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Accountants' Accountability to Nonclients in Texas.

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COMMENTS

ACCOUNTANTS' ACCOUNTABILITY TO NONCLIENTS IN TEXAS

JESSICA P. GOMEZ

I.	Introduction	135
II.	Accounting Functions and Principles	144
	A. The Auditing Function	144
	B. Types of Audit Reports	145
	C. The Accounting Standard	147
III.	History of Accountants' Liability to Nonclients	150
	A. The Privity Rule	151
	B. Foreseeability Standard	155
	C. Restatement Approach	157
IV.	Evolution of Texas Approach to Accountants' Liability to Nonclients	161
V.	Proposal for Expanding Accountants' Accountability	163
VI.	Conclusion	166

I. INTRODUCTION

Corporate America has recently witnessed the demise of several predominant corporations and has witnessed thousands of people lose their jobs and pensions.[1] Now, everyone is looking for someone to blame.[2]

1. *See* Rebecca Smith, *Enron Files for Chapter 11 Bankruptcy, Sues Dynegy: Proceeding Is Biggest Ever in the U.S., with Assets of Just Under $50 Billion*, WALL ST. J., Dec. 3, 2001, at A3, *available at* 2001 WL-WSJ 29679578 (stating that the Enron Corp. bankruptcy filing was, at the time, the biggest filing in U.S. history). "The previous biggest bankruptcy filing was the 1987 filing by Texaco, with $36 billion in assets." *Id.* Enron, along with thirteen major subsidiaries, is named in the filing, under Chapter 11 of the U.S. Bankruptcy Code in the Southern District of New York, including Enron's marketing and trading operation, Enron Energy Services, Enron Metals & Commodity Corp., and Enron Broadband Services. *Id.*; *see also* Shawn Young et al., *Leading the News: WorldCom Files for Bankruptcy*, WALL ST. J., July 22, 2002, at A3, *available at* 2002 WL-WSJ 3401243 (reporting

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The essential component in the corporate downfalls, and the common denominator connecting these recent financial scandals, is the performance of the companies' gatekeepers.[3] The focus is not on why the companies engaged in fraud or deception, but rather on why their gatekeepers allowed the companies to engage in fraud or deception.[4] Accountants are viewed as the company's "gatekeepers."[5] Thus, people are left to question the accountant's role.[6] More importantly, to what extent may accountants be held liable to individuals who rely on the audits they perform?[7]

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that WorldCom, with $107 billion in listed assets, was by far the largest bankruptcy filing in U.S. history). WorldCom's bankruptcy filing significantly exceeded the bankruptcy filing by Enron Corp., which listed $63.4 billion in assets. *Id.*

2. *See* C. William Thomas, *The Rise and Fall of Enron*, J. ACCT., Apr. 2002, at 41, 47, *available at* 2002 WL 11221608 (questioning the acts of Arthur Andersen, LLP, the auditors of Enron, and raising doubts about Andersen's audit independence). "Enron dismissed Andersen as its auditor on January 17, 2002, citing document destruction and lack of guidance on accounting policy issues as the reasons." *Id.*; *see also* David Woodward & Maggie Yar, *A Look at Accountants Liability After Enron*, TEX. LAW., Feb. 25, 2002, at 46 (suggesting that accountants may be blamed for the Enron aftermath).

3. *See* John C. Coffee, Jr., *Guarding the Gatekeepers*, N.Y. TIMES, May 13, 2002, at A17 (emphasizing the fact that none of Enron's gatekeepers detected Enron's problems until it was too late).

4. *See id.* (refuting the myth that professional gatekeepers would not engage in fraud because they are pledging their reputations, built over decades, in vouching for the financial statements or management strategies of their clients). As such, the gatekeeper would not sacrifice its reputation to please only one client of the many clients it serves. *Id.*

5. *See id.* (defining gatekeepers to include auditors, securities analysts, and others); *see also* Constance Frisby Fain, *Accountant Liability*, 21 OHIO N.U. L. REV. 355, 357 (1994) (defining an accountant as "one whose occupation involves accounting and who keeps, audits, and inspects the financial records of individuals or business concerns and prepares financial and tax reports") (quoting the AMERICAN HERITAGE DICTIONARY (2d ed. 1991)). The certified public accountant (CPA) is "[a]n accountant who has satisfied the statutory and administrative requirements of his or her jurisdiction to be registered or licensed as a public accountant." *Id.* The CPA must pass the Uniform CPA Examination given by the American Institute of Certified Public Accountants and "meet certain business experience, educational and moral requirements" that vary among the jurisdictions in the nation. *Id.*

6. *See* Constance Frisby Fain, *Accountant Liability*, 21 OHIO N.U. L. REV. 355, 356 (1994) (listing some civil causes of action brought against accountants including "intentional misrepresentation or fraud, the Racketeer Influenced Corrupt Organization Act (RICO), Section 10b-5 of the Security Exchange Act, state Blue Sky statutes, state consumer protection statutes, breach of contract, defamation, intentional infliction of emotional distress, and interference with business relations"); David Woodward & Maggie Yar, *A Look at Accountant Liability After Enron*, TEX. LAW., Feb. 25, 2002, at 46 (answering the question as to whom else accountants are liable to other than to their clients).

7. *See* David Woodward & Maggie Yar, *A Look at Accountant Liability After Enron*, TEX. LAW., Feb. 25, 2002, at 46 (explaining that Enron's accountants could face liability from a limited class of people, including shareholders and investors, if the shareholders and

To add credibility to a company's financial position, the management of an entity acquires the expertise of an independent auditor[8] to perform an audit of its financial statements.[9] The auditor is expected to filter, verify, and assess complicated financial information.[10] The audit authenticates a company's financial situation by providing opinions that the financial statements do not contain material errors.[11] Although the accountant is hired directly by the company whose financial statements are to be audited, the accountant's opinion is relied upon by persons outside of the company.[12] For example, if the auditor issues a seal of approval indicating a healthy enterprise, investors and creditors will rely on the audit to determine whether to extend any credit or needed capital.[13] Likewise, when a business fails, investors and creditors quickly question the accuracy of the audit opinion.[14] That is, if the audit opinion was erroneous, did the accountants negligently prepare the audit?[15] The public is view-

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investors "relied on the accountants' statements or information and if the accountants knew or should have known that their services would be relied on").

8. The terms "accountant" and "auditor" are used interchangeably throughout this Comment.

9. *See* Bily v. Arthur Young & Co., 834 P.2d 745, 751 (Cal. 1992) (noting that a frequent purpose of auditing financial statements is to establish a company's financial credibility to outside persons); Samuel S. Paschall, *Liability to Non-Clients: The Accountant's Role and Responsibility*, 53 MO. L. REV. 693, 699 (1988) (describing the audit program as a "detailed guide to the audit, . . . so as to ascertain the reliability and integrity of the client's recordkeeping system").

10. *See* John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 BUS. LAW. 1403, 1405 (2002) (defining gatekeepers as "reputational intermediaries who provide verification and certification services to investors").

11. *See* Kenneth Edward Shore, Comment, *Watching the Watchdog: An Argument for Auditor Liability to Third Parties*, 53 SMU L. REV. 387, 388 (2000) (explaining that one purpose for auditing a company's financial statements is to assure the users that the statements are free from material errors).

12. *See id.* at 387 (classifying trade creditors, financial institutions, and investors as people who rely on audited financial statements to decide whether to deal with a given company).

13. *See* Jodi B. Scherl, Comment, *Evolution of Auditor Liability to Noncontractual Third Parties: Balancing the Equities and Weighing the Consequences*, 44 AM. U. L. REV. 255, 256-57 (1994) (expressing that investors are attracted to companies based on their financial stability and thus are more willing to provide credit when auditors issue a clean audit).

14. *See id.* at 257 (noting that questions regarding the audit opinion arise when a business fails); *see also* Michael Schroeder, *Leading the News: SEC Files Civil Suit Against WorldCom*, WALL ST. J., June 27, 2002, at A3, *available at* 2002 WL-WSJ 3399152 (declaring that WorldCom's audit committee uncovered a $3.8 billion accounting irregularity).

15. *See* Jodi B. Scherl, Comment, *Evolution of Auditor Liability to Noncontractual Third Parties: Balancing the Equities and Weighing the Consequences*, 44 AM. U. L. REV. 255, 266 (1994) (posing the question of the accuracy of the audit prepared by the accountant).

ing the recent corporate bankruptcies as audit failures and is looking at the auditor as a solvent party capable of covering the loss sustained.[16] Consequently, the recent corporate scandals will likely initiate lawsuits against the accountants for negligently preparing an audit that failed to depict the accurate financial condition of the company.[17]

An excellent example of the aftermath of the most recent publicized corporate scandal is the ultimate demise of one of the world's largest and best known accounting firms, Arthur Andersen, LLP (Andersen).[18] Enron Corp., one of the nation's premier energy trading companies, hired Andersen to audit its financial statements.[19] From 1985 to 2002, Ander-

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16. *See id.* at 257 (implying that when a business fails the auditor too has failed); *see also What's News: Business and Finance*, WALL ST. J., Apr. 8, 2002, at A1, *available at* 2002 WL-WSJ 3390983 (discussing an amended lawsuit filed by Enron investors aiming to recover billions of dollars against more than three dozen new defendants, including Merrill Lynch and J.P. Morgan Chase, who allegedly "participated in a scheme with the company's top executives to defraud investors").

17. *See* Mindis Acquisition Corp. v. BDO Seidman, LLP, 559 S.E.2d 111, 116-17 (Ga. Ct. App. 2002) (applying the negligent misrepresentation doctrine to accountants by reinstating a verdict against the Chicago-based accounting firm BDO Seidman, LLP, which was charged with misleading an acquirer by overvaluing a target's inventory), *rev'd in part on other grounds*, 578 S.E.2d 400 (Ga. 2003). Three months after the deal was completed in 1993, a subsequent audit revealed that the acquired company's inventory was worth $70 million less than reported by BDO. *Id.* at 114-15; *see also* Dan Ackman, *Whistleblower?*, WALL ST. J., Dec. 4, 2002, at A10, *available at* 2002 WL-WSJ 103129561 (identifying Sherron Watkins, former vice president at Enron, as TIME MAGAZINE's "Person of the Year"). Even after acknowledging TIME's 1938 selection of Adolph Hitler as Person of the Year, Ackman writes that Watkins "looks like Time's worst choice ever." *Id.*

18. *See Andersen Sentenced to 5 Years Probation*, WALL ST. J., Oct. 17, 2002, at C3, *available at* 2002 WL-WSJ 3409072 (reporting that Arthur Andersen, LLP was sentenced to five years probation and ordered to pay a $500,000 fine for its obstruction of justice conviction); Cassell Bryan-Low, *Andersen Ex-Employees File Suit Against Accounting Firms*, WALL ST. J., Nov. 13, 2002, at D2, *available at* 2002 WL-WSJ 3411620 (reporting that "[a] retired Arthur Andersen LLP partner sued four firms that picked up large parts of Andersen's business" since the accounting firm's demise, "accusing them of looting the firm's assets and leaving it unable to pay retirement benefits"). In June 2001, Andersen and three partners were fined $7 million by the SEC, "the largest SEC fine ever against an accounting firm," for their audits of Waste Management Inc.'s financial statements in June 2001. Jonathan Weil, *What Enron's Financial Reports Did and Didn't Reveal*, WALL ST. J., Nov. 5, 2001, at C1, *available at* 2001 WL-WSJ 29676808. Additionally, Andersen settled a shareholder lawsuit involving audits it provided for Sunbeam Corp. for $110 million in 2001. *Id.*

19. *See Board Revokes Andersen's License to Practice Accounting in Texas*, 77 TEX. STATE BD. REP. 14 (Aug. 2002) (Tex. State Bd. Pub. Accountancy) (stating Andersen was licensed in Texas since 1945 and in all fifty-four licensing jurisdictions) (on file with the *St. Mary's Law Journal*); Flynn McRoberts, *Ties to Enron Blinded Andersen*, CHI. TRIB., Sept. 3, 2002, *available at* 2002 WL 26770980 (announcing that Enron was Andersen's $58 million client in fiscal year 2000 alone). "Their paychecks came from Andersen, but their livelihoods depended on the fast-growing darling of Wall Street. . . . Andersen was hooked

sen served as both auditor and consultant to the Houston-based energy company.[20] Andersen's audit work came under intense scrutiny when Enron reported that its financial statements since 1997 "should not be relied upon."[21] Enron's financial statements for those years were materially misstated because the company used certain "special purpose entities" to record debt that should have been reflected on Enron's financial statements.[22] The restatements were necessary to correct these accounting errors.[23] The market reacted immediately and the price of Enron shares plummeted.[24]

Astonishingly, Andersen knew of both the misleading financial information disclosed by Enron and the controversial nature of many of the accounting treatments.[25] After learning of the Securities Exchange Com-

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on a relationship that it found simply too lucrative to abandon." *Id.* In August 2002, Enron stock traded at over $90 per share, but closed at just 61 cents on the eve of Enron's bankruptcy filing. *Id.*

20. *See Board Revokes Andersen's License to Practice Accounting in Texas*, 77 TEX. STATE BD. REP. 1, 14 (Aug. 2002) (Tex. State Bd. Pub. Accountancy) (stating that Andersen audited Enron's or its predecessor's financial records since 1985) (on file with the *St. Mary's Law Journal*); Flynn McRoberts, *Ties to Enron Blinded Andersen*, CHI. TRIB., Sept. 3, 2002, *available at* 2002 WL 26770980 (stating that Enron hired Andersen as internal auditors in 1994 for $18 million over a five-year contract). As a result of becoming Enron's internal auditors, dozens of Andersen auditors reported to work each day at Enron. *Id.* Top executives of both companies took annual golf vacations and went on ski outings together, while others escaped from the office to attend Astros games at Enron Field and took turns buying margaritas at a local Mexican food restaurant. *Id.*

21. Jonathan Weil, *Basic Principle of Accounting Tripped Enron*, WALL ST. J., Nov. 12, 2001, at C1, *available at* 2001 WL-WSJ 29677610. Enron restated its reported net income of $105 million for 1997 by nearly $9 million due to $51 million in various unexplained "audit adjustments and reclassifications" that Andersen had proposed in 1997 but were thought to be "immaterial." *Id.*

22. *See id.* (stressing that Enron overstated its net income by a total of $586 million, or 20%). Wendy Gramm, a former chairman of the Commodity Futures Trading Commission and the wife of U.S. Sen. Phil Gramm (R., Tex.) was among the audit committee members of Enron. *Id.*

23. *See id.* (suggesting that one of Andersen's duties was to make sure that Enron's financial statements were not only accurate but understandable).

24. *See* Rebecca Smith, *Enron Files for Chapter 11 Bankruptcy, Sues Dynegy: Proceeding Is Biggest Ever in the U.S., with Assets of Just Under $50 Billion*, WALL ST. J., Dec. 3, 2001, at A3, *available at* 2001 WL-WSJ 29679578 (reporting that Enron's stock declined due to "big losses in the third quarter, repeated restatements of earnings and revelations . . . that some of its employees participated in partnerships designed to keep debt off the balance sheet").

25. *See* Tom Hamburger & Ken Brown, *Andersen Knew of Enron Woes a Year Ago: Whistleblower Who Warned Energy Firm Also Voiced Concerns to Accountant*, WALL ST. J., Jan. 17, 2002, at A3, *available at* 2002 WL-WSJ 3383224 (noting that Andersen was put on direct notice of the allegations of Sherron Watkins, an Enron vice president and former Andersen employee, regarding possible fraud and other improprieties at Enron, and in particular, Enron's use of off-balance-sheet "special purpose entities" that enabled the

St. Mary's Law Journal, Vol. 35 [2003], No. 1, Art. 4

mission (SEC) investigation into Enron's financial accounting and reporting, Andersen's partners assigned to the Enron engagement launched a wholesale destruction of documents at Andersen's office in Houston, Texas.[26] Andersen personnel were called to an urgent and mandatory meeting, but, instead of being advised to preserve documents so as to assist Enron and the SEC, they were instructed to immediately destroy documentation related to Enron, and to work overtime if necessary to accomplish the destruction.[27] Eventually, in March 2002, Andersen was indicted by a grand jury for obstruction of justice based on the document destruction and was convicted at a jury trial in June 2002.[28] Additionally, the Texas State Board of Public Accountancy revoked Andersen's license

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company to camouflage the true financial condition of the company). Watkins had reported her concerns to a partner at Andersen, who thereafter disseminated them within Andersen, including to the team working on the Enron audit. *Id.*

26. *See* Flynn McRoberts, *Ties to Enron Blinded Andersen*, CHI. TRIB., Sept. 3, 2002, *available at* 2002 WL 26770980 (reporting that David Duncan called the firm's entire Enron team together to tell them that "Andersen would have to aid in an SEC investigation" of Enron, but also added that they should comply with the firm's document retention policy).

27. *See* Ken Brown et al., *Paper Trail: Andersen Fires Partner It Says Led Shredding of Enron Documents*, WALL ST. J., Jan. 16, 2002, at A1, *available at* 2002 WL-WSJ 3383010 (reporting that Andersen fired "David Duncan—the Houston-based lead partner on the Enron account," for leading "'an expedited effort to destroy documents' after" knowing "that Enron had received a request for information from the SEC about its financial accounting and reporting"). Andersen said in its statement:

> The effort [to destroy documents] was initiated following an urgent meeting the lead partner called on Oct. 23 to organize the expedited effort to dispose of Enron-related documents. This meeting occurred shortly after the lead partner learned that Enron had received a request for information from the [Securities and Exchange Commission] about its financial accounting and reporting. This effort was undertaken without any consultation with others in the firm and at a time when the engagement team should have had serious questions about their actions. Nothing in an Oct. 12 e- mail, almost two weeks earlier, or so far as we know, other conversations around that time, authorized this activity.

Id.; *see also* Flynn McRoberts, *Ties to Enron Blinded Andersen*, CHI. TRIB., Sept. 3, 2002, *available at* 2002 WL 26770980 (stating that Andersen implemented the document retention policy a year and a half earlier for the purpose of preventing plaintiff lawyers from using the firm's paperwork as a weapon against it in court). Likewise, Duncan "testified at Andersen's trial that he never thought that his order could lead to obstruction of justice." *Id.* David Duncan had been with Andersen since 1981 and was made partner in 1995. He became the Enron "engagement partner" in 1997. Ken Brown et al., *Paper Trail: Andersen Fires Partner It Says Led Shredding of Enron Documents*, WALL ST. J., Jan. 16, 2002, at A1, *available at* 2002 WL-WSJ 3383010.

28. *See* Cassell Bryan-Low, *Andersen: Called to Account: Foreman Was Last to Be Persuaded*, WALL ST. J., June 17, 2002, at C13, *available at* 2002 WL-WSJ 3397889 (announcing that a jury of nine men and three women returned a guilty verdict against Andersen for obstructing justice).

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for failing to "follow generally accepted auditing standards and generally accepted accounting principles in attest work it performed for Enron between 1997 and 2002."[29] In the end, Andersen closed its doors to the world of accounting by relinquishing "its licenses to practice accounting in every U.S. state" on August 31, 2002.[30]

Consequently, the Andersen scandal sent waves of terror throughout the entire economic system of the nation and undermined investors' trust in the accounting industry's ability to provide sound information.[31] Restoring investors' trust is essential to the survival of corporate America.[32] The Texas Society of Certified Public Accountants (TSCPA) stands behind the notion that "[i]nvestors must have information that is accurate, clear, timely, and relevant."[33] Furthermore, the TSCPA states, "[a]nyone who deceives investors, whether it is a CEO, CPA, board director or stock analyst, must be held accountable."[34] Simply stated, accountants

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29. *See Board Revokes Andersen's License to Practice Accounting in Texas*, 77 TEX. STATE BD. REP. 1 (Aug. 2002) (Tex. State Bd. Pub. Accountancy) (quoting K. Michael Conaway, the state board's presiding officer, as saying "[t]he Board's revocation of Andersen's license is the severest sanction available under the *Public Accountancy Act* for the firm") (on file with the *St. Mary's Law Journal*). Conaway continues by saying, "[a]lthough it is tragic that a firm with Andersen's proud history in Texas should be brought so low, the firm's actions in the Enron case clearly warrant this result." *Id.*

30. *See Andersen Surrenders Accounting Licenses*, WALL ST. J., Sept. 3, 2002 at A6, *available at* 2002 WL-WSJ 3405019 (noting that Arthur Andersen, LLP, once the fifth-largest accounting firm in the nation, surrendered its accounting licenses "[a]fter its criminal conviction in June for obstructing an investigation into Enron Corp.," "marking the end of the accounting business for the 89-year-old firm").

31. *See Restoring Investor Trust*, Editorial, BUFF. NEWS, Mar. 12, 2002, at B10, *available at* 2002 WL 7422205 (illustrating that one of the "most troubling aspects of the Enron debacle is that the company's overstated earnings and understated risks were 'authenticated' by one of the nation's leading accounting firms, corporation auditor Arthur Andersen").

32. *See id.* (arguing that Congress must act in order to "[r]estore investor confidence in capital markets and the American economy"); *see also* Burton Malkiel, Editorial, *Watchdogs and Lapdogs*, WALL ST. J., Jan. 16, 2002, at A16, *available at* 2002 WL-WSJ 3383108 (emphasizing that restoring the "shaken public trust in the safeguards that exist to protect the interests of individual investors . . . is an urgent priority").

33. Press Release, Texas Society of CPAs, Texas Society of CPAs' Statement in Response to Gov. Perry's Reform Proposals (July 9, 2002), *available at* http://www.tscpa.org/pressroom/2002/ResponsToPerry.html (on file with the *St. Mary's Law Journal*).

34. *Id.*

> TSCPA . . . is a nonprofit, voluntary, professional organization representing Texas CPAs. The society has 20 local chapters statewide and has 27,000 members, the largest in-state membership of any state CPA society in the United States. TSCPA is committed to serving the public interest with programs that advance the highest standards of ethics and practice within the CPA profession.

Id.

should be held liable to any foreseeable user of their work product to ensure the deterrence of negligence on the part of accountants.[35]

The scope of accountants' liability varies among the jurisdictions of this country. Texas imposes liability based on § 552 of the Restatement (Second) of Torts.[36] This standard, however, fails to assure the needed protection to third parties who rely upon the accuracy of the financial statements.[37] Further, this standard does not expose accountants to a significant amount of liability to induce greater care.[38] Without this protec-

35. *See* Citizens State Bank v. Timm, Schmidt & Co., 335 N.W.2d 361, 365 (Wis. 1983) (stating "[u]nless an accountant can be held liable to a relying third party, this negligence will go undeterred"). In *Citizens State Bank v. Timm, Schmidt & Co.*, the Wisconsin Supreme Court concluded that an accountant may be held liable to a third party not in privity for the negligent preparation of an audit report under the principles of Wisconsin negligence law. *Id.*; *see also* Enron Corp. Sec., Derivative & ERISA Litig. v. Enron Corp., 235 F. Supp. 2d 549, 611 (S.D. Tex. 2002) (discussing the securities fraud actions brought by the investors of Enron Corp. against Arthur Andersen); Anthony K. Black, *Trends in CPA Liability*, 67 FLA. B.J. 24, 25 (1993) (citing the Wisconsin Supreme Court decision in *Citizens State Bank v. Timm, Schmidt & Co.*).

36. *See* RESTATEMENT (SECOND) OF TORTS § 552 (1977) (providing that

> (1) [o]ne 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 knows that the recipient so intends or in a substantially similar transaction.
>
> (3) The liability of one who is under a public duty to 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.

37. *See* Denise M. Orlinsky, Note, *An Accountant's Liability to Third Parties:* Bily v. Arthur Young & Co., 43 DEPAUL L. REV. 859, 881 (1994) (pointing out that commentators have criticized the Restatement rule as "arbitrary line-drawing, protecting only those who happen to be in the 'limited class' of actually foreseen third parties"). Additionally, commentators insist that the accountant's fault is ignored when "the extent of the negligent accountant's liability to third persons" is based "solely on the accountant's subjective mental state." *Id.*

38. *See* Sherry Anderson & Joseph Wolfe, *A Perspective on Audit Malpractice Claims*, J. ACCT., Sept. 2002, at 59, 66, *available at* 2002 WL 11221756 (asserting that third-party claims made up approximately thirty percent of all claims arising from nonpublic audits). Usual problems involved with third-party claims include: (1) the elapse of substantial time "between the alleged error or omission and the claim," thus obscuring "the memories of

tion, investors will be reluctant to invest in the American economy.[39] The time has come for the accounting profession to assume a role of responsibility and public trust and be held accountable to the general public.[40] An increase in accountants' liability to third parties is needed to "restore[ ] public confidence in the very market system on which [the accounting profession] depends."[41]

This Comment examines the degree of accountant liability to third parties beyond the doctrine of privity, focusing on Texas law. Part II of this Comment describes accounting and the role of the accountant in performing audit functions. Part III traces the historical development of the common law theories applicable to accountant liability, beginning with the most favorable to accountants, the privity rule, to the most expansive view of accountant liability, the foreseeability standard. Part IV continues with an analysis of the adoption of the Restatement approach by Texas courts. Finally, Part V sets forth a proposal for adopting the foreseeability standard in Texas to expand accountants' scope of liability required to provoke greater care by accountants in the accounting services they provide.

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those involved and complicating the review of relevant documents"; (2) targeting diverse parties unfamiliar with each other in the primary lawsuit, thereby polarizing liability and settlement positions which "create barriers to discussions that might facilitate rapid analysis and resolution"; and (3) plaintiffs have a tendency "to be suspicious of early resolution options such as mediation or other alternate dispute-resolution processes." *Id.* Some general themes present in malpractice claims include: (1) "lack of experience and training"; (2) "complacency based on long-term client relationships"; (3) "failure to supervise"; (4) "lack of concurring partner review"; and (5) "failure to report certain audit matters to the appropriate management level." *Id.* Malpractice claims from 1995 to 2000 involved twenty-eight percent of clients in bankruptcy. *Id.* at 65.

39. *See* James G. Castellano, *Restoring Public Confidence*, J. Acct., Apr. 2002, at 37, 38-39, *available at* 2002 WL 11221607 (discussing reforms suggested by the American Institute of Public Accountants to restore public confidence in the capital markets).

40. *See* United States v. Arthur Young & Co, 465 U.S. 805, 817-18 (1983) (observing that the function of a certified public accountant is to engender a greater duty to the public than to the company with which it contracts); Alan Murray, *Accounting Rules Should Still Adapt to New Economy*, WALL ST. J., July 23, 2002, at A4, *available at* 2002 WL-WSJ 3401369 (noting that reform is needed to provide better accounting for intangible assets, such as patents, copyrights, brands, customer lists, unique organizational designs, and processes); *see also* Thomas Scarlett, *Can Investors Seek Accountability for Accountants?*, TRIAL MAG., June 1, 2002, at 12 (citing a statement by Jeffrey Wagner, a Chicago attorney who has handled accounting negligence cases, that "I think nowadays, with more people investing, and especially after Enron, juries will want to say that accountants have a duty to the public at large, as well as to their clients").

41. *See* Editorial, *Restoring Investor Trust*, BUFF. NEWS, Mar. 12, 2002, at B10, *available at* 2002 WL 7422205 (arguing the need for regulating the accounting industry). "You don't have to be an accountant to do that math." *Id.*

II. Accounting Functions and Principles

A. *The Auditing Function*

A solid understanding of accountants' duties begins with a general knowledge of the auditing function.[42] Traditionally, the accountant's most important function is to perform an independent verification of the financial statements[43] of a business entity.[44] The management of the business entity is responsible for preparing the financial statements.[45] The

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42. *See* Rosenblum, Inc. v. Adler, 461 A.2d 138, 147 (N.J. 1983) (exploring the "imposition of a duty on accountants" to appropriately evaluate whether a foreseeable standard is warranted); Constance Frisby Fain, *Accountant Liability*, 21 Ohio N.U. L. Rev. 355, 379-80 (1994) (defining the audit process as "the process whereby the independent certified public accountant conducts an examination of management's financial statements to determine whether the statements present fairly the financial information which they purport to convey"); Julie Faussie, Note, *Limiting Liability in Public Accounting Suits: A Desperate Appeal from a Beleaguered Profession*, 28 Val. U. L. Rev. 1041, 1061 (1994) (suggesting that the audit function begins when an auditor and client sign an engagement letter, thus creating a contractual relationship). Audits are performed for publicly held corporations to protect investors and shareholders as required by the SEC, for smaller businesses and non-publicly held corporations as a way to guarantee their financial condition is solvent, and for lending institutions and bonding companies before they lend funds to potential customers. *Id.*

43. *See* Samuel S. Paschall, *Liability to Non-Clients: The Accountant's Role and Responsibility*, 53 Mo. L. Rev. 693, 698 n.20 (1988) (identifying the four basic financial statements as the balance sheet, the income statement, the statement of retained earnings, and the statement of changes in financial position). The balance sheet demonstrates the financial position of an entity at the end of the accounting period. *Id.* The income statement reports the profit or loss of the entity for a given period of time. *Id.* The statement of retained earnings shows the inflow or outflows of either cash or working capital of the entity for a certain time period. *Id.*; *see also* Black's Law Dictionary 645 (7th ed. 1999) (defining a financial statement as "a balance sheet, income statement, or annual report that summarizes an individual's or organization's financial condition on a date or for a specified period by specified reporting assets and liabilities"). Financial statements are prepared according to Generally Accepted Accounting Principles which are issued by the Financial Accounting Standard Board. Thomas Scarlett, *Can Investors Seek Accountability for Accountants?*, Trial Mag. 12, June 1, 2002, at 12, *available at* 2002 WL 15115956.

44. *See* Jodi B. Scherl, Comment, *Evolution of Auditor Liability to Noncontractual Third Parties: Balancing the Equities and Weighing the Consequences*, 44 Am. U. L. Rev. 255, 259 (1994) (describing the audit process as "evaluating data and assertions made by an entity to determine whether they correspond"); *see also* Denzil Y. Causey & Sandra A. Causey, *The Accounting Profession in the Courts*, 12 Miss. C. L. Rev. 7, 11 (1991) (identifying the three levels of assurance made by an accountant). The highest possible level of assurance is an audit report. *Id.* The second level of service is a review report which is designed to provide limited assurance. *Id.* The third level of assurance is a compilation report which provides no assurance. *Id.*

45. *See* Kenneth Edward Shore, Comment, *Watching the Watchdog: An Argument for Auditor Liability to Third Parties*, 53 SMU L. Rev. 387, 389 (2000) (adhering to the principle that management creates the financial statements and the underlying accounting records).

scope of an audit is to provide a certain degree of assurance that management's financial statements are not materially misleading.[46] Historically, the audit function has not served the purpose of guarding against accounting fraud within the company because the presumption of management dishonesty is both unreasonably costly and impractical.[47] In essence, the auditing function is to evaluate data and assertions made by an entity to determine whether they are accurate and comply with generally accepted accounting principles.[48]

B. *Types of Audit Reports*

Ultimately, the audit function leads to the issuance of an audit report.[49] Accountants may issue one of four types of audit opinions.[50] The four types of audit opinions issued by an accountant include an unqualified, qualified, adverse, or disclaimed opinion.[51] The unqualified opinion, which is the most commonly issued audit report, is an expression of a certified public accountant's opinion that, "without exception, reservation, or qualification, the financial statements of the audited entity give a fair presentation of its financial position, the results of its operations, and

46. *See id.* at 389-90 (providing an overview of an audit process); *see also* John S. Dzienkowski, Note, *Accountants' Liability for Compilation and Review Engagements*, 60 TEX. L. REV. 759, 813 (1982) (stating "[a]rguably, the primary intended user for most reviewed financial statements is a third party").

47. *See* Kenneth Edward Shore, Comment, *Watching the Watchdog: An Argument for Auditor Liability to Third Parties*, 53 SMU L. REV. 387, 390 (2000) (refuting the idea that "[n]on-CPAs often believe that an audit should amount to a guarantee that there is no accounting fraud within the firm").

48. *See* Constance Frisby Fain, *Accountant Liability*, 21 OHIO N.U. L. REV. 355, 355 (1994) (describing accounting as "[t]he bookkeeping methods involved in making a financial record of business transactions and in the preparation of statements concerning the assets, liabilities, and operating results of a business"); Jodi B. Scherl, Comment, *Evolution of Auditor Liability to Noncontractual Third Parties: Balancing the Equities and Weighing the Consequences*, 44 AM. U. L. REV. 255, 259 (1994) (describing the audit function).

49. *See* Jodi B. Scherl, Comment, *Evolution of Auditor Liability to Noncontractual Third Parties: Balancing the Equities and Weighing the Consequences*, 44 AM. U. L. REV. 255, 260 (1994) (describing the types of audit reports).

50. *Id.*; *see also* BLACK'S LAW DICTIONARY 1120 (7th ed. 1999) (defining an audit opinion as "[a] certified public accountant's opinion regarding the audited financial statements of an entity").

51. *See* Julie Faussie, Note, *Limiting Liability in Public Accounting Suits: A Desperate Appeal from a Beleaguered Profession*, 28 VAL. U. L. REV. 1041, 1061-68 (1994) (describing the opinions rendered by a CPA); Denise M. Orlinsky, Note, *An Accountant's Liability to Third Parties:* Bily v. Arthur Young & Co., 43 DEPAUL L. REV. 859, 867 (1994) (discussing how the audited financial statements may lead to a material misstatement of the financial position of the client). "Financial statements can be materially misstated through management fraud, clerical error by the company, or the auditor's negligence in conducting the audit." *Id.*

St. Mary's Law Journal, Vol. 35 [2003], No. 1, Art. 4

changes in its financial position."[52] On the other hand, a qualified opinion indicates that the financial statements are not in compliance with industry principles because they contain improper accounting treatments.[53] An adverse opinion is issued when the financial statements contain material misstatements hindering the fair presentation of the company's financial position.[54] Lastly, an audit report with a disclaimer opinion means no opinion at all.[55] An accountant is required to issue a disclaimer opinion when unable to make an assertion on the financial statements.[56]

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52. Jodi B. Scherl, Comment, *Evolution of Auditor Liability to Noncontractual Third Parties: Balancing the Equities and Weighing the Consequences*, 44 AM. U. L. REV. 255, 260 (1994); *see also* Scott Vick, Bily v. Arthur Young & Co.*: Is Limiting Auditor Liability to Third Parties Favoritism or Fair Play?*, 26 LOY. L.A. L. REV. 1335, 1343 n.67 (1993) (quoting the American Institute of Certified Public Accountant Statement on Accounting and Review No. 1, that "an unqualified opinion will state '[t]he financial statements present fairly the financial position, results of operations and changes in financial position in conformity with generally accepted accounting principles consistently applied'"); Denise M. Orlinsky, Note, *An Accountant's Liability to Third Parties:* Bily v. Arthur Young & Co., 43 DEPAUL L. REV. 859, 864 (1994) (defining an unqualified opinion).

53. *See* Denise M. Orlinsky, Note, *An Accountant's Liability to Third Parties:* Bily v. Arthur Young & Co., 43 DEPAUL L. REV. 859, 865 (1994) (explaining that a qualified opinion means that "except for" or "subject to" that irregular accounting treatment, the financial statements do fairly present the company's financial condition). For instance, an accountant will issue a qualified opinion when there are limitations on the extent of the auditor's examination, "a lack of competent evidential matter, a departure from GAAP, changes in the accounting principles applied," or significant uncertainties affecting the company's financial statement. *Id.*; *see also* Jodi B. Scherl, Comment, *Evolution of Auditor Liability to Noncontractual Third Parties: Balancing the Equities and Weighing the Consequences*, 44 AM. U. L. REV. 255, 260 (1994) (defining a qualified and adverse opinion).

54. *See* Denise M. Orlinsky, Note, *An Accountant's Liability to Third Parties:* Bily v. Arthur Young & Co., 43 DEPAUL L. REV. 859, 865 (1994) (stating that an adverse opinion is when "the financial statements . . . do not present fairly, in conformity with generally accepted accounting principles, the financial position . . . or the results of its operations or its cash flow for the year then ended").

55. *See id.* at 865-66 (discussing the effects of a disclaimer opinion); Jodi B. Scherl, Comment, *Evolution of Auditor Liability to Noncontractual Third Parties: Balancing the Equities and Weighing the Consequences*, 44 AM. U. L. REV. 255, 260 (1994) (defining disclaimer opinion).

56. *See* Julie Faussie, Note, *Limiting Liability in Public Accounting Suits: A Desperate Appeal from a Beleaguered Profession*, 28 VAL. U. L. REV. 1041, 1071 (1994) (clarifying that an accountant cannot issue a disclaimed opinion merely to avoid liability); Denise M. Orlinsky, Note, *An Accountant's Liability to Third Parties:* Bily v. Arthur Young & Co., 43 DEPAUL L. REV. 859, 865-66 (1994) (explaining circumstances when a disclaimer opinion is appropriate).

C. *The Accounting Standard*

An accountant plans, conducts, and reports the audit results in accordance with generally accepted auditing standards (GAAS).[57] "Auditing standards provide a measure of audit quality and the objectives to be achieved in an audit."[58] The Auditing Standard Board (ASB) of the American Institute of Certified Public Accountants (AICPA), a private self-governing national professional accounting organization, is responsible for issuing both the auditing standards and auditing procedures.[59]

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57. *See SAS No. 95—Generally Accepted Auditing Standards*, J. ACCT., Feb. 1, 2002, at 83-84, *available at* 2002 WL 11221579 (explaining generally accepted auditing standards (GAAS)). To comply with GAAS, the auditor must adhere to the following 10 standards:

General Standards

1. The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.
3. Due professional care is to be exercised in the performance of the audit and the preparation of the report.

Standards of Field Work

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
2. A sufficient understanding of internal control is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.
3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.

Standards of Reporting

1. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles (GAAP).
2. The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.
3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
4. The report shall contain either an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking.

Id.

58. *Id.*; *see also* Jodi B. Scherl, Comment, *Evolution of Auditor Liability to Noncontractual Third Parties: Balancing the Equities and Weighing the Consequences*, 44 AM. U. L. REV. 255, 261 (1994) (defining generally accepted auditing standards).

59. *See* Jodi B. Scherl, Comment, *Evolution of Auditor Liability to Noncontractual Third Parties: Balancing the Equities and Weighing the Consequences*, 44 AM. U. L. REV. 255, 261 (1994) (stating that the American Institute of Certified Public Accountants (AICPA) is responsible for creating both the Generally Accepted Auditing Standards (GAAS) and Generally Accepted Auditing Principles (GAAP)); American Institute of

Auditing procedures differ from auditing standards in that auditing procedures are specific acts accountants perform during the audit function.[60] For example, routine auditing procedures performed by an accountant in verifying a company's financial statements include confirming cash balances and observing an inventory count.[61]

In addition to GAAS, auditors of publicly held companies are now subject to standards set forth by the newly created Public Company Accountability Oversight Board (PCAOB).[62] The PCAOB is the result of the recently enacted Sarbanes-Oxley Act of 2002.[63] The Sarbanes-Oxley Act of 2002 is regarded as the most significant accounting reform to impact the accounting profession.[64] The formation of the Sarbanes-Oxley Act of 2002 was a direct result of the repeated accounting scandals and seeks "to improve quality and transparency in financial reporting and independent audits and accounting services for public companies, enhance the standard setting process for accounting practices [and] strengthen the independence of firms that audit public companies."[65]

Certified Public Accountants, *About the Auditing Standards Board, at* http://www.aicpa.org/members/div/auditstd/about_asb.htm (last visited Sept. 10, 2003) (describing the duties of the Auditing Standards Board) (on file with the *St. Mary's Law Journal*).

60. *SAS No. 95—Generally Accepted Auditing Standards*, J. ACCT., Feb. 1, 2002, at 83, *available at* 2002 WL 11221579; *see also* Jodi B. Scherl, Comment, *Evolution of Auditor Liability to Noncontractual Third Parties: Balancing the Equities and Weighing the Consequences*, 44 AM. U. L. REV. 255, 261 (1994) (defining generally accepted auditing standards).

61. *See* Jodi B. Scherl, Comment, *Evolution of Auditor Liability to Noncontractual Third Parties: Balancing the Equities and Weighing the Consequences*, 44 AM. U. L. REV. 255, 261 (1994) (categorizing accounting for cash and observing an inventory count as examples of common audit procedures).

62. *See* C. William Thomas, *The Legislative Solution*, THE CPA J., Jan. 1, 2003, at 10, *available at* 2003 WL 15438424 (stating that the Public Company Accounting Oversight Board was created in Title I of the Sarbanes-Oxley Act); C. William (Bill) Thomas, *Sarbanes-Oxley Act: Sarbanes-Oxley Act Brings Sweeping Reforms*, TODAY'S CPA, Nov./Dec. 2002, at 25 (providing a summary of the major provisions of the Act).

63. *See* C. William (Bill) Thomas, *Sarbanes-Oxley Act: Sarbanes Oxley Act Brings Sweeping Reforms*, TODAY'S CPA, Nov./Dec. 2002, at 25 (stating that the House and Senate conference committee concluded on July 24); Greg Toman & Kentner Sellers, *Restoring Confidence, Rebuilding Trust: How We Got Here & What Does the Future Hold for CPAs?*, DAYTON CHAPTER OF THE OHIO SOCIETY OF CPAS (Oct. 18, 2002) (noting that the President signed Sarbanes-Oxley on July 30, 2002) (on file with the *St. Mary's Law Journal*).

64. *See* C. William (Bill) Thomas, *Sarbanes-Oxley Act: Sarbanes-Oxley Act Brings Sweeping Reforms*, TODAY'S CPA, Nov./Dec. 2002, at 25 (noting that the Securities Act of 1933 and 1934 were the last extensive corporate governance reform before Congress passed the Sarbanes-Oxley Act in 2002).

65. Greg Toman & Kentner Sellers, *Restoring Confidence, Rebuilding Trust: How We Got Here & What Does the Future Hold for CPAs?*, DAYTON CHAPTER OF THE OHIO SOCIETY OF CPAS (Oct. 18, 2002) (on file with the *St. Mary's Law Journal*).

The PCAOB is a five-member agency overseen by the SEC and independently funded by publicly held companies.[66] Only two of the five full-time members may be certified public accountants.[67] The PCAOB was empowered with broad powers including the duties to: (1) register public accounting firms that prepare audits of public companies; (2) "establish or adopt, or both, by rule, auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for" public companies; (3) "conduct inspections of registered public accounting firms"; and (4) conduct investigations and disciplinary proceedings, and impose sanctions for registered public accounting firms.[68]

Although the Act contains provisions allowing the PCAOB to cooperate with professional groups such as the AICPA, it is unclear whether the auditing standard setting will remain in the hands of the AICPA.[69] Just recently, controversy arose when the AICPA proposed new standards on how independent auditors should report on their public-company client's internal financial controls as required under the Act.[70] The SEC was quick to respond that this action by the AICPA could create the misleading impression that it will set standards that the PCAOB was authorized to establish.[71] Although this Act is one giant step toward restoring confidence in American markets, inconsistent national audit standards are a plausible result.[72] In response, the TSCPA's Board of Directors is urging the adoption of national consistency among all the respective organiza-

66. 15 U.S.C.A. § 7211(e)(1) (West Supp. 2003).

67. 15 U.S.C.A. § 7211(e)(2) (West Supp. 2003); *see also PCAOB Update*, THE CPA J., May 1, 2003, *available at* 2003 WL 15438547 (announcing that William J. McDonough, president and chief executive of the Federal Reserve Bank of New York, was appointed chair of the Public Company Accounting Oversight Board along with the appointment of Douglas R. Carmichael, PhD, CFE, CPA, as PCAOB chief auditor and director of professional standards).

68. 15 U.S.C.A. § 7211(c) (West Supp. 2003); *see also* C. William (Bill) Thomas, *Sarbanes-Oxley Act: Sarbanes-Oxley Act Brings Sweeping Reforms*, TODAY'S CPA, Nov./Dec. 2002, at 25 (describing the duties assigned to the PCAOB).

69. *See SEC Reacts Tersely to Accounting Group*, WALL ST. J., Mar. 20, 2003, at C9, *available at* 2003 WL-WSJ 3962417 (reporting on the SEC's reaction to the issuance of auditing standards by the AICPA).

70. *See id.* (stating that Jackson Day, chief accountant for the SEC, was concerned the proposal creates "the misleading impression" that it sets standards that have been granted to the PCAOB).

71. *See id.* (quoting Charles Landes, director of the AICPA's auditing standards, as saying that the proposal "wasn't intended to imply we were trying to undercut or otherwise diminish the role of the PCAOB").

72. *See* C. William (Bill) Thomas, *Sarbanes-Oxley Act: Sarbanes-Oxley Act Brings Sweeping Reforms*, TODAY'S CPA, Nov./Dec. 2002, at 25 (discussing the impact of the Act on the accounting profession).

tions responsible for setting auditing standards.[73] Only time will tell whether this Act is the right medicine for the accounting profession, or whether greed will prevail over the fear of getting caught.[74]

III. HISTORY OF ACCOUNTANTS' LIABILITY TO NONCLIENTS

Generally, the scope of accountants' liability varies among the jurisdictions of this country.[75] The reason for such inconsistence results from "a schism in public policy regarding the measure of liability accountants should bear in favor of third parties for the business errors attributable, in whole or in part, to their work product."[76] The matter is further compli-

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73. *TSCPA Accounting Reform Positions*, Texas Society of CPAs, *at* http://www.tscpa.org/welcome/reformpositions.html (last visited June 22, 2003) (on file with the *St. Mary's Law Journal*).

74. *See* Dr. L. Murphy Smith, *Can Congress Prescribe the Right Medicine for Accounting?*, TODAY'S CPA, Nov./Dec. 2002, at 32 (arguing that the Act will fall short of restoring confidence in the stock market); C. William (Bill) Thomas, *Sarbanes-Oxley Act: Sarbanes-Oxley Act Brings Sweeping Reforms*, TODAY'S CPA, Nov./Dec. 2002, at 27 (recognizing greed and fear as two very strong motivating factors in capitalistic enterprises).

75. *See* Christopher Allegaert & Daniel Tinkelman, *Reconsidering the "Lack of Duty" Defense to State Auditor Negligence Claims*, 25 J. CORP. L. 489, 491 (2000) (providing an overview of the law regarding auditors' duty to nonclients); Denzil Y. Causey & Sandra A. Causey, *The Accounting Profession in the Courts*, 12 MISS. C. L. REV. 7, 14-15 (1991) (discussing the evolution of accountants' duty to third parties from the mid-1960s to the mid-1980s); Jordan H. Leibman & Anne S. Kelly, *Accountants' Liability to Third Parties for Negligent Misrepresentation: The Search for a New Limiting Principle*, 30 AM. BUS. L.J. 345, 421-22 (1992) (noting that four states have enacted statutes requiring third parties to be identified in writing at the time of the audit in order to be eligible to sue); Carl Pacini & David Sinason, *Gaining a New Balance in Accountants' Liability to Nonclients for Negligence: Recent Developments and Emerging Trends*, 103 COM. L.J. 15, 21 (1998) (listing the four main approaches applied by state courts in deciding which nonclients are owed a duty by accountants for negligent misrepresentation); Robert A. Prentice, *Can the Contributory Negligence Defense Contribute to a Defusing of the Accountants' Liability Crisis?*, 13 WIS. INT'L L.J. 359, 414 n.262 (1995) (describing the three major views of an auditor's liability to third-parties adopted by the courts in the United States); Robert W. Walter, *Liability of Independent Public Accountants to Nonclients in Colorado*, 29 COLO. LAW. 51, 52 (2000) (stating that the Colorado Supreme Court found that professionals, other than attorneys, are subject to liability to third parties for negligent misrepresentation); Denise M. Orlinsky, Note, *An Accountant's Liability to Third Parties:* Bily v. Arthur Young & Co., 43 DEPAUL L. REV. 859, 871-72 (1994) (discussing the different approaches used to answer the question of whether auditors should be liable to third parties who read and rely on audit reports).

76. First Nat'l Bank of Commerce v. Monco Agency Inc., 911 F.2d 1053, 1058 (5th Cir. 1990); *see also* Julie Faussie, Note, *Limiting Liability in Public Accounting Suits: A Desperate Appeal from a Beleaguered Profession*, 28 VAL. U. L. REV. 1041, 1074 (1994) (expressing the opinion that "[c]ourts need to apply standards consistently in public accounting suits so that uniformity and predictability may result"); Denise M. Orlinsky, Note, *An Accountant's Liability to Third Parties:* Bily v. Arthur Young & Co., 43 DEPAUL L. REV. 859,

cated since the interests of management and the capital market differ significantly from those of the public.[77] On the one hand, the company's management aims at maximizing "stockholders' and creditors' confidence in the company, . . . whereas, the public demands a sober and impartial evaluation of fiscal performance."[78] The three main common law theories concerning whether nonclients can sue accountants for negligence are: (1) the privity rule; (2) the Restatement (Second) of Torts § 552; and (3) the foreseeability standard.[79] A minority of the states follow the foreseeability standard, whereas a majority of the states have adopted the Restatement approach.[80]

A. *The Privity Rule*

Initially, accountants were only liable to those persons with whom there was privity.[81] Nonclient third parties who had relied on the ac-

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906 (1994) (expressing the opinion that the foreseeability standard should be applied to negligence lawsuits brought against accountants).

77. *First Nat'l Bank of Commerce*, 911 F.2d at 1058; *see also* Denzil Y. Causey & Sandra A. Causey, *The Accounting Profession in the Courts*, 12 MISS. C. L. REV. 7, 17 (1991) (explaining the policy decisions regarded by courts in determining the limits of proper conduct of professional accounting practice).

78. *First Nat'l Bank of Commerce*, 911 F.2d at 1058.

79. *See* Julie Faussie, Note, *Limiting Liability in Public Accounting Suits: A Desperate Appeal from a Beleaguered Profession*, 28 VAL. U. L. REV. 1041, 1057 (1994) (exploring the three liability theories for holding public accounting firms liable to third parties); Denise M. Orlinsky, Note, *An Accountant's Liability to Third Parties*: Bily v. Arthur Young & Co., 43 DEPAUL L. REV. 859, 871 (1994) (providing three distinct approaches to the issue of accountant liability to third parties); Jodi B. Scherl, Comment, *Evolution to Auditor Liability to Noncontractual Third Parties: Balancing the Equities and Weighing the Consequences*, 44 AM. U. L. REV. 255, 263-64 (1994) (explaining the three schools of thought applicable to an accountant who negligently prepares an audit).

80. The Restatement (Second) of Torts § 552 is followed by twenty-two states including: Alabama, Alaska, California, Florida, Georgia, Hawaii, Iowa, Kentucky, Massachusetts, Michigan, Minnesota, Missouri, New Hampshire, North Carolina, Ohio, Oklahoma, Rhode Island, South Carolina, Tennessee, Texas, Washington, and West Virginia. Paul J. Masinter & Walter F. Wolfe, *Non-Client Third Party Claims Against Accounting Firms*, NETWORK (ABA/Bus. Law Section), Spring 2002, at 3, 5, *available at* http://www.abanet.org/buslaw/newsletter/0003/materials/tip1.pdf (on file with the *St. Mary's Law Journal*). Mississippi and Wisconsin are the states that currently utilize the foreseeability standard. *Id.* Courts and legislatures in Arizona, Colorado, Connecticut, Delaware, District of Columbia, Maine, Maryland, Nevada, New Mexico, North Dakota, Oklahoma, Oregon, Puerto Rico, South Dakota, U.S. Virgin Islands, and Vermont apparently have not tackled this issue and thus their standard remains unclear. *Id.*

81. *See* Mark H. Fink, *Third-Party Liability of Public Accountants*, 71 MICH. B.J. 1286, 1286 (1992) (stating that accountants were initially liable only when they were negligent in the performance of professional duties to a person who had contracted their services); John S. Dzienkowski, Note, *Accountants' Liability for Compilation and Review Engagements*, 60

countant's seal of approval were restricted from bringing suit.[82] The privity rule first developed in the English case of *Winterbottom v. Wright* in 1842.[83] In that case, the defendant was hired to repair a mail coach.[84] The plaintiff brought suit against the defendant for injuries suffered from defendant's negligent repairs.[85] However, the court found for the defendant and stated that "[u]nless we confine the operation of such contracts as this to the parties who entered into them, the most absurd and outrageous consequences, to which I see no limit, would ensue."[86] Ultimately, the court held that no liability existed since the plaintiff was not in privity of contract with the defendant.[87]

Ninety years after the *Winterbottom* decision, the New York Court of Appeals applied the privity rule to accountants in *Ultramares Corp. v. Touche.*[88] The plaintiff in this case was a corporation engaged in the factoring business that loaned money to Fred Stern & Co. (Stern) based on a

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TEX. L. REV. 759, 812 (1982) (discussing the different problems facing a court when a third-party relies on reviewed or complied financial statements).

82. *See* Thomas Scarlett, *Can Investors Seek Accountability for Accountants?*, TRIAL MAG., June 1, 2002, at 12 (recognizing that, historically, accountants were liable only to individuals or company clients, and third parties who had relied on the accountants' seal of approval were out of luck).

83. *See* Christopher Allegaert & Daniel Tinkelman, *Reconsidering the "Lack of Duty" Defense to State Auditor Negligence Claims*, 25 J. CORP. L. 489, 491 (2000) (citing *Winterbottom v. Wright* as establishing the general rule of privity); Julie Faussie, Note, *Limiting Liability in Public Accounting Suits: A Desperate Appeal from a Beleaguered Profession*, 28 VAL. U. L. REV. 1041, 1074 (1994) (recognizing that the first case to apply the privity doctrine was *Winterbottom v. Wright*).

84. *See* Christopher Allegaert & Daniel Tinkelman, *Reconsidering the "Lack of Duty" Defense to State Auditor Negligence Claims*, 25 J. CORP. L. 489, 491 (2000) (providing a brief discussion of *Winterbottom v. Wright)*; Julie Faussie, Note, *Limiting Liability in Public Accounting Suits: A Desperate Appeal from a Beleaguered Profession*, 28 VAL. U. L. REV. 1041, 1074 (1994) (discussing the facts of *Winterbottom v. Wright)*.

85. *See* Julie Faussie, Note, *Limiting Liability in Public Accounting Suits: A Desperate Appeal from a Beleaguered Profession*, 28 VAL. U. L. REV. 1041, 1074 (1994) (stating that the "passenger sued the mail coach company for negligently manufacturing a wheel, which broke and caused the accident").

86. *See* Christopher Allegaert & Daniel Tinkelman, *Reconsidering the "Lack of Duty" Defense to State Auditor Negligence Claims*, 25 J. CORP. L. 489, 491 (2000) (quoting *Winterbottom v. Wright*).

87. Julie Faussie, Note, *Limiting Liability in Public Accounting Suits: A Desperate Appeal from a Beleaguered Profession*, 28 VAL. U. L. REV. 1041, 1074 (1994); Jodi B. Scherl, Comment, *Evolution of Auditor Liability to Noncontractual Third Parties: Balancing the Equities and Weighing the Consequences*, 44 AM. U. L. REV. 255, 265 (1994).

88. 174 N.E. 441, 443 (N.Y. 1931); *see also* Denise M. Orlinsky, Note, *An Accountant's Liability to Third Parties:* Bily v. Arthur Young & Co., 43 DEPAUL L. REV. 859, 872-73 (1994) (discussing the *Ultramares* Doctrine); Jodi B. Scherl, Comment, *Evolution of Auditor Liability to Noncontractual Third Parties: Balancing the Equities and Weighing the Consequences*, 44 AM. U. L. REV. 255, 265-66 (1994) (reviewing *Ultramares Corp. v. Touche*).

certified balance sheet prepared by the defendants, a public accounting firm.[89] The defendant knew that Stern financed its operations through extensive credit and borrowed funds, but was not privy to the specific parties who had received a copy of the certified balance sheets.[90] Nearly a year after the plaintiff made several loans to Stern, Stern filed for bankruptcy.[91] At the time of bankruptcy, the loans remained unpaid.[92] After an unsuccessful attempt to recover losses against Stern, the plaintiff filed suit against the accountants to recover the loss suffered by the plaintiff in reliance upon the audit, alleging that the accountants negligently and fraudulently performed the audit.[93]

Despite finding evidence supporting a finding that the auditors were negligent in failing to uncover Stern's fictitious entries, the court refused to hold the accountants accountable to one with whom they had no contractual privity.[94] Chief Justice Cardozo, speaking for the court, wrote, "[i]f liability for 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."[95] The court noted that nothing in its precedent called for a holding of liability for negligence in the absence of privity.[96] Consequently, the court held that "if there has been neither reckless misstatement nor insincere profession of an opinion, but only honest blunder, the ensuing liability for negligence is one that is bounded by the contract, and is to be enforced between the parties by whom the contract has been made."[97]

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89. Ultramares Corp. v. Touche, 174 N.E. 441, 443 (N.Y. 1931).
90. *Id.* at 442.
91. *Id.* at 443.
92. *Id.*
93. *Id.* at 442.
94. *Ultramares Corp.*, 174 N.E. at 446. Cardozo reflected in *Ultramares:*

> Liability for negligence if adjudged in this case will extend to many callings other than an auditor's. Lawyers who certify their opinion as to the validity of municipal or corporate bonds, with knowledge that the opinion will be brought to the notice of the public, will become liable to the investors, if they have overlooked a statute or a decision, to the same extent as if the controversy were one between client and adviser. Title companies insuring titles to a tract of land, with knowledge that at an approaching auction the fact that they have insured will be stated to the bidders, will become liable to purchasers who may wish the benefit of a policy without payment of a premium. These illustrations may seem to be extreme, but they go little, if any, farther than we are invited to go now.

Id. at 448.
95. *Id.* at 444.
96. *Id.* at 447.
97. *Id.* at 448.

The privity rule developed in *Ultramares* was further refined in *Credit Alliance Corp. v. Arthur Andersen & Co.*,[98] becoming known as the "akin to privity" standard.[99] The facts in *Credit Alliance* mirrored those of *Ultramares.* Credit Alliance Corporation provided substantial financing to L.B. Smith, Inc. (Smith) after relying upon audited financial statements prepared by Arthur Andersen & Co.[100] Andersen's audit report reflected Smith as a solvent company.[101] However, Smith defaulted on several million dollars of obligation to the plaintiff when it declared bankruptcy.[102] Credit Alliance sued Andersen alleging that Andersen failed to conduct investigations, in accordance with proper auditing standards, to uncover Smith's precarious financial conditions and the serious likelihood that Smith might not survive as a going concern.[103] On the facts of the case, the court found that the *Ultramares* privity rule was not satisfied because the plaintiff failed to show "the existence of a relationship between the parties sufficiently approaching privity."[104]

The *Credit Alliance* court articulated a more flexible application of the doctrine of privity to accountants' liability to nonclients.[105] The court held that a nonclient third party must establish each of the following three elements to succeed in an action for negligence against an accountant: (1) the accountant knew that "the financial reports were to be used

98. 483 N.E.2d 110 (N.Y. 1985).

99. *See* Credit Alliance Corp. v. Arthur Andersen & Co., 483 N.E.2d 110, 115 (N.Y. 1985) (citing *Ultramares*, 174 N.E. at 446, and stating that a relationship needs to be "so close as to approach that of privity" for accountants to be liable to noncontractual parties for the negligent preparation of financial reports); Jodi B. Scherl, Comment, *Evolution of Auditor Liability to Noncontractual Third Parties: Balancing the Equities and Weighing the Consequences,* 44 AM. U. L. REV. 255, 269-70 (1994) (discussing the decision of the New York Court Appeals in *Credit Alliance Corp. v. Arthur Andersen & Co.*) The American Institute of Certified Public Accountancy determined that the "akin to privity" doctrine has been applied or adopted in the following states and a United States territory through case law or an accountancy statute: Arkansas, Guam, Idaho, Illinois, Indiana, Kansas, Louisiana, Montana, Nebraska, New Jersey, New York, Pennsylvania, Utah, Virginia, and Wyoming. Paul J. Masinter & Walter F. Wolfe, *Non-Client Third Party Claims Against Accounting Firms*, NETWORK (ABA/Bus. Law Section), Spring 2002, at 3, 4, *available at* http://www.abanet.org/buslaw/newsletter/0003/materials/tip1.pdf (on file with the *St. Mary's Law Journal*).

100. *Credit Alliance Corp.*, 483 N.E.2d at 111; *see also* Denise M. Orlinsky, Note, *An Accountant's Liability to Third Parties:* Bily v. Arthur Young & Co., 43 DEPAUL L. REV. 859, 875 (1994) (evaluating the decision of *Credit Alliance v. Arthur Andersen & Co.*).

101. *See Credit Alliance Corp.*, 483 N.E.2d at 111 (explaining that Andersen's audit report stated that Smith's financial position was in conformity with generally accepted accounting principles).

102. *Id.* at 112.

103. *Id.* at 111-12.

104. *Id.* at 119.

105. *Id.* at 118.

for a particular purpose or purposes"; (2) a known party or parties relied on the financial reports; and (3) some conduct by the accountants linking them to the third party demonstrating the accountant's understanding regarding the third parties' reliance.[106] The court recognized that Andersen was aware that Credit Alliance was provided with a copy of its audit report, but, without a claim that Andersen prepared its audit report for the plaintiff's particular purpose, refused to extend Andersen's liability.[107] The court concluded that "there [was] no allegation of any word or action on the part of Andersen directed to plaintiffs, or anything contained in Andersen's retainer agreement . . . which provided the necessary link between them."[108] Thus, *Credit Alliance* reaffirmed New York's privity jurisprudence by not departing from the principles articulated in *Ultramares*.[109]

B. *Foreseeability Standard*

As the accountant's role began to expand, some courts disposed of the restrictive privity approach of *Ultramares* and shifted to a liability-expanding, foreseeability tort theory of negligence.[110] The first court to expand the duty of accountants to all third parties damaged as a result of foreseeable reliance upon the accountants' work product was the New Jersey Supreme Court in *Rosenblum, Inc. v. Adler*.[111] The plaintiffs in *Rosenblum* were stock purchasers who relied on audits of a corporation's financial statement in completing a corporate acquisition transaction.[112] After discovering that the financial statements were fraudulent and that the stock was worthless, the purchasers sued the accountants for negli-

106. *Credit Alliance Corp.*, 483 N.E.2d at 118.

107. *Id.* at 119.

108. *Id.*

109. *Id.* at 118; Jodi B. Scherl, Comment, *Evolution of Auditor Liability to Noncontractual Third Parties: Balancing the Equities and Weighing the Consequences*, 44 AM. U. L. REV. 255, 270 (1994).

110. *See* Samuel S. Paschall, *Liability to Non-Clients: The Accountant's Role and Responsibility*, 53 MO. L. REV. 693, 710 (1988) (acknowledging that accountants' "responsibility was no longer determined by the bounds of an agreement, but expanded to include third parties whom the defendant [accountant] could foresee would be affected by the negligent operation of his or her services"); Jodi B. Scherl, Comment, *Evolution of Auditor Liability to Noncontractual Third Parties: Balancing the Equities and Weighing the Consequences,* 44 AM. U. L. REV. 255, 271 (1994) (discussing the foreseeability approach as applied by the New Jersey Supreme Court in *Rosenblum v. Adler*).

111. 461 A.2d 138 (N.J. 1983); *see also* Denise M. Orlinsky, Note, *An Accountant's Liability to Third Parties:* Bily v. Arthur Young & Co., 43 DEPAUL L. REV. 859, 882 (1994) (recognizing that *Rosenblum, Inc. v. Adler* was the first case to alter accountants' liability to third parties).

112. Rosenblum, Inc. v. Adler, 461 A.2d 138, 141 (N.J. 1983).

gently conducting the audits leading to the proximate cause of their losses.[113]

The court rejected the privity rule and the Restatement approach, and decided to expand accountants' liability for negligence to reasonably foreseeable users after considering the public interest and the dynamics of the auditor's economic role.[114] In support of discarding the prerequisite of privity for recovery, the court questioned why a claim for negligence should be barred for lack of privity when no such restriction exists on a plaintiff's claim for defects in products arising out of a negligent misrepresentation.[115] "If recovery for defective products may include economic loss, why should such loss not be compensable if caused by negligent misrepresentation?"[116]

Accordingly, the court formulated a rule:

> [w]hen the independent auditor furnishes an opinion with no limitation in the certificate as to whom the company may disseminate the financial statements, [the auditor] has a duty to all those whom that auditor should reasonably foresee as recipients from the company of the statements for its proper business purposes, provided that the recipients rely on the statements pursuant to those business purposes.[117]

The court reasoned that holding an auditor accountable for negligence to foreseeable users of the audit was necessary to protect the public.[118] Likewise, the imposition of a duty to foreseeable users may cause accountants to conduct much more thorough examinations of a company's financial situation.[119] For instance, this principle could mandate stricter standards and closer supervision, ensuring a reduction of the number of instances in which liability could arise.[120] The court concluded by limiting

113. *Id.* at 140.

114. *See id.* at 145 (stating that "privity should not be, and is not, a salutary predicate to prevent recovery"); Carl Pacini & David Sinason, *Gaining a New Balance in Accountants' Liability to Nonclients for Negligence: Recent Developments and Emerging Trends*, 103 COM. L.J. 15, 30 (1998) (declaring that "*Rosenblum* radically altered accountants' negligence liability by extending the accountant's duty of care to reasonably foreseeable third parties under certain circumstances").

115. *Rosenblum, Inc.*, 461 A.2d at 147.

116. *Id.*

117. *Id.* at 153.

118. *Id.*

119. *Id.* at 152.

120. *Rosenblum, Inc.*, 461 A.2d at 152.

this principle to only those foreseeable users who obtained the audited statements from the business entity.[121]

C. *Restatement Approach*

As a result of the increasing frustration with both the broad implications of the foreseeability approach and the restrictions of the privity rule, courts began to adopt the Restatement (Second) of Torts § 552, titled "Information Negligently Supplied for the Guidance of Others."[122] The Restatement approach is more generous than the privity rule approach, but is narrower than the foreseeability standard.[123] As one com-

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121. *Id.* at 153 (excluding institutional investors or portfolio managers who fail to obtain a copy of the company's audited financial statements from the category of reasonably foreseeable third parties). Additionally, stockholders who acquired the stock after a negligent audit are not considered reasonably foreseeable third parties. *Id.*

122. RESTATEMENT (SECOND) OF TORTS § 552 (1977); *see also* Boykin v. Arthur Andersen & Co., 639 So. 2d 504, 509 (Ala. 1994) (reversing a prior Alabama Supreme Court decision under the near-privity rule in favor of the Restatement standard); Standard Chartered PLC v. Price Waterhouse, 945 P.2d 317, 340 (Ariz. Ct. App. 1996) (affirming the Restatement approach as the appropriate legal standard for accountants in Arizona). Standard Chartered, through one of its subsidiaries, Union Bank of California, claimed damages in excess of $330 million. *Standard Chartered*, 945 P.2d at 320. The jury awarded the damages sought by Standard Chartered, assigning eighty-five percent of the fault to Price Waterhouse. *Id.* at 326; *see also* Rusch Factors, Inc. v. Levin, 284 F. Supp. 85, 93 (D.R.I. 1968) (holding that "an accountant should be liable in negligence for careless financial misrepresentations relied upon by actually foreseen and limited classes of persons"); First Fla. Bank v. Mitchell, 558 So. 2d 9, 14 (Fla. 1990) (illustrating that the Florida Supreme Court decided to adopt the Restatement approach by holding that an accountant, who personally delivered reports to a bank and asked for a loan on the client's behalf, could be liable to the bank for negligence); Raritan River Steel Co. v. Cherry, 367 S.E.2d 609, 617 (N.C. 1988) (applying the Restatement standard since it accommodates those nonclients who are foreseeable users and accountants who need liability limitations); Bethlehem Steel Corp. v. Ernst & Whinney, 822 S.W.2d 592, 594 (Tenn. 1991) (disregarding the reasonably foreseeable rule previously applied by the trial court under the public policy reasons cited in *Raritan River*); First Nat'l Bank of Bluefield v. Crawford, 386 S.E.2d 310, 313 (W. Va. 1989) (choosing the Restatement position over the foreseeability rule); Carl Pacini & David Sinason, *Gaining a New Balance in Accountants' Liability to Nonclients for Negligence: Recent Developments and Emerging Trends,* 103 COM. L.J. 15, 25-26 (1998) (noting that it has been difficult for courts to apply the Restatement standard since "no bright line exists to distinguish one type of user from another in any given situation"); Samuel S. Paschall, *Liability to Non-Clients: The Accountant's Role and Responsibility,* 53 MO. L. REV. 693, 717 (1988) (commenting that *Rusch Factors, Inc. v. Levin,* was the first case to depart from the privity rule established in *Ultramares*); Jodi B. Scherl, Comment, *Evolution of Auditor Liability to Noncontractual Third Parties: Balancing the Equities and Weighing the Consequences*, 44 AM. U. L. REV. 255, 273 (1994) (referring to the Restatement approach as the intermediate approach).

123. *See* Denise M. Orlinsky, Note, *An Accountant's Liability to Third Parties:* Bily v. Arthur Young & Co., 43 DEPAUL L. REV. 859, 879 (1994) (noting that an accountant gen-

mentator explained, "[s]ection 552 imposes third-party liability on professionals who supply inaccurate information to their clients where the information is reasonably relied on by nonclients, such as creditors, banks, investors, and shareholders."[124] More specifically, the Restatement approach permits a limited group of nonclient third parties to recover for pecuniary losses resulting from an accountant's negligence in providing services to its client.[125] The liability "is limited to loss suffered 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 [so] intends . . . or in a substantially similar transaction."[126] In adhering to the Restatement approach, jurisdictions have interpreted this standard in a variety of ways.[127] The courts' definition of "limited group of per-

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erally undertakes no duty to third parties when he is retained to conduct an audit and to furnish an opinion for no particular purpose).

124. Jodi B. Scherl, Comment, *Evolution of Auditor Liability to Noncontractual Third Parties: Balancing the Equities and Weighing the Consequences*, 44 AM. U. L. REV. 255, 273 (1994); *see also* Carl Pacini & David Sinason, *Gaining a New Balance in Accountants' Liability to Nonclients for Negligence: Recent Developments and Emerging Trends*, 103 COM. L.J. 15, 27 (1998) (identifying that a justifiable reliance test must be met by the plaintiff). In order to show justifiable reliance the plaintiff must establish two elements. *Id.* First, "the plaintiff must in fact rely on the information" and the reliance must be reasonable. *Id.* Second, a reasonable relation must exist "between the contents of the accountant's misrepresentations and the action the plaintiff took in reliance." *Id.*

125. *See* RESTATEMENT (SECOND) OF TORTS § 552 cmt. c (1977) (stating that "[t]he rule stated in Subsection (1) applies only when the defendant has a pecuniary interest in the transaction in which the information is given"). "If he has no pecuniary interest and the information is given purely gratuitously, he is under no duty to exercise reasonable care and competence in giving it." *Id.*; *see also* Paul J. Masinter & Walter F. Wolfe, *Non-Client Third Party Claims Against Accounting Firms*, NETWORK (ABA/Bus. Law Section), Spring 2002, at 3-4, *available at* http://www.abanet.org/buslaw/newsletter/0003/materials/tip1.pdf (discussing the Second Restatement of Torts § 552(2)(a), (b)) (on file with the *St. Mary's Law Journal*).

126. RESTATEMENT (SECOND) OF TORTS § 552(3)(a), (b); *see also* Carl Pacini & David Sinason, *Gaining a New Balance in Accountants' Liability to Nonclients for Negligence: Recent Developments and Emerging Trends*, 103 COM. L.J. 15, 26 (1998) (pointing out that knowledge of the exact identity of the nonclient is not required to hold the accountant liable under the Restatement standard); Julie Faussie, Note, *Limiting Liability in Public Accounting Suits: A Desperate Appeal from a Beleaguered Profession*, 28 VAL. U. L. REV. 1041, 1077 (1994) (stating the requirement that the plaintiff be a member of a limited group "whose existence is known to the auditor").

127. *See* Carl Pacini & David Sinason, *Gaining a New Balance in Accountants' Liability to Nonclients for Negligence: Recent Developments and Emerging Trends*, 103 COM. L.J. 15, 27 (1998) (explaining the liberal interpretation adopted by Minnesota in *Bonhiver v. Graff*, 248 N.W.2d 291 (Minn. 1976)); Kenneth Edward Shore, Comment, *Watching the Watchdog: An Argument for Auditor Liability to Third Parties*, 53 SMU L. REV. 387, 409 (2000) (arguing that the Restatement approach falls short of a complete negligence regime since it restricts an accountant's liability to classes of third parties that the accountant actually foresees, and not to users that are reasonably foreseeable).

sons" or "substantially similar transaction" dictates whether the court broadly or narrowly applies the Restatement approach.[128]

Eventually, in *Bily v. Arthur Young & Co.*,[129] the California Supreme Court moved away from its previous foreseeability standard and adopted a restrictive interpretation of the Restatement approach to accountants' liability to nonclients.[130] In this well-known case, Osborne Computer Co. (Osborne) was the manufacturer of the world's first mass-produced portable personal computer.[131] Sales of Osborne's product rocketed, making the company one of the fastest growing enterprises in American business history.[132] Osborne began preparing for a public offering to raise needed capital; however, the public offering was put on hold due to internal management disputes.[133] In order to compensate for the financing need until the offering, Osborne sought out bank loans secured by direct loans or a letter of credit obtained by investors through a warrant transaction.[134] The plaintiffs in this case included investors who had purchased warrants through the warrant transaction and those individuals who had purchased Osborne's common stock outright.[135]

Osborne employed the defendant, Arthur Young & Co., to perform an audit of the company's 1981 and 1982 financial statements, which had been prepared by Osborne's in-house accounting department.[136] In 1981, Arthur Young issued an unqualified opinion reporting a net operating

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128. *See* Robert W. Walter, *Liability of Independent Public Accountants to Nonclients in Colorado,* 29 COLO. LAW. 51, 53 (2000) (stating that the North Carolina Supreme Court noted that "if the accountant was informed of the intended use of the financial statements or had knowledge that the usage could rise above the level at which such statements are 'customarily used,' the case could not be disposed of on summary judgment"); Julie Faussie, Note, *Limiting Liability in Public Accounting Suits: A Desperate Appeal from a Beleaguered Profession,* 28 VAL. U. L. REV. 1041, 1079 (1994) (inferring that one flaw with the Restatement standard is that the courts are given a large amount of discretion to place more weight on some factors than on others); Kenneth Edward Shore, Comment, *Watching the Watchdog: An Argument for Auditor Liability to Third Parties,* 53 SMU L. REV. 387, 409 (2000) (noting that the Restatement approach may be narrowly or broadly applied by the court, depending on its definition of key phrases).

129. 843 P.2d 745 (Cal. 1992).

130. *See* Denise M. Orlinsky, Note, *An Accountant's Liability to Third Parties:* Bily v. Arthur Young & Co., 43 DEPAUL L. REV. 859, 888 (1994) (discussing the pertinent facts of *Bily v. Arthur Young & Co.*); Jodi B. Scherl, Comment, *Evolution of Auditor Liability to Noncontractual Third Parties: Balancing the Equities and Weighing the Consequences*, 44 AM. U. L. REV. 255, 277 (1994) (listing *Bily v. Arthur Young & Co.* as one of two decisions of vital importance to the jurisprudence of an auditor's third-party liability for negligence).

131. Bily v. Arthur Young & Co., 834 P.2d 745, 747 (Cal. 1992).

132. *See id.* (reporting that sales topped $10 million per month).

133. *Id.*

134. *Id.*

135. *Id.*

136. *Bily*, 834 P.2d at 747.

St. Mary's Law Journal, Vol. 35 [2003], No. 1, Art. 4

loss of approximately $1,000,000 in 1981 on sales of $6,000,000.[137] The 1982 financial statements, indicating a trend towards profitability, reported a modest $69,000 net operating profit on skyrocketing sales of $68,000,000.[138] Plaintiffs alleged that they purchased Osborne's common stock relying on the soundness of the corporation as represented by Arthur Young & Co.'s clean audit opinion.[139] However, the plaintiffs ultimately lost their investments after the company's financial performance began to falter and a decline in sales lead to Osborne's bankruptcy.[140]

In deciding the plaintiffs' negligent misrepresentation claim against Arthur Young & Co., the court delicately analyzed all three approaches for allowing the plaintiff to recover.[141] The court expressly rejected the foreseeability approach because of the danger that an auditor's potential liability to nonclients could be grossly disproportionate to the auditor's fault.[142] The court viewed the Restatement approach as the sensible and moderate way to limit the potential consequences of imposing unlimited liability.[143] In the court's opinion, the Restatement was the most favorable approach because: (1) it requires that an accountant "receive notice of potential third party claims"; (2) it "establishes a closer connection between the [accountant's] negligent act and the recipient's injury"; and (3) "no unfairness results to those recipients who are excluded from the class of beneficiaries because they have means of private ordering . . . they can establish direct communication with an auditor and [can] obtain a report for their own direct use and benefit."[144]

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137. *Id.* at 747-48.

138. *Id.* at 748.

139. *Id.* at 747-48.

140. *Id.* at 748.

141. *Bily*, 834 P.2d at 752-59.

142. *See id.* at 762 (outlining three central concerns for declining to follow the foreseeability standard); Carl Pacini & David Sinason, *Gaining a New Balance in Accountants' Liability to Nonclients for Negligence: Recent Developments and Emerging Trends*, 103 COM. L.J. 15, 43 (1998) (stating that "*Bily* is significant because the court's rejection of the foreseeable user doctrine represents a policy shift away from protecting the rights and expectations of investors, lenders, and the public in favor of a policy that shields accountants from liability to a larger number of nonclients"). In essence, the *Bily* case decreased "auditor business risk in one of the nation's most important commercial states." *Id.* at 44.

143. *Bily*, 834 P.2d at 769.

144. *Id.*; *see also* Denise M. Orlinsky, Note, *An Accountant's Liability to Third Parties:* Bily v. Arthur Young & Co., 44 DEPAUL L. REV. 859, 893 (1994) (listing the justifications for adoption of the Restatement approach).

IV. Evolution of Texas Approach to Accountants' Liability to Nonclients

Along with the California Supreme Court, Texas courts have adopted the Restatement approach in determining accountants' liability to nonclients in negligence suits.[145] Under Texas law, accountants are liable to nonclients if they are a part of a limited class of people who relied on the accountants' statement or information, and if the accountants knew or should have known that their services would be relied on.[146] To be held liable, the accountants' professional negligence must be the proximate cause of injury to a third party.[147]

In fact, the development of accountants' liability to nonclients under Texas law was first discussed in *American Indemnity Co. v. Ernst & Ernst*,[148] a Texas Tenth District Court of Appeals at Waco decision.[149] In *American Indemnity Co.,* the plaintiff, a surety company, sued an accounting firm for the loss sustained due to the accountants' failure to report that an employee of the Mexia School District had been embezzling funds belonging to the school district.[150] The issue of the plaintiff's cause of action and hence the applicable statute of limitation was before the Tenth Court of Appeals.[151] The court held such cause of action was in tort.[152] In essence, the court stated that an accountant who deliberately

145. *See* Fed. Land Bank Ass'n v. Sloane, 825 S.W.2d 439, 442 (Tex. 1991) (agreeing to look at the Restatement to define the duty of care). The Restatement limitation on recovery stems from policy reasons such as "a lower degree of fault indicated by a less culpable mental state and the need to keep liability proportional to risk." *Id.* at 442-43. The court in *Sloane* recognized no trend rejecting the pecuniary loss rule in a commercial tort, and thus declined to extend damages beyond those limits provided in the Restatement. *Id.* at 443.

146. *See* Shatterproof Glass Corp. v. James, 466 S.W.2d 873, 880 (Tex. Civ. App.—Fort Worth 1971, writ ref'd n.r.e.) (citing to the Restatement (Second) of Torts § 552 (Tentative Draft No. 12, 1966)).

147. *See* Blue Bell, Inc. v. Peat, Marwick, Mitchell & Co., 715 S.W.2d 408, 411 (Tex. App.—Dallas 1986, writ ref'd n.r.e.) (asserting that plaintiff must prove defendant's negligence was the sole proximate cause of the damages to plead a negligent misrepresentation cause of action).

148. 106 S.W.2d 763 (Tex. Civ. App.—Waco 1937, writ ref'd).

149. *See* David Woodward & Maggie Yar, *A Look at Accountant Liability After Enron*, TEX. LAW., Feb. 25, 2002, at 46 (providing a history of the Texas law of accountant liability to nonclients).

150. *See* Am. Indem. Co. v. Ernst & Ernst, 106 S.W.2d 763, 764 (Tex. Civ. App.—Waco 1937, writ ref'd) (asserting that Arrington had embezzled more than $5,000 of the funds belonging to the school district).

151. *Id.*

152. *Id.* at 765; *see also* 1 KNOX D. NUNNALLY & RONALD G. FRANKLIN, TEXAS PRACTICE GUIDE TORTS § 2:113 (2003) (illustrating the notion that "[a]ccountants are liable for professional negligence under the common law").

St. Mary's Law Journal, Vol. 35 [2003], No. 1, Art. 4

made false representations to another with intent to deceive a third party was liable for the damages caused by the fraud of the third party.[153]

Subsequently, the holding in *American Indemnity Co.* was further expanded in *Shatterproof Glass Corp. v. James.*[154] In *Shatterproof Glass,* the Texas Second District Court of Appeals at Fort Worth found it immaterial to the defendants' liability whether they made misrepresentation innocently or deliberately, or whether misrepresentations were made with a fraudulent or dishonest intent.[155] The *Shatterproof Glass* court urged the adoption of the tentative draft of the Restatement (Second) of Torts § 552 as the law in Texas, and thus recognized liability of all professionals for negligent misrepresentation made with the intent that a third party plaintiff rely on them.[156] The court affirmatively held that where an accountant knew of the intended use of his services, he owed a duty to exercise ordinary care to those nonclient third parties.[157] The court stressed that the accountant knew that the plaintiff was going to rely on the audit reports in the making of loans to the accounting firm's client.[158]

However, Texas courts no longer apply the "knowingly" standard articulated in *Shatterproof Glass.*[159] In *Blue Bell, Inc. v. Peat, Marwick, Mitchell & Co.*,[160] the Texas Fifth District Court of Appeals at Dallas held that actual knowledge of a particular plaintiff or class of plaintiffs is not necessary if the defendant should have had this knowledge through current business practices.[161] Consequently, the court adopted a less restrictive interpretation of the Restatement.[162] Because of the decision in *Blue Bell,* courts determine whether an accountant "knows or should know"

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153. *See Am. Indem. Co.*, 106 S.W.2d at 765 (applying a two-year statute of limitation to the case since the action is in tort).

154. 466 S.W.2d 873 (Tex. Civ. App.—Fort Worth 1971, writ ref'd n.r.e.).

155. *See* Shatterproof Glass Corp. v. James, 466 S.W.2d 873, 874 (Tex. Civ. App.—Fort Worth 1971, writ ref'd n.r.e.) (stating that the purpose of the audit was to allow Paschal Enterprise to obtain credit from a financial institution).

156. *Id.* at 879.

157. *Id.* at 876.

158. *Id.* at 875.

159. *See* David Woodward & Maggie Yar, *A Look at Accountant Liability After Enron*, TEX. LAW., Feb. 25, 2002, at 46 (announcing the adoption of the "knows or should know" standard and dispensing with the "knowingly" standard for accountant liability to nonclients).

160. 715 S.W.2d 408 (Tex. App.—Dallas 1986, writ ref'd n.r.e.).

161. Blue Bell, Inc. v. Peat, Marwick, Mitchell & Co., 715 S.W.2d 408, 412 (Tex. App.—Dallas 1986, writ ref'd n.r.e.).

162. *See* Scottish Heritable Trust v. Peat Marwick Main & Co., 81 F.3d 606, 614 (5th Cir. 1996) (stating that the court in *Blue Bell* in no way abandoned the "limited group" requirement).

that his services will be relied on by a limited class of persons.[163] Then, the accountant may be liable for damages to the member of that class relying on his certification of the audited reports.[164] Unfortunately, this approach does not rise to the foreseeability standard adopted by the U.S. Court of Appeals for the Fifth Circuit in *Scottish Heritable Trust v. Peat Marwick Main & Co.*[165] The foreseeability standard has not been followed by Texas courts.[166]

V. Proposal for Expanding Accountants' Accountability

Notably, Texas courts' reluctance to expand accountants' accountability stems from public policy considerations.[167] The most persistent public policy objection to expanding accountant liability is the likelihood of devastating liability to the accounting profession.[168] Courts reason that unlimited liability will result in excessive costs to accountants since they lack

163. *Blue Bell, Inc.*, 715 S.W.2d at 412. The court reasoned that allowing liability to depend on the chance occurrence that the "accountant's client specifically mentions a person or class of persons who are to receive the reports, when the accountant may have that same knowledge as a matter of business practice, is too tenuous a distinction for us to adopt as a rule of law." *Id.*

164. *Id.*

165. *See Scottish Heritable Trust*, 81 F.3d at 614 (refuting the concept that a potential investor with no previous connection to either the corporation or the accountant is within the "limited group"). However, the Fifth Circuit Court did state that "we do not suggest that a potential purchaser can never be a member of a 'limited group.'" *Id.; see also* David Woodward & Maggie Yar, *A Look at Accountant Liability After Enron*, TEX. LAW., Feb. 25, 2002, at 46 (evaluating the foreseeability approach standard adopted by the Fifth U.S. Circuit Court of Appeals).

166. *See Scottish Heritable Trust*, 81 F.3d at 613 (refusing to hold that an accountants' duty to third parties is based on the general knowledge the accountants possess about typical investors or tenuous inferences concerning future events); *see also Blue Bell, Inc.*, 715 S.W.2d at 412 (finding the reasoning of the cases and commentators urging adoption of the foreseeability test persuasive, but refused to decide whether the test should be adopted); 1 KNOX D. NUNNALLY & RONALD G. FRANKLIN, TEXAS PRACTICE GUIDE TORTS § 2:113 (2003) (stating that accounting firms' duty of care owed to nonclient third parties is not determined by foreseeability alone).

167. *See* Brown v. KPMG Peat Marwick, 856 S.W.2d 742, 748 (Tex. App.—El Paso 1993, writ denied) (stating that policy considerations behind the statute of limitation justifies protecting the auditor from stale claims).

168. Kenneth Edward Shore, Comment, *Watching the Watchdog: An Argument for Auditor Liability to Third Parties,* 53 SMU L. REV. 387, 416 (2000); *see also* Raritan River Steel Co. v. Cherry, 367 S.E.2d 609, 615 (N.C. 1988) (rejecting the foreseeability approach "because it would result in liability more expansive than an accountant should be expected to bear"). *But see* Samuel S. Paschall, *Liability to Non-Clients: The Accountant's Role and Responsibility,* 53 MO. L. REV. 693, 725 (1988) (stating that "[e]xtending accountant's liability to foreseeable users' audited financial statements will not cripple the now financially strong accounting industry"). The possibility for unlimited liability for the accounting profession is diminished since the plaintiff has a high level of burden in a negligent misrepre-

control over the audit report distribution and, thus, are unaware of potential plaintiffs.[169] However, accountants may take several steps to protect against the fear of unlimited liability.[170] For example, accountants may: (1) use disclaimers in the audit report; (2) limit distribution of the audit report; and (3) obtain malpractice insurance.[171] In addition, the number of potential plaintiffs is limited in duration since the financial statements become obsolete within a few years.[172]

Further, the premise that the client is the primary beneficiary of the audit is clearly outdated.[173] Although one function of the audit is to alert management of internal accounting irregularities, the ultimate beneficiaries of the audit are third parties.[174] Businesses and individuals use audited financial statements as the benchmark in determining a company's financial credibility to help make economic decisions.[175] Consequently, it is these third parties who rely on the audit opinion, not the client, that suffer economic injury.[176] The foreseeable standard is the

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sentation suit. *Id.* The plaintiff has the difficult task of proving the element of reliance and causation. *Id.* at 726.

169. *See* Kenneth Edward Shore, Comment, *Watching the Watchdog: An Argument for Auditor Liability to Third Parties,* 53 SMU L. REV. 387, 416 (2000) (reasoning that an auditor's lack of control over the distribution of the audit report limits an auditor's liability).

170. Denise M. Orlinsky, Note, *An Accountant's Liability to Third Parties:* Bily v. Arthur Young & Co., 43 DEPAUL L. REV. 859, 899 (1994).

171. *Id.*

172. Kenneth Edward Shore, Comment, *Watching the Watchdog: An Argument for Auditor Liability to Third Parties,* 53 SMU L. REV. 387, 419 (2000).

173. *Id.* at 416.

174. *See id.* (tracking the original purpose of an audit back to management's desire to check its internal accounting functions); Denise M. Orlinsky, Note, *An Accountant's Liability to Third Parties*: Bily v. Arthur Young & Co., 43 DEPAUL L. REV. 859, 960 (1994) (stressing that the primary purpose of an audit report is to induce investors and lenders to act on reliance of the audit report); *see also* Burton Malkiel, *Watchdogs and Lapdogs,* WALL ST. J., Jan. 16, 2002, at A16, *available at* 2002 WL-WSJ 3383108 (stating that "it is on the independent accounting profession that we most rely for assurance that a corporation's financial statements accurately reflect the firm's condition"). Although independent auditors cannot detect all fraud, they are relied upon for integrity of financial reporting. *Id.*

175. *See* John S. Dzienkowski, Note, *Accountants' Liability for Compilation and Review Engagements*, 60 TEX. L. REV. 759, 768 (1982) (warning that not only does internal management use the audited financial statements, but so do stockholders, creditors, regulatory agencies, financial analysts, and boards of directors); Kenneth Edward Shore, Comment, *Watching the Watchdog: An Argument for Auditor Liability to Third Parties,* 53 SMU L. REV. 387, 417 (2000) (emphasizing that investors, creditors, shareholders, banks, and suppliers are among the individuals who rely on audit financial statements to make sound business decisions).

176. Kenneth Edward Shore, Comment, *Watching the Watchdog: An Argument for Auditor Liability to Third Parties,* 53 SMU L. REV. 387, 417 (2000); *see also* Denise M. Orlinsky, Note, *An Accountant's Liability to Third Parties:* Bily v. Arthur Young & Co., 43

only appropriate standard to compensate the foreseeable injured plaintiffs.[177]

Expanding an accountant's liability to mirror the same principles as applied to other tortfeasors will encourage greater due care and diligence by accountants.[178] Conversely, an increase in due care will lead to more accurate financial statements.[179] The suggestion by opponents that accountants would simply cut back on the number of audits they perform and replace the lost revenues from the lost audit work through consulting, tax, and other nonaudit services is inapplicable now.[180] Accountants may no longer provide consulting work for clients for whom they perform audit services.[181] In addition, new legislation mandates that publicly traded companies change auditors every five years.[182]

DEPAUL L. REV. 859, 897 (1994) (rejecting the privity doctrine because it fails to acknowledge the reality that third parties are the primary beneficiaries of the audit report).

177. *See* Denise M. Orlinsky, Note, *An Accountant's Liability to Third Parties:* Bily v. Arthur Young & Co., 43 DEPAUL L. REV. 859, 906-07 (1994) (concluding that the reasonably foreseeable standard compensates wrongfully injured plaintiffs).

178. *See id.* at 903 (commenting that the foreseeability approach may induce more careful auditing since accountants are eager to please their client). *But see* Jodi B. Scherl, Comment, *Evolution of Auditor Liability to Noncontractual Third Parties: Balancing the Equities and Weighing the Consequences*, 44 AM. U. L. REV. 255, 286 (1994) (disagreeing with the argument that the foreseeability standard provides the auditor with the incentive to improve the audit quality).

179. Samuel S. Paschall, *Liability to Non-Clients: The Accountant's Role and Responsibility*, 53 MO. L. REV. 693, 729 (1988) (arguing that expanding accountant liability will help prevent an accountant from using "creative methods" to maintain a client relationship).

180. *See* Kenneth Edward Shore, Comment, *Watching the Watchdog: An Argument for Auditor Liability to Third Parties*, 53 SMU L. REV. 387, 421 (2000) (suggesting that fewer audits will result if accountants are liable to third parties); *see also FTI Agrees to Buy Restructuring Unit of Accounting Firm*, WALL ST. J., July 26, 2002, *at* 2002 WL-WSJ 3401894 (reporting that PricewaterhouseCoopers LLP sold its domestic business-recovery services division to FTI Consulting Inc. for $140 million in cash and three million FTI common shares). This transaction occurred because of the intense scrutiny over an auditor's independence when a firm offers both lucrative consulting and auditing services to the same company. *Id.*

181. *See* John F.X. Peloso & Stuart M. Sarnoff, *The Sarbanes-Oxley Act of 2002: Whom Does It Affect and How?*, 228 N.Y. L.J. 3 (2002) (noting that the new Sarbanes-Oxley Act of 2002 prohibits registered accounting firms from providing consulting and audit services to a client at the same time).

182. *See* C. William (Bill) Thomas, *Sarbanes-Oxley Act: Sarbanes-Oxley Act Brings Sweeping Reforms,* TODAY'S CPA, Nov./Dec. 2002, at 26 (noting that the Sarbanes-Oxley Act "requires lead and reviewing partner rotation every five years, as well as timely reporting to the issuer's audit committee of critical accounting policies, alternative accounting treatments and ramifications, and copies of all communications with management, including audit adjustments"). In addition, the Sarbanes-Oxley Act focuses on corporate responsibility. *Id.* For example, its provisions call for the "independent audit committees to hire and receive communication from the auditor; require CEOs and CFOs to certify financial

St. Mary's Law Journal, Vol. 35 [2003], No. 1, Art. 4

Lastly, it must be emphasized that accountants are in the better position to absorb and spread the losses resulting from audit failures.[183] For example, the cost of purchasing adequate malpractice insurance may be passed to the client through higher audit fees.[184] The increased audit fees to the client lower the client's income, thus passing the costs to the client's investors, the ultimate users of the audit report.[185] Investors, on the other hand, who suffer losses resulting from unreliable information, pass the cost of audit failures to the economy.[186] The economy suffers in terms of loss of employment and the loss of investor confidence in the stock market.[187] Enron and the recent corporate scandals provide an excellent real world example of this phenomenon.[188] The devastating economic consequences caused by the sudden collapse of these reportedly sound companies signify the importance of an accountant's role in today's economy. The adoption of a reasonably foreseeable approach in Texas is necessary to restore investors' and lenders' confidence in the audited financial statement they rely on to make sound economic decisions.[189]

VI. CONCLUSION

Accountants find themselves in a higher potential situation for litigation than ever before. The scope of accountant accountability to non-clients in Texas must adapt to the changing dynamics of the accounting

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reports; [and] prohibit officers from improperly influencing the conduct of independent audits." *Id.* The Act imposes severe criminal penalties. *Id.* The maximum prison term for a conviction of securities fraud is ten to twenty-five years. *Id.* The criminal sanction for destroying, altering or fabricating records in a federal investigation is twenty years. *Id.* That prison term is reduced to ten years if the conviction is one of destroying key audit documents. *Id.* People outside the accounting profession have referenced the "Big Four" as the "Final Four".

183. *See* Kenneth Edward Shore, Comment, *Watching the Watchdog: An Argument for Auditor Liability to Third Parties,* 53 SMU L. REV. 387, 419 (2000) (stating that cost spreading is a consideration in expanding an accountant's liability).

184. *Id.* at 420; *see also* Denise M. Orlinsky, Note, *An Accountant's Liability to Third Parties:* Bily v. Arthur Young & Co., 43 DEPAUL L. REV. 859, 904 (1994) (contending that the availability of insurance coverage may protect accountants against liability).

185. Kenneth Edward Shore, Comment, *Watching the Watchdog: An Argument for Auditor Liability to Third Parties,* 53 SMU L. REV. 387, 420 (2000).

186. *See* Bily v. Arthur Young & Co., 834 P.2d 745, 781 (Cal. 1992) (discussing how the cost of audit failures reaches beyond the lender and investor of a defunct business).

187. *Id.*

188. *See* Burton Malkiel, *Watchdogs and Lapdogs*, WALL ST. J., Jan. 16, 2002, at A16, *available at* 2002 WL-WSJ 3383108 (highlighting Enron's demise as a need to reevaluate the adequacy of this nation's financial reporting systems).

189. *See Bily*, 834 P.2d at 783 (concluding that the foreseeability standard benefits the accounting profession, users of the audited financial statements, and the general public).

profession.[190] Dispensing with Texas's well-established general scope of tort liability is no longer justified by public policy considerations since the importance of accountants' role in our market economy has increased. As such, accountants must be held accountable for their audit failures in connection with a company's business failure. The recent dramatic occurrences in the accounting profession have initiated the need to expand accountants' liability to nonclients.[191]

Since the Restatement approach has failed to effectively deter negligent conduct or compensate the victims of such conduct,[192] it is now time for Texas courts to move away from the Restatement approach to accountants' liability to nonclients and toward a foreseeability standard. When an auditor has performed an audit negligently or with material misstatements, and third parties have foreseeably relied upon the auditor's financial statements to their detriment, notions of fairness, economic efficiency, and deterrence mandate that the accountant should bear the liability.[193] Most importantly, recognizing that the accounting profession owes the public a legal duty of care, within the limits of the assurance that it provides in its audited financial statements, is one step to restoring the diminished public confidence in our economy.[194]

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190. *See* Jonathan Weil & Dennis Berman, *Auditing the Audit Committee,* WALL ST. J., Dec. 9, 2002, at C1, *available at* 2002 WL-WSJ 103128173 (writing three lessons for corporate boards). The first lesson is to be skeptical of independent accountants and management. *Id.* The second lesson is to study the company's financial reports. *Id.* The last lesson is to "[p]ay attention to outside critics." *Id.*

191. *See* Don A. Moore, *An Honest Account,* WALL ST. J., Nov. 13, 2002, at A24, *available at* 2002 WL-WSJ 3411562 (questioning whether recent reform will reduce the occurrence of financial scandals and audit failures); Paul J. Masinter & Walter F. Wolfe, *Non-Client Third Party Claims Against Accounting Firms,* NETWORK (ABA/Bus. Law Section), Spring 2002, at 3, *available at* http://www.abanet.org/buslaw/newsletter/0003/materials/tip1.pdf (emphasizing the liability issues resulting from the recent furor over the role of accounting firms in corporate America) (on file with the *St. Mary's Law Journal*).

192. *See* Samuel S. Paschall, *Liability to Non-Clients: The Accountant's Role and Responsibility,* 53 MO. L. REV. 693, 724 (1988) (suggesting that the Restatement standard clearly fails to protect the general public against the negligence of an auditor). The Restatement is flawed because it does not provide the needed protection to the relying public. *Id.*

193. *See* Denise M. Orlinsky, Note, *An Accountant's Liability to Third Parties:* Bily v. Arthur Young & Co., 43 DEPAUL L. REV. 859, 896 (1994) (resolving that the foreseeable standard boils down to a question of fairness and involves the weighing of public policy factors).

194. *See* C. William (Bill) Thomas, *Sarbanes-Oxley Act: Sarbanes-Oxley Act Brings Sweeping Reforms,* TODAY'S CPA, Nov./Dec. 2002, at 27 (predicting that legislative reform, in the long run, will restore the market confidence and integrity in public accounting industry that is responsible for assuring confidence to the public).

St. Mary's Law Journal, Vol. 35 [2003], No. 1, Art. 4

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