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ACCOUNTABLE ACCOUNTANTS: IS THIRD-PARTY LIABILITY NECESSARY?

VICTOR P. GOLDBERG*

I. INTRODUCTION

SHOULD accountants be liable to third parties if they conduct an audit in a negligent manner? A half century ago, in *Ultramares Corporation v. Touche, Niven & Co.*,¹ Cardozo argued that they should not, unless their performance could be characterized as fraud. In recent years, courts in a minority of jurisdictions have concluded that Cardozo's argument is no longer compelling and they have found that "foreseeable" third parties could bring a tort action for ordinary negligence against the accountants.² In addition to being subject to tort actions, accountants may also be liable under federal and state securities laws.³

Suits against accountants by disgruntled shareholders and lenders have

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¹ *Ultramares Corp. v. Touche, Niven & Co.*, 255 N.Y. 170, 174 N.E. 441 (1931).

² The minority position was first adopted in *H. Rosenblum, Inc. v. Adler*, 93 N.J. 324, 461 A.2d 138 (1983). It has been followed in *Citizens State Bank v. Timm, Schmidt & Co.*, 113 Wis.2d 376, 335 N.W.2d 361 (1983); *International Mortgage Co. v. John P. Butler Accountancy Corp.*, 177 Cal. App. 3d 806, 223 Cal. Rptr. 218 (Cal. Ct. App. 1986); and *Touche Ross & Co. v. Commercial Union Insurance Co.*, 514 So.2d 315 (Miss. 1987). The *Ultramares* rule has been followed recently in *Credit Alliance v. Arthur Andersen & Co.*, 65 N.Y.2d 536, 493 N.Y.S.2d 435, 483 N.E.2d 110 (1985); and *Toro Co. v. Krouse, Kern & Co.*, 827 F.2d 155 (7th Cir. 1987).

³ See R. Gormley, *The Law of Accountants and Auditors: Rights, Duties and Liabilities* § 701, n.1 (1981); and Wanda A. Wallace, *Auditing* (1986), ch. 5.

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increased considerably in recent years.⁴ The accountants' increased exposure has manifested itself as one element of the so-called insurance crisis.⁵ Malpractice premiums have been rising, policy limits have been falling, and deductibles have been increasing. Some accountants have chosen to go bare, and some insurers have refused to write coverage for accountants perceived as high risks. The number of firms writing liability insurance for non-Big Eight accounting firms has fallen from twelve to three in the last five years.⁶

A common response to the insurance crisis has been to blame it on recent changes in the tort law and to propose new limitations on liability or on recoverable damages. In this instance at least, I will argue that the response is essentially correct. Holding accountants liable to third parties under tort or securities law is a policy that makes little sense. *Ultramares* should not be overruled. Indeed, I will argue that Cardozo was too lenient, recognizing exceptions that unnecessarily undercut the bar on third-party suits against accountants.⁷

Analytically, it is of no consequence whether the liability arises as a matter of tort or of securities law. The following discussion will be conducted primarily in terms of tort law, but that is a matter of convenience only. The article is organized as follows. After setting out the two alternative positions in Section II, I explore in Section III the implications of holding the accountant liable. I argue there that to hold the accountant liable to third parties would be equivalent to making him a guarantor against an elastically defined set of unfortunate events, and that such a guarantee would not be in the interest, *ex ante*, of the plaintiff class. If the parties want assurance, they can expressly contract for it. However, since the costs of producing the guarantee would probably exceed the

⁴ See Robert Mednick, *Accountants' Liability: Coping with the Stampede to the Courtroom*, 164 J. Acct. 118, 119 (1987); and Wallace, *supra* note 3, at 168-70. An analysis of litigation between 1960 and 1985 involving the fifteen largest accounting firms, however, did not find a dramatic increase in the 1980s; see Zoe-Vonna Palmrose, *Litigation and Independent Auditors: The Role of Business Failures and Management Fraud*, 6 Auditing 90 (1987).

⁵ On the crisis in accountants' insurance, see Michele Galen, *Litigation Blitz Hits Accountants*, 8 Nat'l L.J., June 16, 1986, at 1, col. 4. Information on the insurance "crisis" for accountants and others is collected in Memorandum of Arthur Young & Company Re Third Party Liability Issues filed in *Imark Industries, Inc. v. Arthur Young & Company*, Case No. 622-338 Cir. Ct., Milwaukee County, Wis. I am not claiming that either the general or the particular insurance problems should reasonably be characterized as a crisis. I am merely acknowledging that there is a widespread perception that a crisis exists.

⁶ Nat'l L.J., *supra* note 5, at 26, col. 4.

⁷ Richard Epstein also argues against expanding the accountant's liability under the tort law. See Richard A. Epstein, *Liability of Accountants for Negligence: How Can We Tell the Best Rule?* in *Business Law 1134* (Mark E. Roszkowski ed. 1987).

benefits, most third parties would rationally choose to forgo the protection.

To overcome the lack of privity, the courts have reasoned by analogy to hold accountants liable for negligence. Accountants should be liable since we have already held X liable, and accountants are not really that different from X; X are typically notaries or lawyers whose negligence has resulted in the plaintiff's failing to receive all of his inheritance. I will argue in Section IV that while these cases were decided correctly, they are nevertheless properly distinguishable from the accountant negligence cases.

II. ULTRAMARES AND THE NEGLIGENCE ALTERNATIVE

In *Ultramares* the plaintiff made a number of loans to a company that had falsified its books. When the firm went bankrupt, the plaintiff brought suit against the accountant for negligence and fraud. Cardozo found that the evidence supported a finding that the audit was negligently made. The central question was what duty, if any, the accountant owed to the plaintiff and to others similarly situated. The accountant, he asserted, owed a duty to the client to make the audit without fraud or negligence. To creditors and investors with whom privity was lacking, the accountant would be liable for fraud only. There would be no liability for negligence, since, "[i]f liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class."⁸

The accountant's shield from liability to third parties under *Ultramares* was not absolute. It had two exceptions that could be exploited by a court eager to find liability but reluctant to depart from precedent. The first was Cardozo's modified privity requirement. A lack of privity would not bar the negligence action if the third person was, in effect, if not in name, party to the contract.⁹ The second exception was allowing a fraud action despite a lack of privity. By fraud, Cardozo did not mean that the accountant had deliberately joined the client in an effort to defraud third parties. "Fraud includes the pretense of knowledge when knowledge there is

⁸ *Ultramares*, *supra* note 1, at 444.

⁹ He devoted a considerable portion of the opinion to distinguishing this case from *Glanzer v. Shepard*, 233 N.Y. 236, 135 N.E. 275 (N.Y. 1922), which found a basis for liability even though privity was lacking. There, "[t]he bond was so close as to approach that of privity, if not completely one with it." *Ultramares*, *supra* note 1, at 446.

none."¹⁰ Gross negligence on the part of the accountant might give rise to an inference of fraud, thereby subjecting the accountant to tort liability.¹¹

Cardozo posed the question as one of giving substance to an implied warranty.

[T]he verdict was returned upon the theory that . . . there is a liability . . . for erroneous opinion. The expression of an opinion is to be subject to a warranty implied by law. What, then, is the warranty . . . to be? Is it merely that the opinion is honestly conceived and that the preliminary inquiry has been honestly pursued, that a halt has not been made without a genuine belief that the search has been reasonably adequate to bring disclosure of the truth? Or does it go farther and involve the assumption of a liability for any blunder or inattention that could fairly be spoken of as negligence if the controversy were one between accountant and employer for breach of a contract to render services for pay?¹²

Cardozo did not explain why the implied warranty should be so formulated. Why assume that it is a "genuine belief" or *more*? Why not *less*? Nor did he say whether (or how) the implied warranty could be waived.

Prior to 1983 there were some modest extensions of the *Ultramares* rule.¹³ In that year, two courts dramatically extended the auditor's exposure by holding the accountant liable to reasonably foreseeable persons who rely on the audit to their detriment.¹⁴ Holding the accountants liable,

¹⁰ *Ultramares*, *supra* note 1.

¹¹ "Our holding does not emancipate accountants from the consequences of fraud. It does not relieve them if their audit has been so negligent as to justify a finding that they had no genuine belief in its adequacy, for this again is fraud. . . . [I]f there has been neither reckless misstatement nor insincere profession of an opinion, but only honest blunder, the ensuing liability for negligence is one that is bounded by the contract." *Id.* at 448. "Even an opinion . . . by an expert . . . may be found to be fraudulent if the grounds supporting it are so flimsy as to lead to the conclusion that there was no genuine belief back of it. . . . [N]egligence may . . . be evidence from which a trier of the facts may draw an inference of fraud." *Id.* at 447. "[N]egligence or blindness, even when not equivalent to fraud, is none the less evidence to sustain an inference of fraud. At least this is so if the negligence is gross." *Id.* at 449.

¹² *Id.* at 444-45.

¹³ See, for example, *Rusch Factors, Inc. v. Levin*, 284 F. Supp. 85 (Dist. Ct. R.I. 1968); and cases cited in Howard B. Wiener, *Common Law Liability of the Certified Public Accountant for Negligent Misrepresentation*, 20 San Diego L. Rev. 233, 248 at n. 75 (1983). Section 552 of the Restatement of Torts (Second, 1977) extended the auditor's liability to third parties whose identity was unknown to the auditor, so long as these third parties belonged to an identifiable group for whom the information was intended to be furnished.

Federal and state securities laws make accountants liable to some classes of third parties for losses suffered after an accountant has performed a service for a client in a negligent way. Details as to whom the accountant might be liable, whether "eyeball reliance" is necessary, standards of care, and burdens of proof vary under the statutes and, for my purposes, are unimportant. For details, see Gormley, *supra* note 3, at § 7.01, n.1, § 7.02, n.3.

¹⁴ *Rosenblum*, 461 A.2d 138 (N.J.) and *Timm*, 335 N.W. 2d 361 (Wis.).

the courts argued, would both deter negligence and facilitate risk spreading. For example, in *Rosenblum* the court argued:

The imposition of a duty to foreseeable users may cause accounting firms to engage in more thorough reviews . . . which should tend to reduce the number of instances in which liability would ensue. . . . Accountants will also be encouraged to exercise greater care leading to greater diligence in conducting audits. . . . Isn't the risk of loss more easily distributed and fairly spread by imposing it on the accounting profession, which can pass the cost of insuring against the risk onto its customers, who can in turn pass the cost onto the entire consuming public?¹⁵

These policy arguments for the reasonable foreseeability standard should look familiar. They are the core elements of the "enterprise liability" theory that has been the dominant influence on the development of modern tort law. The validity of the enterprise liability theory of torts is itself controversial.¹⁶ Whether these arguments are valid in the broader context, I need not say. I will argue in the next section that these arguments are of dubious merit when analyzing the liability of accountants to third parties.

III. THE ACCOUNTANT AS GUARANTOR

What rule would be in the interest of third-party users of accountants' services? It is not particularly surprising that, ex post, such a user would want a rule that makes the accountant liable. He has lost \$50,000, the people who defrauded him are judgment-proof, and the accountant has deep pockets. He would favor virtually any rule that enabled him to recover his \$50,000, be it accountant liability, lawyer liability, or federal disaster relief. The analytically more interesting question is the ex ante one.¹⁷ Would potential plaintiffs, third parties who do not know whether

¹⁵ *Rosenblum*, 461 A.2d at 152–53, second paragraph quoted in *Rosenblum* from *Rusch Factors, Inc. v. Levin*, 284 F. Supp. 85, 91. The California court made essentially the same argument in *Butler*, *supra* note 2, at 227: "The risk of such loss is more appropriately placed on the accounting profession which is better able to pass such risk to its customers and the ultimate consuming public. By doing so, society is better served; for such a rule provides a financial disincentive for negligent conduct and will heighten the profession's cautionary techniques."

¹⁶ See George Priest, *The Invention of Enterprise Liability: A Critical History of the Intellectual Foundations of Modern Tort Law*, 14 J. Legal Stud. 461 (1985). See also Richard Epstein, *Product Liability as an Insurance Market*, 14 J. Legal Stud. 645 (1985). This article is concerned only with the smaller question of accountant liability. If the analysis chips away at the broader foundation, that is purely ancillary to my main purpose.

¹⁷ On the ex ante and ex post perspective, see Frank Easterbrook, *The Supreme Court, 1983 Term—Foreword: The Court and the Economic System*, 98 Harv. L. Rev. 4, 10–12 (1984).

their dealings will result in an audited firm's defaulting, want accountants to be held liable for negligence, knowing that in the long run accountants must cover their costs?

It seems plausible that imposing tort liability on accountants would result in their taking greater care and, as a consequence, producing more accurate information. Raising the price of negligent behavior should produce less of it. The argument, however, is almost certainly incorrect. As a first approximation, there would be no effect. This should not be surprising since the problem is simply another manifestation of the Demsetz variation on the Coase theorem.¹⁸ Suppose that it were possible to buy perfect insurance against losses arising from accountant negligence. If accountants are legally liable, they insure and pass the costs on to their clients. If accountants are not legally liable, then the clients could buy the insurance directly, or the third parties could buy the insurance and pay less for whatever the client is trying to sell. The insurer's incentives to monitor the accountant's performance are the same in all three cases. If the insurance is perfect and the insurer's ability to monitor is unaffected by the locus of liability, then the accountant's behavior is the same regardless of who bears the legal liability.

Insurance is not perfect, transactions costs are not zero; the choice of rules will, therefore, affect the outcomes. But the preceding argument directs attention to important questions. How can the market mechanism confront the accountant with the consequences of his actions? How do the costs incurred by accountants, if they are held liable in tort, compare to the benefits to third-party users of accountants' opinions?

The structure of my argument is as follows. If it turned out that it was appropriate that accountants should compensate third parties for their negligence, it would not be very difficult to have them assume the liability by contract rather than by having it imposed by tort.¹⁹ Third parties could

¹⁸ See Harold Demsetz, *Wealth Distribution and the Ownership of Rights*, 1 *J. Legal Stud.* 223, 225-26 (1972); and Ronald Coase, *The Problem of Social Cost*, 3 *J. Law & Econ.* 1 (1960).

¹⁹ I am assuming that the accountant cannot contractually waive tort liability. In the English case that recognized the negligent misrepresentation action, *Hedley Byrne & Co. Ltd. v. Heller & Partners Ltd.*, 2 *All E.R.* 575 (1963), the court held that no duty arose because the defendant had expressly disclaimed liability. At this time, it is probably accurate to characterize the American law as follows. It is said to be possible for an accountant to limit exposure by some form of disclaimer. However, it is not at all clear which disclaimers, if any, are likely to succeed.

For evidence of accountants' efforts to avoid liability by issuing qualified opinions or by asserting that their financial statements are not to be relied upon, see *Nat'l L.J.*, *supra* note 5, at 26, col. 4. A similar strategy was successful in emasculating the tort of negligent inspection by insurance companies. See Victor P. Goldberg, *Tort Liability for Negligent Inspection by Insurers*, 2 *Research L. & Econ.* 65 (1980). If accountants are successful in

receive explicit assurance in the form of a warranty, guarantee, bond, or a similar device. Even without explicit liability, the negligent accounting firm would suffer the consequences of poor performance in the form of a decline in the value of its "brand name." Since it is probably true that accountants are not very good guarantors, I would guess that accountants would rarely agree to compensate third parties. But it is crucial to recognize that it is unnecessary for courts or legislatures to guess. It is sufficient for them to allow the parties to resolve the problem by contract.

The accountant enters into a contract with his client, not with third parties; that, after all, is why they are called third parties. Nonetheless, there is no reason why the accountant could not promise that, in the event that he performed his job poorly, he would compensate all (or some) of the victims for some (or all) of their losses. That is, he could, provide an explicit guarantee.²⁰ One might object to this on the grounds that it would be impractical to have hundreds or thousands of possible reliefs attempt to enter into a contract with the accountant. This objection is not as compelling as it might appear at first glance. The accountant could simply state terms on which guarantees would be available, and either provide the assurance to anyone who accepts the terms (unilateral contract) or allow people to apply for assurance (as is typical of insurance contracts).

The third-party reliefs need not even get in touch with the accountant. Instead, he could buy his protection directly from the client firm. Suppose, for example, that a lender wanted some assurance. He could require, as a condition for making the loan, that the borrower post a bond.²¹ That bond would reimburse the lender for all losses suffered in the event that the borrower defaulted and an outside observer (a jury or arbitrator) concluded that the accountant's audit was negligent.

Such a bond is precisely what is imposed as a matter of law under the tort standard. If the client were to contract for indemnification by the accountant, then the outcome would be the same: if the accountant is negligent, he (or his insurance company) pays third parties. While it is true that the client-accountant contract to compensate third parties might not allow for much fine-tuning of the assurance provided, it surely pro-

adopting such a strategy, the end result of the demise of *Ultramares* might be nothing more than a modest degradation of the language. All accountants' opinions that would heretofore have been clean and unqualified would now be qualified. This is akin to the smallest size of a particular product being labeled "jumbo" or "colossal."

²⁰ I am using the term "guarantee" as a generic term that includes any form of assurance to third parties that they would receive some compensation if the accountant performed in a less than perfect manner.

²¹ Lenders frequently impose conditions that their borrowers must meet—for example, that the borrower purchase life insurance.

vides more flexibility than would imposition of a nonwaivable legal duty under tort or securities law. This would be so even in the case of publicly traded securities. The client firm could, for example, require the accountant to post a bond to pay off some of the claims of certain third parties. The client-accountant contract could make subtle distinctions between the liability to various third parties and their priorities. Or it could simply treat them all as unsecured claimants and give them the same status as other unsecured creditors in a bankruptcy proceeding.

It is true that the contracting solution becomes more difficult as the number of potential reliers increases. But the converse is more significant. Consider the exception, recognized in *Ultramares*, that would permit a cause of action if the nexus were close enough to approach privity. If the plaintiff and the accountant were in such intimate contact, why would it be necessary for the law to divine their intent with respect to the parameters of the latter's guarantee? They are ideally situated to determine the parameters by explicit negotiation. The privity requirement is not merely a technical requirement, a vestige of an era in which courts were hostile to the claims of victims. In this context, the requirement is a clear recognition that, while the third parties are "strangers," they need not be. They remain third parties only by choice. Whatever the flaws of the contract solution, it is clear that contracting will work best in precisely those areas in which courts have shown the greatest inclination to extend tort liability.

Suppose that the contracting option is unavailable. The market still provides the accountant substantial incentives to audit with care. An accountant who provides poor auditing services cannot charge as much for those services. The accounting firm, in effect, engages in activities that enhance the value of its brand name and then rents the brand name to clients. Clients use this brand name as one element of a strategy to induce third parties to enter into financial transactions with them on favorable terms. The clients' willingness to pay will depend ultimately on the quality of the information produced. Thus even if the accountant does not have to compensate third parties for losses arising from his negligence, he must pay indirectly.²²

²² In his analysis of accountant's negligence, William Bishop fails to recognize the significance of the accountant's brand name in providing incentives to produce information. See William Bishop, *Negligent Misrepresentation through Economists' Eyes*, 96 L. Q. Rev. 360, 366-69 (1980). He argues that the accountant with no liability has an incentive to produce information of an inferior quality and too little of it. The low quality would result from the lack of liability and the low quantity from the nonappropriability of the rewards for producing information. That is, if the accountant must spend money to produce information and users do not have to pay him for it, he would not have adequate incentives to produce information. But, as the argument in the text suggests, the accountant is compensated for producing information, albeit indirectly.

The brand name mechanism serves to deter accountant negligence. This does not, of course, mean that "good" accountants will never make expensive mistakes. The mistake-free accountant is almost certainly a luxury that the rational investor would not be willing to pay for. It only means that if an accounting firm performs in such a manner as to degrade its reputation for reliability, then it will suffer the consequences by not being able to charge as high a price for its services in the future.

An objection to this line of argument might run as follows. The accountant is hired by the client, not by the third party. The client might *want* its audit performed by an accountant who is incompetent or of dubious character. A pliant accountant who resolves disputable issues in the client's favor, who overlooks problems, or who fails to uncover fraud could, if he maintained credibility with enough third parties, be invaluable to clients. The client, in effect, would be willing to pay a high fee to rent the accountant's brand name in order to deceive third parties who are unaware of this accountant's reputation.

This objection has some merit, but it is also self-limiting. If third parties are repeat players—for example, institutional investors, insurance companies, and banks—any divergence between the accountant's reputation in the two markets would be unsustainable. Moreover, if traded securities are involved, small investors who know little about the accountant's reliability can free ride on the assessment of the accountant made by the repeat players dealing in the securities. The brand name mechanism will be very effective in disciplining large accounting firms auditing large public corporations.²³

The problem would be more likely to arise if the accounting firm were small and the third parties did not find it in their interest to acquire information on its quality. There is a potential adverse selection problem with the bad accountants driving out the good. Even if this argument were correct, it would not provide much of a basis for holding accountants liable. The adverse selection problem would apply to insurers as well, since they would also have difficulty distinguishing the quality of the small accountants. True, insurers would be repeat players and they would be in a better position to assess the accountants' quality. However, the increased tort exposure seems to have had the classic adverse selection effect on commercial insurers of small accountants—it has driven many of them out of the business.²⁴ In some jurisdictions in which the rea-

²³ The Big Eight audit about 70 percent of all publicly held corporations and 90 percent of the companies listed on the New York Stock Exchange; see U.S. Senate, Committee on Governmental Affairs, Subcommittee on Reports, Accounting, and Management, 94th Cong., 2d Sess., *The Accounting Establishment: A Staff Study* (1976).

²⁴ See the text at note 6.

sonable foreseeability standard has been adopted, the large accountants have arranged for subsidized insurance for the smaller accountants. This insurance is like an assigned risk pool for bad drivers; one cannot expect much in the way of quality monitoring.

Furthermore, there is another way in which third parties can cope with their inability to evaluate the accountant's brand name. They can hire specialists to perform that function. This might sound farfetched, but it is common. For an example in a closely related context, consider a bank that makes a mortgage on a piece of property, using the information compiled by a title abstracter to insure that the mortgagor has title. The bank hires (or requires the buyer or seller to pay for) a title insurer, who vouches for the quality of the abstracter's search by agreeing to pay compensation in the event that the title is flawed. The title insurer provides, among other things, the service of specialized monitoring of the reputation of the abstracters.²⁵ Lenders could also hire third parties who would be in a better position to weigh evidence on the reputation of accountants and who would bear some fraction of the costs if they were wrong. Indeed, in *Commercial Union*, the plaintiff was an insurer who was suing to recover money paid out under a blanket bond against employee fraud.²⁶

The combination of the brand name mechanism and the availability of the option of obtaining an explicit guarantee is not perfect. The question is whether anything is gained (and at what cost) by requiring the accountant to provide a specific guarantee as a matter of tort or securities law. Do the benefits obtained by the third parties in the form of increased deterrence, decreased expenditure on self-protection, and after-the-fact compensation outweigh the costs of producing the compulsory guarantee? There are good reasons for concluding that they do not.

We can begin with a simple inference. In the half century following *Ultramares*, businessmen did not successfully design a guarantee that compensated some classes of losers in the event of an accountant's negligence being associated in some way with their losses.²⁷ Such market evidence suggests that rational third parties would not want to buy *any*

²⁵ For a recent case in which a court erroneously found the abstracter liable to the title insurer, see *First American Title Insurance v. First Title Service of Florida Keys, Inc.*, 457 So.2d 467 (Fla. 1984). The title insurer could ascertain the quality of the abstracter by vertical integration, a more direct method of monitoring performance.

²⁶ See also *Seaboard Surety Co. v. Garrison, Webb & Stanaland*, 823 F.2d 434 (11th Cir. 1987).

²⁷ The accountant was liable for negligence with regard to the initial issuance of securities in a registered public offering under Section 11 of the Securities Act of 1933. The nonappearance of private assurance in this context should not, therefore, be taken as evidence of a lack of adequate demand.

financial product that conditioned recovery on the accountant's fault, given the costs of producing the assurance.²⁸ A fortiori, if the mandatory guarantees embodied in the tort and securities laws were not the most cost-effective guarantees that could be produced, then it is even more certain that these guarantees would not be worth producing.

There is no question that third parties would often want to purchase some form of assurance when they enter into financial transactions. There exists a wide range of options from which parties can choose how much assurance should be provided, by whom, to whom, and with respect to which contingencies. The assurance could take the form of a security interest in specific assets.²⁹ Or some outside party could guarantee payment of certain obligations in the event that the firm were unable to pay (in general or under specified circumstances).³⁰ The guarantees need not be unlimited; they could include ceilings, deductibles, copayments, liquidated damages, exclusions, disclaimers against consequential damages, or other qualifications. Nor need the same assurance be provided to all third parties; the guarantee could be fine-tuned to make it attractive to certain classes of end users.

This cataloging of the varieties of assurance that might be provided suggests why the implied warranties of tort or securities law are inferior to the best explicit warranties. The implied warranty deprives third parties of a number of powerful tools for delimiting the risks they face. This is especially clear when we consider the type of explicit warranties that make it to market. The provider of assurance would not condition compensation on the accountant's fault; indeed, it is unlikely that the accountant's behavior would be singled out for special treatment. It probably would be grouped together with other possible causes for a specific bad outcome, for example, the possibility that management fraud would result in a firm's failure. Thus, in *Commercial Union*, the plaintiff, itself an insurer, provided its client a blanket bond against management fraud. As an insurer, its obligation to pay was not conditioned upon its level of care; it was, however, limited by a ceiling specified by contract.

There are substantial advantages to writing guarantees in a form that

²⁸ Although recovery would be conditioned on the accountant's fault, the accountant need not be the provider of the assurance. The least-cost producer could be the accountant's insurer or an independent third party. The point is that, regardless of the identity of the most efficient provider of the optimal package of assurance, the expected costs always exceed the expected revenue.

²⁹ The plaintiffs had taken security interests in both *Ultramares* and *Credit Alliance*, note 2 *supra*.

³⁰ The plaintiff in *Timm*, note 2 *supra*, had some of its loans guaranteed by the Small Business Administration.

does not invite extensive litigation. *Ceteris paribus*, the clearer the terms of a guarantee, the fewer the resources that have to be expended on litigation.³¹ Flexibility encourages litigation that results in higher expected costs for the accountant and a lower expected benefit for third parties. The fuzzy contours of the accountant's court-determined guarantee increase the costs of providing that guarantee. The open-endedness of the foreseeability standard and the court's temptation to fine-tune the package by manipulating such doctrines as foreseeability, reasonable reliance, and the content of negligence makes fuzziness nearly inevitable.³²

There is no firm evidence on the litigation costs incurred by accountants to produce their guarantee, although the anecdotal evidence is sobering. One insurance company reported that insurance defense costs were five times indemnity payments.³³ The accountant cannot avoid the costs of litigation merely by performing nonnegligent audits. The costs of adding the accountant to the list of defendants in securities fraud class action suits or in suits against defaulting debtors are trivial. If defense costs are high and the accountants are potentially liable, the rewards to nuisance suits can be great.³⁴

³¹ This is a standard result in the "rent-seeking" literature. See, for example, Gordon Tullock, *Efficient Rent Seeking*, in *Toward a Theory of the Rent-seeking Society* (James Buchanan, Robert Tollison, & Gordon Tullock, eds. 1980).

³² Another source of vagueness, and therefore an invitation to wasteful rent seeking, is the possibility that courts will recognize some disclaimers of liability as valid. The courts will often invoke notions such as ambiguity or a lack of sufficient clarity in the notice as a wild card in order to find in favor of the plaintiff. For examples of such strained interpretations in the context of condemnation clauses, see Victor P. Goldberg, Thomas W. Merrill, & Daniel Unumb, *Bargaining in the Shadow of Eminent Domain: Valuing and Apportioning Condemnation Awards between Landlord and Tenant*, 34 U.C.L.A. L. Rev. 1083, 1120-25 (1987).

³³ See Nat'l L.J., *supra* note 5, at 26, col. 4. I hesitate to give too much credence to such numbers. Insurers have been reluctant to make much data public, and I suspect unverifiable data that are selectively released. Moreover, even if the data are accurate, they might be misleading. If the amount of litigation has been increasing (as everyone suggests) and if defense costs are being incurred in cases that have not yet been concluded, it is possible that we are comparing payouts of cases begun in 1980, say, with expenses incurred on the larger caseload of 1985. The faster the growth of litigation, the greater the *apparent* ratio of defense costs to payments.

³⁴ Daniel Fischel, *The Regulation of Accounting: Some Economic Issues*, 52 Brooklyn L. Rev. 1051, 1054 (1986), notes, "[A]fter a decline in a particular industry (energy and computers being the best examples in recent years), securities fraud suits are filed against many of the firms in the industry and their accountants alleging that investors who purchased during the class period did so at artificially inflated prices because of some defect in disclosure. While some of these suits undoubtedly have merit, the fact that suits are filed against a high percentage of firms in a particular industry (and their accountants) suggests that many are frivolous. Unless there is some amazing coincidence whereby a high percentage of wrongdoers wind up in particular industries, and they are responsible for the timing of declines in stock prices (rather than, say, the decline in the price of oil), it is implausible that the problems of an entire industry are attributable to disclosure decisions by firms and their accountants."

In addition to the costs of litigating the fault question, the implied warranty could induce the accountant to engage in “defensive medicine,” efforts that help avoid legal liability but that do not affect the likelihood that the losses would occur.³⁵ This is, of course, a potential problem in all areas of tort law, and it is not at all clear that the problem is any worse in this context. My point is only that anyone designing an explicit assurance package would have an incentive to weigh these potential costs and that, *ceteris paribus*, assurance would be favored that does not entail an inquiry as to fault.

Imposing liability on accountants has been justified in terms of the accountant’s superior ability to spread risks.³⁶ This argument is simply a careless extension of the enterprise liability catechism. Victims in other contexts might find it extremely difficult to spread certain risks by diversification or contract. But that is not a serious problem here where victims are typically financial professionals. It is bizarre to think that accounting firms should provide risk-spreading services for banks (*Timm, Credit Alliance*), mortgage companies (*Butler*), or insurance companies (*Commercial Union*).

Not all victims are financial professionals. Consider the worst-case scenario. How should a court respond to the plaintiff who has lost his life savings when the shares he held turned out to be worthless? Should the possibility of such wipeouts lead to imposition of nondisclaimable accountant liability to protect such investors? It would hardly seem sensible to hold the accountant liable to all investors to protect this one small class; that would allow the “thin-skulled” tail to wag the sophisticated-investor dog. Moreover, even if the liability could be limited to those who lose a substantial portion of their wealth, it would be hard to justify special treatment of the class. The thinness of the plaintiff’s skull, in this instance, is hardly a factor beyond his control. He could hold a diversified portfolio, pay professionals to diversify for him (that is, he could buy mutual funds), or he could take an even safer tack, avoiding the securities markets entirely. The accountant might be in the best position to avoid this “accident” (the occurrence of the fraud), but the victim is in the best position to avoid the special damages arising from putting too many eggs in the wrong basket.

Thus far, I have considered only the problem of the negligent accountant. What about the accountant who commits fraud—not just the soft-core fraud that Cardozo ruled actionable, but the hard-core fraud in which

³⁵ It is possible that the demand for the services of accountants and other experts is itself stimulated by the client’s need to practice defensive medicine. But even if that were true, imposing liability would just compound the distortions.

³⁶ See note 15 *supra*.

the accountant knowingly joined with the client in a successful attempt to defraud others? For example, in the ESM scandal, the former managing director of the South Florida office of Grant Thornton, the accounting firm, pleaded guilty to conspiracy and fraud charges, admitting that he knowingly certified false financial statements in exchange for payments.³⁷ Should the doctrine of *respondeat superior* be extended to hold the accounting firm liable for the fraudulent misdeeds of the individual employee or partner?³⁸

The preceding analysis carries over to the case of fraud. If the market views the fraudulent employee as a random "bad apple," then the accounting firm's reputation remains unimpaired. If, however, the market views the fraud as evidence that the firm's internal controls are faulty (either because it hires less scrupulous personnel or because it does not satisfactorily monitor the employees), then the value of the firm's reputation falls.³⁹ Direct contracting would also be possible. The accounting firm could post a bond against fraud on the part of one of its employees. Such a bond would not be novel. Sureties routinely agree to make good losses arising from dishonest behavior on the part of employees. If investors had a strong enough demand for such assurance, the accounting firms would voluntarily assume the responsibility. To be sure, the likelihood that the firm would offer some form of limited guarantee is greater than it would be in the case of negligence. But it is unnecessary and unwise to take the decision on the scope and extent of the guarantee out of the hands of the parties involved.

IV. WHERE THERE'S A WILL, THERE'S AN ACTION

In order to overcome the privity hurdle, *Rosenblum*, *Timm*, and *Butler* all cited cases drawn from other contexts, in which the courts allowed an action despite the absence of privity. These cases typically hold negligent

³⁷ See Robert J. Sack & Robert Tangreti, ESM: Implications for the Profession, 163 J. Acct. 94 (1987).

³⁸ In *Ultramares*, *supra* note 1, at 450, Cardozo held that the firm would be held responsible for the actions of its subordinates. It is not clear from the opinion whether the firm would be liable for fraud committed by the subordinate for his own purposes, as in the ESM case.

³⁹ The accountant who participated in the scheme should be held liable, although the consequences of not holding him liable would not be great. If the total losses substantially exceed the individual accountant's assets, the victims will not be able to recover much from this source, hence liability is not likely to help much in restoring the victim to the status quo ante. The legal sanction against an employed accountant's participation in a client's fraud consists of both his criminal and civil liability. The deterrent would indeed be reduced if the latter were eliminated without changing the former, but if only criminal sanctions were available, it should not be extremely difficult to achieve the same deterrent effect with a criminal penalty alone as could be obtained with a lesser criminal penalty and a civil penalty.

lawyers or notaries liable to the beneficiaries of a will despite the absence of privity.⁴⁰ These cases can be easily distinguished. Indeed, if the courts treated these precedents as governing contractual situations instead of torts, their outcomes would be the same, but the case law would not be cluttered with confusing and misleading precedents.

The lawyer, in a typical case, writes a will for X, who intends that, upon his death, certain goods or assets will go to Y. The lawyer botches the job, X dies, and Y gets less than he would have if the lawyer had properly performed his contract with X. The lawyer could be sued for breach of contract by X, except that X is now dead and cannot sue anybody. The legal issue might be couched in terms of the contract rights of third-party beneficiaries or the tort liabilities of lawyers to nonprivity beneficiaries,⁴¹ but the simple question is this: should somebody (say, Z) be able to sue the lawyer on behalf of X and, if so, what should be the remedy?

Answering this question does not require a lengthy exegesis of arcane corners of contract doctrine. Even if the black-letter law were that there would not be an action, the lawyer and the testator could draft around the prohibition. That is, the lawyer-testator contract, or the will itself, could include a clause that said, in effect, that if the testator's intentions were thwarted because of the lawyer's malpractice, the lawyer would have to make the proper beneficiaries whole. Two issues then arise: whether the legal default rule should be that the negligent lawyer pay compensation to the beneficiaries, and the magnitude of the hurdle to contracting around that rule.

A prior question is, Who should be able to pursue this interest on X's behalf? That is, who should have the role of Z? It almost certainly would be unwise to have X's estate bear the litigation costs. If the estate bore the costs, this would give anyone who wanted to contest the will a "second bite of the apple." That is, having lost the attack on the will as written, the disappointed claimant could then force the estate to bear the costs of pressing the claim that the will was negligently prepared.⁴² It would make much more sense to have the executor of the estate administer the will as written and have the disappointed heirs act on their own (or employ their own agent). That is, the efficient contract solution would almost certainly

⁴⁰ Rosenblum, *supra* note 14, at 144, cited *Immerman v. Ostertag*, 83 N.J. Super. 364, 199 A.2d 869 (Law. Div. 1964) (notary). *Butler*, *supra* note 2, at 221–22 cited *Biakanja v. Irving*, 49 Cal. 2d 647, 320 P.2d 16 (1958) (notary); *Lucas v. Hamm*, 56 Cal. 2d 583, 15 Cal. Rptr. 821, 364 P.2d 685 (1961) (lawyer); and *Heyer v. Flaig*, 70 Cal. 2d 223, 74 Cal. Rptr. 225, 449 P.2d 161 (1969) (lawyer). *Timm*, *supra* note 2, at 365–66, cited *Auric v. Continental Casualty Co.*, 111 Wis. 2d 507, 331 N.W.2d 325 (1983) (lawyer).

⁴¹ Both doctrines were invoked in *Heyer*, *supra* n. 40.

⁴² Or it could use the threat of additional litigation costs to increase its share of the estate.

entail having the third-party, self-proclaimed beneficiaries pursue their own cause of action against the lawyer.

There is a strong presumption that informed customers would want the lawyer to provide a warranty. People might write a lot of wills in the course of a lifetime, but only one counts. The buyer of lawyers' services will learn virtually nothing from his own experience. Nor is he likely to learn much from the experiences of others, since the primary feedback mechanism (absent lawsuits) would be the complaints of disappointed heirs, hardly the most reliable of sources. On the other hand, if the lawyers are held responsible, then the malpractice insurers serve as the repeat players. The insurer is well situated to gather and process information on the quality of lawyers. By experience-rating lawyers (raising the premiums on those who are repeat offenders), by refusing to insure high-risk lawyers, or perhaps by providing only conditional insurance to some lawyers, the malpractice insurer can do a tolerably good job of disciplining poor performers.⁴³

The lawyer drafting a will is pretty well informed about dollar magnitudes, the nature of the potential claimants, and possible pitfalls, these being generally revealed in the process of drafting. Furthermore, given the heavy reliance of lawyers on formula clauses that have been tested time and time again, a lawyer's mistake is likely to be easy to identify. Few resources would be expended litigating that fact issue. For these reasons, the costs of holding lawyers liable for negligence in such cases would be considerably less than in the accountant cases (or in the analogous cases in which third parties rely upon a lawyer's opinion).

It does not follow, however, that the lawyer should not be able to contract out. But the context suggests that the cost of contracting out should be made very high, if not prohibitive. The lawyer's expertise, the client's inexperience, and the likelihood that the client's reasoning processes are somewhat impaired by age or infirmity combine to cast doubt on the client's consent to a waiver. One might devise some mechanism whereby the client could make an informed waiver of the implied warranty (for example, by having a second lawyer sign a statement that he had advised the client of the consequences of a waiver and that the client had knowingly consented), but I doubt whether anyone would bother.

The remedy question is reasonably straightforward. The wishes of the testator should be carried out to the extent possible, given the fact that the

⁴³ Conceivably, testators or potential beneficiaries could insure. I doubt whether any serious argument could be devised that would make such insurance as effective as malpractice insurance.

estate has already been through probate.⁴⁴ This could present a number of practical problems if the estate included hard-to-value assets (such as land, houses, and heirlooms) that ended up in the wrong hands—people who received more from the estate than they would have, had the testator's intentions properly been carried out. Given the strong public interest in quieting claims to title, it would make no sense to require the recipients of a windfall to disgorge. Indeed, even if one of the testator's primary purposes was to prevent particular individuals from receiving specific items and the lawyer's error resulted in the items' going to that individual, requiring the recipient of the windfall to disgorge would almost certainly be unwise. It would make even less sense in this latter case to allow the lawyer to seek contribution against the recipient. The unfortunate outcome arose because of the lawyer's error. If anything, the money damages owed to the testator (and those claiming on his behalf) should be increased to take into account the harm suffered by the testator from having his assets fall into the wrong hands.

V. CONCLUDING REMARKS

There are plausible reasons for extending the scope of tort liability to cover third parties not in privity with producers of goods or services. Much of the hostility to the privity defense undoubtedly stems from such legitimate concerns. That does not mean, however, that tort law must necessarily supplant contract law across the board. Where contracts can effectively assign responsibility for losses and where it is unlikely that most victims would be willing to pay for protection, it would be unwise to rely on tort law.⁴⁵

⁴⁴ One might argue that the victim of the breach of contract is entitled only to a refund and that compensation for the consequential damages would be excessive. I have argued elsewhere that there are often good grounds for denying compensation for consequential damages. However, that is not the case here. The lawyer has sufficient notice of the nature and magnitude of the risk exposure. Indeed, he probably has a better understanding of the exposure than does his client. Moreover, the lawyer is in a better position to control the risks than is the client. In short, the lawyer is the "least-cost avoider." See Victor P. Goldberg, *Readings in the Economics of Contract Law*, pts. 2 & 3 (1988).

⁴⁵ Many of the arguments in this article carry over to the product liability context as well. See, especially, Epstein, *supra* note 16, and Priest, *supra* note 16. I suspect that further explorations along these lines would lead to the conclusion that product liability law's dismissal of the privity requirement in many contexts is unwise. But I need not go that far here. Even if one believed that the product liability rules were correct, the accountant case can be distinguished on at least three grounds. First, the potential plaintiffs in the accounting cases are generally repeat players who are much more sophisticated about the risks, and the techniques for coping with them, than are their products liability counterparts. Second, in the accounting context, the risk exposure of the third party is transaction-specific. It is

The problem of the negligent accountant falls squarely in that category. The costs of providing a legally imposed, fault-based guarantee on accountants almost certainly outweigh the benefits. If investors want assurance against losses arising from accountant negligence or other causes, they can purchase it. Imposition of nondisclaimable liability on the accountant is a very blunt instrument for providing that assurance. Even more important, an accountant's contract with the client he audits provides an incentive to take an appropriate level of care in his auditing activity. The linkage is complicated, but the incentives are powerful nonetheless. The good accountant can charge a high price to clients because they can use the accountant's good name to sell their securities at a premium or to borrow at lower interest rates.

The law in this area has, therefore, been moving in the wrong direction. Rather than picking away at the *Ultramares* shield against liability and expanding the accountant's exposure, the law should be extending the shield, narrowing or eliminating the exceptions proposed by Cardozo. The accountant's liability to third parties should be determined entirely by voluntary agreement. Neither tort nor securities law should be used to force the accountant to make greater (or different) guarantees than he would otherwise have made.

relatively easy to tailor a warranty to the needs of the third party. In a product liability case, the party can determine whether it should expose itself, but the magnitude of the damages (particularly lost earnings and medical costs) is not specific to the particular transaction. Third, the victims of accountant negligence can insure by diversifying; the potential losses are dollars, and it is a fairly routine exercise to weigh the merits of various strategies (diversification or guarantees) in terms of dollars. That is not the case for physical injuries in product liability cases. The existence of pain and suffering damages in the product-liability context presents an additional problem, although it probably cuts the other way. If, as I believe, reasonable consumers would not voluntarily contract for compensation for pain and suffering, then the compulsory contract of products liability law gives them something they do not find worth the cost.