CONTEMPORARY CURRENTS IN THE THIRD PARTY NEGLIGENCE LIABILITY OF AUDITORS: ONE STATE AS MICROCOSM

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> "Now, let me tell you something about all these lists of figures," he went on. "They may not seem very glamorous, but they are our lifeline. They are the lifeline of our country...."
>
> —Cynthia Ozick[1]

I. INTRODUCTION

It is both an intuitive and well-researched observation that the litigiousness of American society has resulted in a "litigation explosion."[2] The accounting profession—which, by virtue of its audit function, plays a critical role in the nation's commercial life[3]—has not been immune to this trend. In recent years, there has been a drastic increase in the number of lawsuits against auditors,[4] especially by nonclient third parties who do not have a contractual relationship, or are not "in privity,"[5] with the auditors but who allege reliance on a negligently prepared audit report. This

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[1] *No Taste for Accounting,* NEW YORKER, Aug. 3, 1998, at 35.

[2] *See, e.g.,* Mary Ann Glendon, A Nation under Lawyers (1996); Samuel Schwarz et al., *Should a Lawyer be Allowed in Small Claims Court? Some Empirical Light,* Am. Economist, Fall 1995, at 65, 65. See William Gaddis, A Frolic of His Own (1994), for a fictional treatment of the American propensity for litigation. On state tort reform attempts to reduce the number of civil lawsuits see William Glaberson, *Some Plaintiffs Losing Out in Texas' War on Lawsuits,* N Y. TIMES, June 7, 1999, at Al. On the economics of tort reform see Thomas J. Campbell et al., The Causes and Effects of Liability Reform: Some Empirical Evidence (National Bureau of Econ. Research Working Paper No. 4989, 1995).

[3] Nonclient third parties, such as various types of investors and creditors, rely on the audit report prepared by the auditor in deciding whether or not to enter into transactions with the auditor's client. *See, e.g.,* John David Donaldson, *California's Anachronistic Revival of the "Citadel of Privity for Independent Auditors: A Comment on Bily* v. *Arthur Young & Co.,* 46 RUTGERS L. REV. 465, 489-91 (1993). *See also* William J. Casazza, Note, *Rosenblum, Inc.* v. *Adler. CPAs Liable at Common Law to Certain Reasonably Foreseeable Third Parties Who Detrimentally Rely on Negligently Audited Financial Statements,* 70 CORNELL L. REV. 335, 337 (1985) ("The availability of such reliable information is essential to the efficient functioning of a free market economy.") In thus facilitating the obtaining of needed capital and credit by businesses, audits perform a function crucial to the economy.

[4] *See* Julie Faussie, Note, *Limiting Liability in Public Accounting Suits: A Desperate Appeal from a Beleaguered Profession*, 28 VAL. U. L. REV. 1041, 1041-51 (1994).

[5] "Privity" or, more fully, "privity of contract" refers to the existence of a contractual relationship between parties. *See* E. ALLAN FARNSWORTH, CONTRACTS § 10.1, at 710 (1982); LAURENCE P. SIMPSON, HANDBOOK OF THE LAW OF CONTRACTS § 116, at 242 (1965).

modem propensity for resorting to lawsuits has been exacerbated in the case of auditors by the “expectations gap” whereby the public, and third parties in particular, unrealistically expect auditors to insure bad commercial decisions and thus bear the entire cost of business failures.[6]

A more direct cause of this litigation crisis is, however, the enlargement of the scope of auditor liability by state courts, which has made it easier for third parties to recover damages in suits against auditors for negligence. This expansion of liability has produced a counter-reaction in some state legislatures that have limited the extent of auditor liability, thereby affording auditors greater protection against lawsuits.

This polarity will be explored by a study of the recent judicial and legislative activity within one state. Massachusetts is the ideal vehicle for such an examination because its experience reflects the contemporary legal landscape for auditors nationally. This experience concerns a significant decision by the state’s highest court[7] and an important bill that had been pending—but ultimately died—in the state legislature.[8] This decision and bill mirror the predominant rival views on auditor negligence liability to third parties.

II. BACKGROUND

The issue of what criteria do third parties have to meet in order to prevail against auditors in actions for negligence—usually, negligent misrepresentation[9]— has been a central concern of the accounting profession.[10] While the auditing contract is between the auditor and the auditor’s client, it is the third parties that are the anticipated or intended users of the audit report." These third parties rely upon

[6] *See* Richard S. Panttaja, Note, *Accountants' Duty to Third Parties: A Search for a Fair Doctrine of Liability,* 23 STETSON L. Rev. 927,934 (1994).

7 NYCAL Corp. v. K.PMG Peat Marwick LLP, 688 N.E.2d 1368 (Mass. 1998).

8.S. 812, 180th Gen. Ct,, 1997-98 Sess. (Mass. 1997).

[9] Negligent misrepresentation refers to the failure to exercise reasonable care in gathering or communicating information. *See* RESTATEMENT (SECOND) OF TORTS § 552 cmt. e (1977). Most third party negligence lawsuits against auditors are actions for negligent misrepresentation. *See* Lewis P. Checchia, Note, *Accountants' Liability to Third Parties under Bily* v. *Arthur Young & Company: Does a Watchdog Need Protection?,* 38 VILL. L. REV. 249, 254-55 (1993). See W. PAGE KEETON ET AL,, PROSSER AND KEETON ON THE LAW OF TORTS § 107, at 745-48 (5th ed. 1984), for a discussion of the tort of negligent misrepresentation in the wider context. On the historical development of negligent misrepresentation, especially in regard to auditor liability, see G. EDWARD WHITE, TORT LAW IN AMERICA: AN INTELLECTUAL HISTORY 114-38 (1985).

[10] With the demise of the privity-only position, which held that an auditor owed a duty of care only to the client and not to any third party, there is universal agreement that, under the appropriate circumstances, third parties should be allowed recovery for pecuniary losses suffered as result of their reliance on a negligent audit. WHITE, *supra* note 9, at 131, captures the essence of the argument for third party compensation:

> The capacity of unintentional acts or omissions to give rise to tort liability was, of course, a cornerstone of the modem negligence principle. If ‘careless’ acts that led to physical injury were compensated through actions in negligence, why should not careless acts that had led to economic loss be similarly compensated?

The issue, then, is not whether to compensate third parties but rather under what circumstances should third parties be compensated.

[11] *See* John W. Bagby & John C. Ruhnka, *The Controversy Over Third Party Rights: Toward More Predictable Parameters of Auditor Liability,* 22 Ga. L. Rev. 149, 149 (1987).

the report in making decisions regarding the credit-worthiness or investment potential of the client.[12] Common examples of third parties are trade and financial creditors, investors, shareholders, insurers, and potential merger or acquisition partners.[13]

When the transaction between the third party and the client goes awry and losses are incurred, the auditor is vulnerable to being sued, especially if the client has become financially ruined.[14] In such a suit, the third party typically makes a claim for damages for economic loss resulting from negligent misstatements contained in the audit report.[15] The state courts, as well as federal courts interpreting state law, have treated such actions in one of three ways, with the trend being toward relaxing the criteria for recovery against auditors.

The strictest approach by the courts, the near-privity rule, is followed in nine jurisdictions[16] and is against the prevailing judicial current of widening the scope of liability. This rule, emerging from the triad of New York Court of Appeals cases—*Glanzer* v. *Shepard,*[17] *Ultramares Corp.* v. *Touche*,[18] and *Credit Alliance* v. *Arthur Andersen & Co,*[19] allows a third party to recover for negligent misrepresentation if there is a link between the auditor and the third party that is functionally "so close" to a contractual relationship that it can be deemed as its equivalent.[20] Such a linkage, referred to as a near-privity relationship, occurs if the auditor knew that the audit report was to be used by a specifically identified third party for a particular purpose and if the auditor had such direct contact or communication with the third party that it evidences the auditor's understanding of the third party's reliance.[21] While the near-privity approach is outside the mainstream of contemporary judicial thinking, it is the forerunner of almost all legislative

[12] *See id.* ', *see also* Gary Lawson & Tamara Mattison, *A Tale of Two Professions: The Third-Party Liability of Accountants and Attorneys for Negligent Misrepresentation,* 52 OHIO ST. L. J. 1309, 1312 (1991); Thomas G. Mackey, *Accountants ' Liability After Bily v. Arthur Young <S Co.: A More Equitable Proposal for Third Party Recovery,* 45 HASTINGS L. J. 147, 148 (1993).

[13] *See, e.g.,* Bagby & Ruhnka, *supra* note 11, at 149; Mackey, *supra* note 12, at 150-51; Doria Bonham-Yeaman & James John Jurinski, *Auditors ' Liability to Third Parties: Can the States Adopt a Unified Approach?, 22* W. ST. U. L. REV. 37,38 (1994).

[14] *See* Susan S. Paschall, *Liability to Non-Clients: The Accountant 's Role and Responsibility,* 53 Mo. L. REV. 693,695(1998).

[15] *Id.* at 694.

[16] The courts of Connecticut, Idaho, Montana, Nebraska, New York, and Virginia have adopted the near-privity rule. *See* Twin Mfg. Co. v. Blum, Shapiro & Co., 602 A.2d 1079 (Conn. Super. Ct. 1991); Idaho Bank & Trust Co. v. First Bancorp of Idaho, 772 P.2d 720 (Idaho 1989); Thayer v. Hicks, 793 P.2d 784 (Mont. 1990); Citizens Nat'l Bank v. Kennedy & Coe, 441 N.W.2d 180 (Neb. 1989); Credit Alliance Corp. v. Arthur Andersen & Co., 483 N.E.2d. 110 (N.Y. 1985); Ultramares Corp. v. Touche, 174 N.E. 441 (N.Y. 1931); Glanzer v. Shepard, 135 N.E. 275 (N.Y. 1922) (case involving public weigher's certificate); Ward v. Ernst & Young, 435 S.E.2d 628 (Va. 1993) (applying third party beneficiary doctrine).

Furthermore, federal courts, interpreting the law of the states of Colorado, Indiana, and Pennsylvania, have adopted the near-privity rule as well. *See* Stephens Indus., Inc. v. Haskins & Sells, 438 F.2d 357 (10th Cir. 1971); Ackerman v. Schwartz, 947 F.2d841 (7th Cir. 1991); Giant Eagle of Delaware, Inc. v. Coopers & Lybrand, 892 F. Supp. 676 (W.D. Pa. 1995); Coleco Indus., Inc. v. Berman, 423 F. Supp. 275 (E.D. Pa. 1976). *But see infra* note 24 for federal cases that draw a contrary conclusion and adopt the *Restatement* rule.

[17] 135 N.E. 275 (N.Y. 1922).

[18] 174 N.E. 441 (N.Y. 1931).

[19] 483 N.E.2d 110 (N.Y. 1985).

[20] *See Ultramares,* 174 N.E. at 446.

[21] *See Credit Alliance,* 483 N.E.2d at 118.

enactments narrowing the range of auditor liability, as exemplified by the Massachusetts bill.[22]

The most expansive view, adopted by only a very small—and shrinking— minority of states, is the reasonably foreseeable rule.'[3] Under this approach, an auditor is subject to liability for negligent misrepresentation to all third parties whom the auditor, at the time the audit report was prepared, *could* reasonably have foreseen would rely on the audit report. According to this view, actual foresight on part of the auditor is not necessary. Rather, liability may be imposed on all reasonably foreseeable users of the audit report.

Most modern courts—in fact, a majority of the jurisdiction that have considered the issue of auditor liability—have opted to adopt the middle-of-the-road actually foreseen standard, which is set forth in Section 552 of the *Restatement (Second) of Torts}** Section 552 provides, in relevant part, as follows:

[22] S. 812, 180th Gen. Ct., 1997-98 Sess. (Mass. 1997); *see also infra* text accompanying notes 37-45.

[23] The courts of Mississippi, Oklahoma, Texas, and Wisconsin have adopted the reasonably foreseeable rule. *See* Touche Ross & Co. v. Commercial Union Ins. Co., 514 So. 2d 315 (Miss. 1987); Bradford Sec. Processing Services, Inc. v. Plaza Bank & Trust, 653 P.2d 188 (Okla. 1982) (case involving bond counsel's opinion); Blue Bell, Inc. v. Peat, Marwick, Mitchell & Co., 715 S.W.2d 408 (Tex. App. 1986) (construing *Restatement* rule so broadly so as to have Texas effectively follow the reasonably foreseeable rule). *But see* Shatterproof Glass Corp. v. James, 466 S.W.2d 873 (Tex. Civ. App. 1971) (following conventional interpretation of *Restatement* rule); Citizens State Bank v. Timm, Schmidt & Co, 335 N.W.2d 361 (Wis. 1983).

[24] The courts of Alabama, Alaska, Arizona, California, Florida, Georgia, Hawaii, Iowa, Massachusetts, Minnesota, Missouri, New Hampshire, New Mexico, North Carolina, Ohio, South Carolina, Tennessee, Texas, Washington, and West Virginia have adopted the *Restatement* actually foreseen rule. *See* Boykin v. Arthur Andersen & Co., 639 So. 2d 504 (Ala. 1994); Seiden v. Burnett, 754 P.2d 256 (Alaska 1988); Standard Chartered PLC v. Price Waterhouse, 945 P.2d 317 (Ariz. Ct. App.
1996) ; Bily v. Arthur Young & Co.. 834 P.2d 745 (Cal. 1992); First Fla. Bank v. Max Mitchell & Co., 558 So. 2d 9 (Fla. 1990); Amwest Sur. Ins. Co. v. Ernst & Young, 677 So. 2d 409 (Fla. Dist. Ct. App. 1996); Badische Corp. v. Caylor, 356 S.E.2d 198 (Ga. 1987); Kohala Agric. v. Deloitte & Touche, 949 P.2d 141 (Haw. Ct. App. 1997); Eldred v. McGladery, Hendrickson & Pullen, 468 N.W.2d 218 (Iowa 1991); Ryan v. Kanne. 170 N.W.2d 395 (Iowa 1969); NYCAL Corp. v. KPMG Peat Marwick LLP, 688 N.E.2d 1368 (Mass. 1998); Florenzano v. Olson, 387 N.W.2d 168 (Minn. 1986); Bonhiver v. Graff, 248 N.W.2d 291 (Minn. 1976); MidAmerican Bank & Trust Co. v. Harrison, 851 S.W.2d 563 (Mo. Ct. App. 1993); Aluma Kraft Mfg. Co. v. Elmer Fox & Co., 493 S.W.2d 378 (Mo. Ct. App. 1973) (adopting a test that applies the *Restatement* rule upon a balancing of public policy factors); Demetracopoulos v. Wilson, 640 A.2d 279 (N.H. 1994); Spherex. Inc. v. Alexander Grant & Co., 451 A.2d 1308 (N.H. Supreme Court 1982); Stotlar v. Hester, 582 P.2d 403 (N.M. Ct. App. 1978) (case involving real estate appraisal); Raritan River Steel Co. v. Cherry. Bekaert & Holland, 367 S.E.2d 609 (N.C. 1988); Liberty Fin. Co. v. BDO Seidman, 473 S.E.2d 13 (N.C. Ct. App. 1996); Haddon View Inv. Co. v. Coopers & Lybrand, 436 N.E.2d 212 (Ohio 1982); BancOhio Nat'l Bank v. Schiesswohl, 515 N.E.2d 997 (Ohio Ct. App. 1986); ML-Lee Acquisition Fund, L.P. v. Deloitte & Touche. 489 S.E.2d 470 (S.C. 1997); Bethlehem Steel Corp. v. Ernst & Whinney, 822 S.W.2d 592 (Tenn. 1991); Shatterproof Glass Corp. v. James, 466 S.W.2d 873 (Tex. Civ. App. 1971). *But see* Blue Bell, Inc. v. Peat. Marwick, Mitchell & Co., 715 S.W.2d 408 (Tex. App.1986) for an expansive reading of the *Restatement* rule that makes Texas effectively follow the reasonably foreseeable rule, discussed *supra* in text accompanying note 23; Haberman v. Washington Pub. Power Supply Sys., 744 P.2d 1032 (Wash. 1987); First Nat l Bank of Bluefield v. Crawford, 386 S.E.2d 310 (W.Va. 1989).

In addition, federal courts, interpreting the law of the states of Kentucky, Louisiana, Maine, North Dakota, Pennsylvania, and Rhode Island have adopted the *Restatement* rale as well. *See* Ingram Indus., Inc. v. Nowicki, 527 F. Supp. 684 (E.D. Ky. 1981); First Nat'l Bank of Commerce v. Monco Agency' Inc., 911 F.2d 1053 (5th Cir. 1990); Bowers v. Allied Inv. Corp., 822 F. Supp. 835 (D. Me. 1993) Bunge Corp. v. Eide. 372 F. Supp. 1058 (D. N.D. 1974); Eisenberg v. Gagnon, 766 F.2d 770 (3d Cir. 1985); *In re* Chambers Dev. Sec. Litig., 848 F. Supp. 602 (W.D. Pa. 1994); Alten v. Atlantic Fin. Fed., 805 F. Supp. 5 (E.D. Pa. 1992). *But see supra* note 16 for federal cases that draw a contrary conclusion and adopt the

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

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

(a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it: and

(b) through reliance upon it in a transaction that he intends the information to influence or knows that the recipient so intends or in a substantially similar transaction.

According to the *Restatement* actually foreseen rule, an auditor is subject to liability for negligent misrepresentation to relying third parties who may not be precisely identified but who are members of an identified and restricted group of users whose reliance on the audit report is actually foreseen by the auditor at the time the audit report is prepared. Thus, for example, an auditor who knows that an unspecified finance company will receive the audit report and rely upon it in making its lending decision falls within this rule.

III. THE JUDICIAL EXPANSION OF AUDITOR LIABILITY

In 1998, Massachusetts became the latest state to follow the majority *Restatement* approach when the Supreme Judicial Court in *NYCAL Corp.* v. *KPMG Peat Marwick LLP*[25] adopted the actually foreseen view. There, an investor, suing an accounting firm for negligent misrepresentation alleged that, in reliance on an audit report prepared by the firm, it entered into a stock purchase agreement with the firm's client. The client subsequently filed for bankruptcy protection, thus rendering worthless the investment of the third party who was now seeking damages for the losses incurred. The accounting firm prevailed in this case because of a finding that it did not know or intend, at the time the audit report was prepared, that this particular third party or any unidentified member of a group of users to which the third party belonged would rely on the report in making its decision whether or not to invest with the firm's client. The court reasoned that a class of potential future investors does not constitute a limited class as contemplated by the *Restatement* rule.

In rejecting the near-privity and reasonably foreseeable positions, Massachusetts has joined the twenty-five other *Restatement* actually foreseen jurisdictions that have chosen to extend an auditor's duty to third parties who are unnamed members of an identified and limited class of users—but not to merely reasonably foreseeable users.[26] Besides Massachusetts, states that have recently

near-privity rule; Forcier v. Cardello, 173 B.R. 973 (D. R.I. 1994); Rusch Factors, Inc. v. Levin, 284 F. Supp. 85 (D. R.I. 1968).

[25] 688 N.E.2d 1368 (Mass. 1998).

[26] *See supra* note 24.

adopted the *Restatement* rule include Arizona[27] and Hawaii.[28] By assuming this intermediate stance, the courts in these states view themselves as giving protection to auditors and third parties alike in avoiding both the near-privity standard's significant limitation on the liability exposure of auditors and the reasonably foreseeable standard's potential for limitless liability. The Massachusetts court has endorsed the notion held by actually foreseen jurisdictions that the *Restatement* rule should alleviate the auditors' fear of the prospect of open-ended liability: "The rule we adopt today will preclude accountants from having to ensure the commercial decisions of nonclients [third parties] where, as here, the accountants did not know that their work product would be relied on by the plaintiff [third party] in making its investment decision."[29]

Critics of the *Restatement* rule contend that by increasing the auditors' exposure to liability for negligent misrepresentation, the rule may ultimately lead to the dissolution of audit firms[30] and soaring insurance premiums for coverage that will be increasingly difficult to obtain,[31] scenarios that have precedents in the past.[32] Moreover, the argument is made that the expansion of liability will not deter negligent audits but will instead encourage defensive auditing and other strategies to limit the liability exposure of auditors.'[3] One such strategy is the refusal on the part of audit firms to be retained by small companies in high-risk industries, which are prone to being sued when they do not meet the expectations of investors.[34] Huber, in discussing the trend toward expansion of liability in general, dismisses the deterrence argument thus: "When all is said and done, the modem rules [regarding the extension of liability] do not deter risk; they deter behavior that gets people sued, which is not at all the same thing."[35]

IV. THE LEGISLATIVE RESTRICTION OF AUDITOR LIABILITY

The expansion of auditor liability and the ensuing litigation crisis has led to a reaction. Various laws—generically called "privity statutes"—that make it more difficult for third parties to recover against negligent auditors have been enacted by some state legislatures. These statutes, promoted by accountants and part of broader tort reform,'[6] have preempted or superceded more liberal auditor liability rules adhered to by the courts.

A privity bill was introduced in the Massachusetts legislature in 1997[37] and died in committee in 1998. This legislation was drawn, for the most part, directly from the model privity statute advanced by the American Institute of Certified Public

[27] Standard Chartered PLC v. Price Waterhouse, 945 P.2d 317 (Ariz. Ct. App. 1996).

28 kohala Agric. v. Deloitte & Touche, 949 P.2d 141 (Haw. Ct. App. 1997).

29 *NYCAL*, 688 N.E.2d at 1374.

30.See Faussie. *supra* note 4, at 1089.

[31] *See id* at 1083-85.

32. See id. at 1089, 1083-85.

[33] *See* John A. Siliciano, *Negligent Accounting and the Limits of Instrumental Tort Reform.* 86 MICH. L. REV. 1929.1959-1960(1988).

[34] *Id*

[35] Peter W. Huber. Liability: The Legal Revolution and its Consequences 12 (1988).

[36] *See supra* note 2.

[37] S. 812, 180th Gen. Ct., 1997-98 Sess. (Mass. 1997).

Accountants (AICPA) and the National Association of State Boards of Accountancy (NASBA),[38] which itself mirrors the near-privity criteria set forth in the *Credit Alliance* case.[39] In the legislatures of Alabama and Texas, two other *Restatement* states,[40] recent attempts to pass similar versions of the model bill[41] were similarly unsuccessful.

The model statute was enacted so far only by the United States Territory of Guam.[42] However, most privity statutes that have been adopted are descendants or variants of the model statute despite their differences, some nuanced, some more substantive. Accordingly, an analysis of the Massachusetts legislation will shed some light on the legislative counter-trend of restricting the scope of auditor liability.

The Massachusetts bill subjects an auditor to negligence liability to a third party only if the auditor:

> (1) was aware at the time the engagement was undertaken *or agreed in writing after the time of the engagement*, that the financial statements or other information were to be made available for use in connection with a specified transaction by the plaintiff [third party] who was specifically identified to the defendant accountant, (2) was aware that the plaintiff [third party] intended to rely upon such financial statements or other information in connection with the specified transaction, and (3) had direct contact and communication with the plaintiff [third party] and *the defendant accountant directly* expressed by words or conduct the defendant accountant's understanding of the *plaintiff's* [third party's] *intended* reliance on such financial statements or other information.[43] (italics added)

The wording of this bill is that of the model statute except for some additions in language, as indicated above in italics. In all other respects, the model and Massachusetts bills are identical.

The model bill and its Massachusetts variant are legislative codifications of the near-privity standard.[44] As such, an auditor's liability is predicated upon the satisfaction of three criteria: (1) the auditor's awareness that the audit report will be used in connection with a specified transaction; (2) the auditor's awareness that the audit report is intended to be relied upon by a specifically identified third party; and
(3) the auditor's direct contact and communication with the third party along with a manifestation of the auditor's understanding that this audit report will be relied upon by a third party.[45]

In fact, most privity statutes have a requirement of some acknowledgement on the part of the auditor that a third party intends to rely on the audit report in regard to a specified transaction. Unlike the model legislation and the Massachusetts

[38] Uniform Accountancy Act and Uniform Accountancy Act Rules § 20 (3ded. 1998).

[39] 483 N.E.2dat 118.

[40] *But see* Blue Bell, Inc. v. Peal, Marwick, Mitchell & Co., 715 S.W.2d 408 (Tex. App. 1986) for an expansive interpretation of the *Restatement* rule, making the rule indistinguishable from the reasonably foreseeable standard.

[41] H.R. 416,1997 Sess. (Ala. 1997); S. 275, 75th Leg, 1997 Sess. (Tex. 1997).

[42] GUAM GOVT. CODE tit. 57, § 54019 (1994).

[43] S. 812, 180th Gen. Ct., 1997-98 Sess. (Mass. 1997).

[44] *See, e.g.. Credit Alliance,* 483 N.E.2d at 118; *see also* text accompanying notes 16-21.

[45] *See* S. 812,180th Gen. Ct, 1997-98 Sess. (Mass. 1997).

bill, the privity statutes of New Jersey in regard to bank third parties,[46] Wyoming,[47] Arkansas,[48] and Michigan[49] require that the acknowledgement by the auditor be in

[46] N.J. STAT. Ann. § 2A:53A-25(3) (West Supp. 1997). Section 2A:53A-25 provides, in relevant part, as follows:

> [N)o accountant shall be liable for damages for negligence arising out of and in the course of rendering any professional accounting service unless:...(2) [t]he accountant: (a) knew at the time of the engagement by the client, or agreed with the client after the time of the engagement, that the professional accounting service rendered to the client would be made available to the claimant, who was specifically identified to the accountant in connection with a specified transaction made by the claimant; (b) knew that the claimant intended to rely upon the professional accounting service in connection with that specified transaction; and (c) directly expressed to the claimant, by words or conduct, the accountant's understanding of the claimant's intended reliance on the professional accounting service; or (3) [i]n the case of a bank claimant, the accountant acknowledged the bank's intended reliance on the professional accounting service and the client's knowledge of that reliance in a written communication.

[47] Wyo. Stat. Ann. § 33-3-201 (Michie 1996). Section 33-3-201 allows a third party to bring an action for negligence against an auditor only if the auditor:

> (A) [w]as aware at the time of the engagement was undertaken with the [auditor's] client that the financial statements or other information were to be made available for use in connection with a specified transaction by the plaintiff [third party] and the transaction was specifically identified to the defendant [auditor); and (B) [w]as aware that the plaintiff [third party] intended to rely upon such financial statements or other information in connection with the specified transaction, (d) In order to be entitled to the limitation on liability contained in this article, an [auditor] shall: (i) [ijdentify the purpose of the document and the persons or entities that are entitled to receive and rely upon the financial statement or other information examined, compiled, reviewed, certified, audited or otherwise reported or opined on by the [auditor] in the document prepared by the [auditor]; and (ii) [ijnclude thereon a statement in a prominent place that advises users of the document that the liability of the [auditor] to third parties who use the document [audit report] may be limited pursuant to this article.

[48] Ark. CODEANN.§ 16-114-302 (Supp. 1991). Section 16-114-302 provides:

> No person, partnership, or corporation licensed or authorized to practice under the Public Accountancy Act of 1975, §17-12-101 et seq., or any of its employees, partners, members, officers, or shareholders shall be liable to persons not in privity of contract with the person, partnership, or corporation for civil damages resulting from acts, omissions, decisions, or other conduct in connection with professional services performed by such person, partnership, or corporation, except for:
>
> > (1) Acts, omissions, decisions, or conduct that constitutes fraud or intentional misrepresentation; or
> >
> > (2) Other acts, omissions, decisions, or conduct if the person, partnership, or corporation was aware that a primary intent of the client was for the professional services to benefit or influence the particular person bringing the action. For the purposes of this subdivision, if the person, partnership, or corporation:
> >
> > > (A) Identifies in writing to the client those persons who are intended to rely on the services; and
> > >
> > > (B) Sends a copy of the writing or similar statement to those persons identified in the writing or statement, then the person, partnership, or corporation or any of its employees, partners.

writing. And the Kansas statute,[50] literally choosing a different direction, mandates that the written acknowledgement go from the client to the auditor.

The only substantive difference between the model statute and the Massachusetts bill is that the latter provides that the auditor's knowledge of the third party's intended reliance may occur not only before the start of any auditing work— as is also the case in the model statute— but also after the work has begun provided the auditor and client agree to this in writing. The New Jersey privity statute, in connection with non-bank third parties,[51] has a timing-of-awareness provision similar to that of Massachusetts but does not have a requirement that the agreement allowing awareness after the start of the auditing work be in a writing.

The states of Illinois,[52] Arkansas,[53] and Utah[54] have almost identical privity statutes that do not specify when the auditor's awareness of the intended reliance by

> members, officers, or shareholders may be held liable only to the person intended to so rely, in addition to those persons in privity contract with such person, partnership, or corporation.

[49] Mich. Comp. Laws Ann. § 600.2962 (1996). Section 600.2962 provides that an auditor is subject to liability for:

> [a] negligent act, omission, decision, or other conduct of the certified public accountant [auditor] if the certified public accountant [auditor] was informed in writing by the client at the time of the engagement that a primary intent of the client was for the professional public accounting services to benefit or influence the person bringing the action for civil damages. For the purposes of this subdivision, the certified public accountant [auditor] shall identify in writing to the client each person, generic group, or class description that the certified public accountant [auditor] intends to have rely on the services. The certified public accountant [auditor] may be held liable only to each identified person, generic group, or class description. The certified public accountant's [auditor's] written identification shall include each person, generic group, or class description identified by the client as being benefited or influenced.

[50] KAN. STAT. ANN. § 1-402 (1991). Section 1-402 provides that an auditor is subject to negligence liability if:

> the defendant [auditor] knew at the time of the engagement or the defendant [auditor] and the client mutually agreed after the time of the engagement that the professional accounting services rendered to the client would be made available to the plaintiff [third party], who was identified in writing to the defendant [auditor]; and (2) the defendant [auditor] knew that the plaintiff [third party] intended to rely upon the professional services rendered the client in connection with specified transactions described in the writing.

[51] N.J. Stat. Ann. § 2A:53A-25(2)(c) (West Supp. 1997). See *supra* note 46 for the full text of statute.

[52] *See* ILL. Ann. Stat. ch. 225, § 450/30.1 (Smith-Flurd 1993). Section 450/30.1 provides that an auditor will be subject to negligence liability:

> [Clause 1] if [the auditor] was aware that a primary intent of the client was for the professional services to benefit or influence the particular person [third party] bringing the action; [Clause 2*]provided, however,. ..* //[the auditor] (i) identifies in writing to the client those persons [third parties] who are intended to rely on the services, and (ii) sends a copy of such writing or similar statement to those persons [third parties] identified in the writing or statement, *then* [the auditor] may be held liable only to such persons [third parties] intended to so rely.... (emphasis added)

[53] *See* ARK. CODE ANN. § 16-114-302 (Supp. 1991). See *supra* note 48 for the full text of statute.

[54] *See* UTAH CODE Ann. § 58-26-12 (1996). Section 58-26-12 provides that an auditor will be subject to liability for negligence:

a third party must occur. Since the courts of these states have not yet dealt with this issue, there arises the prospect that different courts will give different answers.[55]

Such is already the case with the provision in these three statutes regarding written identification and notification of third parties by the auditor. The Illinois Appellate Court's interpretation of the provision was that the writing by the auditor is elective and functions only to limit the auditor's liability to the third parties identified in the writing and sent a copy of it.[56] In contrast, the construction of the Arkansas Supreme Court was that the writing requirement is mandatory and operates as a prerequisite to liability.[57] The conflicting meanings ascribed by these two courts to the similar provisions produce paradoxical results when the auditor does not send a writing to a third party. Under the Illinois statute, the auditor will be liable to *all* relying third parties, while pursuant to the Arkansas legislation, the auditor will be liable to *none.* With the provision's susceptibility to more than one reading, its future construction by the Utah Supreme Court remains a large unknown.

Notwithstanding the inevitable variety of the eight privity statutes thus far adopted, their fundamental commonality is that they confine the sweep of the auditor's third party legal responsibility. Even the Michigan privity statute, which stands alone in its derivation from the more expansive *Restatement* standard, makes it more difficult for third parties to sue an auditor by adding a provision that requires identical written third party lists sent by the auditor and the client to each other.

V. CONCLUSION

The *Restatement* position, which has enlarged the scope of the negligence liability of auditors, has now become the majority view. This prevailing standard is now being challenged by the privity statute approach, a mosaic of various legislations that, for the most part, look to the near-privity standard as their inspiration and thus restrict in some way the legal responsibility of auditors.

The situation in Massachusetts is emblematic of these two divergent trends. As such, the Massachusetts experience represents, and increases our understanding of, the contemporary debate over auditor liability.

> (2) if the [auditor] knew that a primary intent of the client was for the professional services to benefit or influence the particular person bringing the action; except, however, for the purposes of this subsection, if the person:
> (a) identified in writing to the client those persons who are intended to rely on the services; and
> (b) sent a copy of the writing or similar statement to the person identified in the writing or statement then [the auditor] may be liable only to the person intended to rely ....

[55] Although state courts in Arkansas. Illinois, and Utah have not construed their respective privity statutes, a Federal District Court in Vermont has interpreted the Utah privity statute as requiring awareness by the auditor at the time the audit was performed. *See* Nordica USA, Inc. v. Deloitte & Touche. 839 F. Supp. 1082, 1090-91 (D. Vt 1993).

56.Chestnut Corp. v. Pestine, Brinati, Gamer, Ltd., 667 N.E.2d 543 (111. App. Ct. 1996).
57.Swink v. Ernst & Young. 908 S.W.2d 660 (Ark. 1995).