledgeably to plan and focus performance of audit procedures required to comply with GAAS.

91. *See, e.g., Rosenblum*, 93 N.J. at 350, 461 A.2d at 151.

92. *Raritan River*, 322 N.C. at 214, 367 S.E.2d at 617. Although the court rejected the *Ul-*

Jersey Supreme Court's response has been that "certain built-in limits" assure that the extent of financial exposure remains in proportion to the accountant's undertaking.[93] At least one commentator questions whether in practice these "limitations" exist.[94] In any event, courts could alleviate the potential risk of inordinate liability by requiring the plaintiff to present sufficient evidence at trial on each essential element.[95]

The North Carolina Supreme Court acknowledged that application of the *Restatement* has been less than uniform.[96] The court concluded that the auditor's knowledge of the client's intended use, regardless of the source of his knowledge, is sufficient for liability.[97] Because Sidbec pleaded that defendant knew its client would use the statements to procure credit, the court considered plaintiff among the foreseen class of lenders.

Since the promulgation of the *Restatement*, few courts have reached the issue of what standard of care, as opposed to what duty of care, should be used in evaluating an auditor's performance. The auditor undertakes to perform an audit in accordance with GAAS and to present the financial statements in accordance with GAAP. The issue remains, however, whether compliance with these professional standards should constitute reasonable care.

At least one federal district court answered this question in the negative.[98] In an action under the Securities Exchange Act, the court stated that the issue was "whether the report fairly presents the *true* financial position of [the client] . . . to the *untutored eye of an ordinary investor*."[99]

In *Thor Power Tool Co. v. Commissioner*[100] the United States Supreme Court held that compliance with GAAP did not meet the requirements of the Internal Revenue Code and Regulations, which require compliance with tax accounting procedures.[101] The import of these two cases for accountants is that,

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tramares privity approach, the court cited Cardozo's statement in support of the narrow privity rule that imposing liability for negligence upon accountants will result in "liability in an indeterminate amount for an indeterminate time to an indeterminate class." *Id.* (citing *Ultramares* at 179-80, 174 N.E. at 444).

93. *See Rosenblum*, 93 N.J. at 350, 461 A.2d at 152. For an enumeration of the limitations, see *supra* text accompanying note 42.

94. *See* Gossman, *supra* note 6, at 321-25 (implying that courts avoid addressing the causation or contributory negligence issues and that the foreseeability limitations are illusory).

95. *See infra* note 103 and accompanying text.

96. *Raritan River*, 322 N.C. at 215, 367 S.E.2d at 618. The court noted that some jurisdictions will extend liability only if the "client specifically mentions a person or class of persons." *Id.*

97. *Id.* Thus, the foreseen class includes third parties whose reliance the auditor discovers from a source other than his client.

98. *See* Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, 378 F. Supp. 112, 121 (S.D.N.Y. 1974), *aff'd in part, rev'd in part on other grounds*, 540 F.2d 27 (2d Cir. 1976).

99. *Id.* (emphasis added) (stating compliance with GAAP as the proper way to report financial transactions "misses the point").

100. 439 U.S. 522 (1979).

101. *Id.* at 540. The Court held that compliance with GAAP did not alleviate the duty to comply with federal regulations, but never expressed or implied that compliance with GAAP fails to create a presumption of due care for financial reporting purposes. Nevertheless, at least one commentator says the *Thor* holding leaves professionals with no assurance that compliance with professional standards will protect them from liability for negligence. *See* Note, Thor Power Tool Co. v. C.I.R. *Further Erodes C.P.A.'s Defense of Observing Professional Standards*, 19 AM. BUS. L.J. 87, 96 (1981).

although they do not deal directly with the standard of care required of accountants, they clearly reject GAAP as a conclusive measure of an accountant's performance. Other courts may look to these cases as authority for requiring a standard of care higher than GAAP in negligent misrepresentation cases. Neither case, however, should control a court's formulation of the auditor's common-law standard of care for negligance because auditors undertake only to perform an audit in compliance with GAAS.

The North Carolina Supreme Court correctly observed that the contemporary role of the accountant significantly differs from his role at the time of *Ultramares*.[102] Although the court extended liability in proportion to the profession's growth and increased importance to the public, the court also recognized that some limitation on liability is appropriate. Given the court's narrow scope of inquiry on the issues of detrimental reliance and causation, its adoption of the *Restatement* rule to protect accountants from exposure to inordinate liability is understandable. Both law and policy, however, support extending accountants' liability to all reasonably foreseeable third-party users.

Concerns over the potential for massive accountant liability may be alleviated by at least three factors. First, a requirement that plaintiffs produce sufficient evidence to establish justifiable reliance and causation should severely limit the class of plaintiffs entitled to recover.[103] Second, courts can prohibit recovery by plaintiffs who fail to comprehend the true nature of the audit report. These "misusers" should fall within neither the reasonably foreseeable user category nor the justifiable reliance group. By affording such parties an opportunity to recover, courts improperly permit a third party's misguided perception of the audit report to extend the accountant's liability beyond his actual undertaking.

Third, compliance with the professional standards (*i.e.*, GAAS and GAAP) should, at a minimum, raise a rebuttable presumption that the auditor exercised due care.[104] In rare circumstances, because of the volatile nature of financial transactions and the inability of the AICPA to anticipate all future regulatory requirements, an auditor's compliance with established standards might not constitute reasonable care. Courts should, however, consider such occurrences as the exception, not the rule, and avoid invading the standard-setting function that accounting committees can more ably perform.

Finally, policy-based considerations support recovery by foreseeable third

102. *Raritan River*, 322 N.C. at 211, 367 S.E.2d at 615.

103. For example, by requiring a proper showing at trial of justifiable reliance and causation, courts can reduce the potential for an indeterminate duration of liability. A plaintiff who offers proof of justifiable reliance on an audit report rendered several years earlier should not prevail, because changing financial conditions materially affect the reasonableness of using such information for present-day decisions. Likewise, losses that occur several years subsequent to reliance on an erroneous audit report may indicate lack of causation by the report; changing consumer interests, technological advancements, or poor management planning might have adversely affected the client's financial condition. Finally, state legislatures can develop statutes of limitation if necessary, while adopting a "discovery" rule similar to that used in medical malpractice to avoid the "door-closing" effect on meritorious claims. *Cf.* Teeters v. Currey, 518 S.W.2d 512, 517 (Tenn. 1974) (medical malpractice case applying "discovery" rule).

104. If courts define due care to require performance of procedures not required under GAAS and GAAP, then in most instances the court has unjustly increased the auditor's actual undertaking.

parties. Shifting responsibility for losses from the innocent third party to the negligent auditor justifies extending the right of recovery to foreseeable third parties.[105] The nature and extent of audit procedures necessary to comply with GAAS do not depend upon the potential number of users.[106] Thus, while courts dispute whether shifting responsibility will cause auditors to exercise greater diligence, the burden on the auditor to exercise due care does not increase.[107]

In view of the increased public reliance on audited information, the modern trend to shift responsibility to the accountant is both logical and fair. In their attempt to justify retaining some restrictions on the scope of accountants' liability, however, courts should not adopt the *Restatement* rule as a compromise for their unwillingness to require plaintiffs to prove elements such as detrimental reliance and failure to exercise reasonable care. Furthermore, while increasing the number of potential audit report users would not increase the auditor's burden of complying with GAAS, discovering third parties' identities would better enable the auditor to minimize risk and efficiently plan and focus performance of audit procedures. North Carolina should adopt the reasonable foreseeability standard, which would encourage auditors to make inquiries concerning third parties' identities and uses. The *Restatement* rule adopted by the North Carolina Supreme Court in *Raritan River* provides a disincentive for auditors to ask questions about potential users, because such inquiry would extend the auditor's liability by making such users members of a foreseen class.

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105. *See* Touche Ross & Co. v. Commercial Union Ins. Co., 514 So. 2d 315, 321-22 (Miss. 1987).

106. Auditors develop the nature and extent of audit procedures when performing an audit in accordance with GAAS based upon the size of the client and audit risk. Neither of the factors consists of any inquiry into the number of potential reliants. *See* ACCOUNTING STANDARDS vol. A, *supra* note 1, Statement on Auditing Standards § 312.

107. *Cf.* United States v. Carroll Towing Co., 159 F.2d 169, 173 (2d Cir. 1947) (Judge Learned Hand's duty formulation balances the increased burden of exercising due care against the probability and the gravity of harm.). Arguably, the burden on the auditor to exercise reasonable care is not enlarged by an increase in the number of potential users, because the auditor must perform the audit in accordance with GAAS for a party who always remains foreseen or foreseeable—the client.