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Bily v. Arthur Young & Co.: Is Limiting Auditor Liability to Third Parties Favoritism or Fair Play

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BILY v. ARTHUR YOUNG & CO. : IS LIMITING AUDITOR LIABILITY TO THIRD PARTIES FAVORITISM OR FAIR PLAY?

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I. INTRODUCTION

They are admission tickets to venture capital markets.¹ They are often used by investors and creditors,² and they affect almost every business decision made.³ The importance of audits⁴ can scarcely be overstated. Occasionally, however, businesses that have received "clean"⁵ audit reports fail, leaving creditors and investors holding the bag.⁶ In such cases, the creditors and investors tend to view business failures as audit failures.⁷ This foreseeable group of nonclient third parties often

1. *Bily v. Arthur Young & Co.*, 3 Cal. 4th 370, 382, 834 P.2d 745, 751, 11 Cal. Rptr. 2d 51, 57, modified, 3 Cal. 4th 1049a (1992).

2. *Id.*

3. Faron R. Webb, Note, *New York Upholds Ultramares and Delineates Three-Part Test Which Noncontractual Parties Must Satisfy to Hold Accountants Liable in Negligence: Credit Alliance Corp. v. Arthur Andersen & Co.*, 65 N.Y.2d 536, 483 N.E.2d 110, 493 N.Y.S.2d 435 (1985), 17 TEX. TECH L. REV. 1025, 1026 (1986).

4. An audit is an independent inquiry designed to determine how fairly an entity's financial statements, taken as a whole, represent the entity's actual financial position. William C. Sturm, *Accountant's Liability to Third Parties*, 92 COM. L.J. 158, 159 (1987); see *infra* part II.A.4.

5. A clean audit report refers to an auditor's statement that the client's financial statements, taken as a whole, fairly represent its financial condition. See *infra* part II.A.4.

6. During the 1980s, many businesses and financial institutions failed. These failures, in turn, had an enormous impact on the nation's financial markets. Erica B. Baird, *Legal Liability Under the Expectation Gap Statements on Auditing Standards*, in ACCOUNTANTS' LIABILITY 1991, at 63, 65 (Dan L. Goldwasser ed., 1991). Some of these business failures occurred in spite of clean audit opinions that had been issued by independent auditors. *Id.* "These events prompted a series of questions about the role of the auditors and why they had failed to give adequate warning of the institution's imminent failure. . . . [T]he public asked: 'where were the auditors?'" *Id.*

7. Nancy Chaffee, Comment, *The Role and Responsibility of Accountants in Today's Society*, 13 J. CORP. L. 863, 882 (1988) (citing Joseph E. Connor, *Enhancing Public Confidence in*

includes corporate directors, officers, shareholders, trustees, receivers, sureties and employees who wish to recoup their losses from the auditor⁸ by claiming that the auditor breached a duty owed to them.⁹

The explosion of suits filed against auditors for negligence, negligent misrepresentation and fraud in the past decade attests to the significance of these suits. During the past ten years, the number of lawsuits filed against accountants has dramatically increased,¹⁰ as has the amount of damages sought.¹¹

The increase in litigation has made it difficult, if not impossible, for some accountants to obtain professional liability insurance.¹² Between 1985 and 1986 every major insurance carrier stopped writing liability insurance policies for California accountants.¹³ Premiums in California have skyrocketed, increasing approximately 1480% since 1984,¹⁴ despite the profession's efforts to keep premiums down by creating and running

the Accounting Profession, J. ACCT., July 1986, at 76, 76-77). In *Bily*, the court recognized this when it stated:

The auditing CPA has no expertise in or control over the products or services of its clients or their markets; it does not choose the client's executives or make its business decisions; yet, when clients fail financially, the CPA auditor is a prime target in litigation claiming investor and creditor economic losses because it is the only available (and solvent) entity that had any direct contact with the client's business affairs.

Bily v. Arthur Young & Co., 3 Cal. 4th 370, 401, 834 P.2d 745, 763, 11 Cal. Rptr. 2d 51, 69 (citing John A. Siliciano, *Negligent Accounting and the Limits of Instrumental Tort Reform*, 86 MICH. L. REV. 1929, 1932-33 (1988)), *modified*, 3 Cal. 4th 1049a (1992).

8. Although there are distinctions within the profession between "auditors" and "accountants," this Note will use the terms interchangeably.

9. See Joey D. Duke, Note, *Accountants' Liability to Third Parties for Negligent Misrepresentation: Should There be a Uniform Standard?*, 14 AM. J. TRIAL ADVOC. 133 (1990).

10. Brief of the California Society of Certified Public Accountants as Amicus Curiae in Support of Appellant at 31, *Bily* (No. H003695). The frequency of claims against auditors in California have increased at a faster rate than in the rest of the United States. *Id.* As of 1987 the American Institute of Certified Public Accountants' (AICPA) insurance carrier was faced with 1.77 times as many claims per insured firm in California than in the rest of the country. *Id.* Additionally, between 1978 and 1990 there were more lawsuits against auditors than in the entire previous history of the profession. Samuel S. Paschall, *Accountants' Liability*, TRIAL, May 1990, at 42.

11. Rick Telberg, *Turning the Tide on Liability*, ACCT. TODAY, Sept. 7, 1992, at 1. Between January and September 1992, Big Six accounting firms incurred court judgments totaling almost \$1 billion. *Id.* A negligence verdict for \$332 million handed down against Price Waterhouse was included within this amount. John E. Morris, *State High Court Limits Claims Against Auditors*, RECORDER, Aug. 28, 1992, at 1.

12. See *infra* notes 13-19 and accompanying text.

13. Brief of the California Society of Certified Public Accountants as Amicus Curiae in Support of Appellant at 34. Some insurers will not write policies for firms with more than five accountants. *Id.* at 35. Others will not insure firms that perform audits. *Id.*

14. *Id.* In fact, some accountants who perform audits in connection with savings and loans or public offerings must pay an additional premium. *Id.* In addition, litigation costs for accounting firms topped 10% of audit income as of September 1992. Telberg, *supra* note 11, at 1.

its own non-profit carrier.¹⁵ Meanwhile, the extent of coverage has steadily eroded.¹⁶

Within this context, it is hardly surprising that more than half of the approximately 7000 accounting firms that are members of the California Society of Certified Public Accountants are uninsured.¹⁷ The Society estimates that due to high insurance premiums and shrinking coverages, forty-one percent of accounting firms no longer perform audits and seventy-six percent will not do audits for forecasts, projections or public offerings.¹⁸ Only five percent of California accounting firms will do any audit work for financial institutions.¹⁹

Although the entire professional liability insurance crisis cannot be attributed to any one factor,²⁰ court decisions expanding auditor liability are one major reason for the current crisis.²¹

Courts have adopted three different rules for determining if a non-client has standing to sue for negligently audited financial statements: (1) the privity rule, which generally allows only clients to recover;²² (2) the foreseeability rule, which allows any reasonably foreseeable party to recover as long as the party reasonably relied on the audit;²³ and (3) the

15. Brief of the California Society of Certified Public Accountants as Amicus Curiae in Support of Appellant at 34. After some insurance companies began to leave the California market, the California Society of Certified Public Accountants created its own carrier, the California Accountants Mutual Insurance Company. *Id.* In addition to the draconian increase in premiums, the scope of coverage has decreased markedly. For example, the maximum coverage of \$5 million per firm fell to \$1 million in 1983 and is now only \$3 million. *Id.*

16. Moreover, policy limits include litigation expenses, which further reduces the extent of coverage. *Id.* at 34-35.

17. See *id.* at 36; see also Denzil Y. Causey, Jr., *Accountants' Liability in an Indeterminate Amount for an Indeterminate Time to an Indeterminate Class: An Analysis of Touche Ross & Co. v. Commercial Union Ins. Co.*, 57 Miss. L.J. 379, 414 (1987) ("Insurance premiums for CPAs have increased by a factor of five since 1984 while deductibles have increased many times over. One out of five CPA firms responding to a recent survey indicated that it had been forced to drop its insurance coverage." (citing *As Accounting Firms Premiums Soar, Some Might Drop Liability Insurance*, WALL ST. J., May 30, 1985, at 17)). But see Mark Nelson, *Risky Business: Professional Liability Exposure on the Rise*, OUTLOOK, Fall 1990, at 36, 37-38 (stating that 40-50% of accounting firms in California are uninsured).

18. Brief of the California Society of Certified Public Accountants as Amicus Curiae in Support of Appellant at 38.

19. *Id.*

20. See generally Kenneth S. Abraham, *Making Sense of the Liability Insurance Crisis*, 48 OHIO ST. L.J. 399 (1987) (describing various factors contributing to liability insurance crisis). Part of the reason that tort liability could increase liability insurance rates is that California "juries tend to compensate victims more readily and generously than other states." Nelson, *supra* note 17, at 38.

21. See Abraham, *supra* note 20, for a discussion of other factors contributing to the liability insurance crisis.

22. See *infra* part II.B.1.a.

23. See *infra* part II.B.1.b.

approach of the *Restatement (Second) of Torts* section 552, which allows an audit's intended beneficiaries to recover.²⁴

In 1986 a California court of appeal adopted the foreseeability rule, holding that an auditor is liable to all those who reasonably and foreseeably rely on an audit opinion.²⁵ This decision expanded the scope of auditor liability in California.²⁶

In *Bily v. Arthur Young & Co.*,²⁷ however, the California Supreme Court rejected the foreseeability rule and created several bright-line rules to limit the scope of an auditor's liability to third parties.²⁸ The court ruled that an accountant's duty of care extends only to his or her client for professional negligence²⁹ and only to an audit's intended beneficiary for negligent misrepresentation.³⁰ The decision did not change the common-law rule that any party who foreseeably relies on a fraudulent representation may recover.³¹

Since the 1960s, the California Supreme Court has fashioned new rules to expand tort liability.³² In fact, since its decision in *Biakanja v. Irving*³³ thirty-five years ago, the court has continually rejected the privity rule for negligence actions against professional suppliers of information.³⁴ *Bily* is a departure from that course. It is a significant decision not merely because it has redrawn the lines of auditor liability to non-client third parties, but, as importantly, it has redefined who will bear the

24. See *infra* part II.B.2.

25. *International Mortgage Co. v. John P. Butler Accountancy Corp.*, 177 Cal. App. 3d 806, 223 Cal. Rptr. 218 (1986), *overruled by* *Bily v. Arthur Young & Co.*, 3 Cal. 4th 370, 834 P.2d 745, 11 Cal. Rptr. 2d 51, *modified*, 3 Cal. 4th 1049a (1992).

26. See Ann Simmons, *International Mortgage Co. v. John P. Butler Accountancy Corp.: Third Party Liability—Accountants Beware*, 18 PAC. L.J. 1055, 1066 (1987).

27. 3 Cal. 4th 370, 834 P.2d 745, 11 Cal. Rptr. 2d 51, *modified*, 3 Cal. 4th 1049a (1992).

28. *Id.* at 416, 834 P.2d at 774, 11 Cal. Rptr. 2d at 80.

29. *Id.* at 406, 834 P.2d at 767, 11 Cal. Rptr. 2d at 73.

30. *Id.* at 408, 834 P.2d at 768, 11 Cal. Rptr. 2d at 74. Language in the opinion was so strong that "it startled even officials at the California Society of CPAs." Telberg, *supra* note 11, at 41.

31. *Bily*, 3 Cal. 4th at 415, 834 P.2d at 773, 11 Cal. Rptr. 2d at 79.

32. Stephen R. Barnett, *The Rose Bird Myth*, CAL. LAW., Aug. 1992, at 85; see also *Sindell v. Abbott Labs.*, 26 Cal. 3d 588, 607 P.2d 924, 163 Cal. Rptr. 132 (holding defendant manufacturers liable based on their market share), *cert. denied*, 449 U.S. 912 (1980); *Greenman v. Yuba Power Prods.*, 59 Cal. 2d 57, 377 P.2d 897, 27 Cal. Rptr. 697 (1963) (holding manufacturer strictly liable in tort to third party when defective product put into market causes injury); *Biakanja v. Irving*, 49 Cal. 2d 647, 320 P.2d 16 (1958) (holding notary public liable to nonclient third party for negligence).

33. 49 Cal. 2d 647, 320 P.2d 16 (1958).

34. See *id.* at 650, 320 P.2d at 19 (adopting balancing test to determine whether nonclient third parties may sue notary public for negligence); see also *Goodman v. Kennedy*, 18 Cal. 3d 335, 342, 556 P.2d 737, 742, 134 Cal. Rptr. 375, 380 (1976) (applying balancing test of policy factors to determine whether nonclient third parties may sue attorney for negligence).

cost associated with third-party use of the audit report.³⁵ One commentator has noted that *Bily* is likely to fundamentally change the manner in which accountants, and those who rely on audited financial statements, do business.³⁶ For example, before the *Bily* decision, a reasonably foreseeable third party could sue an auditor for negligence.³⁷ To pay for the expenses associated with exposure to liability, auditors presumably absorbed the costs or passed them on to their clients. After *Bily*, the burden of financial responsibility shifted.³⁸ To recover damages, a third party who intends to rely on audited financial statements must inform the auditor about its intended reliance and the nature of the contemplated transaction.³⁹

This Note explains the nature and functions of an audit and presents the divergent approaches courts have taken to define the group of persons to whom auditors owe a duty of care.⁴⁰ Next, it discusses the California Supreme Court's opinion in *Bily v. Arthur Young & Co.* and its implications on auditor liability to third parties.⁴¹ Finally, this Note recommends that the California Legislature codify *Bily* and the standards of care developed within the accounting profession.

II. BACKGROUND

A. The Audit Process

1. Financial statements

Before an audit is performed, the client gives the auditor a copy of its financial statements, which portray assets, liabilities and equity.⁴² Fi-

35. See *infra* part IV.B.1. In this respect, *Bily* is consistent with other recent California Supreme Court decisions. One commentator has noted that:

The present court has slowed the steady growth of expanding liability, damages and insurance coverage. In part, this appears to be based upon recognition that greater tort and insurance remedies entail corresponding costs to the community, often in the form of higher prices or decreased availability of beneficial products and services.

Ellis Horvitz, *An Analysis of Recent California Supreme Court Developments in Tort and Insurance Law: The Common-Law Tradition*, 26 LOY. L.A. L. REV. 1145 (1993).

36. M. Laurence Popofsky et al., *The Professional Community Can Sigh with Relief for 'Bily,'* L.A. DAILY J., Oct. 27, 1992, at 7. For a discussion of *Bily*'s ramifications on commercial transactions, see *infra* part V.A.1.

37. See, e.g., *International Mortgage Co. v. John P. Butler Accountancy Corp.*, 177 Cal. App. 3d 806, 820, 223 Cal. Rptr. 218, 227 (1986) (holding that reasonably foreseeable third parties could recover against accountant for negligence), *overruled by* *Bily v. Arthur Young & Co.*, 3 Cal. 4th 370, 834 P.2d 745, 11 Cal. Rptr. 2d 51, *modified*, 3 Cal. 4th 1049a (1992).

38. See *infra* part IV.B.1.

39. See *infra* part IV.B.1.

40. See *infra* part II.

41. See *infra* part III.

42. Dan L. Goldwasser, *Glossary of Terms*, in ACCOUNTANTS' LIABILITY 1992, at 73, 77 (Dan L. Goldwasser ed. 1992).

financial statements do not contain records of every financial transaction and are not meant to include all information investors and creditors may find pertinent.⁴³ If they did, they would be too unwieldy to be useful.⁴⁴ Additionally, although financial statements are a compilation of numbers, they do not necessarily reflect exact values.⁴⁵ Analysis of financial statements, therefore, depends on the informed professional judgment of the auditor.⁴⁶

Even though an auditor may be held liable for negligently auditing a client's financial statements, courts have long recognized that the client, and not the auditor, is responsible for the accuracy and adequacy of representations made in the financial statements.⁴⁷ If a client has "cooked its books,"⁴⁸ the auditor generally cannot be held liable for failing to detect material misrepresentations in them as long as the auditor complied with professional standards.⁴⁹

2. The audit

Before an audit begins, the accountant usually prepares an "engagement letter" that specifies the duties and responsibilities of the parties.⁵⁰ During an audit, the auditor examines the client's tangible assets, confirms account balances, and traces⁵¹ and vouches⁵² transactions. In addition, the auditor scrutinizes internal controls for weaknesses based on evidence acquired from statistical sampling, and seeks to ensure that no

43. *United States v. Weiner*, 578 F.2d 757 (9th Cir.) (stating that financial statements summarize financial position rather than recite all information third parties might want to know before lending or investing), *cert. denied*, 439 U.S. 981 (1978); Carl D. Liggio, *The Expectation Gap: The Accountant's Legal Waterloo?*, 3 J. CONTEMP. BUS. 27, 38 (1974).

44. One commentator has noted that an overabundance of information in financial statements would lead to "a hopeless morass of irrelevant data . . . from which one will be unable to draw any logical conclusions." Liggio, *supra* note 43, at 38.

45. *Id.*

46. *Id.* at 30.

47. *See SEC v. Bangor Punta Corp.*, 331 F. Supp. 1154 (S.D.N.Y. 1971), *cert. denied*, 414 U.S. 924 (1973).

48. In other words, a client intentionally overstates its assets or understates its liabilities.

49. Although this is the general rule, there are exceptions. For example, in *Bily*, even though the auditors complied with professional standards, they were held to different standards, which were articulated in their internal auditing manuals. *See infra* part IV.B.2.

50. GEORGE SPELLMIRE ET AL., ACCOUNTANTS LEGAL LIABILITY GUIDE 1.16 (1990); Travis M. Dodd, Comment, *Accounting Malpractice and Contributory Negligence: Justifying Disparate Treatment Based Upon the Auditor's Unique Role*, 80 GEO. L.J. 909, 913 (1992).

51. Tracing is the process whereby an auditor tracks a particular transaction through the client's accounting and bookkeeping process to determine whether it has been properly accounted for and recorded. Willis W. Hagen II, *Certified Public Accountants' Liability for Malpractice: Effect of Compliance with GAAP and GAAS*, 13 J. CONTEMP. L. 65, 67 n.15 (1987).

52. Vouching is the process of determining whether transactions are supported by the underlying data. *Id.*

material misrepresentations exist in the client's financial statements.⁵³ In this endeavor, an auditor rarely reviews every recorded transaction.⁵⁴ To do so would be prohibitively expensive and would not significantly improve the reliability of the audit.⁵⁵ For this reason, planning and executing the audit depends on the auditor's professional skill and judgment.⁵⁶

3. The auditor's role

Creditors and investors often use audit reports.⁵⁷ The capital-seeking audit client hopes the opinion will add to its financial statements the credibility necessary to gain access to financial markets.⁵⁸

At one time, accountants were not considered to have any special responsibility to the general public.⁵⁹ More recently, however, the United States Supreme Court compared auditors to watchdogs to emphasize their public responsibility.⁶⁰ Thus, while clients commission audits, the auditor's role transcends that of an employee or independent contractor. An auditor is required to maintain a degree of independence.⁶¹

53. *Id.* at 67, 68 n.21.

54. *Bily v. Arthur Young & Co.*, 3 Cal. 4th 370, 380, 834 P.2d 745, 749, 11 Cal. Rptr. 2d 51, 55, *modified*, 3 Cal. 4th 1049a (1992).

55. *See id.*

56. *Id.*

57. *See infra* note 62.

58. *See infra* note 62.

59. In his majority opinion in *Ultramares Corp. v. Touche*, Judge Cardozo argued that accountants are public "only in the sense that their services are offered to any one who chooses to employ them," not in the sense that the "services [are] rendered in the pursuit of an independent calling, characterized as public" and giving rise to the duty of care for the public's benefit. 174 N.E. 441, 448 (N.Y. 1931).

60. *United States v. Arthur Young & Co.*, 465 U.S. 805, 817-18, *cert. denied*, 466 U.S. 936 (1984). Accountants bitterly oppose this characterization. Nelson, *supra* note 17, at 46. One commentator noted that characterizing auditors as watchdogs "almost assumes that we have a responsibility to the entire world—that there could be an infinite number of potential plaintiffs." *Id.* at 44 (quoting Wanda Ginner, former Chair, California Society of CPAs Amicus Curiae Brief Task Force). In addition, Ms. Ginner noted that "you can't operate in the business world with that kind of uncertainty." *Id.* (quoting Wanda Ginner, former Chair, California Society of CPAs Amicus Curiae Brief Task Force).

61. *Arthur Young & Co.*, 465 U.S. at 817-18.

Because third parties use and rely on audit reports,⁶² auditors are vulnerable to suits by them.⁶³ Significantly, some defenses the auditor may use against the client—such as contributory negligence and comparative negligence—may not be used against third parties.⁶⁴ Thus, an auditor's potential liability to third parties may be far greater than the risk he or she faces from a client.⁶⁵

4. The audit report

At the conclusion of an audit, an auditor will issue an opinion or audit report. The report states whether the client's financial statements, taken as a whole, fairly represent the client's financial condition.⁶⁶ There are four types of audit reports: (1) an unqualified, or "clean," opinion;⁶⁷

62. See *Bily v. Arthur Young & Co.*, 3 Cal. 4th 370, 383, 834 P.2d 745, 751, 11 Cal. Rptr. 2d 51, 57, *modified*, 3 Cal. 4th 1049a (1992). Audits are "a principle means of communicating accounting information to those outside an enterprise." *Id.* (quoting Statement of Financial Accounting Concepts of the Financial Accounting Standards Board of the AICPA No. 1, ¶ 6, at 7); see also CAL. BUS. & PROF. CODE § 5051(d) (West 1990) (stating that accounting practice involves auditing third-party financial statements for purposes of obtaining credit). See generally John S. Dzienkowski, *Accountants' Liability for Compilation and Review Engagements*, 60 TEX. L. REV. 759, 773 (1982) (stating that third parties are primary users of audit reports).

63. See Nelson, *supra* note 17, at 44.

64. SPELLMIRE ET AL., *supra* note 50, at 1.14.

65. *Id.*

66. John A. Siliciano, *Negligent Accounting and the Limits of Instrumental Tort Reform*, 86 MICH. L. REV. 1929, 1931 (1988). Under California law, an auditor is required to give an opinion on a client's financial statements:

This rule applies to the accountant's report issued in connection with examinations of financial statements that are intended to present financial position, results of operations and changes in financial position in conformity with generally accepted accounting principles. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons should be stated.

CAL. CODE REGS. tit. 16, § 58.1 (1990).

67. An unqualified opinion will state "[t]he financial statements present fairly the financial position, results of operations and changes in financial position in conformity with generally accepted accounting principles consistently applied." Sturm, *supra* note 4, at 161 (quoting American Institute of Certified Public Accountants, *Statements on Accounting and Review No. 1* (codified in AICPA 2 Professional Standards § 509.28 (CCH 1984))).

(2) a qualified opinion;⁶⁸ (3) an adverse opinion;⁶⁹ and (4) a disclaimer of opinion.⁷⁰

Although a "clean" opinion means the auditor reasonably believes the financial statements fairly present the client's financial condition, it does not mean that the client has been issued a "clean bill of health."⁷¹ Nor does an audit report expressly guarantee that the audited financial statements accurately reflect the client's financial situation.⁷² Rather, the audit report simply means that the audit has been conducted in accordance with the relevant auditing and accounting standards and the auditor therefore believes that the client's financial statements fairly present its financial position.⁷³

5. The expectation gap: Auditing as art or science?

The public and accountants view audits very differently. This rift is called the "expectation gap."⁷⁴ The public tends to believe that an auditor has the duty to search for and detect fraud.⁷⁵ Although an auditor may be engaged specifically to search for fraud, in the usual engagement the auditor is hired merely to uncover "errors and irregularities" in the client's financial statements.⁷⁶ Although the detection of fraud may be a

68. An auditor issues a qualified opinion if the auditor lacks sufficient evidence to unconditionally support the client's financial statements or if the audit was limited in scope. *Id.*

69. An auditor issues an adverse opinion if there have been material departures from generally accepted accounting principles (GAAP), or if the auditor is uncertain whether the financial statements, taken as a whole, have been presented in conformity with GAAP. *Id.* See *infra* part II.A.6 for a discussion of GAAP and GAAS.

70. An auditor issues a disclaimer of opinion if he or she lacks enough information to form an opinion or knows of any material departures from GAAP. Sturm, *supra* note 4, at 161.

71. Dodd, *supra* note 50, at 915 & n.32. An auditor may issue a clean report even if the financial statements show that the client is losing money. Thus, a client can become insolvent despite being issued a clean audit report. *Id.*

72. *See id.*

73. *See id.*

74. Kean K. McDonald, *Accountants' Liability to Third Parties: Unmanageable Risks of Foreseeability*, 57 DEF. COUNS. J. 194, 197 (1990). Although the expectation gap presents a significant problem between auditors and the public, there generally exists no expectation gap between an auditor and third-party investor or creditor. The *Bily* court said these third parties "often possess considerable sophistication in analyzing financial information and are aware from training and experience of the limits of an audit report . . . that is . . . simply a broadly phrased professional opinion based on a necessarily confined examination." *Bily v. Arthur Young & Co.*, 3 Cal. 4th 370, 403, 834 P.2d 745, 765, 11 Cal. Rptr. 2d 51, 71, *modified*, 3 Cal. 4th 1049a (1992).

75. McDonald, *supra* note 74, at 197; Chaffee, *supra* note 7, at 880-81.

76. *See* Chaffee, *supra* note 7, at 881.

by-product of the audit, fraud actively concealed by a client can be difficult to detect due to the inherent limitations of the audit process.⁷⁷

In addition, the public often believes that auditors who issue "clean" opinions guarantee a client's financial health as well as the prudence of investment and loan decisions.⁷⁸ This is simply not the case.

Even though audited financial statements present a composite of numbers that reflect exact values, they are estimations that represent the independent judgment of an auditor who applied professionally-accepted accounting conventions such as sampling.⁷⁹ Consequentially, auditing is more than a "'mathematical exercise.'"⁸⁰ In reality, an audit is more akin to art than science.

6. Professional standards

Auditors are expected to use the skill, care and competence exercised by reasonably competent accountants under similar circumstances.⁸¹ Auditors also must comply with formal standards established within the profession: generally accepted accounting principles (GAAP) and generally accepted auditing standards (GAAS).⁸² GAAP is a compilation of rules and procedures that define how financial information should be presented.⁸³ GAAS are principles designed to guide the audit

77. See McDonald, *supra* note 74, at 198. One commentator described how a client could perpetrate and hide a fraud from an auditor:

[A] company that wants to overstate its assets could either increase its accounts receivable by creating false sales documents or effectuate a double counting of the inventory by transferring goods between locations during the observation phase of the audit. In both cases, either by testing the accounts receivable or by varying the inventory counting tests, an audit may uncover the fraud. On the other hand, as a result of the combination of the auditors' professional judgment and the use of sampling techniques, it is possible for a client's fraudulent misrepresentation to go undetected by auditors despite following techniques that are accepted throughout the profession.

Id. In some situations, a client's fraud may absolve an auditor of liability. For an excellent discussion of the "insider fraud defense" see David B. Newdorf, Comment, *Inside Fraud, Outside Negligence and the Savings & Loan Crisis: When Does Management Wrongdoing Excuse Professional Malpractice?*, 26 LOY. L.A. L. REV. 1165 (1993).

78. Liggio, *supra* note 43, at 28.

79. *Id.* at 29. See *infra* part II.A.6 for a discussion of GAAP and GAAS.

80. Liggio, *supra* note 43, at 29 (quoting Phillip A. Loomis, Commissioner, SEC).

81. *Lindner v. Barlow, Davis & Wood*, 210 Cal. App. 2d 660, 665, 27 Cal. Rptr. 101, 104 (1962); George Donaldson, *Accountants Liability: Professional Standards and the Securities Laws*, TRIAL, Feb. 1987, at 38, 38.

82. Donaldson, *supra* note 81; see CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES, Statement on Auditing Standards No. 1, § 150 (Am. Inst. of Certified Pub. Accountants 1972) (GAAS); RESEARCH AND DEVELOPMENT ARRANGEMENTS, Statement of Financial Accounting Standards No. 68, § 32 (Fin. Accounting Standards Bd. 1982) (GAAP).

83. Donaldson, *supra* note 81, at 38.

process.⁸⁴ Specifically, GAAS governs how an auditor should obtain information for the audit report.

Courts generally hold that an auditor meets the requisite standard of care if he or she has complied with GAAS and GAAP.⁸⁵ However, one court has held that GAAP and GAAS do not exclusively define the standard of care.⁸⁶ Failure to comply with GAAP or GAAS is not negligence per se,⁸⁷ but a showing that an auditor failed to comply with GAAP or GAAS is strong evidence of a breach.⁸⁸ Likewise, a material misstatement may also create an inference that the auditor breached the standard of care.⁸⁹

B. *Defining to Whom an Auditor Owes a Duty*

1. Common law

An accountant cannot be held liable to a plaintiff absent a duty of care flowing to the plaintiff. Courts have adopted three different rules defining those to whom an auditor owes a duty of care: (1) privity; (2) foreseeability; and (3) the *Restatement (Second) of Torts*.

a. *privity*

In the landmark case of *Ultramares Corp. v. Touche*,⁹⁰ the New York high court was asked to determine whether an auditor could be held liable to a nonclient for negligently-audited financial statements that caused only intangible economic injury. In Chief Judge Benjamin Cardozo's famous opinion, the court upheld a privity of contract requirement, holding that auditors owe a duty of care only to those who contract for their services.⁹¹

Driving Judge Cardozo's analysis in *Ultramares* was the recognition that the accounting profession was uniquely exposed to potentially limitless liability from third parties.⁹² Judge Cardozo feared auditors would

84. William J. Casazza, Rosenblum, Inc. v. Adler: *CPAs Liable at Common Law to Certain Reasonably Foreseeable Third Parties Who Detrimentially Rely on Negligently Audited Financial Statements*, 70 CORNELL L. REV. 335, 337-38 (1985).

85. *Id.* at 339 (citing William H. Voltz, *Accountant's Liability to Third Persons: Resistance in Negligence*, 9 BARRISTER, Fall 1982, at 31, 33).

86. *Bily v. Arthur Young & Co.*, 7 Cal. App. 4th 1636, 1646, 271 Cal. Rptr. 470, 474 (1990), *rev'd on other grounds*, 3 Cal. 4th 370, 834 P.2d 745, 11 Cal. Rptr. 2d 51, *modified*, 3 Cal. 4th 1049a (1992).

87. Dodd, *supra* note 50, at 918.

88. *Id.* at 919.

89. *Id.*

90. 174 N.E. 441 (N.Y. 1931).

91. *Id.* at 447-48.

92. *Id.* at 444.

face "liability in an indeterminate amount for an indeterminate time to an indeterminate class" for "a thoughtless slip or blunder" simply because of a "failure to detect a theft or forgery beneath the cover of deceptive entries."⁹³

In 1985 the New York Court of Appeals adopted a broader privity requirement than *Ultramares* in *Credit Alliance Corp. v. Arthur Andersen & Co.*⁹⁴ The court held that an auditor owes a duty to nonclients if the auditor's relationship with them "sufficiently approaches privity."⁹⁵

The court identified three prerequisites to establish this privity of relationship: (1) The auditor must know that the audit will be used for a particular purpose; (2) the auditor must act in a way calculated to induce the nonclient's reliance;⁹⁶ and (3) there must be conduct *linking*⁹⁷ the auditor to the party that demonstrates the auditor's understanding of the nonclient's reliance.⁹⁸ While this new rule is more flexible than the strict privity requirement because it allows some nonclients to sue auditors, it does not depart from the principles articulated in *Ultramares*.⁹⁹

At least nine states follow privity rules similar to those announced in either *Ultramares* or *Credit Alliance*.¹⁰⁰ In five of these states, the judiciary has embraced privity.¹⁰¹ In four states, legislatures have enacted privity statutes.¹⁰² In addition, federal courts have applied privity

93. *Id.*

94. 483 N.E.2d 110 (N.Y. 1985). Recently, New York reaffirmed this rule and the controlling principles initially set forth in *Ultramares* in *Security Pacific Business Credit, Inc. v. Peat Marwick Main & Co.*, 597 N.E.2d 1080 (N.Y. 1992).

95. *Credit Alliance*, 483 N.E.2d at 119. This relationship has been called "near privity." See *Bily v. Arthur Young & Co.*, 3 Cal. 4th 370, 384, 834 P.2d 745, 752, 11 Cal. Rptr. 2d 51, 58, *modified*, 3 Cal. 4th 1049a (1992).

96. The New York high court has interpreted this to mean that the auditor must be aware of the "particular purpose" of the audit and act to achieve that purpose. *Security Pacific*, 597 N.E.2d at 1084.

97. The *Bily* court questioned whether the "linking" requirement should be necessary in light of the auditor's knowledge that the audit was undertaken to benefit the third party. *Bily*, 3 Cal. 4th at 387-88, 834 P.2d at 754-55, 11 Cal. Rptr. 2d at 60-61.

98. *Credit Alliance*, 483 N.E.2d at 118 (emphasis added).

99. *Id.*

100. *Bily*, 3 Cal. 4th at 388-89, 834 P.2d at 755, 11 Cal. Rptr. 2d at 61. The *Bily* court noted that the more recent cases have adopted the rule articulated in *Credit Alliance*. *Id.*

101. *Id.* These states are: Alabama, *Colonial Bank v. Ridley & Schweigert*, 551 So. 2d 390 (Ala. 1989); Idaho, *Idaho Bank & Trust Co. v. First Bancorp.*, 772 P.2d 720 (Idaho 1989); Nebraska, *Citizens Nat'l Bank v. Kennedy & Coe*, 441 N.W.2d 180 (Neb. 1989); New York, *Credit Alliance*, 483 N.E.2d 110; and Pennsylvania, *Landell v. Lybrand*, 107 A. 783 (Pa. 1919).

102. *Bily*, 3 Cal. 4th at 388-89, 834 P.2d at 755, 11 Cal. Rptr. 2d at 61. These states are: Arkansas, ARK. CODE ANN. § 16-114-302 (Michie Supp. 1991); Illinois, ILL. REV. STAT. ch. 111, para. 5535.1 (Supp. 1992); Kansas, KAN. STAT. ANN. § 1-402(b) (1991); and Utah, UTAH CODE ANN. § 58-26-12 (Supp. 1990).

rules in three other states whose high courts have yet to consider the issue.¹⁰³

b. foreseeability

In general, foreseeability permits recovery if the plaintiff's harm was a reasonably foreseeable result of the defendant's conduct.¹⁰⁴ Despite wide acceptance of the foreseeability rule for other torts, New Jersey,¹⁰⁵ Wisconsin¹⁰⁶ and Mississippi¹⁰⁷ are currently the only states that allow recovery in negligence actions against auditors based solely on foreseeability.¹⁰⁸

In 1983 New Jersey became the first United States jurisdiction to adopt the reasonable foreseeability standard in *H. Rosenblum, Inc. v. Adler*.¹⁰⁹ The court premised its holding on the availability of insurance,¹¹⁰ the opinion that liability would deter negligent audits¹¹¹ and the belief that the auditor was in the best position to spread the risks of financial losses.¹¹²

Before *Bily*, one district of the California Court of Appeal adopted the foreseeability rule.¹¹³ The court in *International Mortgage Co. v. John P. Butler Accountancy Corp.*¹¹⁴ ruled that accountants could be held liable to third parties who reasonably and foreseeably relied on negligently audited financial statements.¹¹⁵ The court noted that the public policy factors it had articulated in *Biakanja v. Irving*¹¹⁶ supported a foreseeability rule.¹¹⁷

103. *Bily*, 3 Cal. 4th at 388-89, 834 P.2d at 755, 11 Cal. Rptr. 2d at 61. Cases from these states include: *Ackerman v. Schwartz*, 947 F.2d 841 (7th Cir. 1991) (applying Indiana law); *McLean v. Alexander*, 599 F.2d 1190, 1202 (3d Cir. 1979) (applying Delaware law); *Stephens Indus. v. Haskins & Sells*, 438 F.2d 357 (10th Cir. 1971) (applying Colorado law).

104. *MacPherson v. Buick Motor Co.*, 111 N.E. 1050, 1054-55 (N.Y. 1916).

105. *H. Rosenblum, Inc. v. Adler*, 461 A.2d 138 (N.J. 1983).

106. *Citizens State Bank v. Timm, Schmidt & Co.*, 335 N.W.2d 361 (Wis. 1983).

107. *Touche Ross & Co. v. Commercial Union Ins. Co.*, 514 So. 2d 315 (Miss. 1987).

108. *Bily*, 3 Cal. 4th at 390-91, 834 P.2d at 756-57, 11 Cal. Rptr. 2d at 62-63.

109. 461 A.2d 138 (N.J. 1983).

110. *Id.* at 151.

111. *Id.* at 152.

112. *Id.*

113. *International Mortgage Co. v. John P. Butler Accountancy Corp.*, 177 Cal. App. 3d 806, 223 Cal. Rptr. 218 (1986), *overruled by Bily v. Arthur Young & Co.*, 3 Cal. 4th 370, 834 P.2d 745, 11 Cal. Rptr. 2d 51, *modified*, 3 Cal. 4th 1049a (1992).

114. *Id.*

115. *Id.*

116. 49 Cal. 2d 647, 320 P.2d 16 (1958). For a discussion of those factors, see *infra* notes 170-73 and accompanying text.

117. *Butler*, 177 Cal. App. 3d at 820, 223 Cal. Rptr. at 227.

Some commentators have enthusiastically supported a foreseeability rule, arguing that it serves important policy objectives such as deterrence and cost spreading.¹¹⁸ However, only the *Rosenblum* court has predicated its adoption of the foreseeability rule on the availability of insurance, the prospects of deterrence and the efficiency in spreading the risk.

2. The *Restatement* approach

The *Restatement (Second) of Torts* approach allows recovery by a "limited group" of nonclients, provided they qualify as an audit's intended beneficiary.¹¹⁹ An intended beneficiary is a third party whom the auditor intends to influence for a particular type of transaction.¹²⁰ However, if an auditor "merely knows of the ever-present possibility of repetition to anyone," the auditor will bear no legal responsibility to the nonclient for his or her negligence.¹²¹

In adopting this rule, the American Law Institute (ALI) reasoned that allowing all foreseeable nonclients to sue could cause accountants

118. See, e.g., Howard B. Wiener, *Common Law Liability of the Certified Public Accountant for Negligent Misrepresentation*, 20 SAN DIEGO L. REV. 233, 256 (1983) (stating that imposition of liability deters negligence and compensates injured parties).

119. RESTATEMENT (SECOND) OF TORTS § 552 (1977).

120. *Id.* § 552(2)(b). The *Restatement* provides:

(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.

Id.

121. *Bily v. Arthur Young & Co.*, 3 Cal. 4th 370, 409-10, 834 P.2d 745, 770, 11 Cal. Rptr. 2d 51, 75 (quoting RESTATEMENT (SECOND) OF TORTS § 552 cmt. h (1977)), *modified*, 3 Cal. 4th 1049a (1992).

In many situations the identity of the person for whose guidance the information is supplied is of no moment to the person who supplies it, although the number and character of the persons to be reached and influenced, and the nature and extent of the transaction for which guidance is furnished may be vitally important. This is true because the risk of liability to which the supplier subjects himself by undertaking to give the information, while it may not be affected by the identity of the person for whose guidance the information is given, is vitally affected by the number and character of the persons, and particularly the nature and the extent of the proposed transaction.

RESTATEMENT (SECOND) OF TORTS, *supra* note 119, § 552 cmt. h.

significant losses.¹²² The ALI feared that auditors would respond to broad liability by reducing audit services, thereby restricting the flow of information "upon which the operation of the economy rests."¹²³ The ALI also justified its approach on the ground that financial loss is substantially different from property or physical injury that results from other types of negligence.¹²⁴ These rationales echo the concerns that Judge Cardozo expressed in *Ultramares Corp. v. Touche*—that foreseeable liability is unfair because it is limitless.¹²⁵

The *Restatement* approach is more expansive than the *Credit Alliance* rule because it does not require a link between the auditor and the third party as a prerequisite to recovery. As a result, more third parties have standing to sue the auditor under the *Restatement*. Many jurisdictions favor the approach taken in the *Restatement*, viewing it as "a satisfactory compromise between their discomfort with the traditional privity approach and the 'specter of unlimited liability' " of the foreseeability rule.¹²⁶

III. *BILY V. ARTHUR YOUNG & CO.*¹²⁷

A. *The Facts*

In 1980 Osborne Computer Corporation was formed, becoming the first company to manufacture portable personal computers.¹²⁸ Two years later, sales of its only product, the Osborne I Computer, had reached \$10 million per month, making it one of the fastest growing companies in the history of American business.¹²⁹

In order to raise capital for its continued growth, Osborne contemplated and began planning for a public offering.¹³⁰ In preparation, it engaged Arthur Young & Company to audit its 1981 and 1982 financial statements.¹³¹ In early 1983, Arthur Young completed its audit and is-

122. *See id.* cmt. a.

123. *Id.*

124. *Id.*

125. 174 N.E. 441, 448 (N.Y. 1931).

126. RESTATEMENT (SECOND) OF TORTS, *supra* note 119, § 552; *Bily v. Arthur Young & Co.*, 3 Cal. 4th 370, 394, 834 P.2d 745, 759, 11 Cal. Rptr. 2d 51, 65 (quoting *Briggs v. Sterner*, 529 F. Supp. 1155, 1177 (S.D. Iowa 1981)), *modified*, 3 Cal. 4th 1049a (1992).

127. 3 Cal. 4th 370, 834 P.2d 745, 11 Cal. Rptr. 2d 51, *modified*, 3 Cal. 4th 1049a (1992).

128. *Id.* at 376, 834 P.2d at 747, 11 Cal. Rptr. 2d at 53.

129. *Id.*

130. *Id.*

131. *Id.* at 377, 834 P.2d at 747, 11 Cal. Rptr. 2d at 53. Arthur Young's audit of Osborne was performed years before any court in the United States had applied the foreseeability rule to cases alleging accountant negligence. Arthur Young therefore had no reason to believe that it might be held liable to unknown third parties.

sued an unqualified audit opinion.¹³² One hundred duplicates of the opinion were hand-delivered to Osborne.¹³³

At the suggestion of its three investment banking underwriters, and for reasons unrelated to the audit, Osborne delayed its initial public offering.¹³⁴ Because of the delay, it needed operating capital to continue its basic operations until the public offering could take place.¹³⁵ Using Arthur Young's clean audit report,¹³⁶ Osborne solicited investors to provide direct loans or letters of credit as security for bank loans.¹³⁷ In return, Osborne issued warrants to the investors entitling them to buy Osborne stock at a price that was expected to return a sizable profit if and when the offering took place.¹³⁸ Osborne acquired additional capital by selling stock held by a major shareholder.¹³⁹

As the transactions closed, Osborne's "performance began to falter."¹⁴⁰ Poor business planning and strong competition from IBM derailed the public offering.¹⁴¹ Starved for capital, Osborne eventually fell into insolvency, and the investor-creditors lost all of their money.¹⁴² Later, the investors discovered weaknesses in Osborne's internal accounting procedures.¹⁴³ In spite of these weaknesses, Arthur Young's 1982

132. *Id.* at 377, 834 P.2d at 748, 11 Cal. Rptr. 2d 54. See *supra* part II.A.4 for a description of the audit report.

133. *Bily*, 3 Cal. 4th at 377, 834 P.2d at 748, 11 Cal. Rptr. 2d at 54. The dissent implicitly recognized the significance of the fact that Arthur Young delivered 100 copies of the audit report to Osborne, see *id.* at 417, 834 P.2d at 774, 11 Cal. Rptr. 2d at 80 (Kennard, J., dissenting), and noted that audits are frequently performed so that the client may solicit an investment or loan. *Id.* at 420, 834 P.2d at 776, 11 Cal. Rptr. 2d at 82 (Kennard, J., dissenting). Justice Kennard argued that liability should flow from such knowledge, *id.*, 834 P.2d at 776-77, 11 Cal. Rptr. 2d at 82-83 (Kennard, J., dissenting), and that policy considerations supported liability, *id.* at 420-30, 834 P.2d at 777-83, 11 Cal. Rptr. 2d at 83-89 (Kennard, J., dissenting). Arthur Young anticipated that concern and argued: "[F]or all it appears, the 100 copies of the audited financial statements approximates the Osborne shareholders, senior employees and other 'insiders' who would be expected to receive copies of the financial statements, and no evidence cited or of record suggests otherwise." Petition for Review at 6.

134. *Bily*, 3 Cal. 4th at 376-77, 834 P.2d at 747, 11 Cal. Rptr. 2d at 53. The offering was delayed in part because of concerns associated with Osborne's new CEO and plans to replace the Osborne I computer. *Id.*

135. *Id.*

136. *Id.* at 377, 834 P.2d at 747, 11 Cal. Rptr. 2d at 53.

137. *Id.*

138. *Id.*

139. *Id.*

140. *Id.* at 378, 834 P.2d at 747, 11 Cal. Rptr. 2d at 53.

141. *Id.*

142. *Id.*

143. *Id.* at 377, 834 P.2d at 748, 11 Cal. Rptr. 2d at 54.

audit showed a \$69,000 profit, although losses actually exceeded \$3 million.¹⁴⁴

The stock and warrant investors sued Arthur Young for fraud, negligence and negligent misrepresentation.¹⁴⁵ After a lengthy trial, the jury was instructed, pursuant to the foreseeability standard of *Butler*,¹⁴⁶ that "an accountant owes a . . . duty of care to those third parties who reasonably and foreseeably [sic] rely on an audited financial statement prepared by the accountant."¹⁴⁷ Based on this language, the jury found Arthur Young liable for over \$4 million for professional negligence.¹⁴⁸

The California Court of Appeal readily acknowledged that if the trial court had applied either the privity or the *Restatement* rules, the plaintiff-investors and lenders would not have been able to recover because Arthur Young would not have owed them a duty.¹⁴⁹ The appellate court also held that the jury correctly considered Arthur Young's internal auditing manuals in determining whether Arthur Young fulfilled its professional duties under GAAP and GAAS.¹⁵⁰ This ruling allowed the jury to consider standards of care independent of those established by GAAS or GAAP.¹⁵¹

Before the California Supreme Court, Arthur Young argued that the state's adherence to a foreseeability standard would place it alone among the major common-law commercial jurisdictions that had considered the issue since *Butler*.¹⁵² With the exception of Mississippi,¹⁵³ the scope of duty announced in *Butler* had been uniformly rejected in all eighteen American jurisdictions that had considered the issue since *But-*

144. *Id.* at 378, 834 P.2d at 748, 11 Cal. Rptr. 2d at 54.

145. *Id.* at 379, 834 P.2d at 748, 11 Cal. Rptr. 2d at 54.

146. *International Mortgage Co. v. John P. Butler Accountancy Corp.*, 177 Cal. App. 3d 806, 223 Cal. Rptr. 218 (1986), *overruled by* *Bily v. Arthur Young & Co.*, 3 Cal. 4th 370, 834 P.2d 745, 11 Cal. Rptr. 2d 51, *modified*, 3 Cal. 4th 1049a (1992). See *supra* part II.B.1.b for a discussion of the foreseeability rule.

147. *Bily*, 3 Cal. 4th at 379, 834 P.2d at 749, 11 Cal. Rptr. 2d at 55.

148. *Id.* Not all plaintiffs, however, were able to show reliance on the report, which was necessary in order to recover. *Id.* at 378 n.2, 834 P.2d at 748 n.2, 11 Cal. Rptr. 2d at 54 n.2.

149. *Bily v. Arthur Young & Co.*, 7 Cal. App. 4th 1636, 1650, 271 Cal. Rptr. 470, 477 (1990), *rev'd*, 3 Cal. 4th 370, 834 P.2d 745, 11 Cal. Rptr. 2d 51, *modified*, 3 Cal. 4th 1049a (1992).

150. *Id.*

151. *Id.*

152. 177 Cal. App. 3d 806, 223 Cal. Rptr. 218; Petition for Review at 1; see *supra* notes 25-26 and accompanying text.

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

ler.¹⁵⁴ After balancing competing policy considerations, the California Supreme Court reversed, thus rejecting the foreseeability rule.

B. The Reasoning of the Court

Bily marks a significant shift in how California courts treat auditor liability to third parties. The California Supreme Court's opinion limits the duty owed by an auditor to reasonably foreseeable third parties who rely on negligently audited financial statements with respect to three different torts: negligence, negligent misrepresentation and fraud.¹⁵⁵ The court concluded that for each tort a different duty applied.

1. Negligence

To support their argument that a duty should extend to those other than the client in auditor liability cases, the plaintiffs analogized to products liability cases, in which courts have found that a duty extends beyond the client.¹⁵⁶ The court rejected this comparison for several reasons. First, a manufacturer exercises complete control over the design and manufacture of its product,¹⁵⁷ whereas an auditor merely expresses an opinion about financial statements that the client provided.¹⁵⁸

Additionally, the court recognized that third parties in auditor liability cases tend to be more sophisticated than third parties in products liability cases.¹⁵⁹ The court noted that those who read and rely on audit reports prior to investing or lending money tend to "possess considerable

154. See *Bank of New Orleans & Trust Co. v. Monco Agency, Inc.*, 719 F. Supp. 1328 (E.D. La. 1989), *aff'd sub nom.* *First Nat'l Bank of Commerce v. Monco Agency, Inc.*, 911 F.2d 1053 (5th Cir. 1990); *Frymire v. Peat, Marwick, Mitchell & Co.*, 657 F. Supp. 889 (N.D. Ill. 1987); *Toro Co. v. Krouse, Kern & Co.*, 644 F. Supp. 986 (N.D. Ind. 1986), *aff'd*, 827 F.2d 155 (7th Cir. 1987); *Robertson v. White*, 633 F. Supp. 954 (W.D. Ark. 1986); *Colonial Bank v. Ridley & Schweigert*, 551 So. 2d 390 (Ala. 1989); *First Florida Bank v. Max Mitchell & Co.*, 558 So. 2d 9 (Fla. 1990); *Badische Corp. v. Caylor*, 356 S.E.2d 198 (Ga. 1987); *Idaho Bank & Trust Co. v. First Bancorp.*, 772 P.2d 720 (Idaho 1989); *Pahre v. Auditor of State*, 422 N.W.2d 178 (Iowa 1988); *Law Offices of Lawrence J. Stockler v. Rose*, 436 N.W.2d 70, 81-82 (Mich. Ct. App. 1989); *Thayer v. Hicks*, 793 P.2d 784 (Mont. 1990); *Citizens Nat'l Bank v. Kennedy & Coe*, 441 N.W.2d 180 (Neb. 1989); *Security Pac. Business Credit, Inc. v. Peat Marwick Main & Co.*, 597 N.E.2d 1080 (N.Y. 1992); *Raritan River Steel Co. v. Cherry, Bekaert & Holland*, 367 S.E.2d 609 (N.C. 1988); *Bethlehem Steel Corp. v. Ernst & Whinney*, 822 S.W.2d 592 (Tenn. 1991); *Haberman v. Washington Pub. Power Supply Sys.*, 744 P.2d 1032 (1987), *modified*, 750 P.2d 254 (Wash.), *appeal dismissed*, 488 U.S. 805 (1988); *First Nat'l Bank v. Crawford*, 386 S.E.2d 310 (W. Va. 1989).

155. *Bily*, 3 Cal. 4th at 376, 834 P.2d at 747, 11 Cal. Rptr. 2d at 53.

156. *Id.* at 401, 834 P.2d at 764, 11 Cal. Rptr. 2d at 70.

157. *Id.*

158. *Id.*

159. *Id.* at 403, 834 P.2d at 765, 11 Cal. Rptr. 2d at 71.

sophistication in analyzing financial information.”¹⁶⁰ These individuals therefore know an audit report is simply a professional opinion based on a limited examination.¹⁶¹ The “presumptively powerless consumer”¹⁶² in the products liability case, who is unable to contractually allocate risk with the manufacturer, stands in stark contrast to the investor or lender who can contract with the auditor.¹⁶³ Therefore, it is improper to analogize auditor liability to products liability.

Finally, the court held that as a matter of policy third parties should protect themselves by relying “on their own prudence, diligence, and contracting power, as well as other information tools,” rather than on tort law.¹⁶⁴ The court stated that this policy “promotes sound investment and credit practices and discourages the careless use of monetary resources.”¹⁶⁵ In addition, the court explained that if third parties could recover against auditors for negligence, auditors would become insurers of bad loans and investments.¹⁶⁶

Since its decision in *Biakanja v. Irving*,¹⁶⁷ the California Supreme Court has consistently rejected privity as a barrier to negligence actions against professional suppliers of information.¹⁶⁸ The court’s decision in *Bily* departs from that course by requiring that plaintiffs establish privity in negligence suits against auditors.¹⁶⁹

160. *Id.*

161. *Id.*

162. *Id.*

163. *Id.* (quoting John A. Siliciano, *Negligent Accounting and the Limits of Instrumental Tort Reform*, 86 MICH. L. REV. 1929, 1956-57 (1988)).

164. *Id.*; see *infra* part III.B.1.b.

165. *Bily*, 3 Cal. 4th at 403, 834 P.2d at 765, 11 Cal. Rptr. 2d at 71.

166. *Id.*

167. 49 Cal. 2d 647, 320 P.2d 16 (1958).

168. See *id.* at 650, 320 P.2d at 19 (adopting balancing test to determine whether nonclient third parties may sue notary public for negligence); see also *Goodman v. Kennedy*, 18 Cal. 3d 335, 342, 556 P.2d 737, 742, 134 Cal. Rptr. 375, 380 (1976) (applying balancing test of policy factors to determine whether nonclient third parties may sue attorney for negligence).

169. *Bily*, 3 Cal. 4th at 406, 834 P.2d at 767, 11 Cal. Rptr. 2d at 73. Negligence is conduct that falls below the standard of care established for the protection of others. *Id.* at 396, 834 P.2d at 760, 11 Cal. Rptr. 2d at 66. In California, liability for negligence is established by statute. CAL. CIV. CODE § 1714(a) (West 1985 & Supp. 1993). The California Civil Code provides:

(a) Every one is responsible, not only for the result of his willful acts, but also for an injury occasioned to another by his want of ordinary care or skill in the management of his property or person, except so far as the latter has, willfully or by want of ordinary care, brought the injury upon himself.

Id.

The first requirement for a negligence cause of action is the existence of a duty. To determine whether a defendant owes a plaintiff a duty the court begins by looking to policy considerations. *Bily*, 3 Cal. 4th at 397, 834 P.2d at 760, 11 Cal. Rptr. 2d at 67 (“‘[D]uty’ . . . is . . . an expression of the sum total of those considerations of policy which lead the law to say

In *Biakanja*, the court identified a list of factors to determine whether a duty should exist absent privity.¹⁷⁰ These factors include: (1) whether a transaction was intended to affect the plaintiff; (2) whether the injury was foreseeable; (3) whether the plaintiff was certain to suffer injury; (4) whether there was a close relationship between the defendant's conduct and the plaintiff's injury; (5) whether the defendant's conduct merits moral blame; and (6) whether future harm can be prevented.¹⁷¹ Applying these factors, the *Bily* court concluded that an auditor owes a duty only to his or her client for negligence suits.¹⁷² The court premised its holding on three concerns: (1) Finding that auditors owed a duty to those other than their clients would disproportionately impose liability on auditors; (2) a third party who intends to rely on an audit could seek protection through contractual recitals; and (3) auditors and the public would suffer negative consequences if auditors owed a duty to third parties.¹⁷³

a. disproportionate liability in negligence suits

In *Bily* the California Supreme Court reasoned that it would be unfair for auditors to owe a duty beyond the client for negligence because auditors would suffer liability disproportionate to their fault. This finding was premised on the client's control over the audit process, the complexity of conducting an audit and the nature of the third-party damages.

First, the supreme court noted that clients control the audit process in several important ways. Most importantly, the auditor typically relies on the client for information.¹⁷⁴ The client usually provides the auditor with a copy of its financial statements, over which the client has direct control.¹⁷⁵ The auditor also depends on the client for information about its business and record-keeping systems.¹⁷⁶

In addition, clients control the dissemination of the audit report.¹⁷⁷ A client can distribute an opinion to almost any potential lender or investor quickly and easily. Auditors, therefore, have no real control over the extent to which a report is spread and relied on by third parties.

that the particular plaintiff is entitled to protection."'' (quoting *Dillon v. Legg*, 68 Cal. 2d 728, 734, 441 P.2d 912, 916, 69 Cal. Rptr. 72, 76 (1968)).

170. *Biakanja v. Irving*, 49 Cal. 2d 647, 650, 320 P.2d 16, 19 (1958).

171. *Id.*

172. *Bily*, 3 Cal. 4th at 406, 834 P.2d at 767, 11 Cal. Rptr. 2d at 73.

173. *Id.* at 398, 834 P.2d at 761, 11 Cal. Rptr. 2d at 67.

174. *Id.* at 399, 834 P.2d at 762, 11 Cal. Rptr. 2d at 68.

175. *Id.*

176. *Id.*

177. *Id.* at 400, 834 P.2d at 762, 11 Cal. Rptr. 2d at 68.

Second, the court reasoned that the complexity of audits and the high degree of professional judgment required to conduct an audit¹⁷⁸ make it unfair to impose liability on auditors for negligence to third parties.¹⁷⁹ The court noted that audit reports are not "simple statements of verifiable fact . . . which can easily be checked against uniform standards of indisputable accuracy."¹⁸⁰ Rather, they are professional opinions that require evaluations of complex factors subject to differing interpretations.¹⁸¹

The court also questioned the reasonableness of third-party reliance on audit reports as the sole aspect of a credit or investment decision. The court stated that reasonable investors and lenders should "dig far deeper in their 'due diligence' investigations than the surface level of an auditor's opinion."¹⁸² Therefore, the court found that the complexity of audit opinions and their role in investment and credit decisions supported a more limited duty.

Finally, the court did not want to hold auditors liable for economic losses associated with investment and credit decisions.¹⁸³ To begin with, the court recognized that if auditors owed a duty to investors and creditors for negligently audited financial statements, they would be exposed to vast liability.¹⁸⁴ In addition, the court did not believe that intangible injuries to third parties warranted a more stringent duty because third parties could protect themselves through private ordering.

b. private ordering

The court next addressed the ability of third-party investors and lenders to allocate the risk of negligently audited financial statements through private ordering.¹⁸⁵ A third party who intends to rely on an audit report may contract with the audit client for a special security arrangement or for improved terms.¹⁸⁶ Alternatively, the third party can become an intended beneficiary by insisting that the audit be conducted on its behalf.¹⁸⁷ Lastly, the third party could personally inspect the cli-

178. *Id.*, 834 P.2d at 763, 11 Cal. Rptr. 2d at 69.

179. *Id.* at 406, 834 P.2d at 767, 11 Cal. Rptr. 2d at 73.

180. *See id.* at 400, 834 P.2d at 763, 11 Cal. Rptr. 2d at 69.

181. *Id.*

182. *Id.* at 401, 834 P.2d at 767, 11 Cal. Rptr. 2d at 73.

183. *Id.*

184. *Id.* at 402, 834 P.2d at 768, 11 Cal. Rptr. 2d at 74.

185. Private ordering uses contract law rather than tort law to allocate the risks between parties. *Id.* at 398, 834 P.2d at 761, 11 Cal. Rptr. 2d at 67.

186. *Id.* at 403, 834 P.2d at 765, 11 Cal. Rptr. 2d at 71.

187. *Id.*

ent's financial statements or hire an auditor to conduct an audit on its behalf.¹⁸⁸ In sum, private ordering allows third parties to establish a relationship with an auditor to guarantee their standing to sue, or in the alternative, to bargain for better terms.

Therefore, the court concluded that private ordering was a sufficient alternative to tort liability for allocating the risk among the parties who prepare and use audit reports.

c. consequences of a duty to third parties

The California Supreme Court next rebutted the arguments favoring auditor liability to third parties. The proponents of expanded liability contended that imposing a duty to third parties would deter negligent audits, encourage more careful audits and provide an efficient way to spread the risk associated with negligently audited financial statements.¹⁸⁹ The court rejected each of these arguments.

The court found that a duty to third parties would not deter negligent audits.¹⁹⁰ It reasoned that regardless of the audit's quality, auditors would consider themselves targets of third parties any time a client went bankrupt.¹⁹¹ In response, auditors could decrease audit services for industries with high failure rates, thereby reducing the amount of financial information available to the public.¹⁹²

The court also rejected the plaintiffs' arguments that imposing a duty to protect third parties would improve the quality of audits, noting that it had not seen any empirical data to support that argument.¹⁹³ Further, in light of the complexities of conducting an audit,¹⁹⁴ the court questioned whether it was possible for audits to be conducted more accurately without increasing costs and thus decreasing availability.¹⁹⁵

Finally, the court expressed doubt that auditors are the parties best able to absorb losses.¹⁹⁶ It noted that investors and lenders can limit their losses by diversifying their investments and loans.¹⁹⁷

188. *Id.*

189. *Id.*

190. *Id.* at 427, 834 P.2d at 781, 11 Cal. Rptr. 2d at 87.

191. *Id.* at 404, 834 P.2d at 766, 11 Cal. Rptr. 2d at 72.

192. *Id.*

193. *Id.*

194. *See supra* part II.A.

195. *Bily*, 3 Cal. 4th at 404, 834 P.2d at 766, 11 Cal. Rptr. 2d at 72 (citing John A. Siliciano, *Negligent Accounting and the Limits of Instrumental Tort Reform*, 86 MICH. L. REV. 1929, 1963-68 (1988)).

196. *Id.* at 405, 834 P.2d at 766, 11 Cal. Rptr. 2d at 72.

197. *Id.*

2. Negligent misrepresentation

In addition to negligence, the court considered the extent to which auditors owe a duty to nonclients for the separate tort of negligent misrepresentation.¹⁹⁸ A negligent misrepresentation is a false statement,¹⁹⁹ honestly made, but without reasonable grounds.²⁰⁰

While negligence focuses on an auditor's due care and adherence to professional standards, negligent misrepresentation concerns the veracity of representations in an audit report and a plaintiff's actual and justifiable reliance on that report.²⁰¹ The court noted that "the distinction is important" due to practical considerations at trial, such as the burden of proof.²⁰²

The California Supreme Court adopted the rule articulated in the *Restatement (Second) of Torts*.²⁰³ This rule allows a plaintiff to recover if the plaintiff was within the class of persons that the audit was intended to benefit for a particular transaction known to the auditor.²⁰⁴ A plaintiff falls within this class as long as the auditor manifested an intent to benefit the plaintiff as a member of a "narrow and circumscribed" group of third parties for a specific transaction.²⁰⁵ The auditor is not liable to other third parties even if he or she should have known that the third party would rely on his or her report.²⁰⁶ The court reasoned that liability is fair if the auditor accepted responsibility for "influencing particular business transactions involving third persons," but unfair if the auditor has not done so.²⁰⁷

The court adopted the *Restatement* rule to ensure that auditors have "notice of potential third party claims."²⁰⁸ Because every client has a different risk potential,²⁰⁹ notice of potential third-party plaintiffs allows an auditor to assess its potential liability before accepting an engagement.

198. *Id.* at 407, 834 P.2d at 768, 11 Cal. Rptr. 2d at 74.

199. An audit opinion is a statement for purposes of negligent misrepresentation. *Id.* at 407-08, 834 P.2d at 768, 11 Cal. Rptr. 2d at 74.

200. *Id.* at 407, 834 P.2d at 768, 11 Cal. Rptr. 2d at 74 (citing 5 BERNARD E. WITKIN, SUMMARY OF CALIFORNIA LAW *Torts* § 720, at 819 (9th ed. 1988)).

201. *Id.* at 413, 834 P.2d at 772, 11 Cal. Rptr. 2d at 78. The court criticized courts, commentators and the *Restatement* drafters for failing to clearly distinguish between the two. *Id.* at 407, 834 P.2d at 768, 11 Cal. Rptr. 2d at 74.

202. *Id.*

203. *Id.* at 414, 834 P.2d at 773, 11 Cal. Rptr. 2d at 79.

204. See *supra* part II.B.1.b.

205. *Bily*, 3 Cal. 4th at 408, 834 P.2d at 768, 11 Cal. Rptr. 2d at 74.

206. *Id.*

207. *Id.*, 834 P.2d at 769, 11 Cal. Rptr. 2d at 74.

208. *Id.* at 408-09, 834 P.2d at 769, 11 Cal. Rptr. 2d at 75.

209. Chaffee, *supra* note 7, at 892.

In addition, the *Restatement* approach satisfied the court's concern with attenuated causal links and false claims of reliance by nonclients.²¹⁰ The court recognized that an auditor's knowledge of third-party reliance on a specific transaction established a "closer connection" between the negligent act and injury, "thereby ameliorating the otherwise difficult concerns of causation and of credible evidence of reliance."²¹¹

3. Fraud

An auditor who knowingly submits a false opinion makes an intentional misrepresentation and commits fraud.²¹² Specific knowledge that a statement is false is not required for fraud.²¹³ Rather, an auditor can commit fraud by making a statement without a belief in its truth or by making it recklessly, not knowing whether the statement is true or false.²¹⁴

The policy rationales driving the court to limit auditor liability to third parties for negligence and negligent misrepresentation are not justified in fraud cases.²¹⁵ The court explained that "the moral force of the argument against unlimited liability for mere errors or oversights and the uncertain connection between investment and credit losses and the auditor's report pale as policy factors when intentional misconduct is in issue."²¹⁶

In fraud cases, courts have held auditors liable to third parties who proved representations were made with the intent to defraud them.²¹⁷ Plaintiffs must show that their reliance on the audit report was foreseeable to the accountant.²¹⁸

210. *Bily*, 3 Cal. 4th at 409, 834 P.2d at 769, 11 Cal. Rptr. 2d at 75.

211. *Id.*

212. *Id.* at 415, 834 P.2d at 773, 11 Cal. Rptr. 2d at 79. This Note uses the terms "intentional misrepresentation" and "fraud" interchangeably.

213. *Id.*

214. *Id.*

215. *Id.* at 414-15, 834 P.2d at 773, 11 Cal. Rptr. 2d at 79.

216. *Id.* at 415, 834 P.2d at 773, 11 Cal. Rptr. 2d at 79.

217. *Id.*

218. *Id.*

IV. ANALYSIS

A. *Bily Was Correctly Decided*

1. The foreseeability rule will not significantly improve the quality of audits

An auditor's desire to charge a premium for his or her services provides quality incentive. Because audit reports are necessarily based on professional judgment and statistical sampling, expanding tort liability will not increase this incentive.²¹⁹ The uncertainty and imprecision inherent in the auditing process, coupled with the high degree of client control over financial statements, means that there will always be a margin of error in audit opinions.²²⁰ Spending more time conducting audits and increasing statistical samples will not mitigate the impact of client control and sampling error. Thus, an expansion of an auditor's tort liability will not significantly improve the accuracy and reliability of audits.

2. The foreseeability rule gives a windfall to third parties

If parties who are neither clients nor intended beneficiaries could recover from the auditor for negligence, auditors would be turned into investment insurers to a potentially infinite group of third parties who paid nothing for the auditing services. Because audit reports can be inexpensively reproduced and circulated, third parties have an opportunity to use them free of charge.²²¹ If an investment or loan turns bad, a third-party investor can try to recover it by suing the auditor. As a result, far-removed third parties can reap the full benefits of successful investments and enjoy some protection against bad investments at the auditor's expense. Thus, under a foreseeability rule third parties may get a windfall. In addition, this rule would provide creditors and investors with an illogical and judicially established incentive to "relax their efforts to control the risks inherent in the[ir] transaction[s]."²²²

Without the liability limitations of privity or the *Restatement*, auditors are forced to bear the costs associated with the risk of liability to third parties or pass them on to clients. Forcing auditors to insure third-party investments is unfair and ineffective. If auditors pass increased fees to clients, clients are likely to pass them to consumers. It is also inequita-

219. See *supra* part II.A.1-6.

220. See *supra* part II.A.1-6.

221. It is not feasible to charge these third parties for the use of an audit report primarily because it may be impossible to determine their identities.

222. Eric R. Fencil, Comment, *Rebuilding the Citadel: State Legislative Responses to Accountant Non-Privity Suits*, 67 WASH. U. L.Q. 863, 879 (1989).

ble to force consumers to subsidize corporate investment risks because they do not share in the profits from third-party investments.

3. Insurance is not an efficient way to spread risks or protect auditors

Auditors are free to purchase insurance to insulate themselves against the more extensive liability of the foreseeability rule. However, the "vast majority" of auditors sued belong to small- or medium-sized accounting firms.²²³ The professional liability insurance squeeze is most likely to affect these firms—causing them either to drop insurance or stop auditing.²²⁴ Presumably, uninsured accountants are generally not in a position to pay large damage awards. Consequently, these auditors are less able to satisfy judgments. In turn, the lack of insurance under a foreseeability rule means that auditors can neither efficiently spread risk nor compensate injured third parties.²²⁵

Insurance premiums are based on the degree of potential loss and the predictability of the risk.²²⁶ If liability is uncertain, premiums are increased.²²⁷ By reasonably limiting liability to nonclients, liability becomes more certain and insurance premiums are likely to stabilize.²²⁸

The privity and *Restatement* rules the court has articulated do this. *Bily* limits liability and makes it more predictable. Because there is a nonprofit, industry-created insurance carrier for auditors,²²⁹ the market may respond quickly to the reduction in liability by lowering insurance premiums.

4. *Bily* provides certainty

Bily's clearly defined spheres of liability make liability to third parties predictable. Consequently, parties to financial transactions can make better informed decisions. For example, a party who intends to invest or extend credit and is neither a client nor an intended beneficiary, knows that a private contract may be desirable.²³⁰ Alternatively, an investor may forego standing to sue the auditor, and instead seek better investment or credit terms with the client. The auditor also knows the extent

223. Brief of the California Society of Certified Public Accountants as Amicus Curiae in Support of Appellant at 32.

224. Fencel, *supra* note 222, at 882.

225. Causey, *supra* note 17, at 415.

226. Fencel, *supra* note 222, at 882.

227. *Id.*

228. Deborah E. Cooper, *Accountants' Liability: Privity Rule is Necessary in Today's Marketplace*, N.Y. L.J., Apr. 9, 1990, at 7.

229. See *supra* note 15 and accompanying text.

230. See *infra* part IV.B.1.

of risk undertaken and can set fees and make appropriate insurance arrangements prior to the engagement. This predictability and certainty will translate into less litigation because parties will know their rights and responsibilities prior to an audit.

5. Foreseeable liability impinges upon the amount and quality of financial information

Auditors are likely to respond to foreseeable liability by performing fewer audits, thereby reducing the amount and quality of financial information available to investors and creditors.²³¹ In fact, this has happened. A nationwide survey found that accounting firms are cutting back on services and turning clients away in order to reduce their exposure to liability.²³² From a policy perspective, the free flow of financial information is more important than compensating for a third party's lost investment.²³³ Because foreseeability impinges on the free flow of vital financial information, it should be rejected.

*B. Bily's Implications*²³⁴

As comprehensive as the *Bily* decision is, some questions remain unanswered: (1) How will *Bily* affect business transactions? (2) How will the decision impact an auditor's professional standards? (3) Are there permissible suits for negligence by nonclients? (4) How will courts interpret who qualifies as an intended beneficiary? and (5) How will *Bily* affect a case's settlement value?

1. *Bily's* effect on business transactions

The California Supreme Court's decision in *Bily* was a "welcome break" from court decisions that have recently expanded auditor liability.²³⁵ In addition to protecting auditors from liability to certain third parties, it is likely to have several other consequences. According to one

231. See RESTATEMENT (SECOND) OF TORTS, *supra* note 119, § 552 cmt. a.

232. Nelson, *supra* note 17, at 37.

233. See Cooper, *supra* note 228, at 7.

234. This Note does not explore *Bily's* impact on negligence and negligent misrepresentation suits against professional suppliers of information other than accountants. However, the rules articulated in *Bily* are likely to be applied to attorneys, architects, engineers and abstractors. Popofsky et al., *supra* note 36, at 7.

235. Morris, *supra* note 11, at 1; Popofsky et al., *supra* note 36, at 7 ("Ernst & Young [formerly Arthur Young & Co.], and the entire accounting profession, recently achieved a significant victory [with the *Bily* decision].").

commentator, *Bily* is likely to change the manner in which creditors and investors do business with accountants.²³⁶

Specifically, nonclient creditors and investors who intend to rely on audits will now have the "burden and incentive" to privately order their risk.²³⁷ This is currently the case in New York, where a nonclient who intends to rely on an audit will seek a contractual recital or express acknowledgment from an auditor in conjunction with a particular transaction.²³⁸ This allows the nonclient to sue the auditor in the event the financial statements are negligently audited. However, the auditor's exposure to liability is justified because the auditor has notice of the nonclient's intent to rely and can therefore decide whether to accept the engagement.

One open question regarding private ordering, however, is whether it is a real alternative for small or unsophisticated investors. If small or unsophisticated investors purchase securities on an exchange, they may recover from the auditor by virtue of federal securities laws.²³⁹ *Bily* is relevant to transactions that do not invoke federal securities or state Blue Sky laws.²⁴⁰ The small investor can avoid the risks of a negligent audit by not investing in companies that do not conduct audits on the investor's behalf. Companies eager for capital from small investors can make contractual arrangements with the auditor to account for the small investor. Consequently, the small investor would not need to privately contract with the auditor to ensure his or her right to sue for negligently audited financial statements. Alternatively, investors or creditors may use the lack of a recital or acknowledgment from an auditor to bargain for more favorable terms from the client.

Unsophisticated investors are treated differently. To recover for negligent misrepresentation, a third party must show justifiable reliance

236. Popofsky et al., *supra* note 36, at 7.

237. *Id.*

238. *Id.*

239. 15 U.S.C. § 78j(b) (1988); 17 C.F.R. § 240.10b-5 (1992); *see also* Basic, Inc. v. Levinson, 485 U.S. 224, 230-32 (1988) (holding that defrauded buyer of securities must prove that omitted fact would have been considered significant by reasonable investor to recover under 10b-5); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 (1976) (holding that buyer of securities must prove seller intended to defraud to recover under 10b-5); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975) (holding that defrauded buyers and sellers of securities have implied private cause of action under 10b-5).

240. "Blue Sky laws" are state securities laws that were designed to prevent "'speculative schemes which have no more basis than so many feet of blue sky.'" Therese H. Maynard, *The Uniform Limited Offering Exemption: How "Uniform" is "Uniform?"—An Evaluation and Critique of the ULOE*, 36 EMORY L.J. 357, 359 n.4 (1987) (quoting Hall v. Geiger-Jones Co., 242 U.S. 539, 550 (1917)).

on the audited financial statements.²⁴¹ Because unsophisticated investors by definition will not understand complicated financial statements, they cannot show the justifiable reliance necessary to recover.²⁴²

2. The professional standard of care

Bily leaves another question unanswered. The California Supreme Court granted review only to consider whether and to what extent an auditor owes a duty of care to reasonably foreseeable third parties who detrimentally rely on negligently audited financial statements.²⁴³ Interestingly, the court did not grant review on the appellate court's second major holding, that it is proper for juries to consider factors other than an auditor's compliance with GAAS and GAAP to determine whether an auditor acted negligently.

The appellate court's decision is significant because it was the first time a court subjected an auditor to negligence liability in spite of compliance with GAAP and GAAS.²⁴⁴ This holding is inconsistent with California law and unsupported by public policy.²⁴⁵

a. going beyond GAAP and GAAS

At trial the plaintiffs introduced Arthur Young's internal auditing manuals, which detailed procedures that its auditors followed, as evidence of the standard of care.²⁴⁶ The internal procedures were more

241. *Bily v. Arthur Young & Co.*, 3 Cal. 4th 370, 412-13, 834 P.2d 745, 772, 11 Cal. Rptr. 2d 51, 77-78, *modified*, 3 Cal. 4th 1049a (1992).

242. *Id.* at 403-04 n.13, 834 P.2d at 765 n.13, 11 Cal. Rptr. 2d at 71 n.13. The court stated: If a third party possesses sufficient financial sophistication to understand and appreciate the contents of audit reports . . . he or she should also be aware of their limitations and of the alternative ways of privately ordering the relevant risks. If, on the other hand, a third party lacks the threshold knowledge to understand the audit report and its terms, he or she has no reasonable basis for reliance.

Id.

243. *Bily v. Arthur Young & Co.*, 798 P.2d 1214, 274 Cal. Rptr. 371 (1990).

244. Brief of the California Society of Certified Public Accountants as Amicus Curiae in Support of Appellant at 48; *see, e.g.*, *SEC v. Arthur Young & Co.*, 590 F.2d 785, 788 (9th Cir. 1979) (holding that auditor's good faith compliance with GAAS relieved auditor of negligence liability); *In re Hawaii Corp.*, 567 F. Supp. 609, 617 (D. Haw. 1983) (holding that absent intentional misrepresentation auditor meets standard of care by complying with GAAP and GAAS). *See supra* part II.A.6 for a discussion of GAAP and GAAS.

245. *See, e.g.*, *International Mortgage Co. v. John P. Butler Accountancy Corp.*, 177 Cal. App. 3d 806, 223 Cal. Rptr. 218 (1986) (stating that auditor's ordinary skill and competence is defined by GAAP and GAAS), *overruled by Bily v. Arthur Young & Co.*, 3 Cal. 4th 370, 834 P.2d 745, 11 Cal. Rptr. 2d 51, *modified*, 3 Cal. 4th 1049a (1992).

246. *Bily v. Arthur Young & Co.*, 7 Cal. App. 4th 1636, 1645-49, 271 Cal. Rptr. 470, 474-76 (1990), *rev'd on other grounds*, 3 Cal. 4th 370, 834 P.2d 745, 11 Cal. Rptr. 2d 51, *modified*, 3 Cal. 4th 1049a (1992).

rigorous than those in GAAP and GAAS.²⁴⁷ Over Arthur Young's objection, the jury was instructed that it "may" consider GAAP and GAAS "among other evidence" to determine if the standard of care had been met.²⁴⁸ This instruction permitted the jury to disregard GAAP and GAAS entirely and find Arthur Young negligent based on other standards.²⁴⁹

On appeal Arthur Young argued that, as a matter of law, GAAP and GAAS conclusively define an auditor's standard of care.²⁵⁰ The court of appeal disagreed, holding that an auditor could be subject to a standard of care independent from GAAP and GAAS.²⁵¹ The court first reasoned that GAAP and GAAS could not provide appropriate guidance in every conceivable situation, and therefore the jury should be allowed to consider other standards.²⁵² Second, the court reasoned that the accounting profession should not exclusively set its own standards of care.²⁵³

Assuming GAAP and GAAS were inapplicable to a particular situation, the broad principles embodied within them can nevertheless be used to gauge whether an auditor was negligent.²⁵⁴ There is no need to go beyond these standards simply because the GAAP and GAAS drafters did not envision a specific situation. Further, because neither the trial nor the appellate court believed that a unique auditing situation was even at issue, the court was not justified in going beyond GAAP and GAAS. Accordingly, the jury should have considered only whether Arthur Young's performance met the standard of care established in GAAP and GAAS.

The court of appeal's second rationale, that the accounting profession should not be trusted to set its own standards of care, is also faulty. While juries are well suited to establish standards of care for certain industries based on their everyday experiences, the ordinary jury is not equipped to understand the complexities of an audit as evinced by the "expectation gap."²⁵⁵ Without an instruction limiting the standard of

247. *See id.* Arthur Young's manual required it to assign a "concurring partner" although GAAS has no such requirement. *Id.* at 1649, 271 Cal. Rptr. at 476.

248. *Id.* at 1645-46, 271 Cal. Rptr. at 474.

249. *Id.* at 1648, 271 Cal. Rptr. at 476. For example, plaintiff Bily's counsel told the jury to use its common sense in determining if Arthur Young was negligent "irrespective of GAAS and GAAP." *Id.* (quoting plaintiff Bily's counsel).

250. *Id.*

251. *Id.*

252. *Id.*, 271 Cal. Rptr. at 475.

253. *Id.*

254. *See id.*

255. *See supra* part II.A.5.

care to GAAP and GAAS, the jury's decision-making process will be infected by its heightened expectations of what auditors should detect. If an auditor did not discover material misrepresentations in a client's financial statements despite compliance with widely-accepted professional standards, a jury could nevertheless hold the auditor liable.

Further, in determining whether an auditor's conduct met the standard of care, a jury is not entitled to subjectively create its own standard; it must hear evidence of the professional standard of care through expert testimony.²⁵⁶ This testimony is used to determine whether the auditor performed with ordinary skill and competence.²⁵⁷ Accountants, acting as expert witnesses, will always be used to establish ordinary skill and competence. In addition, if courts allow parties to articulate a standard of care different from GAAP and GAAS, juries will be free—and may even be encouraged by plaintiffs—to allow their own higher expectations to impact their decision making. In effect, auditors would be held to standards defined by the public's expectations of auditing, which may be excessive and inaccurate. By allowing the parties to articulate a standard of care more rigorous than GAAP and GAAS, the trial and appellate court decisions demonstrated a misunderstanding of the auditing process that unfairly exposed auditors to liability.

When testifying, expert witnesses will assess whether the auditor's conduct met or failed to meet the professional standard.²⁵⁸ Because GAAP and GAAS are the only standards recognized throughout the accounting profession, expert witnesses must necessarily refer to the GAAP and GAAS standards in their testimony.²⁵⁹ Therefore, testimony could not reasonably be based on anything but GAAP and GAAS.²⁶⁰

GAAP and GAAS should exclusively define an auditor's standard of care. Unlike other professions, audit report users have specific expectations of the standard of care that an auditor will exercise.²⁶¹ It is commonly understood by those who use audit reports that audits are conducted in compliance *only* with GAAP and GAAS.²⁶² In fact, the

256. See *Lindner v. Barlow, Davis & Wood*, 210 Cal. App. 2d 660, 665, 27 Cal. Rptr. 101, 104 (1962).

257. *Id.*

258. Petition for Review at 19.

259. *Id.* This does not mean that experts will agree on interpretation of GAAS and GAAP. Expert witnesses may try to establish higher or lower standards of care based on the GAAP and GAAS framework.

260. *Id.*

261. Brief of the California Society of Certified Public Accountants as Amicus Curiae in Support of Appellant at 49.

262. *Id.*

audit report itself proclaims compliance only with GAAP and GAAS.²⁶³ Thus, the client has notice that these are the standards being used and has no reasonable basis for believing an auditor will comply with higher standards. Further, these standards are widely published, discussed and available to those who rely on audit reports.²⁶⁴ Therefore, because third parties know what standard of care to expect, and make investment decisions accordingly, auditors should not be held to a different standard.

In addition, courts should use the standards set forth in GAAP and GAAS because they provide certainty. Auditors should not be held to other, unknown and undefined standards. Otherwise, auditors will be less able to predict conduct that can result in liability.

Finally, by extending the standard of care beyond GAAP and GAAS, courts risk holding auditors to standards for which they may lack the competence to comply. For example, a court might require an auditor to detect fraud, rather than to simply search for it.²⁶⁵ Auditors may be unable to do this because of the inherent nature of the auditing process.²⁶⁶ While hindsight may be useful for determining whether the standards within GAAP and GAAS should be changed, it is unfair to impose higher standards on an auditor after an audit has been conducted.²⁶⁷ Auditors should therefore be held only to the standards defined by GAAP and GAAS.

b. internal manuals and the standard of care

Permitting internal manuals to establish a different standard of care will do little to improve the quality of audits. Accounting firms should be encouraged, even applauded, for setting higher standards of conduct than those required by GAAP and GAAS. Instead, the trial and appellate courts, in effect, punished Arthur Young for setting higher standards.

To avoid exposure to liability, accounting firms are likely to adopt internal procedures that reflect the lowest acceptable professional standards of care. While public policy dictates that courts should encourage auditors to adopt a high standard of care, basing the higher standard of care on internal manuals will actually encourage, and reward, lower in-

263. See *supra* part II.A.4.

264. Brief of the California Society of Certified Public Accountants as Amicus Curiae in Support of Appellant at 49.

265. See *supra* part II.A.5.

266. See *supra* part II.A.5.

267. See Liggio, *supra* note 43, at 31.

ternal standards of care. Consequently, firms will lack incentive to set standards higher than GAAP and GAAS.

In addition, the court of appeal's ruling creates a double standard. Whereas one firm could be held negligent for failing to follow its internal procedures, another firm whose internal manuals did not set similar standards could be exonerated for the same conduct. As a result, larger firms, which typically use internal manuals, may be held to higher standards than smaller firms, which typically do not use them.²⁶⁸ This double standard is unfair. Clients engage larger firms because of their expertise or their ability to add credibility to their financial statements not because they have and use internal manuals. Those who use and rely on audit reports know precisely the standards with which auditors comply—GAAP and GAAS. Allowing an investor or creditor to recover for a bad investment based on standards other than GAAP and GAAS will discourage firms from adopting higher standards and will inequitably punish large firms that do.

3. Recovery by contractual third-party beneficiaries

The court in *Bily* held that "an auditor's liability for general negligence in the conduct of an audit of its client's financial statements is confined to the client."²⁶⁹ The court also ruled that others "may not recover on a pure negligence theory."²⁷⁰ However, the court declined to address whether it would treat contractual third-party beneficiaries as the legal equivalent of clients for purposes of negligence suits.²⁷¹ The court noted that "[t]hird party beneficiaries may under appropriate circumstances possess the same rights as parties to the contract."²⁷² Unfortunately, this statement sheds no light on whether a third-party beneficiary will be allowed to sue for negligence.

Section 1559 of the California Civil Code provides: "A contract, made expressly for the benefit of a third person, may be enforced by him at any time before the parties thereto rescind it."²⁷³ To prove that one is a third-party beneficiary, one must show more than that "the contracting parties acted against a backdrop of knowledge that the [third party]

268. Petition for Review at 19.

269. *Bily v. Arthur Young & Co.*, 3 Cal. 4th 370, 406, 834 P.2d 745, 767, 11 Cal. Rptr. 2d 51, 73.

270. *Id.*

271. *Id.* at 406 n.16, 834 P.2d at 767 n.16, 11 Cal. Rptr. 2d at 73 n.16.

272. *Id.*

273. CAL. CIV. CODE § 1559 (West 1982).

would derive benefit from the agreement.”²⁷⁴ Rather, the contracting parties must have affirmatively sought to benefit the third person, and such a benefit must have been a “motivating factor in the parties’ decision to enter into the contract.”²⁷⁵

If courts allow third-party beneficiaries to recover for negligence, nonclients would attempt to portray themselves as third-party beneficiaries so they could also recover for negligence.²⁷⁶ It is easier for third parties to prove negligence than negligent misrepresentation because the focus of the case is on the auditor’s breach of a standard of care rather than on the third party’s reasonable reliance on the audit report. In negligence cases the court seems more willing to presume a *client’s* reliance—principally because the client was the one who commissioned the audit with the intention to rely on it.²⁷⁷ This presumption would be undermined if nonclients could sue for negligence. In fact, if nonclients—otherwise qualifying as intended beneficiaries—could sue for negligence, there would be little, if any, reason for the court’s adoption of the *Restatement* approach—limiting nonclients to suits for negligent misrepresentation. Therefore, intended beneficiaries, otherwise qualifying as third-party beneficiaries, should not be allowed to sue for negligence.

4. The intended beneficiary

One commentator has suggested that *Bily* will “create a lot of litigation over precisely who auditors were aware of, and over what type of knowledge is required to impose liability.”²⁷⁸ In other words, California case law has yet to define precisely who qualifies as an intended benefi-

274. *Eastern Aviation Group v. Airborne Express, Inc.*, 6 Cal. App. 4th 1448, 1453, 8 Cal. Rptr. 2d 355, 358 (1992) (quoting *Corrugated Paper Prods. v. Longview Fibre Co.*, 868 F.2d 908, 912 (7th Cir. 1989)).

275. *Id.* (quoting *Corrugated Paper Prods. v. Longview Fibre Co.*, 868 F.2d 908, 912 (7th Cir. 1989)). “Third-party beneficiary” is a contract law term. See E. ALLEN FARNSWORTH, *CONTRACTS* §§ 10.1-3 (2d ed. 1990). In contrast, “intended beneficiary” is a tort law term. See *RESTATEMENT (SECOND) OF TORTS*, *supra* note 119, § 552. This Note does not attempt to explain the difference, if any, between the two terms. Rather, this Note explores the possible effects of an audit’s intended beneficiary attempting to qualify as a third-party beneficiary in an effort to circumvent *Bily’s* rule that nonclients may not sue for negligence.

276. A third party could do this by showing that its use of the audit report was a “motivating factor” behind the audit engagement. Because an intended beneficiary’s reliance on an audit report can be a “motivating factor” for the engagement—the client usually wants an investment or loan—it may not be difficult for intended beneficiaries to qualify as contractual third-party beneficiaries.

277. *Bily*, 3 Cal. 4th at 413, 834 P.2d at 772, 11 Cal. Rptr. 2d at 78. The court noted that “[t]he reliance element [for negligence instructions] is only implicit” and is considered as part of the overall causation evaluation. *Id.*

278. *Morris*, *supra* note 11, at 10.

ary. This point is well taken. Interpretations of the *Restatement* section 552 vary according to jurisdiction.²⁷⁹ For example, one Texas decision interpreted the *Restatement* very broadly.²⁸⁰

In order to comport with the spirit of *Bily* and the comments to the *Restatement*, California courts are likely to require that the auditor have knowledge of the third party's reliance before an audit takes place. In *Bily*, the court noted that the *Restatement* "does not seek to probe the state of mind of the accountant."²⁸¹ Instead, the court concluded that an intended beneficiary is one whom an auditor seeks to supply with information for a transaction with "sufficiently specific economic parameters to permit" the auditor to assess whether or not to accept an engagement.²⁸² Thus, to keep with the spirit of *Bily*, California courts should require proof that an auditor entered into an engagement knowing and intending a third party to rely on the audit report for a specific transaction.

A more relaxed requirement would, in essence, emulate a foreseeability rule. Had the *Bily* court wanted to adopt the foreseeability rule it simply would have affirmed the lower court's decision. It did not. Instead, the court analyzed in detail the reasons auditors should have knowledge of third-party reliance before courts impose liability on them.

279. See, e.g., *Bush v. Rewald*, 619 F. Supp. 585, 593 (D. Haw. 1983) (holding that lawyer had no duty to disclose material facts unless he or she knew third parties would rely on advice); *Briggs v. Sterner*, 529 F. Supp. 1155, 1176 (S.D. Iowa 1981) (holding that *Ryan v. Kanne*, 170 N.W.2d 395 (Iowa 1969), dictates that only third parties known by accountant as prospective user of audit may recover for negligence); *Chun v. Park*, 462 P.2d 905, 909 (Haw. 1969) (holding that title company's duty of reasonable care extended to buyers and lending bank in which seller informed title company of other party's identity); *Bonhiver v. Graff*, 248 N.W.2d 291, 302 (Minn. 1976) (holding that accountants are liable because they had actual knowledge of third-party reliance); *BancOhio Nat'l Bank v. Schiesswohl*, 515 N.E.2d 997, 999 (Ohio Ct. App. 1986) (holding that no liability exists when third party was not specifically foreseen); *Blue Bell, Inc. v. Peat, Marwick, Mitchell & Co.*, 715 S.W.2d 408, 412 (Tex. Ct. App. 1986) (holding that "less restrictive interpretation" of § 552 should be applied).

280. *Blue Bell*, 715 S.W.2d at 412. In *Blue Bell* a Texas appellate court held that an auditor will be liable to third parties if the auditor "knows or should know that such statements will be relied upon by a limited class of persons." *Id.* Although the court said it was applying the *Restatement*, its use of the "should know" language bears little practical difference to the foreseeability rule.

281. *Bily*, 3 Cal. 4th at 409, 834 P.2d at 769, 11 Cal. Rptr. 2d at 75.

282. *Id.* The *Restatement* adds that the auditor must "'manifest[] an intent to supply the information for the sort of use in which plaintiff's loss occurs.'" *Id.* (quoting RESTATEMENT (SECOND) OF TORTS, *supra* note 119, § 552 cmt. a).

5. Settlement value

The nuisance value of a lawsuit gives it a settlement value independent of its merits.²⁸³ This premise applies forcefully in the context of auditor liability. Negligence suits are easily filed and are “virtually impossible to end.”²⁸⁴ In filing a lawsuit, a plaintiff has a minimal burden of showing an injury.²⁸⁵ In addition, a suit filed against a professional accountant is likely to “cloud [the auditor’s] professional reputation” and “threat[en his or her] professional standing.”²⁸⁶ One commentator has noted that the “*in terrorem* effect” of such suits create a settlement value “having no relationship to the size or merit of the claim.”²⁸⁷ The commentator also noted that because auditor liability issues are complex and difficult to litigate, cases against auditors can yield an even higher settlement value.²⁸⁸

In the absence of a rule limiting an auditor’s liability to nonclients, an auditor may be exposed to “vexatious litigation” that is “virtually limitless.”²⁸⁹ By allowing only the client to sue for negligence and only an intended beneficiary to sue for negligent misrepresentation, *Bily* decreases the settlement value of suits initiated by many third parties. Because a case filed by a nonclient, non-intended beneficiary will be easily dismissed under *Bily*, it follows that such cases have little, if any, settlement value.

Bily, of course, does not affect the settlement value of cases initiated by clients and intended beneficiaries—nor should it. One of the main policy justifications for *Bily* is that auditors have notice at the time of the party’s engagement of who would have standing to sue and the nature of the transactions for which they could sue.²⁹⁰

283. See Note, *Extortionate Corporate Litigation: The Strike Suit*, 34 COLUM. L. REV. 1308 (1934).

284. Cooper, *supra* note 228, at 7. One reason for this is that a plaintiff who pleads reliance “however groundless” will have “an excellent chance of surviving a motion to dismiss.” *Id.*

285. Newton N. Minow, *Accountants’ Liability and the Litigation Explosion*, J. ACCT., Sept. 1984, at 70, 71-72.

286. Cooper, *supra* note 228, at 7.

287. *Id.*

288. *Id.*

289. *Id.*

290. *Bily v. Arthur Young & Co.*, 3 Cal. 4th 370, 414, 834 P.2d 745, 773, 11 Cal. Rptr. 2d 51, 79, *modified*, 3 Cal. 4th 1049a (1992).

V. RECOMMENDATION: THE CALIFORNIA LEGISLATURE SHOULD
CODIFY *Bily* AND RECOGNIZE GAAP AND GAAS AS
CONCLUSIVELY DEFINING AN AUDITOR'S
STANDARD OF CARE

The day after the California Supreme Court handed down its decision in *Bily*, the powerful California Trial Lawyers Association (CTLA), allied with the banking lobby, persuaded Senator McCorquodale to introduce a bill in the California Legislature to reverse the ruling.²⁹¹ Anticipating the court's holding, the CTLA and the banking lobby had prepared language to overturn the decision: "A licensee owes a duty of ordinary care and shall be liable to reasonably foreseeable persons for his or her negligence or other tortious conduct."²⁹² The amendment was then added to a bill—in this case Senate bill 1900 that concerned mosquito abatement.²⁹³ The Assembly approved the bill with little discussion,²⁹⁴ but a senator objected to it on technical grounds—that state law requires amendments to bills be germane.²⁹⁵ The Senate killed the bill.²⁹⁶ Nevertheless, there are plans to introduce to the California Legislature another bill that would overturn *Bily*.²⁹⁷

The California Legislature should not overturn *Bily*. To the contrary, the legislature should codify *Bily* and clarify the ambiguities that were not addressed by the California Supreme Court. Specifically, the legislature should prohibit negligence suits by all nonclients. This will stop nonclients from circumventing *Bily* by casting themselves as contractual third parties in an effort to sue for negligence. Most importantly, however, the legislature should regard auditor compliance with GAAP and GAAS as per se reasonable. As it now stands, *Bily* allows juries to completely ignore the comprehensive standards of care developed within the accounting profession and apply wholly independent factors to gauge the reasonableness of an auditor's conduct.²⁹⁸ As a result, juries may measure an auditor's performance against their own height-

291. Bill Ainsworth, *Capitol Abuzz Over Accountants: Trial Lawyers Acted Fast to Restore Auditor Liability Following Thursday Ruling but Lost on Technicality*, RECORDER, Sept. 3, 1992 at 1; see S. 1900, 1991-92 Reg. Sess. (Cal. 1992).

292. S. 1900, 1991-92 Reg. Sess. (1992) (section 4).

293. *Id.*

294. Ainsworth, *supra* note 291.

295. *Id.*

296. *Id.*

297. *Id.*

298. See *Bily v. Arthur Young & Co.*, 7 Cal. App. 4th 1636, 1645-49, 271 Cal. Rptr. 470, 474-76 (1990), *rev'd on other grounds*, 3 Cal. 4th 370, 834 P.2d 745, 11 Cal. Rptr. 2d 51, *modified*, 3 Cal. 4th 1049a (1992).

ened expectations,²⁹⁹ thereby undermining the rule that expert testimony establish the professional standard of care.³⁰⁰

By opening the doors to standards independent of GAAP and GAAS, an auditor lacks notice of the conduct for which he or she could be liable. Additionally, if juries determine liability independent of GAAP and GAAS, the benefits of uniformity will be undermined. Therefore, auditors should not be held to higher, unknown and undeterminable standards of care.

VI. CONCLUSION

Because accountants audit financial statements involving hundreds of billions of dollars every year,³⁰¹ the legal and economic ramifications of auditor liability to third parties are far-reaching. Over sixty years ago Judge Cardozo recognized the problems of limitless liability in *Ultramares*. Today those concerns are even more serious because audit reports involve more money and can be circulated to more people than Judge Cardozo could have imagined.

Bily does not give auditors an arbitrary advantage by limiting their liability. Rather, it strikes the proper balance between traditional principles of tort law and the realities of the modern marketplace. Auditors who commit fraud are and should be liable to *any* party they intend to deceive. But public policy compels a more limited scope of liability for mere errors and oversights.

For these reasons, the California Legislature should codify *Bily* and answer the questions that the California Supreme Court left open.³⁰² But most importantly, the legislature should tie the auditor's standard of care *exclusively* to GAAP and GAAS so that auditors have notice of the conduct for which they may be held liable. By doing so, the legislature will fairly apportion liability without undercutting commercial relationships. In the end this is the best approach for auditors, those who use audit reports and the general public.

Scott Vick *

299. See *supra* part II.A.5.

300. See *Lindner v. Barlow, Davis & Wood*, 210 Cal. App. 2d 660, 27 Cal. Rptr. 101 (1962).

301. Petition for Review at 2.

302. See *supra* part IV.B.

* For her continual encouragement and support, I dedicate this Note to the most important person in my life, my wife Laura. I am also grateful to Professor Therese Maynard for her sage advice and unending enthusiasm.

