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COMMENTS

ACCOUNTANTS' LIABILITY TO THE THIRD PARTY AND PUBLIC POLICY: A CALABRESI APPROACH

by Thomas E. Bilek

ACCORDING to certain courts the liability of accountants to third parties arises from a balancing of public and private interests.¹ The balance as outlined by these courts imposes liability only when the imposition of such liability will serve the public interest.² Some recent decisions³ follow the lead of many law commentators⁴ and state that public policy considerations demand that accountants be held liable to all foreseeable third parties for injuries caused by the accountants' negligent acts.⁵

1. *Rusch Factors, Inc. v. Levin*, 284 F. Supp. 85, 91 (D.R.I. 1968) (noting policy questions of justifiable reliance, risk spreading, and insurance); *Ryan v. Kanne*, 170 N.W.2d 395, 401 (Iowa 1969) (social utility rationale for privity requirement not reasonable); *Aluma Kraft Mfg. Co. v. Elmer Fox & Co.*, 493 S.W.2d 378, 383 (Mo. Ct. App. 1973) (privity analysis involves a balancing of several factors); *H. Rosenblum, Inc. v. Adler*, 93 N.J. 324, 461 A.2d 138, 147 (1983) (liability depends on whether the public interest will be served); *Shatterproof Glass Corp. v. James*, 466 S.W.2d 873, 877 (Tex. Civ. App.—Fort Worth 1971, writ ref'd n.r.e.) (relying on *Rusch Factors* in its holding); *Citizens State Bank v. Timm, Schmidt & Co.*, 113 Wis. 2d 376, 335 N.W.2d 361, 366 (1983) (liability depends on public policy).

2. See, e.g., *Rusch Factors, Inc. v. Levin*, 284 F. Supp. 85, 93 (D.R.I. 1968) (liability imposed after noting policy factors favoring imposition); *H. Rosenblum, Inc. v. Adler*, 93 N.J. 324, 461 A.2d 138, 153 (1983) (public interest served by imposing liability); *Citizens State Bank v. Timm, Schmidt & Co.*, 113 Wis. 2d 376, 335 N.W.2d 361, 366 (1983) (public policy demands imposing liability absent special facts).

3. *H. Rosenblum, Inc. v. Adler*, 93 N.J. 324, 461 A.2d 138 (1983); *Citizens State Bank v. Timm, Schmidt & Co.*, 113 Wis. 2d 376, 335 N.W.2d 361 (1981).

4. See, e.g., Besser, *Privity? An Obsolete Approach to the Liability of Accountants to Third Parties*, 7 SETON HALL L. REV. 507, 541-42 (1976); Bradley, *Auditor's Liability and the Need for Increased Accounting Uniformity*, 30 LAW & CONTEMP. PROBS. 898, 921 (1965); Solomon, *Ultramares Revisited: A Modern Study of Accountants' Liability to the Public*, 18 DE PAUL L. REV. 56 (1968); Wiener, *Common Law Liability of the Certified Public Accountant for Negligent Misrepresentation*, 20 SAN DIEGO L. REV. 233, 259-60 (1983); Wyatt, *Auditors' Responsibilities*, 12 ST. LOUIS U.L.J. 331, 331-32 (1968); Comment, *Accountants' Liabilities to Third Parties under Common Law and Federal Securities Law*, 9 B.C. INDUS. & COM. L. REV. 137, 149 (1967); Comment, *Public Accountants and Attorneys: Negligence and the Third Party*, 47 NOTRE DAME LAW. 588, 608 (1972) [hereinafter cited as Comment, *Third Party*]; Comment, *Auditors' Responsibility for Misrepresentation: Inadequate Protection for Users of Financial Statements*, 44 WASH. L. REV. 139, 177 (1968) [hereinafter cited as Comment, *Inadequate Protection*]; Note, *Accountants' Liabilities for False and Misleading Financial Statements*, 67 COLUM. L. REV. 1437, 1468-69 (1967).

5. RESTATEMENT (SECOND) OF TORTS § 552 (1981) defines "negligent misrepresenta-

This Comment asserts that courts that have held accountants liable to all foreseeable third parties have not adequately considered the relevant public policy implications⁶ of their decisions. The decisions imposing liability merely analyze a number of questionably relevant factors.⁷ No underlying economic methodology exists to justify the use of these factors or the results their use produces.⁸

An alternative analysis suggested in this Comment approaches the question of liability by determining the most efficient allocation of society's resources. This approach considers whether imposing liability to third parties results in a greater maximization of scarce resources than failing to impose such liability. Problems of determining the nature, standards, and extent of liability, and the proper application to large and small corporations complicate the solution.

The imposition upon an accountant of liability to all foreseeable persons for damages caused by his negligence is not economically or legally⁹ justifiable. Generally, a more efficient allocation of resources results when accountants are not liable to any third party for their negligence. In other words, the accountant should have no duty to third persons to render an audit devoid of negligent mistakes, but only to refrain from making intentional misrepresentations.¹⁰ This position, although admittedly contrary to current interpretations, both deters the accountant from making financial misrepresentations and maximizes society's resources. Resolving the issue of accountant liability to third parties requires an analysis of certain background information, including the scope of the accountant's function and judicial decisions and rationales.

tion" by a professional as the failure "to exercise reasonable care or competence in obtaining or communicating the information" for the guidance of others in business transactions.

The commentators generally argue for expanded liability because they believe that the accounting profession is best able to bear the loss and that the negligent accountant should bear the loss instead of the innocent reliant party. Ebke, *In Search of Alternatives: Comparative Reflections on Corporate Governance and the Independent Auditor's Responsibilities* (to be published in 79 NW. U.L. REV. (Dec. 1984)); see Besser, *supra* note 4, at 523, n.70; Wiener, *supra* note 4, at 252.

6. "Public policy" is a nebulous concept. In this Comment public policy considerations are (1) the maximization of society's scarce resources and (2) fairness. Liability should be imposed upon a party only if it is the most efficient and fair solution.

7. See, e.g., *Rusch Factors, Inc. v. Levin*, 284 F. Supp. 85, 90-91 (D.R.I. 1968) (three factors); *H. Rosenblum, Inc. v. Adler*, 93 N.J. 324, 461 A.2d 139, 147, 150-53 (1983) (listing various policy considerations); *Citizens State Bank v. Timm, Schmidt & Co.*, 113 Wis. 2d 376, 335 N.W.2d 361, 365-66 (1983) (same); see also *infra* notes 27-64 and accompanying text (discussion of the policy factors and underlying rationales of courts' decisions).

8. A few authorities have developed methodologies for imposing liability. See G. CALABRESI, *THE COSTS OF ACCIDENTS—A LEGAL AND ECONOMIC ANALYSIS* (1970) [hereinafter cited as CALABRESI, *COSTS OF ACCIDENTS*]; R. POSNER, *ECONOMIC ANALYSIS OF LAW* (2d ed. 1977); Coase, *The Problem of Social Cost*, 3 J. LAW AND ECON. 1 (1960). These commentators attempt to develop a strategy for determining who should be liable, based on economic principles of maximizing society's resources.

9. Absent an economic or fairness justification no legal justification exists for imposing liability. See CALABRESI, *COSTS OF ACCIDENTS*, *supra* note 8, at 24.

10. Negating accountant liability for intentional misrepresentation, however, would not result in a more efficient allocation. "Intent," as defined in criminal law, includes a reckless disregard of the truth.

I. BACKGROUND

A. *The Nature of the Accountant's Task*

Accounting is the art of identifying, measuring, recording, and communicating financial information concerning an economic unit.¹¹ The independent accountant analyzes pertinent information provided by the client company. By scrutinizing this information the accountant attempts to create statements¹² that accurately reflect the company's financial position.¹³ The accountant's ultimate objective is to certify that the resulting financial statement fairly represents the "financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles."¹⁴

Several difficulties exist in fairly representing a company's financial position. The accountant may choose from a multitude of acceptable accounting procedures.¹⁵ Ideally, the accountant uses the procedure that will most accurately reflect the company's financial position.¹⁶ The accountant must

11. W. PYLE & J. WHITE, *FUNDAMENTAL ACCOUNTING PRINCIPLES* 1 (6th ed. 1972).

12. The basic financial statements generally required are: (1) statement of financial position; (2) statement of operations (income statement); (3) statement of changes in financial position—statement of inflows and outflows of funds; and (4) supporting schedules essential for full disclosure. G. WELSCH, C. ZLATKOVICH & W. HARRISON, *INTERMEDIATE ACCOUNTING* 34 (5th ed. 1979) [hereinafter cited as *INTERMEDIATE ACCOUNTING*].

13. Professor Fiflis states the accountant's function as follows: (1) preliminary fact-finding to familiarize the accountant with the nature of the client's business, its operations, and organization; (2) determining the specific audit procedure that will be used; (3) performing the audit; (4) reporting the findings. Fiflis, *Current Problems of Accountants' Responsibilities to Third Parties*, 28 *VAND. L. REV.* 31, 35-42 (1975).

14. 1 AICPA PROFESSIONAL STANDARDS, *Statements on Auditing Standards* § 110.01 (1972) [hereinafter cited as AICPA, *Statement on Auditing Standards*]. Similarly, the Securities and Exchange Commission requires that the audit be in accordance with generally accepted auditing standards. 17 C.F.R. § 210.2-03 (1984). The accounting profession generally regulates itself through three organizations: The American Institute of Certified Public Accountants (AICPA), the Financial Accounting Standards Board (FASB), and the American Accounting Association. *INTERMEDIATE ACCOUNTING*, *supra* note 12, at 5. The SEC has broad statutory authority to regulate virtually all aspects of the issuance and sale of securities in interstate commerce, but has generally declined to use the full extent of that authority. Instead, the SEC relies on the accounting profession to define and enforce professional accounting standards and to regulate itself. *Id.* at 8. An accountant, therefore, must comply with the generally accepted accounting principles as defined by his profession in order to avoid negligence. *See id.* at 8.

Federal securities laws require an annual audit for many companies. 15 U.S.C. §§ 77aa, 77g (1981). The Securities Exchange Act of 1934 requires that independent certified financial statements be included in the annual reports for most companies having assets of \$1,000,000 and 500 holders or more of a class of equity securities. 15 U.S.C. § 78(l)(g)(1) (1981).

15. The many choices that confront an accountant in determining an accounting procedure may unfairly trap him. If he chooses a descriptive technical procedure, the statement may grow incomprehensible, conferring negligence upon the accountant. If he chooses a less technical alternative, he may not sufficiently portray the company's financial condition, and again the accountant is negligent. *See Comment, Auditors' Third Party Liability: An Ill-Considered Extension of the Law*, 46 *WASH. L. REV.* 675, 692 n.76 (1971).

16. Accounting may be more of an art than a science. Minow, *Accountants' Liability and the Litigation Explosion*, *J. ACCOUNTANCY*, Sept. 1984, at 70, 78; *see also Comment, supra* note 15, at 691-92. While endeavoring to reflect adequately the company's financial position in the statement, the accountant cannot possibly find every imaginable mistake or deception. Negligence results when the accountant fails to choose the proper standards that would correctly reflect the company's financial position. *See H. Rosenblum, Inc. v. Adler*, 93 N.J. 324,

also convey this information in an understandable and nondeceptive manner.¹⁷ Words of art peculiar to the accounting profession complicate the reporting duty.¹⁸ Accountants, therefore, must make their language understandable to the frequent nonaccountant users of such information.¹⁹

Originally, the purpose of the audit was to inform management of irregularities and inefficiencies in the business.²⁰ Although this remains a principal reason for conducting audits, the accounting profession has become increasingly aware of third-party reliance on audited financial statements.²¹ This reliance by so many different groups requires that the accountant be independent.²² An accountant is expected to represent each interest by playing the role of watchdog, thus enabling each interested person to detect whether his interest is in jeopardy.²³

Accountants provide necessary services to society.²⁴ By arbitrating all the varied interests represented in a financial statement, an accountant maintains the orderly flow of the free market system. Without the independent accountant, every interested party would be forced to make a separate audit.²⁵ This repetition of effort would needlessly expend societal resources.²⁶

B. *The Judicial Positions*

Two cases best exemplify the conflicting precedent for extending liability for breach of contract to third parties.²⁷ These cases, *Ultramares Corp. v. Touche*²⁸ and *Glanzer v. Shephard*,²⁹ were both decided by Judge Cardozo more than fifty years ago.³⁰ In each case Judge Cardozo grappled with ex-

461 A.2d 138, 148 (1983). Difficulties abound in making the determination of negligence. 1 AICPA, Statements on Auditing Standards, *supra* note 14, § 203.

17. See 1 AICPA, Statements on Auditing Standards, *supra* note 14, § 430.

18. An example is the term "credit." Most nonaccountants almost certainly would not guess that the term "credit" refers to the amounts representing the liabilities and equity of a business enterprise. Most nonaccountants would also not realize that "deferred credit" means the received-but-uneared revenue.

19. Comment, *supra* note 15, at 687-90.

20. See Comment, *Accountants' Liability for Negligence—A Contemporary Approach for a Modern Profession*, 48 FORDHAM L. REV. 401, 404-05 (1979); Comment, *Inadequate Protection*, *supra* note 4, at 178.

21. In 1957 the Securities and Exchange Commission stated that "[t]he responsibility of a public accountant is not only to the client who pays his fee, but also to investors, creditors and others who may rely on the financial statements which he certifies." *In re Touche, Niven, Bailey, & Smart*, 37 S.E.C. 629, 670 (1957).

22. *Id.* at 671.

23. One commentator has explained the watchdog function in greater detail. Ebke, *supra* note 5.

24. See J. CAREY, PROFESSIONAL ETHICS OF PUBLIC ACCOUNTING 14 (1946).

25. *Id.*

26. *Id.* Additionally, the endless doubts, delays, misunderstandings, and controversies arising from multiple audits would result in further considerable expense. *Id.*

27. For an extended current case development, see Gormley, *The Foreseen, the Foreseeable, and Beyond—Accountants' Liability to Nonclients*, 14 SETON HALL L. REV. 528, 531-58 (1984). For a good case development without *Rosenblum* or *Citizens*, see Besser, *supra* note 4, at 510-31.

28. 255 N.Y. 170, 174 N.E. 441 (1931).

29. 233 N.Y. 236, 135 N.E. 275 (1922).

30. Courts addressing accountant liability discuss both cases. *Rusch Factors, Inc. v.*

tending liability for economic harm beyond the privity of contract. In *Glanzer* the court allowed recovery by the third party,³¹ but the court in *Ultramares* denied third-party recovery in an apparently analogous situation.³²

In *Glanzer* the defendants operated public scales and certified the weight of beans to establish a contract purchase price. The sellers arranged for a copy of the report certifying the weight of the beans to be sent to the plaintiff-buyers. The plaintiffs, upon resale of the beans, discovered that the report overstated the weight of the beans. Although the court recognized the absence of a contractual relationship between the parties, it nevertheless ruled that the defendant-certifiers owed a duty of care to the plaintiffs.³³ The defendant's knowledge of the prospective use of their weight certification expanded this duty. Since the defendants knew that others would rely on their service, the court established a duty to protect the third-party interests.³⁴

Judge Cardozo reached a seemingly opposite result nine years later in his *Ultramares* decision.³⁵ In this case the defendant public accounting firm contracted to prepare and certify a balance sheet and released an audit with the customary certification.³⁶ The accountants knew, as did the weighers in *Glanzer*, that third parties would rely on their representations.³⁷ Yet the court held that negligent preparation and certification of the financial statements did not give rise to accountant liability beyond contract privity.³⁸ The court attempted to distinguish *Glanzer* by noting that the certification in *Glanzer* was intended for the ultimate use of third parties, whereas the pri-

Levin, 284 F. Supp. 85, 90-91 (D.R.I. 1968); *H. Rosenblum, Inc. v. Adler*, 93 N.J. 324, 461 A.2d 138, 154 (1983).

31. 135 N.E. at 277.

32. 174 N.E. at 449-50.

33. 135 N.E. at 275-76.

34. In reaching this conclusion, the court stated that the defendants knew that the beans had been sold, with payment contingent on reliance on their certificate. They sent a copy to the plaintiffs for the very purpose of inducing such action. In such circumstances assumption of the task of weighing constituted the assumption of a duty to weigh carefully for the benefit of all whose conduct was to be governed. *Id.*

35. 174 N.E. at 449-50.

36. We have examined the accounts of Fred Stern & Co. . . . and hereby certify that the annexed balance sheet is in accordance therewith and with the information and explanation given us. We further certify that . . . the said statement, in our opinion, presents a true and correct view of the financial condition of Fred Stern & Co. . . .

Id. at 442. The four types of opinions are the unqualified opinion, the qualified opinion, the adverse opinion, and the disclaimer of opinion. An unqualified opinion is given when the accountant finds that the statements: (1) fairly reflect results of operations, financial position, and changes in financial position; (2) conform to generally accepted accounting principles, applied on a consistent basis; and (3) fully disclose the necessary facts so as not to be misleading. A qualified opinion occurs when there is an "exception" or "subject to" clause because all of the key criteria for an unqualified opinion are not fully met. The reasons for qualification must be given. An adverse opinion is given when the statements do not reflect the results of operations and financial position of the company. A disclaimer opinion occurs when the accountant offers no opinion on the validity of the statements. Auditors must explain the reasons for not giving an opinion. INTERMEDIATE ACCOUNTING, *supra* note 12, at 151-52.

37. *Ultramares*, 174 N.E. at 442.

38. *Id.* at 444-48. The court however did allow liability for gross negligence. *Id.* at 449.

mary purpose of the audit was for use by the company.³⁹ Whether or not this attempt to distinguish these cases is valid, considering the fact that the accountant furnished thirty-two copies of the audit, does not seem to be the controlling issue.⁴⁰ Arguably the true reason for the holding was a recognition that failure so to decide the case would result in unlimited liability for the accounting profession.⁴¹ The crucial inquiry, therefore, is whether the fear of unlimited liability constitutes a valid reason for refusing to impose liability.⁴²

A nonprivity plaintiff⁴³ first successfully maintained an action against an accountant for ordinary negligence in *Rusch Factors, Inc. v. Levin*.⁴⁴ Relying on the defendant-accountant's audit, the plaintiff loaned money to the defendant's client. The court found that this case more closely fitted the *Glanzer* analysis than the decision in *Ultramares* because the ultimate goal of the transaction was completion of an audit for use by the plaintiff rather than by the client.⁴⁵ The court proceeded to hold the accountant liable based on two factors. First, the court ruled that, as between the negligent accountant and the innocent third party, the accountant should bear the loss.⁴⁶ Second, the court noted that the accounting profession could more fairly spread such losses by insuring against the risk and thereby passing the costs of neg-

39. *Id.* at 445-46.

40. *Id.* One commentator has argued that this distinction is invalid and that Cardozo was aware of this at the time he wrote the opinion. Gormley, *supra* note 27, at 553-54. Cardozo did note that the accountant knew that the audit would be relied upon by others. *Ultramares*, 174 N.E. at 442.

41. Chief Judge Cardozo stated:

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

Ultramares, 174 N.E.2d at 444.

Professor James explains his objections to the extension of liability to allow recovery for indirect loss: "[T]he physical consequences of negligence usually have been limited, but the indirect economic repercussions of negligence may be far wider, indeed virtually open-ended." James, *Limitations on Liability for Economic Loss Caused by Negligence: A Pragmatic Appraisal*, 25 VAND. L. REV. 43, 45 (1972).

42. Many commentators make this argument. See Besser, *supra* note 4, at 527-28; Solomon, *supra* note 4, at 86-89. Both commentators argue that fear of unlimited liability in itself does not justify the negation of liability. Professor Besser contends that the requirement of proof of proximate causation would limit indirect liability. Besser, *supra* note 4, at 526-27 n.79. Both commentators assert that insurance is available for the loss. See Besser, *supra* note 4, at 534-37; Solomon, *supra* note 4, at 86-89.

43. Privity occurs when the parties have a contractual relationship. 4 A. CORBIN, CORBIN ON CONTRACTS 778 (1951).

44. 284 F. Supp. 85 (D.R.I. 1968). "No appellate court, English or American has held an accountant liable in negligence to reliant third parties not in privity." *Id.* at 90.

45. *Id.* at 91. The court also stated that the *Glanzer* principle applied to accountants through the tentative drafts of the *Restatement (Second) of Torts* § 552. *Id.* This section states that a maker of representations would be liable to "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" RESTATEMENT (SECOND) OF TORTS § 552 (Tent. Draft No. 12, 1966).

46. 284 F. Supp. at 91-92.

ligent accounting to the general public.⁴⁷ The *Rusch* opinion stated that the accountant's duty, therefore, must extend not only to specifically foreseen third parties but also to unknown members of a specifically foreseen and limited class.⁴⁸

Two courts recently extended the accountant's duty to include all foreseeable parties.⁴⁹ In *Rosenblum, Inc. v. Adler*⁵⁰ the plaintiffs alleged negligence by the auditor in failing to detect a large-scale management fraud.⁵¹ The New Jersey Supreme Court held that the negligence count stated a valid cause of action.⁵² The court resolved the scope of liability issue solely on public policy grounds.⁵³ The public policy analysis required balancing the relationship between the parties, the type of risk involved, and the effect of each outcome on the public interest.⁵⁴ The court ruled that this public policy analysis should prevail over any outdated concepts of privity⁵⁵ and irra-

47. *Id.*

48. *Id.* at 93. The court left unanswered the question of whether liability could be extended to the full range of foreseeability. *Id.* A distinction, therefore, exists between a specifically foreseen and a foreseeable standard. A specifically foreseen standard relates to a more limited group. The accountant must have actual cause to know that certain identifiable persons will rely on the financial statements. The foreseeable standard encompasses every person that the accountant realizes at the time of the audit may rely on the statement in the future. Gormley, *supra* note 27, at 540-58.

49. The broadening of the foreseeability standard was presaged by the Commonwealth courts. In *Hedley Byrne & Co. v. Heller Partners Ltd.*, [1964] A.C. 465, 471, the court in a dictum recognized that an action would lie for negligent misrepresentation against accountants. This position was again taken by the British courts in *J.E.B. Fasteners Ltd. v. Marks, Bloom & Co.*, [1981] 3 All E.R. 289 (Q.B.). The court in *Rosenblum* cited both decisions. 461 A.2d at 142, 152, 153 n.14. The value of the British decisions as precedent is debatable. Three factors mitigate against their relative value: (1) the British have a different procedural law that deters the bringing of suits; (2) the British have a different corporate law; and (3) a different common law history has evolved. Ebke, *supra* note 5.

50. 93 N.J. 324, 461 A.2d 138 (1983).

51. The plaintiffs began negotiations with the auditor's client for the acquisition of plaintiffs' business in exchange for stock in the client company. The plaintiffs relied on an unqualified opinion of the client's worth made by the auditor in the prospectus. Two years after an exchange of stock, the plaintiffs learned that the client had falsified its accounts, causing the auditor's misstatement. The client company filed bankruptcy, and the plaintiffs' shares in the client became worthless. In addition to their allegation of negligence the plaintiffs also charged the auditor with fraudulent misrepresentation, gross negligence, and breach of warranty in the audits. 461 A.2d at 140-41.

52. *Id.* at 155-56.

53. *Id.* at 140. The court seems to use "public policy" in the sense of maximizing society's resources.

54. *Id.* at 147. California applied a similar balancing test in *Biakanja v. Irving*, 49 Cal. 2d 647, 650, 320 P.2d 16, 19 (1958), a case involving an attorney's negligence. The court considered:

the extent to which the transaction was intended to affect the plaintiff, the foreseeability of harm to him, the degree of certainty that the plaintiff suffered injury, the closeness of the connection between the defendant's conduct and the injury suffered, the moral blame attached to the defendant's conduct, and the policy of preventing future harm.

Id.

55. In the nineteenth century a party owed a duty of care only to the persons in privity with him. See *Winterbottom v. Wright*, 10 M. & W. 109, 152 Eng. Rep. 402, 405 (Ex. 1842) (plaintiff, a driver of a mailcoach, denied recovery from defendant responsible for maintenance of coach because they were not in privity). This privity doctrine slowly eroded until it met with outright repudiation at the turn of the century. See, e.g., *Thomas v. Winchester*, 6 N.Y.

tional distinctions between types of harm.⁵⁶

Applying the balancing test to the facts of the case, the court found no reason why an innocent reliant party should bear a loss induced by a negligent accountant.⁵⁷ Insurance enables the accountant to pass the loss on to the entire consuming public.⁵⁸ Furthermore, the court concluded that broadening accountant liability to include generally foreseeable third parties would intensify the accountant's caution and thereby benefit the general public.⁵⁹ On these grounds the court held that public policy required expansion of the scope of imposed liability.⁶⁰

The latest decision, *Citizens State Bank v. Timm, Schmidt & Co.*,⁶¹ is in accord with the *Rosenblum* holding. The plaintiff bank sued the defendant accounting firm for negligent misrepresentation in the audit of the defendant's client. Relying on the audit, the bank loaned money to the client. The client was actually insolvent at the time of the loan, and the bank sued the accountants for their negligent misrepresentations. For substantially the same reasons discussed by the *Rosenblum* court,⁶² the Wisconsin court also imposed liability on the accounting firm,⁶³ stating that the bank as a foreseeable user of the audit should not suffer for its reliance.⁶⁴

C. Summary

Based on the preceding discussion, four reasons appear to explain why

396, 408-09 (1852) (exception to privity doctrine if human life was put in imminent danger); *Devlin v. Smith*, 89 N.Y. 470, 477 (1882) (privity doctrine not applicable because the negligently constructed scaffold was a "trap"); *MacPherson v. Buick Motor Co.*, 217 N.Y. 382, 111 N.E. 1050, 1053 (1916) (persons owe a duty not to cause harm irrespective of privity); see also W. KEETON, D. DOBBS, R. KEETON, & D. OWEN, PROSSER AND KEETON ON TORTS § 96 (5th ed. 1984); RESTATEMENT (SECOND) OF TORTS § 402A(2)(b) (1965).

56. 461 A.2d at 145-47. One commentator has noted that economic harm can be just as crippling as physical bodily harm. Comment, *Third Party*, *supra* note 4, at 604-05.

57. 461 A.2d at 153.

58. *Id.* at 151-53. The loss passes on to the public through the higher cost of goods or services. The accountant's liability for his negligent misrepresentations to third parties will translate into higher insurance premiums. The accountant must, therefore, charge more for his service. The clients, wishing to maintain their profit margins, will charge a higher price for their products in order to pay the increased auditing fees. The public, therefore, pays for the negligent misrepresentations in the form of higher priced goods and services. See *id.* at 152.

59. *Id.* at 153.

60. See *Besser*, *supra* note 4, at 541-42. The accounting profession should bear the costs of its negligence like any other industry. The traditional argument for insulating the accountant from a duty to third parties was that the audit's primary purpose was not for third-party use. The accounting profession, then a fledgling industry, could not afford extended liability to all possible third-party users. Now, however, the accounting industry is a multibillion dollar industry, and the audit is designed for use by third parties. Enterprise liability, therefore, should be imposed. See *id.*

61. 113 Wis. 2d 376, 335 N.W.2d 361 (1983).

62. *Rosenblum*, 461 A.2d at 147-52.

63. 335 N.W.2d at 365-66. The court held that the negligent party should suffer rather than the innocent third party, that negligence should be deterred, and that loss spreading demands the imposition of liability. *Id.* The court also noted a strong Wisconsin public policy that holds a tortfeasor fully liable for all foreseeable consequences of his acts. *Id.* at 366.

64. The court did not impose liability, but instead remanded the case to explore these public policy goals. *Id.* at 367. The court predetermined the imposition of liability since it outlined how the policy factors should be weighed.

courts should impose liability on accountants for their negligent acts. First, the concept of enterprise liability demands that accounting firms, like all other industries, should bear the costs of their negligent actions. Second, the fault principle requires that the negligent accountant suffer the loss rather than the reliant third party. Third, the theory of risk allocation dictates the imposition of liability on accountants because the accountant may obtain insurance and distribute the loss to the public. Finally, the doctrine of deterrence favors imposing liability so that the accountant will use a higher standard of care to avoid that liability.

II. THE DILEMMA

The courts discuss enterprise liability, fault, deterrence, and risk allocation and then state that these factors justify the imposition of liability. The process is conclusory. The courts fail to explain why these factors are important or what facts support their conclusions. Instead, the courts should have a methodology to justify these factors and the result.

The ease with which counter arguments can be made against these four factors further demonstrates the need for a methodology. First, enterprise liability and its underlying rationale may be inconsistent with risk allocation principles. Liability should not lie on a person if another person can bear the risk with less cost.⁶⁵ Second, the fault rationale is similarly debatable.⁶⁶ Several authorities have criticized this factor as an improper reason to impose liability.⁶⁷ Third, the risk allocation justification appears less compelling when one considers the fact that third parties can also buy insurance.⁶⁸ Finally, alternate methods of accomplishing deterrence may exist. For example, government regulation may achieve deterrence.⁶⁹ The following section of the Comment attempts to provide the methodological support for

65. See Coase, *supra* note 8, at 19.

66. A factual question exists as to whether many of the third parties do indeed rely on the financial statements. See Ebke, *supra* note 5.

67. See, e.g., Calabresi, *Optimal Deterrence and Accidents*, 84 YALE L.J. 656, 666-67 (1975) [hereinafter cited as Calabresi, *Optimal Deterrence*] (liability based upon fault does not necessarily result in optimal deterrence of accidents); Epstein, *A Theory of Strict Liability*, 2 J. LEGAL STUDIES 151, 151-52 (1973) (rejection of fault as basis for imposing liability). Calabresi argues that the fault system cannot efficiently determine who should have avoided the accident. In order for the fault system to be efficient either of two "incredible" assumptions must be made. First, the victim class must be able to decide best whether accident avoidance is worthwhile and accomplish best the worthwhile avoidance. Second, transaction costs must be zero. See Calabresi, *Optimal Deterrence*, *supra*, at 666-67. For extensive readings on economic and other approaches to the analysis of tort law, see R. RUBIN, PERSPECTIVES ON TORT LAW (2d ed. 1983).

68. See Ebke, *supra* note 5.

69. The government already has various mechanisms for punishing undesirable conduct by accountants. For example, accountants can be sanctioned for fraud in the purchase and sale of securities, see 15 U.S.C. § 78(b) (1976); 17 C.F.R. § 240.10b-5 (1984), or for misstatements or omissions in proxy statements, see 15 U.S.C. § 78n(a) (1976); 17 C.F.R. § 240.14(a) (1984). The accountant could also be suspended or barred from practice before the Securities and Exchange Commission. See 17 C.F.R. § 201-2(e) (1984); see also Marsh, *Rule 2(e) Proceedings*, 35 BUS. LAW. 987, 995-1002 (1980) (describing history, operation, statutory basis, and constitutionality of rule 2(e)).

these counter-arguments that the judicial justifications for general accountant liability have lacked to date.

III. AN ECONOMIC ANALYSIS

If the courts seriously believe that accountants should be liable only if public policy considerations demand imposition of liability,⁷⁰ then an economic perspective that examines the costs and benefits of imposing liability should apply.⁷¹ Accountants, rather than third parties, should bear the loss only if such imposition minimizes the costs to society.⁷² The methodology used herein is basically a Calabresi model.⁷³ The validity of using Calabresi's analysis depends on whether negligent misrepresentation by the accountant constitutes an accident. Calabresi never defines "accident"; however, one can infer that he tried to develop a broad methodology to cover all occurrences that cause unintended harm.⁷⁴ This Comment assumes, therefore, that negligent misrepresentation constitutes an accident within Calabresi's model. Application of this methodology to the problem at hand involves determining whether imposition of liability on accountants for any damage to third parties caused by the accountants' negligent acts will produce a more efficient allocation of resources.

A. Who Should Bear the Risk?

Before determining whether accountants or third parties should bear the risk of loss from negligent misrepresentations in an audited report, a thorough understanding of the costs of accidents is necessary. Accidents and accident prevention are questions of costs.⁷⁵ Two types of costs occur in the accident context: the costs associated with the accident itself,⁷⁶ and the costs of preventing accidents.⁷⁷ Often the cost of avoiding the accidents will exceed the actual cost of the accident.⁷⁸ In this situation the most efficient

70. See *supra* note 1 and accompanying text.

71. See *infra* text accompanying note 113, which examines the justice constraint in Calabresi's analysis.

72. Liability could be determined on the basis of fairness or justice. Determining liability on the basis of fairness is nearly an impossible task. CALABRESI, COSTS OF ACCIDENTS, *supra* note 8, at 24-26. Defining "fair solution," is a very difficult task. Justice, therefore, should be used as a constraint rather than as a basis for imposing liability. *Id.*

73. Calabresi has developed perhaps the most extensive model for determining who should bear the costs of accidents. See, e.g., CALABRESI, COSTS OF ACCIDENTS, *supra* note 8, at 309-18; Calabresi, *Views and Overviews*, 1967 U. ILL. L.F. 600, 610-11 [hereinafter cited as Calabresi, *Views and Overviews*]; Calabresi & Hirschhoff, *Toward a Test for Strict Liability in Torts*, 81 YALE L.J. 1055, 1084-85 (1972); Calabresi, *Optimal Deterrence*, *supra* note 67, at 666-71.

74. See CALABRESI, COSTS OF ACCIDENTS, *supra* note 8, at 14-16. For example, Calabresi's analysis has been applied to far-reaching problems of pollution. See Michelman, *Pollution as a Tort: A Non-Accidental Perspective on Calabresi's Costs*, 80 YALE L.J. 647 (1971).

75. Calabresi, *Views and Overviews*, *supra* note 73, at 600.

76. See *infra* text accompanying notes 86-89.

77. See Calabresi, *Views and Overviews*, *supra* note 73, at 600.

78. Actually the question is who should be allowed to harm whom. See Coase, *supra* note 8, at 2. For example, a rancher's cattle that stray onto a farmer's land pose a dilemma. If society allows the cattle to eat the crops, then the farmer is harmed. On the other hand, the

solution involves allowing the accident to occur.⁷⁹ Avoiding accidents at all costs, therefore, should not be society's goal.⁸⁰

Calabresi divides accident costs into three subcategories: primary, secondary, and tertiary costs. Primary costs directly result from the accident itself.⁸¹ The goal is to reduce primary costs through a reduction in the number and severity of accidents.⁸² Society can accomplish this goal by making accident-causing activities more expensive and thus less attractive.⁸³ The ideal solution would increase the cost of the activity to the extent of the costs of the accident to reflect accurately the actual cost of the activity to society.⁸⁴ If the actual cost of the activity is known, then rational decision-making determines whether or not to engage in the activity. Alternatively, society could forbid the activity.⁸⁵

Secondary costs include the societal costs resulting from the accident itself.⁸⁶ These costs generally arise from economic dislocation or aggravation of injury.⁸⁷ Loss spreading may reduce secondary costs even after the primary costs have been reduced to a minimum.⁸⁸ Calabresi points out that adequate loss spreading could nearly eliminate secondary costs.⁸⁹

cost to the rancher of erecting fences to keep his cattle out of the farmer's field may outweigh the cost to the farmer. In the accountant's situation the choice is between harming the accountant by forcing him to undertake procedures to prevent negligent audits or allowing negligent audits to harm the reliant third parties.

79. See Coase, *supra* note 8, at 18.

80. Avoiding accidents at all costs is one of Calabresi's three myths. Another is that economic law provides absolute answers. To the contrary, society's values must be taken into account when one is evaluating various solutions to problems. The third myth is that a necessary financial link exists between the injurer and the victim. Sometimes neither the injurer nor the victim will bear the cost of the accident. See CALABRESI, COSTS OF ACCIDENTS, *supra* note 8, at 17-23.

81. Professor Michelman explains primary costs as the "accident costs proper—the costs which can be reduced only by terminating or altering one or more of the various activities whose interaction culminates in the costly event called an accident." Michelman, *Pollution as a Tort: A Non-Accidental Perspective on Calabresi's Costs*, 80 YALE L.J. 647, 650 (1971).

82. *Id.*

83. This is the general deterrence approach. This approach allows the market to decide which activities society shall engage in. See CALABRESI, COSTS OF ACCIDENTS, *supra* note 8, at 69. The underlying rationale is that each person knows his own needs. Therefore, each person is best able to determine what activities he should engage in, provided he knows the costs of participating in those activities. *Id.*

84. The goal is to know the cost of having independent auditors evaluate corporate records for each party that conducts business with the company. If every cost that accountants impose on society could be quantified, these costs could be compared to the benefits they confer. Obviously, if the costs are greater than the benefits, courts should not award damages to third parties based on the accountant's negligence.

85. Societal prohibition is the specific deterrence approach. Under the specific deterrence approach society collectively decides which activities should occur and to what extent. CALABRESI, COSTS OF ACCIDENTS, *supra* note 8, at 68-69. Government regulations forbidding certain behavior constitute an example of specific deterrence.

86. *Id.* at 39.

87. Calabresi does not include among secondary costs any resentment or demoralization that might flow from a failure to compensate. See Michelman, *Property, Utility, and Fairness: Comments on the Ethical Foundations of "Just Compensation" Law*, 80 HARV. L. REV. 1165, 1214 (1967). These effects, if noted at all, would be considered under the justice constraints.

88. Loss spreading is the process of distributing a loss throughout society. See CALABRESI, COSTS OF ACCIDENTS, *supra* note 8, at 21.

89. *Id.* at 39-45. Perfect loss spreading distributes the costs of all accidents evenly. Given

Tertiary costs involve the frictional or transactional costs of operating society's administrative or market machinery to control primary and secondary costs.⁹⁰ This category probably constitutes the most important cost.⁹¹ Through an evaluation of the tertiary costs, society can determine whether reduction of the number of accidents or reduction of the secondary effects of accidents provides the cheaper solution.⁹²

Ideally, society should try to minimize the sum of the primary, secondary, and tertiary costs of accidents.⁹³ The reduction of one category of costs, however, may conflict with the reduction of another category of costs, and thus complicate cost minimization. For example, if society chooses to reduce the secondary costs to zero, then neither the injurers nor the victims will bear the cost of their activities.⁹⁴ This will adversely affect primary costs because the risk and the loss will be externalized.⁹⁵ Neither the victim nor the injurer will evaluate whether engaging in alternative activities would be cheaper, since society, through loss spreading, bears the cost of the activity.

With the concept of accident costs firmly in mind, the next step in the Calabresi approach involves an evaluation of who should bear the costs of the accident. The person who can best reduce the costs of the accident should bear the costs.⁹⁶ In the perfect society⁹⁷ the initial cost bearer makes

perfect loss spreading, no secondary costs would exist; no one would have any change in income because of the accident. *See id.* at 28.

90. CALABRESI, COSTS OF ACCIDENTS, *supra* note 8, at 28.

91. *Id.* Calabresi believes that activities can be compared through the tertiary costs. The cheapest cost avoider will probably be the one with the lowest transaction costs. *See id.*

92. *Id.* An example may help to explain these concepts. Suppose an accountant makes negligent misrepresentations in the financial statements that cause harm to *A* and are borne totally by him. The primary costs are the actual loss suffered by *A*. The secondary costs include loss of income and status. For instance, *A* may have to sell his house. The tertiary costs include the cost of negotiating, before the financial statements are prepared, who should bear the loss.

93. *Id.* at 28. Two problems make the calculation of these costs difficult. First, defining the cost of accidents is difficult. Second, market decisions for or against accidents are affected by the income distribution in society. A poor man has less of a say than a rich man. The rich man, therefore, has a disproportionate vote in the market. Finally, the market method may create more expense than it's worth. *See Calabresi, Views and Overviews, supra* note 73, at 604-05. A perfect allocation may never be reached because the transaction costs are prohibitive.

94. Reduction of secondary costs could occur if the government maintained a general fund for accidents. Neither the injurer nor the victim would have an incentive to pay to prevent accidents since the government would cover the cost of the accident. CALABRESI, COSTS OF ACCIDENTS, *supra* note 8, at 144.

95. Externalization occurs when some costs of an activity are not born by the participants. *See id.* This externalization leads to market inefficiency. The market does not encourage the most efficient activity because the true costs of the activity are not accurately portrayed to the parties. *See id.* Too much of an activity will exist when other people besides the users are paying for a portion of the activity.

96. Ronald Coase has analyzed the problem of who should bear the costs as follows: The cost should not always be put on the injurer because putting the cost on the injurer will allow the victim to inflict harm on the injurer. "The real question that has to be decided is: should *A* be allowed to harm *B* or should *B* be allowed to harm *A*? The problem is to avoid the more serious harm." Coase, *supra* note 8, at 2.

Society could make the activity costless to both *A* and *B* by distributing the loss to society in general. This solution would externalize the loss, which in turn would result in an inefficient amount of the activity. *See CALABRESI, COSTS OF ACCIDENTS, supra* note 8, at 144.

97. The concept of a perfect society is important for economists. The perfect society is a

no difference.⁹⁸ If voluntary transactions were costless, i.e., if no tertiary costs existed, then the injurer and the victim would bargain with each other to achieve an efficient solution. If courts initially impose liability on the injurer when liability should be on the victim because he can better avoid the accident, then the injurer will pay the victim to assume the risk.⁹⁹ The victim should readily accept the injurer's payment because the victim's overall costs will decline.

In the real world, however, tertiary costs exist. Furthermore, not everyone is in a position to bargain.¹⁰⁰ Calabresi believes that the cheapest cost avoider,¹⁰¹ the party best able to evaluate the cost and risk of the accident and act on that evaluation, should bear the cost and risk.¹⁰² Calabresi argues that the cheapest cost avoider concept constitutes the most efficient test for imposing liability because society cannot evaluate the true costs of accidents.¹⁰³ A more efficient outcome results if the decision rests in the hands of the persons who can more easily make the evaluation.¹⁰⁴ In short, the easier choice involves determining who can best evaluate the costs rather than determining what the costs of each alternative are and then placing liability on the cheapest alternative.¹⁰⁵

Choosing the cheapest cost avoider requires examination of three factors.¹⁰⁶ First, who can evaluate the risk more precisely?¹⁰⁷ Second, who can best prevent the risk from being externalized?¹⁰⁸ Third, who can best reduce the secondary cost of accidents through efficient loss spreading?¹⁰⁹ The goal is to place the cost on the independent activities that will result in the great-

society without tertiary costs. See Calabresi, *Optimal Deterrence*, *supra* note 67, at 657 n.5. The value of the concept lies in the fact that the economist is able to reduce the variables in the problem.

98. Coase, *supra* note 8, at 15.

99. *Id.* at 2-6.

100. Coase theorizes that every situation can be made into a bargaining transaction. *Id.* at 15. The transaction costs of turning every situation into a bargaining situation will often prove too expensive, however. *Id.* at 15-16.

101. Calabresi defines the cheapest cost avoider as the party who is the "arbitrary initial bearer of accident costs [who will] . . . find it most worthwhile to 'bribe' in order to obtain that modification of behavior which would lessen accident costs most." CALABRESI, COSTS OF ACCIDENTS, *supra* note 8, at 135. The most worthwhile bribe would be the one made by the party "who is in the best position both to determine what accident cost avoidance measures will result in the minimal sum of avoidance costs and accident costs . . . and to act upon that determination." Calabresi & Hirschhoff, *supra* note 73, at 1060 n.19.

102. Calabresi & Hirschhoff, *supra* note 73, at 1060.

103. Calabresi supports this premise by comparing his test against the test formulated by Judge Learned Hand in *United States v. Carroll Towing Co.*, 159 F.2d 169, 173 (2d Cir. 1947), which requires a determination of who can actually best reduce accident cost. Calabresi, *Optimal Deterrence*, *supra* note 67, at 658.

104. Calabresi, *Optimal Deterrence*, *supra* note 67, at 658.

105. *Id.*

106. Calabresi makes distinctions between those people in a bargaining relationship and those that are not and delineates factors for each group. See Calabresi, *Views and Overviews*, *supra* note 73, at 605-07. These factors are substantially the same, however, as Calabresi readily admits. *Id.* at 607.

107. *Id.* at 607.

108. *Id.*

109. *Id.*

est degree of internalization.¹¹⁰ Thus, the Calabresi analysis asks which cost allocation will allow the party to know the true accident cost of the activity and take the proper measure to reduce that accident cost.¹¹¹

This analysis of who should bear the cost remains incomplete. Sometimes society does not want to put the cost on a party in the interests of fairness. An overarching justice constraint derives from society's values.¹¹² Unfortunately, the worth of justice cannot be accurately quantified. This justice constraint is important when formulating the solution. Calabresi, however, merely derives a system for measuring costs.¹¹³ The final decision of liability must be made in light of this justice analysis and not conclusively based on cost analysis alone.

B. An Additional Consideration: the Unique Character of Information

The nature of the accountant's task is the production of information from company records.¹¹⁴ Information is an unusual good because the producer can rarely receive the full social value of the information due to the free rider¹¹⁵ problem.¹¹⁶ In general information once produced can be reproduced to others at small cost. Once a third party receives the information, he can reconvey the information at a low cost and thus adversely affect the original producer's sale value to others.¹¹⁷ Due to this low cost reproduction, the original producer of the information can never receive the full value of his information.¹¹⁸ Since the producer is not fully compensated for the information, he will produce an inefficiently low amount.¹¹⁹

Society can produce an efficient amount of information through two possible means. First, society can attempt to require everyone who uses the information to pay for it. The transaction costs of implementing this result would be prohibitive in many situations and thus render this solution im-

110. *Id.* Internalization results when each activity bears its full costs. *See id.*

111. *Id.*

112. CALABRESI, COSTS OF ACCIDENTS, *supra* note 8, at 24.

113. Michelman, *supra* note 81, at 647. This would be a constraint in the Calabresi analysis. Due to a market inefficiency, the cost analysis would be erroneous and outside the constraints before the problem would even be analyzed.

114. *See* A. ARENS & J. LOEBBECKE, AUDITING AN INTEGRATED APPROACH 1-3 (2d ed. 1980).

115. A free rider problem exists in all public goods. Characteristically, public goods are reusable and not excludable from use by others. Since users can consume the good for "free," no incentive exists for them to pay for it. Thus, producers of public goods rarely receive full value for the good. The classic example is national defense. The military protects everyone in the country whether they want protection or not. Since everyone is automatically protected, an incentive exists to let others pay for the costs because each person will receive the benefits in any event.

116. R. ARROW, ESSAYS IN THE THEORY OF RISK-BEARING 151, 183 (1971); Bishop, *Negligent Misrepresentation Through Economists' Eyes*, 96 L.Q. REV. 360, 364 (1980).

117. Of course the legal system tries to protect some information through copyright and patent laws.

118. Bishop, *supra* note 116, at 364.

119. *Id.* at 369. When the market does not produce an efficient amount, a market failure occurs. "A market failure occurs when some factor . . . prevents simple incentives to private production from achieving an efficient use of society's resources *Id.* at 369 n.24.

practicable.¹²⁰ Second, society can subsidize the information producers, causing them to realize more fully the social value of their good. One commentator has argued that such a subsidy actually occurs in negligent misrepresentation cases.¹²¹ Because society does not force information producers to pay for the full social cost of their mistakes,¹²² the information producers have an incentive to produce greater amounts of information. In short, the restricted liability subsidizes the producer of information. The subsidization benefits society in general by causing a more efficient amount of information to be produced.¹²³

IV. THE ACCOUNTANT AND COST AVOIDANCE

The question remains whether the accountant or the third parties should bear the risk of loss induced by negligent misrepresentation. The solution must be predicated on the above economic foundation. The Calabresi analysis places liability on the accountant only if he is the better cost avoider. Determining the better cost avoider requires a closer look at the elements of a typical fact situation. First, studies of different liability situations reflect that liability for negligence in an audit for a small business differs drastically from liability for negligence in an audit for a large, publicly owned corporation.¹²⁴ Second, third parties fall into two distinguishable groups: (1) creditors, which are usually banks; and (2) investors and shareholders.¹²⁵ In light of these factors this part of the Comment evaluates which party constitutes the best cost avoider in cases involving negligent misrepresentation of information by accountants.

A. *The Publicly Owned Corporation Versus the Small Business*

Courts should not hold accountants liable for negligence in the audit of a publicly owned corporation. First, the accountant cannot shift the costs of the accident in the context of a public corporation because he cannot restrict his opinion. Federal law requires the accountant to give an unqualified opinion of the sufficiency of the audit.¹²⁶ If the accountant is prohibited from shifting the cost of the accidents, then by definition he cannot be the cheapest cost avoider.¹²⁷

Federal constraints on an accountant's ability to restrict his opinion may constitute an insufficient reason, however, to insulate the accounting profes-

120. *See id.* at 378-79.

121. Bishop, *supra* note 116, at 365-66.

122. *Id.* at 366. Accountants are information producers.

123. The law should especially limit liability when (1) the information is valuable to many potential users, (2) the information cannot be fully excluded from use, and (3) the imposition of liability to all injured persons would lead to a discontinuance of the production of the information. *Id.* at 378.

124. Professor Ebke argues that the accountant should have no duty to third parties in the publicly owned corporate context. Ebke, *supra* note 5.

125. "Third parties" is an imprecise category. In order to make comparisons between the third party and the accountant, the third party must be more precisely identified.

126. 15 U.S.C. §§ 77aa, 77g (1983).

127. CALABRESI, COSTS OF ACCIDENTS, *supra* note 8, at 135.

sion from liability. The legislature could have decided that the accountant is in fact the cheapest cost avoider.¹²⁸ In this case the accountant should bear the burden of liability because Congress would have determined the accountant to be in the best position to achieve the ultimate goal of reducing the cost of accidents.¹²⁹

The accountant, however, does not seem to be in a position to reduce costs of accidents in the public corporation context because he cannot fairly evaluate the risk. Since the potential number of third-party plaintiffs is virtually limitless, any negligence in the audit could expose the auditor to unlimited liability.¹³⁰ The accountant cannot evaluate the costs of the negligence and, therefore, he cannot determine whether forgoing certain activities would be economical.¹³¹ Since the accountant cannot determine the primary cost of accidents, he is not in the best position to reduce such costs.

Second, although at first glance the accountant appears to have the capability to spread the losses and thereby reduce the secondary cost, an adverse economic effect will result if the accountant does spread the losses.¹³² As the court in *Rosenblum* observed, the public will eventually bear the cost of the negligence.¹³³ The increased liability of the accountant will result in higher fees, which the companies in turn will pass to the consumer in the form of higher-priced products.¹³⁴ The participants thus externalize the costs.¹³⁵

128. Legislative history of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk (1983) reveals no evidence that Congress meant to place liability on the accountant for mere negligence. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 201 (1976).

129. If Congress had so found, the result should be questioned. The collective approach should only apply when society knows with certainty which party is the cheapest cost avoider. Calabresi, *Optimal Deterrence*, *supra* note 67, at 670-71. Since the question of who should bear the initial cost has troubled the courts and commentators for 50 years, any public certainty as to risk allocation is doubtful. Under the Calabresi analysis, market deterrence should determine the outcome in uncertain cases. *Id.*

130. *See supra* note 41 (discussion of the unlimited potential third-party plaintiffs from *Ultramares*). The foreseeable standard may have limits, but those limits are greatly extended beyond any previous standard and are uncertain in scope. No rational method appears to limit the number of potential plaintiffs in the situation of a negligent audit. In any event, having a standard that is uncertain in scope leads to litigation and increased transaction costs.

131. The theory that unlimited liability potential would force the accountant to eliminate mistakes is erroneous. Prevention of all accidents would consume a prohibitive amount of resources, if possible at all. In fact, much doubt exists as to whether society currently has the resources to avoid all accidents. A manpower shortage exists in the accounting profession. Comment, *supra* note 15, at 694-95.

132. Justice constraints may also negate liability. For a discussion of the justice considerations, see *infra* notes 139-40 and accompanying text.

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

134. Increased audit costs could be deemed an additional necessary cost of producing goods that the public should bear because the accountant has an integral place in the financial system. All who benefit from that system should bear its costs. When the public bears the costs, however, the accountant and the third parties lose their incentives to reduce accident costs. In other words, the probability of externalization must negate this line of reasoning.

135. Another possible negative economic effect could occur. Only the larger auditing firms could remain solvent because only they could distribute the losses. Comment, *supra* note 15, at 698; see also McConnell, *Are the Big 8 Increasing Their Share of the NYSE, AMEX and OTC Audit Markets?*, 7 J. ACCT., AUDITING & FIN. 178 (1983) (92% land market share in the NYSE and 76% share in the AMEX is increasing). An oligopoly consisting of the "big eight" accounting firms could, through price-fixing powers, extract a larger profit from society. Comment, *supra* note 15, at 701.

This result weighs against the accountant's bearing the risk.¹³⁶

Finally, the transaction costs in the publicly owned corporation context are high. Use of a negligence standard will necessitate a complicated and costly trial because the exposure to liability is so extensive that accounting firms will likely defend each case with vigor.¹³⁷ The existence of negligence will always be uncertain. The performance of an audit is an art;¹³⁸ therefore, whether or not negligence has occurred turns on subjective interpretation.

Although third-party liability should not be imposed on the accountant in the case of the large public corporation, public policy may dictate a contrary result in the case of small businesses and closely held corporations.¹³⁹ One can argue for a contrary result because liability is limited; the accountant can foresee the number of plaintiffs and the extent of the liability. The accountant, therefore, possibly can evaluate the primary costs. The accountant can better determine the cost of the injury and the cost of avoiding that injury.

To counter this argument, analysis of the transaction costs weighs against recognizing a duty of accountants to third parties in a small business situation. As in the public corporation setting, the participants will externalize the cost of the accident, and the public will bear the cost in the long run.¹⁴⁰ More importantly, the tertiary costs are even greater in the context of small businesses than in the public corporation context. A greater incentive to litigate exists because each party would contest the extent of the liability. If unlimited liability existed, the policy for imposing the cost on the accountant would be unjustified. Conversely, an imposition of a limited degree of liability may be justifiable. The process of line drawing would prove difficult.

That the accountant is an expensive cost avoider follows from the preceding analysis. If third parties are not in a superior position to evaluate and bear the costs of negligence, however, such analysis is worthless. The next section focuses on third parties as cost avoiders.

B. The Third Party as the Cheapest Cost Avoider

A negligent audit will potentially affect two distinguishable groups of persons, creditors and investors. Investors seem to be in the best position to evaluate primary costs. Each investor knows the extent of his liability from the amount of his investment. Furthermore, the investor can evaluate whether he or the accountant can better assume the risk of a negligent audit. The investor may influence the contract for the accounting of the corpora-

136. See *supra* notes 106-11 and accompanying text (discussion on the inefficiency of externalization).

137. The interest on the damages assessed would justify full legal battle. Most jurisdictions do not allow pretrial interest to be collected as part of the damages. On a \$10,000,000 claim this amount could be quite substantial.

138. See *supra* notes 15-19 and accompanying text (discussion of accounting as an art rather than a science).

139. For definition of public policy, see *supra* note 6.

140. The availability of insurance is questionable. Compare Besser, *supra* note 4, at 534-37 (insurance readily available), with Comment, *supra* note 15, at 682-85 (insurance unavailable), and Gormley, *supra* note 27, at 572 (insurance unavailable).

tion so that the accountant assumes the risk of the negligent audit.¹⁴¹ The investor must decide whether paying the accountant a higher fee to assume the risk of a negligent audit is more cost efficient than paying a lower fee and personally assuming the risk.

If the investor assumes the risk, then no loss spreading will occur. The investor, however, had the choice of not bearing the risk¹⁴² and can reduce the secondary costs to zero if he so chooses by paying the accountant to bear the risk of loss.

Additionally, tertiary costs would diminish if third parties assumed the risk of negligent audits. Each party knows his position. Transaction costs will be reduced if each party has an expectation of the liabilities.¹⁴³ If the investor decides to assume the risk of damage stemming from a negligent audit, no incentive exists for him to litigate if the accountant is only negligent. If the accountant has assumed liability for damage flowing from his negligence, the result in a subsequent negligence suit against the accountant will be more predictable.¹⁴⁴ Since the investor paid the higher price, the accountant will realize that doubts will probably be resolved against him. In sum, the investor is a cheaper cost avoider than the accountant.

Creditors are usually banks. Although banks know the exact amount of their loss if a negligent audit takes place, they have a greater control problem. Banks have very little control over who performs the audit and who bears the risk.¹⁴⁵ The lack of control over primary costs is offset, however, by greater control over secondary and tertiary costs. Banks can readily spread losses throughout society by writing off bad loans as a cost of doing business.¹⁴⁶ Banks' tertiary costs are less for the same reasons the investor's tertiary costs are less. If banks expect that they cannot recover damages resulting from negligent audits, then banks will not litigate the question, and costly trials will be avoided. Banks may also contractually shift the risk of a negligent audit to the accountant. The accountant, on the other hand, can-

141. Whether or not an investor or shareholder could control the selection of an auditor remains to be seen. In the case of shareholders, however, an argument could be made that they do have a degree of control. Shareholders could unite and dictate the choice of the accounting firm to the corporation. See Ebke, *supra* note 5. If this option is not available, then the shareholder assumes the risk of a negligent audit.

142. Whether society wishes to spread the risk is debatable. See *infra* notes 148-52 and accompanying text (discussion of justice considerations).

143. Bishop, *supra* note 116, at 371-72.

144. The number of suits is increasing. This increase can be traced to the relaxed liability standards. See Minow, *supra* note 16, at 76; Comment, *supra* note 15, at 676-77.

145. Creditors, however, unlike accountants, at least know the amount at risk. From this standpoint creditors seem to be in a slightly better position than the accountant to evaluate the primary costs.

146. The subcategorization is less than ideal. Calabresi describes subcategorization using an automobile example. Liability for cars is based on the different models of cars. The higher risk cars cost more because they cause more accidents. Yet the other subcategories, age of driver and driving record, etc., would not be reached with models of cars bearing their relative costs. Calabresi, *Views and Overviews*, *supra* note 73, at 606. In the accountant's case the losses sustained by the bank from reliance on a negligent audit would be grouped with other bad loans. The deterrent effects of the negligent audit are effectively lost, with the result an inefficient solution. Like the bad drivers, the negligent audit is subsumed by using a different categorization.

not shift the risk to the creditors without incurring prohibitive transaction costs.¹⁴⁷ Although the case is less clear, creditors generally should be able to bear the risks better than the accountants.

C. Constraints

Additional considerations lead to the conclusion that accountants should not be held liable for their negligent audits. First, even if the Calabresi model leads to the imposition of liability to third parties, the justice constraint should prevent this result. If courts hold accountants liable to third parties, then society will subsidize the losses.¹⁴⁸ This subsidization occurs because society will pay for any losses incurred by third parties due to the negligent audit through loss spreading. This result is contrary to the free market system. If a person engages in an enterprise for profit, he should also have to bear any losses that occur.¹⁴⁹ Society should not have to bear the losses when it will also not share in the profits.¹⁵⁰

The second constraint arises from the fact that accounting involves information.¹⁵¹ Since the accountant produces a public good, efficiency dictates that society subsidize the full social costs of this activity. Limited liability for the accountant accomplishes this goal.¹⁵²

V. SCIENTER

To say that the accountant has no duty for negligent misrepresentation does not mean that the accountant can make mistakes with impunity. The policy of not imposing liability is based on the concept of accidents. The accountant should pay for any errors made with scienter¹⁵³ or intent. Third

147. Every situation is potentially a bargaining situation. Often the extent of the transaction costs will make bargaining unpractical. Coase, *supra* note 8, at 15-16. Similarly, the accountant faces high transaction costs and therefore is not in a bargaining situation with the third parties. In most situations the accountant will not know who the creditors are or how many creditors will rely on the audited financial statements.

148. One commentator has termed this an "individualizing of the profits" and "a socializing of the losses." Ebke, *supra* note 5.

149. This argument is especially true for the investor. He invests for the purpose of profit. The author can see no reason why society should subsidize his unfortunate investments.

150. A distinction exists in this situation between physical injury and economic injury. Physical injury is usually not bargained for; on the other hand economic injury in the form of a decrease in the value of investment is a known possibility. Ventures for profit should be treated differently from the unavoidable automobile accident. *See also supra* note 41 (courts should take pragmatic approach to economic losses).

151. Information is a public good. *See supra* notes 114-19 and accompanying text.

152. This argument is somewhat weak since many other courses of action could also achieve subsidization of information production. Limited liability as a subsidy may not be desirable since society as a whole benefits from the production of information, yet only a limited class bears the costs of the subsidy. The third parties, however, are the primary users of the information. Therefore, an unreasonable result does not occur by making them pay the subsidy. In addition, limited liability may be the most politically expedient method of making the subsidy. For example, the government could give a direct subsidy to all information producers. If the government tried to give money directly to accounting firms, one could only imagine the taxpayer uproar.

153. Scienter as defined by *Ultramares* requires intent to deceive. *Ultramares v. Touche*, 255 N.Y. 170, 174 N.E. 441, 447 (1931). This standard is the liability requirement in most

parties cannot foresee when audits will be made in bad faith and therefore should not have to bear the costs of the errors. In addition, the wrongdoer is in the best position to prevent willful departures from fact.

Since the term accident connotes an unavoidable event, a reckless disregard for the truth would not qualify as an accident.¹⁵⁴ When an accountant displays a reckless disregard for the truth, a court should hold that this disregard meets the requirement of scienter.¹⁵⁵ Imposing a broad definition of scienter should deter the accountant from making bad faith audits. More importantly, public policy demands this result.

VI. CONCLUSION

Accountants should be liable to third parties only for acts committed with scienter. Public policy does not support holding accountants liable for negligent acts. Imposing the risk of liability on third parties for accountants' negligence produces a more efficient use of society's resources. Furthermore, spreading the losses of a profitable enterprise while individualizing the profits seems unfair. In any event, if the courts choose to base their decisions on public policy analysis, the courts should more thoroughly develop an analytical framework that accounts for the dimensions of public policy outlined in this Comment.

states. The court in *Ultramares* held that a showing of gross negligence was necessary in order to maintain a cause of action against the accountant. 174 N.E. at 449.

154. Professor Ebke argues that liability should attach when a reckless disregard of the truth occurs. Ebke, *supra* note 5.

155. The Supreme Court has also said that scienter must be shown for all cases brought under the securities laws. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976). The Court declined to decide whether recklessness is sufficient grounds for civil liability. *Id.* at 193 n.12.