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Cover

JOHN COX. *This young Bahamian artist is a lecturer at The College of The Bahamas. He has recently staged exhibitions at the Central Bank of The Bahamas and in Hong Kong. The cover is a reproduction of his untitled mixed media on paper (22" X 60") created in 1995.*

Design & Typesetting

EARTH&SUN ENTERPRISES: PUBLICATIONS

The ideas expressed by the contributors to this journal are solely their own and are not in any way intended to reflect views of their respective employers or of The Bahamas Institute of Bankers.

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Accountants and Expanding Legal Liability in The Bahamas

Comparative View of The Commonwealth and United States of America Jurisdictions

By ALFRED M. SEARS

Illustrations: Edmund Dorsett

The growth of the accounting profession from what Chief Judge Cardozo of the New York Court of Appeals in the *Utramares* case in 1931 referred to as "a fledgling profession" into a multi-billion dollar industry has led to the perception that accountants play a public watchdog function in the market place and, from a litigation perspective, represent deep pockets from whom large judgments may be recovered.

This shift in perception of the accounting profession has made courts more willing to extend the scope of liability of accountants to third parties, not in privity with the accountant, who rely on audit reports by accountants. A number of factors have contributed to this shift in the perception of the accountant.

First, the increased complexity in financial transactions dictates that the general public rely more heavily now than ever before on the work product of the professional accountant. For example, in 1991 the Bahamas Parliament passed the *Financial Administration and Audit Act* which requires public agencies to maintain strict accounting records.

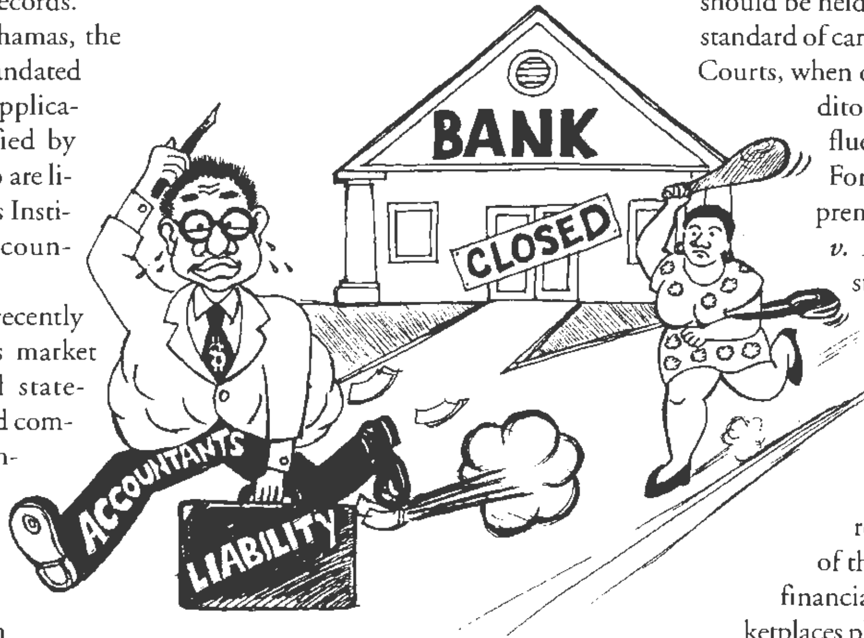
Recently in The Bahamas, the Ministry of Finance mandated that business license applications should be certified by public accountants who are licensed by The Bahamas Institute of Chartered Accountants.

The Bahamas has recently established a securities market wherein the financial statements of publicly traded companies will influence investment decisions in the financial market place.

These developments in The Bahamas, which are common throughout the Caribbean, will require the public accountant to play an increasingly important role in the fiscal and economic life of The Bahamas. In fact, Mr. Philip G. Galanis, M.P., a Past President of The Bahamas Institute of Chartered Accountants and Managing Partner of Ernst & Young, reflected this perspective when he addressed the Rotary Club of Nassau on the 28th February, 1992. Mr. Galanis stated that:

"...because of the increased demand for public accountability by the Government, professional accountants will assist in monitoring the effectiveness and efficiency of spending by Government departments, ministries and agencies... advise the Government on ways and means to eradicate waste and inefficiency in the public sector, assist the Government to achieve its objectives of ensuring greater public accountability and to obtain value for money... propelled by public needs and expectations, changing client requirements and market place opportunities, the public accounting profession has changed dramatically over the years."

Increasingly, therefore, more third parties — persons with whom the accountant has no privity — will rely upon the special skills and independence of the accountant to make investment and other decisions. In fact, the American Institute of Public Accountants, in its auditing standards, requires that "in all matters relating to assignment, an independence in mental attitude is to be maintained by the auditor or auditors." The standards further provide that if an accountant is not independent, any procedures he performs will not comport with generally accepted auditing standards.



This requirement of auditor's independence creates an ethical dilemma for accountants today who are increasingly providing a wide range of management advisory services, such as marketing analysis, profit planning, project analysis, cash controls and project and financial counseling. These activities now provide an important source of revenue for the largest accounting firms. Executives often seek counsel from senior accountants to assist them in decision-making; thus, involving accountants in the business operations of their clients. How can they perform their independent auditor's function to protect the public from questionable financial reports when they have a financial and professional interest in the business operation of their clients?

Some commentators argue that this third-party reliance of the public imposes a particular obligation of a duty of care on the certified public accountant and a duty to be independent. It would appear that Caribbean accountants themselves, like Mr. Galanis, have contributed to this public perception that accountants should be held to a higher professional standard of care based on a public trust. Courts, when defining the scope of auditors' liability, have been influenced by this perception. For example, the U.S. Supreme Court in the case ***U.S. v. Arthur Young & Co.*** stated that "the independent auditor's obligation to serve the public interest insures that the integrity of the securities market will be preserved." Thus, the realities and expectations of the participants of today's financial and commercial marketplaces place increased third-party reliance upon the work product of accountants.

Second, **increased competition for audit clients has resulted in price wars among the big accounting firms;** therefore, some commentators assert that **lower accounting fees create pressure on firms to cut corners so that they may remain profitable on each job. Cutting corners may result in compromise of professional standards and risk potential lawsuits at a time when the scope of the accountants liability to third parties remain unsettled.**

EXPANDING SCOPE OF ACCOUNTANTS' LIABILITY TO THIRD PARTIES

The shift in the public perception of the accountant's role and public responsibility has made the courts in the United States and the Commonwealth more willing to extend the scope of legal liability of the accountant. This is more dramatically illustrated in respect to the accountant's liability to third parties.

THE UNITED STATES

The common law liability of public accountants in the United States was first defined by the seminal case *Ultramares Corp. v. Touche* in 1931. Chief Judge Cardozo, writing for a unanimous New York Court of Appeals, held that accountants have no duty to refrain from negligence toward third parties not in privity of contract with the auditor, unless they are primary beneficiaries of the contract. The auditor's liability was restricted to those whom the auditor knew would benefit from the services. Thus, the accountant's liability was restricted to the contract of service.

In *Ultramares* the plaintiff loaned the Stern Company large amounts of money based on financial statements certified by Touche. The statement listed fictitious assets, which the auditors failed to detect; the Company subsequently went bankrupt. Unable to collect on the loans, Ultramares sued Touche Nevin for negligence and fraud.

The New York Court of Appeals absolved the accountants of any liability for negligence to relying third parries, stating that "if liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class."

The court posited two policy reasons for relieving accountants of liability to rhird parties for negligence. The courr's first concern was that if held liable for negligence, accountants who comprised a weak, fledgling profession in the 1920s, would be exposed to enormous financial liability based not on culpability of their error but on the extent to which erroneous reports were circulated.

The second policy consideration was the court's desire to punish fraud (intentional misrepresentation) more severely than negligent misrepresentarion. By this privity doctrine, the *Ultramares* decision, for almost a half a century, insulated accountanrs from the claims of third parties who were nor primary beneficiaries or in privity with the auditor.

The decision may also be partly responsible for the judicial limiration of accountants' liability under the *Securities Exchange Act* of 1934.

In the 1970s and 1980s, given the growth of the accounting profession and the changing public perception of the profession, the privity doctrine enunciated in *Ultramares* came under increased attack and erosion. Today it is estimated that the Big Six accounting firms boast annual world-wide revenues in excess of $20 billion, over 20,000 partners and over 300,000 employees. Therefore, some commentators argued that the *Ultramares* rationale of protecting a "fledgling industry" is no longer valid to determine auditors' liability.

How can they perform their independent auditor's function to protect the public from questionable financial reports when they have a financial and professional interest in the business operation of their clients?

Several commentators, such as the New York litigating attorney, Norman B. Arnoff, argue that the Privity Rule has undermined the efficacy of professional liability insurance programs for accountants. Arnoff contends that plaintiffs often circumvent the privity bar by bringing suits againsr accountants on theories of fraud and conspiracy.

However, most professional liability insurers, through reservation of righrs letters, fraud and prior knowledge exclusions and reporting obligations where fraudulent and conspiratorial conduct is charged, limit coverage on the very areas accountants need for honest errors and omissions. Since fraud is an intentional tort, with knowledge as its essential element, the charge itself creates for the accountant an uncertainty as to his coverage by reason of the self awareness of the conduct it necessarily assumes.

Therefore, the Privity Rule's basic intent to achieve fairness is circumvented by the invitation it has created for litigants to bring fraud and conspiracy lawsuits. Thus, more expenses and complexity are directly related to the need lawyers have to circumvent the Privity Rule.

Consequently, as early as the 1960s a number of jurisdictions in the United States started to reject the *Ultramares* strict privity rule and have extended auditors' liability to memhets of diffetent groups of third parties. Currently, there are four differenr legal standards of the scope of liability of accountants to third parties in the United States.

Restatement Standard

The second legal standard of accountants' liability to third parties, which reflects the modern trend in the United States, adopts the American Law Institute's Restatement (Second) of Torts Standard. Under this standard, the right ro recovery is available to any "petson, or one of a group of persons, whom the accountant or his client intends the information to benefit." If the client holds the requisite intent, "then the accountanr must know of his client's intent at the time the accountant audits or prepares the information."

Therefore, if the auditor knows the client intends to use the financial statements to negotiate a bank loan but does not know the specific bank, the auditor nevertheless is potentially liable for negligence to any bank with which the client negotiates and obtains the loan. Thus, if the third party is foreseen by tbe auditor, then the auditor will be held liable.

The North Carolina Supreme Court applied this standard in the case ***Raritan River Steel Co. v. Cherry, Bekaert & Holland.*** In this case Intercontinental Metals Corporation (IMC) engaged the

defendant, the public accounting firm of Cherry Bekaert & Holland, to perform an audit of the company's financial statements for the fiscal years ending September 30, 1980 and 1981.

The defendant's audit reports expressed an unqualified opinion that IMC's comparative financial statements presented fairly the company's financial position as of September 30, 1981. The audit report also included a statement that the defendant performed the audit in accordance with Generally Accepted Auditing Standards (GAAS). IMC subsequently went bankrupt.

Raritan Steel Company, one of the plaintiffs and a creditor to IMC, alleged that the defendant's negligence in preparing the audit reports resulted in an overstatement of IMC's actual net worth in the financial statements. Raritan claimed that it had extended more than two million dollars credit on open account for IMC's purchase of raw steel.

Raritan had obtained IMC's net worth figure from a report published in *Dun & Bradstreet*, and the report cited the defendant's audit report as its source of information. The court rejected the privity rule of *Ultramares* and elected to adopt the aforesaid Restatement standard.

Balancing Test Standard

The third legal standard of the scope of auditors' liability to third parties is the balancing test used in some U. S. jurisdictions. The Montana Supreme Court in the case *Aluma Craft Manufacturing Co. v. Elmer Fox & Co.*, using a balancing test, rejected the privity rule of *Ultramares* and balanced several factors to determine liability. The factors the court considered include the following: (a) the extent to which the transaction was intended to affect the plaintiff; (b) the foreseeability of harm to the plaintiff; (c) the degree of certainty that the plaintiff suffered injury; and (d) the closeness of the connection between the defendant's conduct and the injury suffered.

Although this attempt at case by case fairness reflects honest doubt in the Privity Rule, its basic ambiguity leaves the law without the stability essential for the financial services market place. According to my research, Montana is the only U.S. jurisdiction which applies this balancing test standard.

Negligence (Reasonable Foreseeability) Standard

The fourth legal standard of the scope of the auditors liability to third parties for negligent misrepresentation is the simple negligence standard based on reasonable foreseeability. This standard represents the most radical departure from and total abandonment of the privity rule of *Ultramares*.

In two 1983 decisions, ***H. Rosenblum, Inc. v. Adler*** and ***Citizens State Bank v. Timm, Schmidt & Co.*** New Jersey and Wisconsin departed from both the *Ultramares* privity requirement and the Restatement position and applied standards based on foreseeability.

In ***Rosenblum*** the New Jersey Supreme Court held that accountants who issue opinions without distribution limitation in the certificates have a duty to exercise ordinary care to those reasonably foreseeable recipients of the statement who (a) received the statement from the company for proper business purposes, and (b) relied on the statements pursuant to those business purposes.

The court reasoned that, under this broadened scope of liability, the accountant still had certain safeguards such as limitation of recovery to the actual loss flowing from the reliance; the amount of recovery is governed by the New Jersey Comparative Negligence Act; and that the accounting firm can seek indemnity or contribution from the audited company and the "blameworthy" officers and employees.

The ***Rosenblum*** court, like all of the other courts adopting each of the three standards which departed from the *Ultramares* privity rule, used a number of public policy justifications for this expansion.

First, **the court emphasized that the auditor's function has changed over the years from that of a management tool to that of an independent evaluator of the accuracy of financial statements issued by management and used by third parties not in privity with the auditor.**

Second, the court dismissed the *Ultramares* "financial catastrophe" objection to a broad duty of care for accountants. The court reasoned that **accountants, who today comprise a powerful profession, could obtain malpractice insurance for an extended duty of care.**

Third, the court found that **an expanded duty could result in stricter auditing standards and more thorough reviews, thus reducing the incidents of negligent audits. The court felt that the increased cost of auditing work and increased insurance costs should not preclude these changes since the cost could be passed on to the business being audited and ultimately the consuming public.**

Fourth, the court felt that **innocent third parties required some protection from erroneous financial statements.**

As this analysis has demonstrated, the trend in the United States is towards extending the scope of legal liability of accountants commensurate with the public perception of the power and resources of the profession and the public function the profession serves.

BRITISH COMMONWEALTH

The position of the Caribbean accountant is determined by the Commonwealth position which attempts to find a compromise between the obvious limitations of the Privity Rule of *Ultramares* and the radical extreme of the reasonably foreseeable standard of ***Rosenblum***. On the 8th February, 1990 the English House of Lords unanimously decided in favor of Touche Ross in the case of ***Caparo Industries PLC v. Dickman and Others (Touche Ross)*** on the basis that a company's auditors do not owe a duty of care to potential investors in the stock market or to the company's individual shareholders.

The auditor's duty is to the shareholders as a whole — qua company. With respect to accountants' liability to third parties, Lord Bridge of Hawwich held

that liability for economic loss due to negligent misstatement was confined to cases where the statement or advice had been given to a known recipient for a specific purpose of which the maker was aware and upon which the recipient had relied and acted to his detriment.

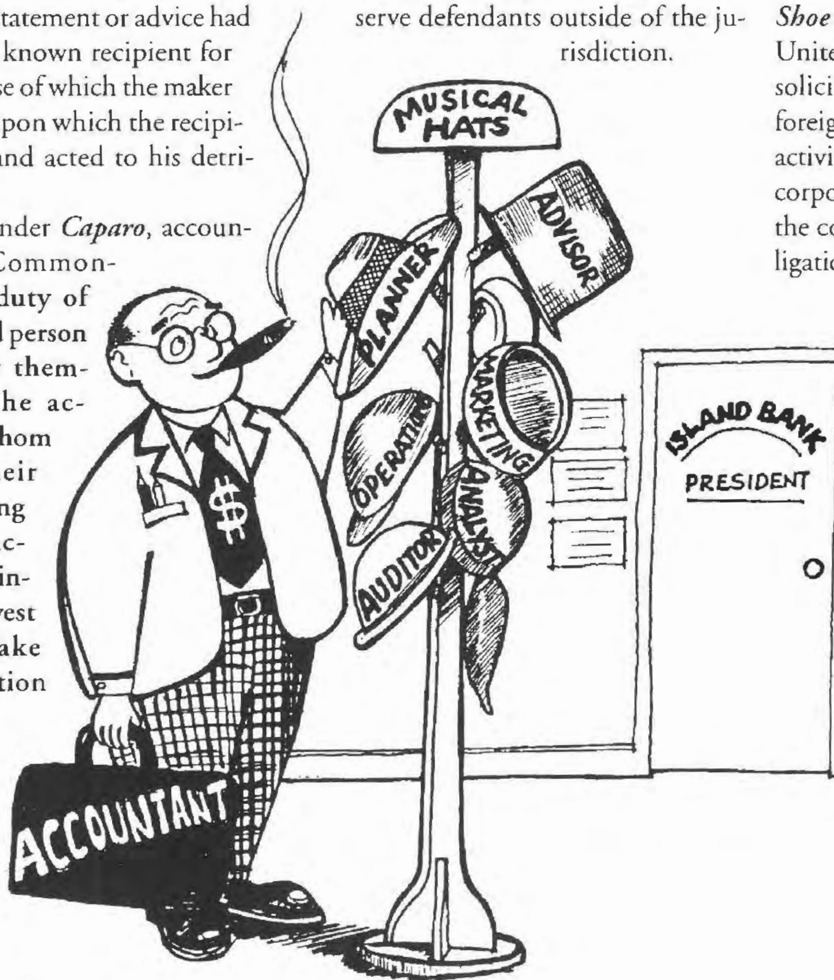
Therefore, under *Caparo*, accountants in the Commonwealth owe a duty of care to any third person to whom they themselves show the accounts, or to whom they know their employer is going to show the accounts, so as to induce him to invest money or take some other action on them.

However, the situation in England may change soon when the European Community Fifth Company Law Directive comes into effect. This Directive threatens to impose specific liability on the auditor to individual shareholders and third parties for loss caused by the auditor's alleged wrongful acts.

The limitation of *Caparo* may have been put in doubt by ***Henderson v. Merrett Syndicates Ltd. (1994) 3 All E.R. 506.*** The English House of Lords, opinion of Lord Goff, found that accounts managers had a duty of care to third parties, on the theory of assumption of a duty of care towards third party where the manager possessed a special skill and undertook to apply that skill for the assistance of another who relies upon it and subsequently suffers economic loss.

From the plaintiff's perspective, there are many advantages for preferring a tort and not contract theory of liability: (a) longer statute of limitation period, latent damage theory; (b) right of contribution from joint tortfeasor; (c) flexibility rule re remoteness of damages; and,

(d) opportunity to obtain leave to serve defendants outside of the jurisdiction.



EXTRA-TERRITORIAL REACHOF UNITED STATES JURISDICTION

Another legal danger facing Caribbean based accountants is the possibility of having a U.S. state court assert personal jurisdiction over the accounting partnership. Caribbean accounting firms which are not branches or subsidiaries of U.S. based firms may take the position that the aforesaid expanding theories of accountants' liability to third parties in some U.S. jurisdiction may not directly concern them. However, this attitude would be a mistake because, through what is known as "long-arm" jurisdiction, a U.S. state courts may exercise jurisdiction over a Caribbean based accounting partnership for activities conducted in the Caribbean but which impact within that U.S. jurisdiction.

Domicile and citizenship have traditionally been accepted as proper bases for persona jurisdiction in the U.S. However, in the case of ***International Shoe Co. v. State of Washington*** the United States Supreme Court held "that solicitation within a State by agents of a foreign corporation plus some additional activities there are sufficient to render the corporation amenable to suit brought in the courts of the State to enforce an obligation arising out of its activities there."

Therefore, under the U.S. Federal Constitution, due process requires only that in order to subject a defendant to a judgment in personam, if he is not present within the territory of the forum, he must have certain minimum contacts with it such that the maintenance of the suit does not offend "traditional notions of fair play and substantial justice." In 1980 the U.S. Supreme Court in the seminal case ***World-Wide Volkswagen Corp. v. Woodson*** held that "when a corporation purposefully avails itself of the privilege of conducting activities in the forum State... it has clear notice thar it is subject to suit there, and can act to alleviate the risk of burdensome litigation by procuring insurance, passing the expected cost on to the consumers, or if the risk is too great severing its connection with the State... the Forum State does not exceed its powers under the Due Process Clause if it asserts personal jurisdiction over a corporation that delivers its products into the stream of commerce with the expectation that they will be purchased by consumers in the forum State."

The Court further held that the foreseeability test of due process analysis applies if the defendant's conduct and connection with the forum State are such that he should reasonably anticipate being "haled" into court there.

In some U.S. States, such as New York, this common law expansion of the concept of extra-territorial personal jurisdiction has been codified in long-arm jurisdiction statutes. New York's *Civil Procedure Law and Rules (CPLR), Section*

302, states that the New York State courts may exercise personal jurisdiction over any non-domiciliary or his executor or administrator if, in person or through an agent, he:

1. transacts any business within the state or contracts to supply goods or services in the state; or
2. commits a tortious act within the state...; or
3. commits a tortious act within the state causing injury to person or property within the state, ... if he (i) regularly conducts or solicits business, or engages in any other persistent course of conduct, or derives substantial revenue from goods used or consumed or services rendered, in the state, or (ii) expects or should reasonably expect the act to have consequences in the state and derive substantial revenue from interstate commerce or international commerce...

Applying these common law tests and the New York long-arm statute to accountants in the Caribbean, is it conceivable that a Bahamian, Barbadian, or Jamaican accountant who, as part of investment promotion teams, regularly goes to New York State to solicit business, sends firm's promotional literature there, enters into retainer agreements on occasions while in the State with new clients to perform professional services from The Bahamas, could be subject to the long-arm jurisdiction of the New York state courts? Further, would that accountant's conduct and connection with the New York state such that he should have reasonably anticipated being "hauled" into court there?

If these questions are answered in the affirmative, in light of the aforesaid test and statute, then the Caribbean based accounting firms need to inform themselves about the manner in which they solicit and conduct business in certain U.S. jurisdiction so that they do not unwittingly expose themselves to the assertion of personal jurisdiction by certain U.S. courts.

CONCLUSION

With the globalisation of the market place, the increasingly public role the accountant is called on to play and the realities of the market place, it is more rational to allow accountants' liability to specified third parties when the consequences of harm to the third parties are reasonably foreseeable. But it is of critical importance to establish safeguards against unrealistic liabilities, by careful analysis of what the professional actually undertook to do by his engagement and by not allowing parties who did not rely upon the accountant's opinion to recover. There needs to be greater precision in judicial reasoning for more ordered expectations and uniformity in the global market place and the better development of the law.

Plaintiffs in negligent misrepresentation cases should be made to demonstrate, by documentary evidence contemporaneous with the financial transactions in issue, (a) what the accountant undertook to perform (compilation, review or audit), (b) that the claimed error/omission caused the economic harm for which recovery is sought, and (c) actual reliance.

The imposition of rigorous tests requiring both the investor and lender to present real proof of undertaking, causation and reliance is a better safeguard against indeterminate liability than the Privity Rule.

This approach will require precise analysis and insistence on documentary evidence and that the plaintiff show that the specific misstatement sued upon was actually relied upon and did, in fact, cause the loss. These strict standards of causation and reliance should be applied in any financial or commercial case where an accountant is called upon to render an opinion which everybody in the marketplace knows is traditionally and customarily relied upon by third persons.

The courts, especially in some U.S. jurisdictions, have not clearly and fairly balanced the accounts' liability with market place expectations. But a fair balance is needed for settled and ordered expectations in the global market place and the dynamic growth of the law towards clearer and fairer standards for guiding and judging human conduct. The carefully reasoned judgment of ***Caparo*** strikes a fair balance in recognizing the limitations of both the privity rule and the blanket reasonable foreseeability standard. The decision offers some measure of uniformity and predictability to the financial services market place.

Judge Cardozo recognized the need for uniformity and predictability in the law and the market place when he stated:

The judicial process comes then to this, and little more: logic, and history, and custom, and utility, and the accepted standards of right conduct, are the forces which singly or in combination shape the progress of the law. Which of these forces shall dominate in any case, must depend largely upon the comparative importance or value of the social interests that will be thereby promoted or impaired.

One of the most fundamental social interests is that law shall be uniform and impartial. There must be nothing in its action that savors of prejudice or favor or even arbitrary whim or fitfulness. Therefore in the main there shall be adherence to precedent. There shall be symmetrical development, consistently with history custom when history or custom has been the motive force, or the chief one, in giving shape to existing rules, and with logic or philosophy when the motive power has been theirs. But symmetrical development may be bought at too high a price. Uniformity ceases to be a good when it becomes uniformity of oppression.

The social interest served by symmetry or certainty must then be balanced against the social interest served by equity and fairness or other elements of social welfare. These may enjoin upon the judge the duty of drawing the lines at another angle, of staking the path along new courses, of marking a new point of departure from which others who come after him will set out upon their journey.

Fully referenced text obtainable from the Contributor (see pg. 3)