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***THE SURETY AND FIDELITY INSURER'S RELIANCE
UPON ACCOUNTING PROFESSIONALS IN
UNDERWRITING:
AUGMENTING SALVAGE PROSPECTS***

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I. INTRODUCTION

The importance of responsible public accounting has developed over the years not only to meet the need of corporate management and equity owners for professional assurance as to the accuracy of a corporate enterprise's financing reporting and integrity, but also to provide similar assurance to certain third parties. Indeed, many corporate enterprises have no internal need for auditing by independent certified public accountants. Rather, such professionals may be retained solely to meet the requirements imposed upon the corporation by lenders and others with whom the corporation seeks to engage in various business transactions. The Supreme Court of the United States has recognized that the function of a certified public accountant is such to engender a greater duty to the public than to the company with whom it contracts. In United States v. Arthur Young & Co.¹, the Court observed that:

By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders as well as to the investing public. This "public watchdog" function demands that the accountant maintains total independence from the client at all times and requires complete fidelity to the public trust.²

Even accountants themselves recognize their obligations to third part users of audit opinions. The American Institute of Certified Public Accountants (AICPA) Professional Standards provide that:

A distinguishing mark of a profession is acceptance of its responsibility to the public. The accounting profession's public consists of clients, credit grantors, governments, employers, investors, the business and financial community, and others who rely on the objectivity and integrity of certified public accountants to maintain the orderly functioning of commerce. This reliance imposes a public interest responsibility on certified public accountants.³

Among third parties who frequently rely upon the audits of certified public accountants are sureties and fidelity insurers. This paper will address the extent to which such sureties and fidelity insurers may in fact rely upon the representations made by certified public accountants. In addition, it will review ways in which such sureties and fidelity insurers may augment their ability to obtain reimbursement for losses sustained as a result of their detrimental reliance upon accounting professionals' proper discharge of their auditing engagements.

The overall objective of any surety is to earn a profit by extending surety credit

¹465 U.S. 805 (1983).

²Id at 817-18.

³AICPA Professional Standards at § 53.01 (1993).

selectively to contractors which present relatively low risk to the surety. Such contractors are identified by the surety through the underwriting process, in which the surety analyzes the risk presented by a particular contractor, and makes a decision whether to accept this risk by issuing surety bonds on behalf of that contractor. One of the primary underwriting considerations in determining whether to issue performance and payment bonds is the financial condition of the principal and its individual indemnitors. Toward this end, sureties must carefully review and analyze the financial statements of the principal and indemnitors. Such careful review is imperative, in that a surety is, in effect, "betting" on its principal's financial wherewithal to finance the underlying project by timely paying its subcontractors and material suppliers while absorbing any losses or setbacks which may occur. Hence, a surety strives to issue bonds on behalf of only those contractors with a strong financial condition such that the risk of default (and therefore loss to the surety) is relatively low. Furthermore, because of the surety's contractual and common law rights of indemnification, the surety would, ideally, like to be satisfied that the individual indemnitors have the financial capacity to reimburse the surety in the event of a loss. Thus, suffice it to say that careful review and analysis of the financial statements of both the principal and individual indemnitors is a vital component of underwriting surety bonds.

The financial statements which sureties examine and rely upon are generally compiled, reviewed, or audited by accountants engaged by the principal. These financial statements may contain misrepresentations or omissions which result in such statements showing a materially higher net worth, working capital, operating profit, or other indicia of financial health for the principal than actually exists. Upon suffering a loss in connection with bonds it has issued, a surety normally will seek recovery against the principal and the individual indemnitors on whose behalf the bond was issued. This right of recovery stems from both contractual rights of indemnification, as well as common law rights of exoneration, contribution and reimbursement. In addition, subrogation rights may exist which could further mitigate the surety's loss. Such sources of recovery may prove limited, however, in that the principal and indemnitors may be without assets sufficient to compensate the surety for its loss, and contract balances may have either already been expended or may be inadequate to compensate the surety for the loss incurred.

With increasing frequency, sureties have been turning to a variety of entities other than the principal and its indemnitors or obligees to recover some or all of its losses. These "third parties" have no contractual relationship with the surety, and they may include accountants, architects, engineers and lenders. This paper will focus upon accountants as a source of salvage and will examine the various theories of recovery which a surety can pursue against an accountant who has audited financial statements upon which the surety relied in issuing performance and payment bonds. This paper will also touch upon the fidelity insurer's reliance upon an audit conducted of an insured institution, and examine the prospects for recovery against the insured's accountants for negligence in connection with such audit.

II. ACCOUNTANTS' SERVICES WITH RESPECT TO FINANCIAL STATEMENTS.⁴

⁴Information in this section was obtained from the Professional Standards of the American Institute of Certified Public Accountants (1993).

Before examining the various theories of an accountant's liability to a third party such as a surety or fidelity insurer, a brief summary of the various professional services that an accountant renders with respect to the financial statements of a client is warranted. In general, there are three types of such services.

A. Compilation.

Compilation involves merely gathering and presenting in the form of financial statements information that is the representation of the client (in the surety context, the principal; in the fidelity context, the insured institution) without undertaking to express any assurances as to the accuracy of such information. Thus, compilation involves no representations of the accountant with respect to the fair presentation of the financial statements.

B. Review.

The review function consists of performing an inquiry and analytical procedures that provide the accountant with a reasonable basis for expressing limited assurance that there are no material modifications that should be made to the financial statements in order for them to be in conformity with generally accepted accounting principles. Thus, review involves a limited representation by the accountant as to the fair presentation of the financial statements.

C. Audit.

Audit involves analyzing the financial statements and accounting procedures of the client and expressing an opinion as to whether the financial statements present fairly, in all material respects, the company's financial position in conformity with generally accepted accounting principles. The accountant must identify those circumstances in which such principles have not been consistently observed in the preparation of the financial statements of the current period in relation to those of the preceding period. Audit involves the most complete representation of the accountant with respect to the fair presentation of the financial statements. Since sureties and fidelity insurers generally review and rely upon audited financial statements or an audit report, this paper will focus on recovery against accountants who perform the audit function with respect to their clients' financial statements.

III. THEORIES OF RECOVERY AGAINST THE ACCOUNTANT

Suppose a surety suffers a loss resulting from its reliance upon material misrepresentations in the audited financial statements of its principal. In essence, the surety's argument is that had those misrepresentations not existed, the financial condition of the principal would have been shown to be such that the surety would not have issued any bonds on behalf of that contractor. Thus, but for the surety's reliance upon the misrepresented financial condition of the principal, no loss would have been incurred. The question therefore arises whether the surety may bring a direct action against the accountant whose audit was relied upon.

A surety normally has no contractual relationship with an accountant who is retained by the principal for the purpose of auditing its financial statements. Similarly, a fidelity insurer

generally has no contractual relationship with the accountant who has audited the insured institution. Such a contractual relationship is called "privity" and typically exists only between the accountant and his client whose statements are to be audited. Thus, a threshold issue to be addressed, and a primary focus of this paper, is whether the surety or fidelity insurer has standing to sue the accountant with whom it has no contractual privity.

A. Actions in Tort - Negligence.

While the applicable law varies from state to state, courts have generally taken four approaches with respect to determining whether and to what extent an accountant may be held liable in tort to a third party, such as a surety or fidelity insurer, for negligence in connection with the audit of financial statements upon which the surety or fidelity insurer had relied. Although relatively few cases have involved a surety or fidelity insurer as plaintiff, all of the approaches are applicable to the situation where a surety or fidelity insurer seeks recovery from an accountant, alleging that it relied to its detriment upon misrepresentations by the accountant with respect to the financial statements of the principal/insured. Accordingly, the surety and fidelity insurer should be cognizant of all four approaches.

(1) The Privity Approach

The approach which makes it most difficult for third parties to recover against an accountant for negligence is the privity approach, which requires some sort of contractual privity between the accountant and the third party before any duty arises on the part of the accountant to such third party. Two standards for establishing privity have been adopted - the "strict privity" standard and the more relaxed "near privity" standard.

a. The *Ultramares* Approach - "Strict Privity"

In 1931, the New York Court of Appeals decided the landmark case of *Ultramares Corp. v. Touche*.⁵ In *Ultramares*, an accounting firm was retained by Fred Stern & Co. ("Stern") to prepare and to certify its balance sheet. The accounting firm supplied Stern with 32 certified copies of the balance sheet. No mention was made as to how Stern would use the balance sheets or to whom they would be furnished. In reliance upon the certified balance sheet, a corporation made certain loans to Stern. Thereafter, Stern was declared bankrupt and it was discovered that Stern's books had been falsified. The lender corporation sued the accounting firm for negligence and fraud, alleging that a fuller inquiry would have uncovered the truth. Although the court found that the accounting firm was negligent in conducting the audit, it disallowed the corporation's negligence claim against the accounting firm because the plaintiff had no privity with the accountants.⁶

Ultramares thus held that accountants are only liable for negligence to those persons with whom they have privity of contract. The court was concerned that extending liability beyond this "may expose accountants to a liability in an indeterminate amount for an indeterminate time to an

⁵174 N.E. 441 (N.Y. 1931).

⁶Id. at 444.

indeterminate class."⁷

In the context of a surety or fidelity insurer's reliance upon the accountant's audit, this decision meant that such surety or fidelity insurer could not recover from the accountant who prepared financial statements upon which the surety or fidelity insurer relied, even if the accountant had been negligent in preparing such statements. For several decades, Ultramares remained the authoritative view on this issue. Over the past several decades, however, courts have relaxed, modified, and even abandoned the strict privity requirement of Ultramares. As a result, different jurisdictions have adopted various approaches which range from requiring "near privity" to requiring no privity at all so long as the third party's reliance on the financial statements was reasonably foreseeable. Nonetheless, Ultramares remains an influential case on accountants' liability, and for those jurisdictions that continue to follow Ultramares, the "strict privity" rule remains the standard precluding accountants' liability to third parties.

b. The Credit Alliance Approach - "Near Privity"

In 1985, the New York Court of Appeals somewhat eased the rigidity of its Ultramares "strict privity" requirement in Credit Alliance v. Arthur Andersen & Co.⁸ In this case, the plaintiffs were financial service companies that had been regularly financing a capital intensive company ("Smith"). At one point during this business relationship, the plaintiffs notified Smith that audited financial statements would be a condition to further financing, and thereafter, Smith provided plaintiffs with financial statements which were audited by Arthur Andersen. The audit report stated that the statements were audited in accordance with generally accepted auditing standards. In addition, the statements certified that they fairly reflected the financial position of Smith in accordance with generally accepted accounting principles. In reliance upon these financial statements, the plaintiffs provided substantial amounts of financing to Smith and, ultimately, sustained a significant loss. The plaintiffs then sued Arthur Andersen, alleging that it had not followed proper standards in conducting the audit, and thus, negligently failed to discover Smith's true financial position.

The court, without overruling Ultramares, opened the door somewhat for third party actions against accountants by adopting a "near privity" approach. According to the court, a party without a contractual relationship with an accountant can recover for negligence if the following criteria are established:

- (1) the accountant must have been aware that the financial reports were to be used for a particular purpose or purposes;
- (2) the accountant must have been aware that the financial report was to be used in furtherance of which a known party was intended to rely; and
- (3) there must have been some conduct on the part of the accountant

⁷Id.

⁸483 N.E.2d 110 (N.Y. 1985).

linking the accountant to the known party which evidences the accountant's understanding of that party's reliance.⁹

Thus, although Credit Alliance somewhat relaxed the "strict privity" requirement of Ultramares, it still requires a significant "nexus" between the accountant and the third party to establish liability. A surety or fidelity insurer which seeks to recover from an accountant under this standard must demonstrate not only that the accountant knew of its intended reliance upon the statements, but also that the accountant exhibited conduct which evidenced this knowledge.

The Credit Alliance "near privity" rule remains the standard in New York for determining an accountant's liability to a third party, and this rule has been adopted in several other jurisdictions as well.¹⁰ In addition, several states have enacted legislation which adopts the "near privity" rule¹¹ and several others are considering similar legislation.¹²

(2) The Restatement Approach - A "Middle Ground"

Section 552 of the Restatement (Second) of Torts, entitled "Information Negligently Supplied for the Guidance of Others," represents a more relaxed standard than the "near privity" rule. Essentially, it constitutes a "middle ground" between requiring strict privity and requiring no privity. It provides, in pertinent part:

⁹Id. at 118.

¹⁰See, e.g., Colonial Bank v. Ridley & Schweigert, 551 So.2d 390 (Ala. 1989) (Alabama); F.D.I.C. v. Deloitte & Touche, 834 F. Supp. 1129 (E.D. Ark. 1992) (Arkansas); Idaho Bank & Trust Co. v. First Bancorp, 772 P.2d 720 (Idaho 1989); Thayer v. Hicks, 793 P.2d 784 (Mont. 1990) (Montana); Citizens Nat'l Bank v. Kennedy & Coe, 441 N.W.2d 180 (Neb. 1989) (Nebraska); Landell v. Lybrand, 107 A. 783 (Pa. 1919) (Pennsylvania); Nordica USA, Inc. v. Deloitte & Touche, 839 F. Supp. 1082 (D. Vt. 1993) (Vermont).

In addition, federal courts have interpreted the laws of three additional states to follow the privity rule even though the highest courts of those states have not expressly considered the question. See Stephens Indus., Inc. v. Haskins & Sells, 438 F.2d 357 (10th Cir. 1971) (Colorado law); McLean v. Alexander, 599 F.2d 1190 (3d Cir., 1979) (Delaware law); Ackerman v. Schwartz, 947 F.2d 841 (7th Cir. 1991) (Indiana law).

¹¹See Ark. Code Ann. § 16-114-302 (Supp. 1990) (Arkansas); 225 ILCS 450/30.1 (1993) (Illinois); Kan. Stat. Ann. § 1-402(b)(1991) (Kansas); N.J.S.A. § 2A:53A-25 (1995) (New Jersey); Utah Code Ann. § 58-26-12 (Supp. 1990); W.S. 33-3-210 (February 24, 1995). The New Jersey statute is discussed in section III.A.(3) infra.

¹²Texas (HB 505); Arizona (SB 1188); Hawaii (HB 313/SB 1267); Massachusetts (HB 1028/SB 1036); Nebraska (LB 220/LB 261).

- (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.¹³

Thus, the Restatement not only allows for recovery to those persons that accountants intend to influence directly, but it also allows for recovery to persons whom the accountants know their client intends to influence. This is significant for the surety or fidelity insurer, since the accountant may have no interaction whatsoever with the surety, yet still may be liable to it if it knows that its client (the principal or insured) will ultimately furnish the information to the surety. The Restatement's "middle ground" approach is the most widely applied doctrine concerning the liability of professionals for negligent misrepresentation.¹⁴

¹³Restatement (Second) of Torts § 522.

¹⁴See, e.g., Selden v. Burnett, 754 P.2d 256 (Alaska 1988); Bily v. Arthur Young & Co., 834 P.2d 745 (Cal. 1992) (California); First Florida Bank, N.A. v. Max Mitchell & Co., 558 So.2d 9 (Fla. 1990) (Florida); Badische Corp. v. Caylor, 356 S.E.2d 198 (Ga. 1987) (Georgia); Chun v. Park, 462 P.2d 905 (Haw. 1969) (Hawaii); Pahre v. Auditor of State, 422 N.W.2d 178 (Iowa 1988); Ingram Indus., Inc. v. Nowicki, 527 F. Supp. 683 (E.D. Ky. 1981) (Kentucky); First Nat'l Bank of Commerce v. Monco Agency, Inc., 911 F.2d 1053 (5th cir. 1990) (Louisiana); Bowers v. Allied Inv. Corp., 822 F. Supp. 835 (D. Me. 1993) (Maine); Law Offices of Lawrence J. Stockler, P.C. v. Rose, 436 N.W.2d 70 (Mich. App. 1990), appeal denied, 434 Mich. 861 (1990) (Michigan); Bonhiver v. Graff, 248 N.W.2d 291 (Minn. 1976) (Minnesota); Mid-American Bank & Trust Co. v. Harrison, 851 S.W.2d 563 (Mo. App. 1993) (Missouri); Thayer v. Hicks, 793 P.2d 784 (Mont. 1990) (Montana); Spherex, Inc. v. Alexander Grant & Co., 451 A.2d 1308 (N.H. 1982) (New Hampshire); Raritan River Steel Co. v. Cherry, Bekaert & Holland, 367 S.E.2d 609 (N.C. 1988) (North Carolina); Bunge Corp. v. Eide, 372 F. Supp. 1058

(3) The Rosenblum Approach - "The Foreseeable User"

In H. Rosenblum, Inc. v. Adler,¹⁵ the New Jersey Supreme Court held that a reasonably foreseeable user of financial statements, without privity, may recover in a negligence action against the accountants who prepared such statements. This approach adopts standard negligence rules and represents the most liberal rule for accountant liability to third parties. Until very recently, when the New Jersey Legislature abolished this rule by statute, Rosenblum represented the leading decision nationally that supported an accountant's liability to a third party absent privity. Nevertheless, Rosenblum remains the law in New Jersey with respect to transactions entered into before the March 17, 1995 effective date of N.J.S.A. § 2A:53A-25. Moreover, Rosenblum has led to other jurisdictions adopting the "foreseeable user" approach¹⁶ and has been at the center of most debates concerning the issue of accountants' liability to third parties. The importance of this decision, therefore, warrants some detailed discussion.

In Rosenblum, the accounting firm of Touche Ross & Company ("Touche Ross") was engaged to audit the financial statements of Giant Corporation ("Giant"). Unbeknownst to Touche Ross, Giant had fraudulently recorded assets that it did not own and omitted substantial liabilities on its books. Touche Ross conducted the audit and issued an unqualified opinion, but it failed to uncover the fraud. Rosenblum subsequently acquired the common stock of Giant in exchange for the sale of its business to Giant. After the stock proved to be worthless, Rosenblum sued Touche Ross, alleging that because its reliance upon the financial statements was reasonably foreseeable, Touche Ross had breached a duty of care by negligently failing to discover the fraudulent representations of the client.

The Rosenblum court rejected the Ultramares privity rule and the Restatement (Second) of Torts §552 and adopted a rule which requires no contractual or intended relationship between an accountant and a third party.¹⁷ The court concluded that the public interest is served by holding an auditor responsible for its negligence to those persons the auditor "should reasonably foresee" will

(D.N.D. 1974) (North Dakota); Haddon View Inv. Co. v. Coopers & Lybrand, 436 N.E.2d 212 (Oh. 1982) (Ohio); Mill-Mar, Inc. v. Statham, 420 A.2d 548 (Pa. Super. 1980) (Pennsylvania); Rusch Factors, Inc. v. Levin, 284 F. Supp. 85 (D.R.I. 1968) (Rhode Island); Bethlehem Steel Corp. v. Ernst & Whinney, 822 S.W.2d 592 (Tenn. 1991) (Tennessee); Shatterproof Glass Corp. v. James, 466 S.W.2d 873 (Tex. Civ. App. 1971) (Texas); Christenson v. Commonwealth Land Title Ins. Co., 666 P.2d 302 (Utah 1983); Haberman v. Washington Pub. Power Supply Sys., 744 P.2d 1032 (Wash. 1988) (Washington); First Nat'l Bank v. Crawford, 386 S.E.2d 310 (W. Va. 1989) (West Virginia).

¹⁵461 A.2d 138 (N.J. 1983).

¹⁶See infra notes 20-28 and accompanying text.

¹⁷Id. at 145.

rely upon the audit and do in fact so rely.¹⁸ The court stated that in order to establish liability in this context, reasonably foreseeable users of financial statements must show:

- (1) that they received the audited statements pursuant to a proper company purpose;
- (2) that they relied upon those statements;
- (3) that the misstatements were attributable to the auditor's negligence; and
- (4) that the misstatements were the proximate cause of the plaintiffs' damages.¹⁹

The Rosenblum Court reasoned that the accountant is in the best position to spread the loss along to his clients and ultimately to the consuming public. Because accountants can procure liability insurance or disclaim their certification as to the financial condition of the audited company making it applicable only to certain specified parties, the Court opined that the accounting profession would not be unduly harmed by this rule.

The Rosenblum standard was obviously extremely helpful to a surety which relied upon the negligently prepared financial statements of its principal. Under this standard, the surety need only have demonstrated that the accountant should have foreseen that the surety would have relied upon the financial statements. This was by no means a difficult standard to satisfy since a surety's reliance in this context is usually rather obvious. The most obviously foreseeable users of the accountant's reports concerning his client's (i.e., the contractor's) financial condition are the contractor's surety, banker and outside investors. The insiders of the contracting company presumably already know its financial condition.

Indeed, accountants who are engaged to audit financial statements are charged with the responsibility of learning the nature of their clients' businesses. For companies engaged in public construction, procurement of surety credit is an essential element of conducting business. That fact certainly would and should be known to its accountant if such accountant exercised due care in learning the nature of its client's business. Thus, for accountants providing services to companies engaged in public construction, a surety arguably is always a foreseeable party who is likely to rely upon the accountants' representations regarding their clients' financial condition. Thus, in jurisdictions adopting this rule, the surety should always have standing to sue its principal's accountant.

New Jersey was the first, but not the last, state to adopt the "foreseeable user" rule. In Citizens State Bank v. Timm, Schmidt & Co.²⁰, the Supreme Court of Wisconsin held that an accountant was liable to a third party who relied on a bank's accountant's negligently-prepared audit report in extending loans to the bank. The court abrogated the Restatement rule as "too restrictive."²¹

¹⁸Id. at 152.

¹⁹Id.

²⁰335 N.W.2d 361, 366-67 (Wis. 1983).

²¹Id. at 166.

The court reasoned that accountants should be liable to foreseeable users of an accountant's professional services unless recovery is denied on grounds of public policy. The court considered the following public policy factors:

- (1) The injury is too remote from the negligence;
- (2) the injury is too wholly out of proportion to the culpability of the negligent tortfeasor;
- (3) in retrospect it appears too highly extraordinary that the negligence should have brought about the harm;
- (4) allowance of recovery would place too unreasonable a burden on the negligent tortfeasor;
- (5) allowance of recovery would be too likely to open the way for fraudulent claims;
- (6) allowance of recovery would enter a field that has no sensible or just stopping point.²²

The court found no public policy considerations to bar recovery when a foreseeable bank lender could show justifiable reliance on the auditor's report.²³ According to the court, denying protection to banks who rely upon the audited financial statement of their borrowers would force banks to absorb the losses resulting from negligent auditors and drive up the cost of credit to the general public.²⁴

In Touche Ross & Co. v. Commercial Union Ins. Co.²⁵, the Mississippi Supreme Court continued the trend begun in Rosenblum. In this case, Touche Ross ("Touche"), as independent auditor for Fidelity Bank (the "Bank"), was sued by Commercial Union who, in reliance upon the audit, extended fidelity insurance to the Bank. Under the facts of the case, Touche would not have been liable in either a privity jurisdiction or a Restatement jurisdiction, because Touche did not know of Commercial Union's reliance, nor did it supply the Bank with the audited financial statement for the benefit of Commercial Union. However, the court applied the "foreseeable user" approach and found that Touche should have "reasonably foreseen that an entity such as Commercial Union" might rely on the audit.²⁶

California adopted the "foreseeable user" rule in International Mortgage Co. v. John Butler Accountancy Corp.,²⁷ which held that an accountant owes a duty to those third parties who reasonably and foreseeably rely on audited financial statements. However, six years later, in Bily v.

²²Id.

²³Id.

²⁴Id. at 365.

²⁵514 So.2d 315 (Miss. 1987).

²⁶Id. at 322.

²⁷223 Cal. Rptr. 218 (Cal. Ct. App. 1986).

Arthur Young & Co.,²⁸ the California Supreme Court overruled International Mortgage and adopted the Restatement rule regarding accountants' liability to third parties.

a. New Jersey Senate Bill 826 - The Pendulum Swings Back

While the Rosenblum "reasonably foreseeable" standard has been adopted in several jurisdictions, in March 1995, New Jersey enacted into law New Jersey Senate Bill 826 which cut back on the broad "foreseeable user" rule and provides for a "near privity" requirement substantially similar to the Credit Alliance approach with respect to transactions entered into after the effective date of such legislation.²⁹ The bill was the result of negotiations among various political factions which are representative of the nationwide tort reform movement.

Under the New Jersey statute, an accountant will not be liable to a third party for negligence unless the following criteria are met:

- (1) The accountant knew that the professional accounting services rendered to his client would be made available to the third party who was specifically identified to the accountant in connection with a specified transaction;
- (2) The accountant knew the third party intended to rely on the professional accounting services regarding the specific transaction;
- (3) The accountant directly expressed to the third party, by words or conduct, the accountant's understanding of the third party's reliance on the professional accounting services.

(b) Recent Legislation in Other States

As discussed above, several states have enacted legislation closely resembling the "near privity" rule while other states are currently considering such legislation.³⁰ Most recently, Wyoming has introduced legislation which is substantively identical to New Jersey's law with one important exception: to take advantage of the limitation of liability provided by the law, Wyoming accountants must prominently disclose in their reports or opinions the purpose of such report or

²⁸834 P.2d 745 (Cal. 1992).

²⁹See New Jersey P.L. 1995, c.50; N.J.S.A. § 2A:53A-21. See also Statement of New Jersey Senators Kyrillos and Cardinale at the introduction of New Jersey S.B. 826 ("In Rosenblum, Inc. v. Adler, the New Jersey Supreme Court expanded the scope of accountants' liability to include all 'reasonably foreseeable' plaintiffs... This bill [S.B. 826] would restore the concept of privity to accountants' liability").

³⁰See supra notes 8-9 and accompanying text.

opinion, the persons entitled to rely on them, and that liability to third parties may be limited by law.³¹

(4) The Balancing Approach.

At least one court has adopted a fourth approach, which involves the balancing of the following policy considerations:

- (a) The extent to which the transaction was intended to affect the plaintiff;
- (b) The foreseeability of harm;
- (c) The degree of certainty that the plaintiff was injured; and
- (d) The proximity between the defendant's conduct and the plaintiff's injury.³²

This approach, which appears to be a sort of mix between the Restatement rule and the "foreseeable user" rule, has not gained widespread acceptance.

B. Actions in Contract - Third-Party Beneficiary Theory.

As stated, a surety or fidelity insurer maintains no contractual privity with an accountant who is retained by the principal or the insured. Nevertheless, a surety or a fidelity insurer may be in a position to assert a contractual cause of action against the accountant under a third-party beneficiary theory. The essence of this contractual theory of liability is that the surety was an intended beneficiary of the contract between the principal and the accountant and, therefore, should be afforded the benefits of such contract.

Such an approach was taken by a surety in Seaboard Surety Company v. Garrison, Webb & Stanaland, P.A.³³ In this case, an accounting firm was retained by the principal to perform an audit, and the surety relied upon this audit in issuing bonds on behalf of the principal. After the principal defaulted, the surety sued the accounting firm, claiming that the audit failed to reveal \$500,000 of indebtedness. In addition to asserting claims for negligence and fraud, the surety asserted a contract claim based upon a third-party beneficiary theory. The court allowed the third-party beneficiary theory to go to the jury. While the jury determined that the surety was a third-party beneficiary of the accounting contract, it ultimately found that the accounting firm did not breach that contract.³⁴ Nonetheless, Seaboard Surety opens another potential avenue of redress to the surety.

In order for a third party to an accounting contract to qualify as a third-party beneficiary,

³¹W.S. 33-3-201 (February 24, 1995).

³²Aluma Kraft Manufacturing Co. v. Elmer Fox & Co., 493 S.W. 2d 378 (Mo. App. 1973).

³³823 F.2d 434 (11th. Cir. 1987).

³⁴Id. at 436.

it must show that "the intent and purpose of the contracting parties was to confer a direct and substantial benefit upon the third party."³⁵ Thus, in some sense, the requirements of the third-party beneficiary theory are similar to those of the tort approach of "near privity." Consequently, except in an Ultramares "strict privity" jurisdiction, it is unlikely that a surety could succeed on a contract action and not on a tort action. This tempts one to ask whether, in such jurisdictions, the third-party beneficiary really adds anything to the surety's chances of recovery against accountants with whom it has no contractual privity.

C. Fraud/Intentional Misrepresentation.

Courts have long recognized that where an accountant's conduct in preparing an audit amounts to fraud, third parties who rely upon the fraudulent audit have a cause of action against the accountant. In this situation, lack of privity would not be a valid defense. In Ultramares Corp. v. Touche³⁶, Judge Cardozo stated that:

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.³⁷

Thus, an extreme level of negligence (i.e., gross negligence) on the part of accountants may raise an inference of fraud.³⁸

Sureties and fidelity insurers should note, however, that from a practical standpoint, establishing fraud ultimately may hurt their chances of collecting a judgment against the accountant, depending upon the financial resources of the accounting firm. Accountants' professional liability policies typically do not cover fraudulent conduct or other intentional wrongdoing. Thus, in analyzing the strategies for litigation, a surety or fidelity insurer should, to the extent feasible, investigate and consider both the terms of the accountant's liability policy, as well as the depth of the accountant's pockets.

One practical problem is that the line between an accountant's negligence (i.e., his failure to conform to generally accepted accounting principles) and fraud can be a difficult one to draw, especially since, as noted, gross negligence may raise an inference of fraud.³⁹

³⁵Blu-J, Inc. v. Kemper C.P.A. Group, 916 F.2d 637 (11th Cir. 1990).

³⁶174 N.E. 441 (N.Y. 1931).

³⁷Id. at 448.

³⁸See, e.g., Robertson v. White, 633 F. Supp. 954 (W.D. Ark. 1986) (finding that plaintiffs could bring an action against accountants based upon gross negligence, proof of which would raise an inference of fraud).

³⁹See E.F. Hutton Mortgage Corp. v. Pappas, 690 F.Supp. 1465, 1471 (D. Md. 1988).

IV. RECENT SURETY CASES

With the exception of the Seaboard Surety case, none of the foregoing cases arose in the context of a surety suing its principal's accountant alleging negligence in auditing the financial statements on which it relied. Nonetheless, as explained, the reasoning of these cases can be extended to the principal-surety-accountant context.

Notwithstanding the relative sparsity of accountant negligence cases involving sureties, three recent cases involved sureties as plaintiffs in such actions. This section will briefly discuss these three cases.

In School District of Borough of Aliquippa v. Maryland Casualty Co.,⁴⁰ the surety for a school district's tax collector sued the district's accounting firm for negligence in conducting an audit. The tax collector's prior sureties were named as defendants in the case. Although the plaintiff surety was unable to recover against the accounting firm because the statute of limitations had run, the court indicated that one of the defendant sureties was not so time-barred and could pursue a negligence action against the accountants.⁴¹ Although the court did not explain the specific bases for such an action, the case reinforces in general the surety's right to sue an accountant for negligence.

In Industrial Indemnity Co. v. Touche Ross & Co.,⁴² a surety which was a guarantor on certain types of commercial paper brought an action against a debtor's accountants, alleging negligent preparation of an audit under Restatement §522. Relying specifically on the language of §522, the court held that the accountants could not be held liable to the surety because the surety was not one of the "class of persons" which the accountants intended to influence.⁴³ Since the accountants were retained simply to conduct an annual audit for no specific purpose, and had no knowledge of the debtor-surety relationship at the time they conducted the audit, the court reasoned that no duty was owed to the third-party surety.⁴⁴ Although the surety was denied recovery in Industrial Indemnity, which adopted the Restatement approach to liability, one can only wonder whether that surety would have prevailed in a "foreseeable user" jurisdiction.

In St. Paul Fire & Marine Insurance Co. v. Touche Ross & Co.,⁴⁵ a surety sued an accountant, alleging negligent misrepresentation of its client's financial condition, upon which the surety detrimentally relied. The court found for the surety, relying in particular upon the fact that the accountant communicated with the surety directly, made its work product available to the surety, and intended for the surety to rely upon such work product. Based upon the court's findings, it would

⁴⁰587 A.2d 765 (Pa. Super. 1991).

⁴¹Id. at 771.

⁴²17 Cal Rptr. 2d. 29 (1993).

⁴³Id. at 35.

⁴⁴Id.

⁴⁵507 N.W.2d 275 (Neb. 1993).

appear that the surety would have recovered even in a "near privity" jurisdiction.⁴⁶

V. THE FIDELITY INSURER'S SALVAGE PROSPECTS AGAINST ACCOUNTANTS

While the primary focus of this paper has been the contract bond surety's right of recovery against its principal's accountant for negligently audited financial statements, a fidelity insurer may also seek salvage against its insured's accountant for negligence in connection with the audit of its insured. This most commonly occurs in the context of the insured's accountant negligently failing to uncover earlier defalcations by employees of the insured such that the fidelity insurer, if informed of such defalcations, would not have issued the fidelity bond. For example, suppose an accountant conducts an audit of a bank, and this audit is conducted at a time when the senior loan officer is manipulating the loan portfolio to his own benefit. Suppose, also, that the auditor uncovers enough information concerning the scheme to put it on inquiry notice that he, in accordance with Generally Accepted Auditing Standards (GAAS), should investigate further into the matter, but fails to do so. Now assume a fidelity insurer, in reliance upon the audit report, decides to issue the bank a financial institution bond. Three months later, the loan officer's dishonest activity is discovered and reported to the insurer, resulting in a significant loss to that insurer. May the fidelity insurer seek salvage against the negligent auditor for failure to uncover the loan officer's conduct? While the aforementioned theories of recovery may be applied by the fidelity insurer in seeking salvage against the negligent accountant, the theory of recovery most commonly advanced in this scenario is that the fidelity insurer is subrogated to, or has been assigned, the rights of its insured against the negligent accountant.

Fidelity policies typically contain clauses regarding the insurer's subrogation and assignment rights. For example, Section 7 of the Financial Institution Bond - Standard Form 24, entitled "Assignment-Subrogation-Recovery-Cooperation," contain express contractual support for the insurer's subrogation and assignment rights. With respect to subrogation, section 7(b) of the standard bond provides as follows:

In the event of payment under this bond, the Underwriter shall be subrogated to all of the Insured's rights of recovery thereto against any person or entity to the extent of such payment.

In addition, with respect to assignment, section 7(a) of the standard bond provides that:

In the event of payment under this bond, the Insured shall deliver if so requested by the Underwriter an assignment of such of the Insured's rights, title and interest and causes of action as it has against any person or entity to the extent of the loss payment.

⁴⁶The court did not specify which negligence standard it applied. In fact, it stated that the accountant's duty arose "by virtue of a contract implied from the conduct of the parties." *Id.* at 281. Thus, the court seemed to apply a negligence analysis and then hold the accountant liable under a contractual third-party beneficiary theory. Notwithstanding this apparent inconsistency, the St. Paul case demonstrates that a surety can succeed in an action against an accountant with whom it lacks contractual privity.

The fidelity insurer also has a common law equitable right of subrogation which arises by operation of law.⁴⁷ These subrogation and assignment rights have been used by fidelity insurers to seek salvage against accountants who negligently conducted an audit upon which it relied.

For example, in Western Surety Co. v. Loy,⁴⁸ a fidelity insurer paid an embezzlement loss under a county treasurer's bond and brought a negligence action as subrogee of the county against the treasurer's accountant who had audited the treasurer. The court concluded that, although a factual issue existed as to whether the insurer relied upon the audits in continuing to bond the treasurer annually, the insurer was entitled to bring an action against the accountant without alleging fraud, gross negligence or privity of contract. The court stated:

Ample authority exists that a surety may be subrogated to the creditor's right of action against public accountants who, by negligently conducting an audit, failed to discover earlier defalcations, and as a result, additional losses to the creditor occur which would have been prevented if the earlier defalcations had been disclosed.⁴⁹

The court reasoned that the question of privity was irrelevant in light of the fidelity insurer's rights of subrogation:

...while the question of privity is of importance in a suit against a certified public accountant by a third person (nonclient) who has relied on an audit report of the certified public accountant [citation omitted], it is of no real significance in this case. In Kansas, the right of legal or equitable subrogation arises by operation of law and does not necessarily depend on the existence of privity of contract.⁵⁰

Similarly, in Fed. Ins. Co. v. Arthur Andersen & Co., 552 N.E.2d 870 (N.Y. 1990), the New York Court of Appeals allowed a fidelity insurer to pursue an action against the insured's auditor for negligent failure to discover the defalcations of a dishonest employee. The court reasoned that:

Since fidelity insurers have been permitted to recover against negligent banks, there is no reason why they should not be able to recover against negligent accountants....

Assuming for the sake of argument that defendant's negligence in failing to discover the dishonest employee's defalcations caused the loss,

⁴⁷See, e.g., Federal Ins. Co. v. Arthur Andersen & Co., 552 N.E.2d 870 (N.Y. 1990); Liberty Mut. Ins. Co. v. Thunderbird Bank, 555 P.2d 333 (Ariz. 1976); Western Surety Co. v. Loy, 594 P.2d 257 (Kan. App. 1979).

⁴⁸594 P.2d 257 (Kan. App. 1979).

⁴⁹Id. at 261.

⁵⁰Id. at 260.

defendant could have been held directly liable to [the insured] in a suit brought by it. The rule defendant urges here would allow it to escape this liability simply because the victim, [the insured], carried fidelity insurance. In effect, defendant seeks to avail itself of [the insured's] fidelity insurance as its own liability policy without paying for it.⁵¹

In National Surety Corp. v. Lybrans,⁵² a stockbroker's fidelity insurer paid an embezzlement loss and brought an action as assignee against the broker's accountants. The accountants had audited the broker's books for years but failed to discover the embezzlement. The court held that the fidelity insurer stated a cause of action for negligence, breach of warranty and fraudulent misrepresentation against the accountants. The insured's contributory negligence was a defense only if it contributed to the accountant's own failure to perform.

In Maryland Casualty v. Cook,⁵³ an insurer on a city treasurer's fidelity bond paid an embezzlement loss, took an assignment, and brought an action against the dishonest employee and the city's accountants, who had failed to uncover the embezzlement earlier during an audit. The court permitted the fidelity insurer to recover against the accountants for negligence.

While the foregoing cases analyzed the fidelity insurer's right of action against the accountant in terms of its being subrogated or assigned to the insured's rights, the theories of third-party recovery previously discussed would also apply to a fidelity insurer seeking recovery against its insured's accountant.

VI. PRACTICAL SUGGESTIONS FOR THE SURETY AND FIDELITY INSURER

Based upon the foregoing, the following underwriting and litigation recommendations should be considered by surety and fidelity bond underwriters:

- (1) To the extent possible, the surety should inform its principal's accountants directly that it intends to review and rely upon both the financial statements which have previously been audited, as well as any further financial statements which they have been engaged to audit. A sample letter for consideration is attached. Similarly, the fidelity insurer should send a letter to the insured's auditor with a copy to the insured institution, stating that the underwriter is in receipt of the audit report, and that it is the intention of the underwriter to use that information in deciding to renew or write for the first time the fidelity bond. Such correspondence should be carefully documented and maintained. In addition, the surety and fidelity insurer should require the accountants to confirm to them directly the accountants' knowledge and understanding that the surety or fidelity insurer will be relying upon its professional services rendered in connection with its audit. This will strengthen the chances of recovery against the accountants even in a "near privity" jurisdiction.

⁵¹Id. at 875-76.

⁵²9 N.Y.S.2d 554 (App. Div. 1939).

⁵³35 F. Supp. 160 (D. Mich. 1940).

- (2) The surety should make clear to its principal and its accountants that a condition for bonding is the surety's satisfaction as to the financial well-being of the company as reflected in the principal's financial statements. In addition, the surety should document and maintain correspondence relating to the financial statements of the principal, keeping a record of the date of receipt of such statements. Similarly, the fidelity insurer should advise the insured institution and its accountants of its intent to rely upon the accountants' independent audit in determining to issue a fidelity bond. Adherence to these suggestions should help resolve any doubt as to whether the surety or fidelity insurer can demonstrate actual reliance upon the audit, a necessary element for recovery.
- (3) In the event bond losses occur, the surety or fidelity insurer should attempt to promptly obtain access to the principal's or insured's books, records and computer data to determine whether the financial statements or reports upon which the surety relied accurately reflected the principal's or insured's economic condition as of the dates reported and if not, why not. In addition, such books, records and computer data should be secured or copied to prevent their destruction or disappearance.
- (4) In the discovery stages of an action against accountants, particularly in "foreseeable user" jurisdictions, the surety or fidelity insurer should demand production of all documents which placed restrictions upon, or otherwise limited the use of, the audited financial statements or audit report. Proceeding under the assumption that no such documents exist, this will enhance the surety or fidelity insurer's argument that the accountants should have foreseen that a third party such as it would rely upon the statements or report.
- (5) The surety or fidelity insurer should obtain and carefully examine the accountants' professional liability policy. Determining the limits of coverage and investigating the financial condition of the accountants will influence whether it is advisable to also allege gross negligence or even fraud on the part of the accountants.
- (6) As noted above, three types of financial statements may be presented by an accountant: compilation, review, or audited statements.⁵⁴ Because of the disclaimers accompanying a compilation, it will normally be extremely difficult for a surety to prevail in an action against an accountant who has merely compiled its principal's financial statement unless evidence of fraud on the part of the accountant may be shown. Similarly, review statements contain substantial disclaimers, making it more difficult, although not impossible, to prevail against the accountant for its negligent conduct. By contrast, an audited financial statement contains substantial affirmative representations regarding the scope of the accountant's examination of the financial affairs of the principal, justifying substantial reliance on the part of the surety. Therefore, where feasible the surety should require its principals to supply audited financial statements prepared in accordance with generally accepted accounting principles from a reputable accounting firm. Preferably, the accounting firm should be of a significant size,

⁵⁴See Section II supra.

increasing the likelihood that it will have the resources or sufficiently substantial malpractice insurance coverage to reimburse the surety for any losses it sustains in reliance upon the accountants' negligent misrepresentations.

- (7) With respect to fidelity insurers, the insurer should carefully examine the fidelity policy at issue, since it may specifically provide for lawsuits to be brought in the insured's name, or may specifically set forth the insurer's subrogation rights and assignment. Depending upon the type of policy and the jurisdiction in question, common law subrogation rights may also be available. Such subrogation claims can avoid privity obstacles in any jurisdiction.
- (8) With respect to fidelity insurers, it should be noted that a properly conducted audit should address the area of internal controls. The auditor performing an opinion audit has a duty to review, comment upon and make recommendations for changes in the institution's system of internal controls. If, after an audit, a loss occurs for which the fidelity insurer is liable and its investigation reveals that the institution's internal procedures were such that the auditors knew or should have known that the procedures were deficient, it may have a cause of action against the auditor for failing to make recommended changes in the procedures, or at the least, commenting upon it in the notes to the financial statements or audit report.

VII. CONCLUSION

Both sureties and fidelity insurers rely upon opinions expressed by accountants in connection with their audits of the financial statements of the principal or insured in underwriting bonds. The surety or fidelity insurer typically has no contractual privity with the accountant conducting such audit since he or she is normally engaged directly by the principal or insured. Should these audited financial statements or reports contain material misrepresentations upon which the underwriter relied, the surety or fidelity insurer may look to the negligent accountant as a source of salvage despite the lack of privity. Jurisdictions vary on whether, and the extent to which, a third party such as a surety or fidelity insurer may recover from the accountant. By engaging in direct communications with the principal or insured's accountant in the underwriting process and creating a record of the accountant's knowledge of the underwriter's reliance upon its professional work product, a surety or fidelity insurer may increase substantially its ability to recover losses caused by such accountant's negligence.

SAMPLE LETTER TO PRINCIPAL'S ACCOUNTANTS

(Date)

Expert Accounting Firm
250 Ferret Road
Nerdsville, New York

Gentlemen:

Your client, Principal Construction Co., has made application to us for the extension of surety credit on its behalf. Among the materials that have been provided to us for our use in determining whether or not to grant such surety credit are your financial reports on Principal Construction Co.'s financial statements addressed to your client for the periods ending _____
_____. We understand that you may also be engaged to render reports in the future with respect to Principal Construction Co.'s financial statements and that such reports will be provided to us by Principal Construction Co. from time to time in the future.

The purpose of this letter is to specifically advise you that, in our underwriting process, we will rely completely upon the professional accounting services which you have rendered and may hereafter render and the opinions you have expressed and may hereafter express in your reports. It is also our understanding that you have been advised by Principal Construction Co. of its intention to provide us with such reports and that you understand that we will be relying upon your professional accounting services in our underwriting process. Please confirm such understanding by returning a copy of this letter with your acknowledgement below at your earliest opportunity so that we may

consider your client's request for bonding.

Very truly yours,

WISTFUL SURETY CO.

BY: _____

Underwriter

We hereby acknowledge this _
day of _____, 19_, that
Wistful Surety Co. will be relying
upon our professional accounting
services as rendered on behalf of
Principal Construction Co. in
connection with Principal Construction
Co.'s application for surety bonds.

EXPERT ACCOUNTING FIRM

BY: _____

cc: Principal Construction Co.