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FINANCIAL REPORTING AND RISK MANAGEMENT IN THE 21st CENTURY

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TABLE OF CONTENTS

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INTRODUCTION

A common theme of modern financial analysis is that traditional financial statements do not tell you enough. Some assert that financial statements focus too much on the past and not enough on the future. Some assert that financial statements do not adequately focus on critical factors that create long-term value. Some assert that financial statements need to focus more on the separate segments of the enterprise. In the broadest sense, many assert that traditional financial statements simply do not sufficiently focus on just what users need.[1]

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1. The underlying sentiment was captured fairly vividly in an article last April in *Forbes*. Financial writer William Davidow observed:

> To put it bluntly, reported profits have become increasingly meaningless. You won't get very far explaining this to your banker or to your shareholders, but it's undeniably true. Basically, profits measure the rate of change in a company's assets. Increase assets by $10 million and you report a $10 million profit. Write down $25 million in inventory and profits go down by the same amount.
>
> Double-entry bookkeeping, developed by Luca Pacioli in 1494, lets businesses keep track of changes in their asset base. But this system, still in use today, deals primarily with tangible assets such as cash, inventory, accounts receivable, factory plants and equipment. It ignores intangible assets: goodwill, employee knowledge, quality of management, customer relationships,

In truth, many of the criticisms make fair points. And in 1991, the American Institute of Certified Public Accountants ("AICPA") formed a Special Committee on Financial Reporting—commonly referred to as the "Jenkins Committee," after its chair Edmund Jenkins—to assess the needs of users of financial information and to recommend improvements in financial reporting. The Jenkins Committee found a broad consensus that, while financial statements remained "an excellent framework for capturing and organizing financial information," they could be made better.[2] Among other things, the Jenkins Committee found that, to meet users' changing needs, business reporting must provide more information with a forward-looking perspective; focus more on those factors that create long-term value, including non-financial measures; and better align the information reported externally with the information reported to senior management.[3] The Jenkins Committee proposed a new "model of business reporting," with a look noticeably different from the finan-

> information infrastructure, trade secrets, patents, etc. What companies report today are really "old profits" based on changes in tangible assets. But any meaningful measure of profits would have to include the rate of change in the total asset base—both tangible and intangible.

William Davidow, *Why Profits Don't Matter*, Forbes ASAP, Apr. 8, 1996, at 24, 24; *see also* Andrea Gabor, The Man Who Discovered Quality: How W. Edwards Deming Brought the Quality Revolution to America—The Stories of Ford, Xerox, and GM 7 (1990) ("Another problem is that legally mandated financial statements are little more than 'a fuzzy approximation of a distant past,' notes Professor John Whitney of Columbia University Business School . . . ."); Justin Fox, *Searching for Nonfiction in Financial Statements*, Fortune, Dec. 23, 1996, at 39, 39 ("Financial statements—in particular the earnings numbers they produce—have actually become less reliable as a measure of corporate performance and value. . . . The Generally Accepted Accounting Principles, set by FASB, don't allow for some of the prime drivers of corporate success—investments in intangible assets such as know-how, patents, brands, and customer loyalty."); Jeffrey M. Laderman, *Earnings Schmernings—Look at the Cash*, Bus. Week, July 24, 1989, at 56, 56 ("[S]ome savvy investors say the singular focus on net income is foolhardy."); Dana W. Linden, *Lies of the Bottom Line*, Forbes, Nov. 12, 1990, at 106, 106 ("Reported earnings have become virtually worthless in terms of their ability to tell us what's really going on at a company."); *SEC Sponsors Discussions on Future of Financial Reporting*, J. Acct., Apr. 1996, at 15, 15 ("We need to investigate the current accounting model with a critical eye, because it is not keeping pace with the changes in the business world." (quoting SEC commissioner Steven M. H. Wallman)); Steven M.H. Wallman, *Regulation for a New World*, Bus. L. Today, Nov./Dec. 1996, at 8, 8 [hereinafter Wallman, *Regulation for a New World*] ("Disclosure requirements and accounting principles designed for stable industrial businesses are not necessarily cost-effective, or even appropriate, when applied to volatile knowledge-based start-ups.").

2. Special Committee on Financial Reporting, AICPA, Improving Business Reporting—A Customer Focus: Meeting the Information Needs of Investors and Creditors 5 (1994) [hereinafter Jenkins Committee Report].

3. *Id.*

cial statements of today.[4] The Jenkins Committee recommendations continue to be the subject of debate.[5]

It is almost universally acknowledged, however, that a significant impediment to the improvement of financial reporting is the risk of litigation. As one leader of the accounting profession has complained, "It is very difficult to be innovative if you are always concerned that every new service you offer could be subject to significant liability."[6] The basic problem is that improvement in the systems of financial reporting will largely involve a trend away from objectively verifiable data into data that is more subjective and therefore based on judgment. This increases the litigation risk, insofar as a trend to subjective data increases the opportunity for second-guessing, particularly when things do not turn out as planned. Where the data is objective, judgment is limited and the evidence is clear. Where the data is subjective, an expert can almost always be found to give a jury something to think about.

The result is that the world of financial reporting—and the accounting profession in particular—is faced with a conundrum. On the one hand, there is justifiable demand for improvement in financial reporting. On the other hand, any change in that direction will, where the profession has given assurance as to more modern presentations of data, potentially increase its exposure to litigation. While courts have shown increasing sensitivity to the problems of litigation in financial reporting, they do not seem to appreciate the extent to which the litigation risk is freezing progress in its tracks.[7]

4. The Jenkins Committee's proposed model contains five "major components": (1) "Financial and Non-Financial Data"; (2) "Management's Analysis of Financial and Non-Financial Data"; (3) "Forward-Looking Information"; (4) "Information about Management and Shareholders"; (5) "Background about the Company." *Id.* at 136.

5. *See Jenkins Report Symposium*, J. Acct., Sept. 1996, at 19, 19; *see also* Peter D. Fleming, *What's Next for the Business Reporting Model*, J. Acct., Dec. 1996, at 14, 14 ("[SEC Commissioner Steven Wallman] said the current financial reporting model was not working as well as it might and the one proposed by the Jenkins committee was worthy of review to see if it could provide users with better information.").

6. John von Brachel, *Reinventing the CPA*, J. Acct., Nov. 1996, at 49, 50 (comments of Robert Mednick). For its part, the Jenkins Committee concluded that a consequence of the litigation risk "is to deprive users of information and inhibit the progress in business reporting that comes from experience with voluntary disclosure." Jenkins Committee Report, *supra* note 2, at 116.

7. The chilling effect of the litigation risk is very much in evidence in the Jenkins Committee Report itself. For example, while earnestly advocating greater emphasis on forward-looking information, the report cautioned that "[c]ompanies should not have to expand reporting of forward-looking information until there are more effective deterrents to unwarranted litigation that discourages companies from doing so." Jenkins Committee Report, *supra* note 2, at 57 (emphasis omitted). Subsequent to publication of the Jenkins Committee Report, Congress has enacted the Private Securities Litigation Reform Act of 1995, one of the purposes of which was to address this concern. Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended in scattered sections of 15 U.S.C.A. (West Supp. 1996)).

It is in this context that a new committee of the AICPA has been formed. It is the Special Committee on Assurance Services—informally referred to as the "Elliott Committee," after its chair Robert Elliott. The charge of the Elliott Committee is to "analyze and report on the current state and future of the audit/assurance function and the trends shaping the audit/assurance environment, focusing on the current and changing needs of users of decision-making information and other stakeholders in the audit/assurance process and how best to improve the related services."[8] As an important part of its mission, the Elliott Committee is to assess the future evolution of financial reporting systems and to identify and develop new assurance services that improve the quality and usefulness of financial information.

Last month, the Elliott Committee issued its report.[9] In discussing the future of CPA assurance services, the report posits the development, in the not-too-distant future, of a financial reporting system in which the principal vehicle for the transmission of financial information may be a computer network accessible on a "real time" basis by the reporting entity and its investors, creditors, suppliers, customers, and analysts.[10] The accounting professional in such a system evolves from one who provides annual assurance on historical financial statements into one who, among other things, provides real-time or "just-in-time" assurance to facilitate reliable interactive communication.[11]

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8. Board of Directors, AICPA, Charge to AICPA Special Committee on Assurance Services (Apr. 22, 1994). For a discussion of the work undertaken by the Elliott Committee, see *The CPA Journal Symposium on the Future of Assurance Services*, CPA J., May 1996, at 14, 14; Robert Mednick, *Chair's Corner*, The CPA Letter, Dec. 1996, at 9; Don Pallais, *Assurance Services: Where We Are; Where We're Going*, J. Acct., Sept. 1996, at 16, 16; *Professional Growth Through New Assurance Services*, The CPA Letter, Jan./Feb. 1996, at 5; Rick Telberg, *CPA Leaders Forge New Vision*, Acct. Today, Nov. 25-Dec. 15, 1996, at 1, 1; von Brachel, *supra* note 6, at 50-51.

9. Special Committee on Assurance Services, AICPA, Report of the Special Committee on Assurance Services (1997) [hereinafter Elliott Committee Report]. The Elliott Committee Report has been published exclusively on the AICPA's Web site. *See* Elliott Committee Report (published Mar. 19, 1997) <http://www.aicpa.org/assurance/scas/index.htm>.

10. *Id.* at <http://www.aicpa.org/assurance/scas/comstud/effect/newopps.htm>.

11. Users will need data assurance at points in time other than just at the end of a year or quarter. Some users may require "continuous audits" of a broad data set, others "just-in-time audits" of key transactions or data, and still others mixes of the two. When users' real-time access to databases becomes routine, they will need continuous data assurance.

Id. The Committee anticipates that such enhanced financial information services may be paid for by the reporting entity, the financial information user, or both. *Id.* at <http://www.aicpa.org/assurance/scas/comstud/effect/constr.htm>.

The subject of such real-time or "just-in-time" assurance was the focus of a talk this past December by SEC Commissioner Steven Wallman. In describing his vision of technology's impact on financial reporting, Wallman reportedly

> pointed to a shift to "process attestation" from "substance attestation" with certifications of data disseminated through new information technologies. Thus, accountants of the future would attest to the integrity of the system that a company uses to generate data relating to its operations, rather than to the integrity of the data per se.

The Elliott Committee hypothesizes the transmission of both purely financial and certain types of non-financial information.

The Elliott Committee Report also addresses the litigation risk. Basically, the report outlines a series of risk-management proposals applicable to accountant assurance services;[12] these include the enhancement of risk management through such devices as the use of cautionary language, a change of the vehicles of liability from tort to contract, loss-limiting clauses, alternative dispute resolution provisions, and explicit consideration of litigation risk in the development of new assurance services.[13] Many of the Elliott Committee's risk-management proposals are based on established legal precepts. Some explore risk management in areas in which the law has yet to develop.

This Article outlines the legal precepts underlying the Elliott Committee's risk-management proposals in one particularly important area in which the law has yet to develop: liability as the systems of financial reporting shift from paper to a computer network such as the Internet. This Article addresses four issues. First, it addresses the liability risk of accountants disseminating financial information over the Internet. Second, it addresses the possibility of enhancing risk management by shifting the avenues of liability from tort to contract. Third, it discusses the enhancement of risk management by making full use of the "bespeaks caution" doctrine, both as that doctrine is embodied in common law and, more recently, in the Private Securities Litigation Reform Act of 1995.[14] Fourth, it addresses risk management in the context of computer-disseminated financial information outside the United States. The Article's purpose is to familiarize the accounting profession, those responsible for structuring financial reporting relationships, governmental authorities, the courts, and others as to both the potential liability arising out of computer-disseminated financial information, and how that liability may be managed in a way that facilitates honest financial reporting while still permitting financial reporting systems the flexibility to evolve.

Rachel Witmer, *SEC's Wallman Describes View of Technology's Impact on Accounting*, 28 Sec. Reg. & L. Rep. (BNA) No. 48, at 1531, 1532 (Dec. 13, 1996).

12. The Elliott Committee's risk-management proposals address risk management in the context of the full scope of assurance services analyzed and reported on by the committee. The discussion here is limited to aspects of the risk management proposals in the context of financial reporting.

13. Elliott Committee Report, *supra* note 9, at <http://www.aicpa.org/assurance/scas/majtheme/svcliab/index.htm>.

14. Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended in scattered sections of 15 U.S.C.A. (West Supp. 1996)).

I. Risk Management and Computer-Disseminated Financial Information

A. *Overview*

It is certainly true that one of the most significant changes in financial reporting may not involve the substance of the information, but the means by which it is transmitted.[15] An ever-growing consensus acknowledges that transmission by paper, while serving civilization admirably for more than a thousand years, is outdated.[16] And it is increasingly apparent that the future systems of financial reporting will turn away from paper and move largely or entirely to real-time computer-based—perhaps Internet-based[17]—transmissions.[18] In a

15. "Information technology is probably the single most important factor affecting future information flows and CPA services. It affects all aspects of the CPA's work: how and when information is created, processed, stored, communicated, acquired, refined, and interpreted—as well as how CPAs will both produce and communicate assurance." Report of the Chairman of the AICPA Special Committee on Assurance Services to AICPA Council 4 (Oct. 1995).

16. *See* Davidow, *supra* note 1, at 24 ("New technologies have fundamentally changed the way we do business.... But while so much else has undergone a seismic shift, the way business continues to account for profits remains as outmoded as the clipper ship."); Steven M.H. Wallman, *Regulating in a World of Technological and Global Change*, Metropolitan Corp. Couns., Oct. 1996, at 1, 64 [hereinafter Wallman, *Regulating in a World of Technological and Global Change*] ("[T]he continued growth of the Internet presents even more of an opportunity for expansion in financial services through the use of technology."); Wallman, *Regulation for a New World*, *supra* note 1, at 8 ("Technology, and the Internet in particular as the first worldwide interactive mass communication vehicle, is especially critical in forcing us to refashion the way we think about regulation.").

17. SEC Commissioner Steven Wallman has recently observed: "I think we will really see innovation in this area, over the Internet and through proprietary systems, including: more real-time individual consumer securities trading; and the providing of more real-time disaggregated financial information through access to select portions of a company's management information system." Wallman, *Regulating in a World of Technological and Global Change*, *supra* note 16, at 64; *see also* Wallman, *Regulation for a New World*, *supra* note 1, at 10 ("Increasingly, we have issuers seeking 'just-in-time capital,' as they have previously sought just-in-time inventory.").

18. Already the vehicles of transmission of financial information are rapidly shifting from paper to computer. *See* Gerard R. Boyce, *Offering and Trading Securities on the Internet*, N.Y. L.J., May 9, 1996, at 3, 3 ("The Spring Street Brewing Company's Internet-based initial public offering and trading scheme has generated significant media attention."); Jack Egan, *Ready, Set, Search*, U.S. News & World Rep., Apr. 29, 1996, at 64, 68 ("'We'll also be able to provide access to valuable private information like Dun & Bradstreet business credit reports.' In tandem with IBM's 'cryptolope,' (for encrypted envelope) such value-added data will be sent over the Internet to users who pay a fee."); Michael Gianturco, *Investing on the Web: Surf and Grow Rich!*, Forbes ASAP, June 3, 1996, at 36, 36 ("There is a lot of free stuff for investors on the Internet. . . . [The INVESTools Website is] great for reading investment resources like investment newsletters, opinion pieces, helpful lists of money managers and advisers, and books and periodicals."); *Journal Introduces Interactive Edition*, Wall St. J., Apr. 29, 1996, at B1 ("The Wall Street Journal today introduces its Interactive Edition, an electronic newspaper that works through the burgeoning Internet to deliver high-quality, timely business news and information around the clock and around the globe."); Thomas McCarroll, *Investors Rush the Net*, Time, June 3, 1996, at 54, 56

world in which the financial markets are influenced almost instantaneously by electronically-reported events and developments, financial information that comes plodding along three months after year-end in an annual report or Form 10-K may increasingly seem somewhere between useless and absurd.[19]

("[T]he movement to the Internet has tremendous momentum, and Wall Street knows better than to swim against the tide."); Vanessa O'Connell, *Stock Answer*, Wall St. J., June 17, 1996, at R8 ("Buying and trading securities on the Web could revolutionize the relationship between investors and brokerage firms."); Michael Selz, *Small Stock Issuers Find a New Market on the Internet*, Wall St. J., May 14, 1996, at B2 ("Entrepreneurs are creating Web pages that help investors purchase stock directly from small issuers, which don't interest most underwriters."); Rick Telberg, *CPA Societies Click with Net Developer*, Acct. Today, May 20-June 2, 1996, at 1, 1 ("More than 30 state CPA societies have signed on with a nascent Seattle-based Internet developer to join the traffic on the information superhighway."); Thomas E. Weber, *Ernst & Young's Consulting Services to Be Sold on Internet for Annual Fee*, Wall St. J., May 21, 1996, at B10 ("Ernst & Young is expected to begin selling its consulting services over the Internet, offering small businesses a chance to query the firm's experts electronically in exchange for a flat-fee annual subscription. The move, expected to be announced today, marks the first major effort by a Big Six accounting firm to embrace the Internet to distribute its services.").

The transmission of financial information has come a long way:

> When Charles Dow and Edward Jones first launched their business-news enterprise in 1882, they disseminated the news on "flimsies," essentially sheets of carbon paper with the handwritten news on it. A clerk pressing hard on the paper could generate up to 24 flimsies at a time: runners carried these to businessmen and speculators . . . .

John R. Dorfman, *Sending News over Broad Tape*, Wall St. J., May 6, 1996, at C1.

19. This point is being made with increasing frequency. In September 1994, Robert Elliott observed, "[t]he audit also is threatened by the fact that annual printed financial statements may be destined for history's scrap heap because information technology permits far more frequent and timely reports." Robert K. Elliott, *The Future of Audits*, J. Acct., Sept. 1994, at 74, 75. More recently, the chairman of the Financial Accounting Foundation has commented:

> Your annual reports and even your 10Qs are pretty much ancient history by the time they're prepared and distributed. . . . All the effort that goes into preparing them and being sure they meet the requisite standards of accuracy and completeness is something of a wasted effort because by the time they reach the marketplace, the marketplace has long since absorbed the information from other sources.

Glenn Cheney, *Cook Defends Independence, Pushes for Global Standards*, Acct. Today, Nov. 25-Dec. 15, 1996, at 16, 20 [hereinafter Cheney, *Cook Defends Independence*] (quoting chairman of the Financial Accounting Foundation J. Michael Cook). One popular anecdote involves a foods manufacturer that reportedly offered shareholders their choice of the company's annual report or a free pound of cookies. Most shareholders went for the cookies. *Id.*

An obvious consequence of expedited systems of financial reporting is that, if the accounting profession is to keep up, there will not be enough time within the constraints of real-time financial reporting for an "audit" in the traditional sense to take place. It is for that reason, among others, that the emphasis will almost inevitably shift from audits of financial statements to assurance as to financial reporting systems. *See* discussion *infra* part III.C; *see also* Elliott Committee Report, *supra* note 9, at <http://www.aicpa.org/assurance/scas/comstud/effect/constr.htm> ("Real-time auditing, for example, will require a far better understanding of systems and systems reliability."); *Professional Growth Through New Assurance Services*, *supra* note 8, at 6 ("Information technology is probably the single most important factor influencing fu-

One need not think too deeply before recognizing that the liability implications, if left unmanaged by the profession, are potentially staggering.[20] The availability of Internet-transmitted information may mean that everyone in the computer-owning world—at least to the extent they choose to become subscribers to the professional service at issue—may end up as a putative plaintiff should transmitted information turn out to be wrong.[21] And note that attention must focus upon liability throughout the world. There is no existing barrier that would limit the litigation exposure to those in the United States.[22]

If ever there were a litigation risk to stop innovation in its tracks, this would seem to be it. The situation, however, is not without hope.

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ture information flows and CPA services. . . . In the future, investors, creditors and others with valid interests may be allowed access through [Electronic Data Interchange] to a company's data base . . . ."). As noted in the *CPA Journal*:

> This new paradigm in the world of the accounting profession starts with a decision maker making inquiries (or having direct access to the data base) of an enterprise and then seeking corroboration from the auditor that the information he or she obtained online on a real-time basis is true. It will look like a network of information flying around in various directions.

The CPA Journal Symposium on the Future of Assurance Services, *supra* note 8, at 16.

20. If the liability implications are potentially staggering, so are the opportunities for fraud. Last May, for example, the *Wall Street Journal* described a company whose stock quickly quintupled as a result of "[o]ne positive earnings report and literally thousands of messages over The Motley Fool, an on-line bulletin board on America Online. . . . [S]ome of these cyberscribes, both bulls and bears, have taken liberties with the truth, adding to the stock's 'volatility.'" Roger Lowenstein, *Who's the Fool in Iomega's Skyrocket?*, Wall St. J., May 23, 1996, at C1; *see also* SEC v. Western Executive Group, Inc., No. 96-6938 (C.D. Cal. Oct. 7, 1996) (involving SEC procurement of a temporary restraining order in the largest reported Internet investment fraud to date); Richard Raysman & Peter Brown, *Regulating Internet Advertising*, N.Y. L.J., May 14, 1996, at 3, 3 ("The use of the Internet to transmit ads containing fraudulent claims or consumer 'scams' comprises an area of growing concern for federal and state authorities."); Jeffrey Taylor, *SEC Has a Message for the Media: We Are Keeping Our Eyes on You*, Wall St. J., Apr. 19, 1996, at C1 ("In particular, regulators worry that the proliferation of media activity, in newsletters and on the Internet, allows people who are bearish on a stock to grind their axes in print and provide a road map for other bears to sell the stock as well.").

21. Even under the conservative "*Ultramares* rule," one in privity with an accountant may potentially state a claim for negligent misrepresentation. *See* Ultramares Corp. v. Touche, 174 N.E. 441 (N.Y. 1931); *see also* Credit Alliance Corp. v. Arthur Andersen & Co., 483 N.E. 2d 110 (N.Y. 1985) (reaffirming the *Ultramares* rule).

22. As one author recently has observed:

> And, just as events in cyberspace thus take place "nowhere," they also can be characterized as taking place everywhere at once, in the sense that the effects of on-line activities are felt simultaneously in every corner of the global network. A World Wide Web page located on a machine in, say, Berlin can be accessed just as easily by users in Frankfort, Kentucky, as by those in Frankfurt, Germany. *All* jurisdictions simultaneously feel the effects of the information posted there, and thus all would appear to have equal claims to make the law governing the content of this site—surely a recipe for international chaos.

David Post, *The New Electronic Federalism*, Am. Law., Oct. 1996, at 93, 93; *see also* Wallman, *Regulation for a New World*, *supra* note 1, at 10 ("It is difficult and expensive to *limit* the geographic reach or audience in an Internet-based world.").

Developing judicial precedent suggests that the law is coming to recognize the benefits of computer-disseminated financial information, and is developing an increasing recognition of a need to limit the litigation risk. To the extent the profession makes the leap to a computer-based information source providing financial information to a wide audience, it may gain the benefit of these judicial developments which, while not eliminating risk entirely, may make it more manageable.

B. *Technological Innovation and the Law*

Ironically, what may be the most important case affecting computer dissemination of CPA-associated financial information in the United States was decided by a low-level, New York state court decades before the computer was even invented. The case is *Jaillet v. Cashman*,[23] and it involved a then-innovative device for reporting financial information—the ticker service. On March 8, 1920, Dow Jones & Co. misreported over its ticker service the effect of a court decision on the taxable status of stock dividends as income. An investor saw the report, believed stock prices were going to drop, and sold. In fact, the Dow Jones report was wrong, and when its report was corrected the market rose. In a move that would be widely imitated in subsequent decades, the investor sued. The claim was against Dow Jones for negligence in misreporting the effects of the court decision.[24]

The court sustained a demurrer—or, in modern parlance, dismissed the complaint. True, the court conceded, Dow Jones had a "moral obligation" not to say anything that was untrue.[25] But a moral obligation did not necessarily give rise to legal liability. To permit a negligence claim, the court reasoned, would establish a precedent whereby "there was a liability by the defendant to every member of the community who was misled by the incorrect report."[26] Considerations of "practical expediency," the court said, made dismissal of such a complaint "absolutely necessary."[27]

Fast-forward to the 1980s, and we see that the law has continued to develop in order to accommodate technological innovation. In the intervening half-century, Dow Jones has improved immeasurably its financial information systems, developing, among other things, the Dow Jones News/Retrieval Service, providing to about 200,000 subscribers real-time financial news accessed by computer. The system works as follows:

23. 189 N.Y.S. 743 (Sup. Ct. 1921), *aff'd*, 194 N.Y.S. 947 (App. Div. 1922), *aff'd*, 139 N.E. 714 (N.Y. 1923).
24. 189 N.Y.S. at 744.
25. *Id.*
26. *Id.*
27. *Id.*

> The subscriber telephones defendant's computer. Then, by use of a personal computer and modem, a device which converts computer signals for telephone transmission, the subscriber enters the necessary passwords and access codes to set up an instantaneous, continuous, "interactive" "on-line" linkage with defendant's computer, thus allowing access to the Dow Jones News Service.[28]

Alas, while the technology has improved, Dow Jones is still making mistakes. Thus, when the Canadian corporation Husky Oil underwent a restructuring, Dow Jones disseminated over its computer system a report on the restructuring, but neglected to mention that the prices referred to were in Canadian, not United States, dollars. An investor (who happened to be a law student) lost money in alleged reliance on the Dow Jones report and sued.[29] The claim was for negligent misrepresentation.[30]

Again, Dow Jones found itself litigating a significant technological issue in a low-level New York state court. For the court itself, the case presented a dilemma. On the one hand, the court acknowledged that New York had "long recognized" a claim for negligent misrepresentation.[31] On the other hand, the court also acknowledged that a failure to dismiss that claim might nip in the bud a developing technology.[32]

The court thus framed the issue as one of technological development needing to be accommodated by the strictures of the law. Heralding back to the time when "town criers . . . for centuries informed the local citizenry," the court stated:

> With the inexorable march of time has come an age of technology of previously unimagined dimensions. Methods for news delivery have advanced apace with general scientific achievements. While town criers had for centuries informed the local citizenry, general circulation newspapers eventually made criers superfluous. Early in this century, news, transmitted by radio and telephone, became available to subscribers through dedicated news tickers and to the public by "extra" editions of newspapers. Widely available radio and television made news known to the public within minutes of its occurrence. In the last few years, instantaneous news has become available to subscribers with access to a microcomputer and a telephone, even at home.
>
> Do technological advances require rethinking legal principles that have existed for previous modalities? Do modern techniques for delivering the news change the rules applicable to its providers? This case raises the question of whether the providing of a premium service for instantaneous transmission of the news by computer-to-

28. Daniel v. Dow Jones & Co., 520 N.Y.S.2d 334, 335 (Civ. Ct. 1987).
29. *Id.*
30. *Id.* at 335-36.
31. *Id.* at 336.
32. *Id.* at 338, 340 (declaring the need to evaluate new forms of technology in accordance with established legal rules).

computer linkup places the news service at greater risk to readers than does the providing of the same news by another modality.[33]

The court's holding was that technology won and the law lost. More precisely, the court held that the complaint was to be dismissed, largely for reasons of policy. Looking to the Restatement of Torts and its limitation on claimants for negligent misrepresentation to "one of a limited group of persons,"[34] the court held that "as a matter of public policy, the class of potential plaintiffs must be carefully circumscribed to avoid the potential of unlimited liability."[35] Here, there was not a sufficiently close relationship to permit the investor to state a claim:

> The relationship between the parties here is the same as between any subscriber and a news service; it is functionally identical to that of a purchaser of a newspaper. The advances of technology bring the defendant's service into the home or office of more than 200,000 persons; indeed even non-subscribers may receive defendant's service through computerized linkages with other database enterprises. There is no functional difference between defendant's service and the distribution of a moderate circulation newspaper or subscription newsletter. The instantaneous, interactive, computerized delivery of defendant's service does not alter the facts: plaintiff purchased defendant's news reports as did thousands of others. The "special relationship" required to allow an action for negligent misstatements must be greater than that between the ordinary buyer and seller.[36]

For support, the court relied largely upon the "rule in *Jaillet*" as established more than fifty years earlier.[37]

C. *The Basic Rule*

The basic rule that emerges from these two cases, and a number of others,[38] applies generally to those who disseminate, through media-type channels, financial and other information. The rule appears to be that one who disseminates financial or other information through publicly-available media will generally be immune from a claim based on

33. *Id.* at 335.
34. Restatement (Second) of Torts § 552(2)(a) (1977) [hereinafter Torts Restatement].
35. *Daniel*, 520 N.Y.S.2d at 336.
36. *Id.* at 337-38.
37. *Id.* at 338.
38. *See* First Equity Corp. v. Standard & Poor's Corp., 869 F.2d 175, 180 (2d Cir. 1989); First Equity Corp. v. Standard & Poor's Corp., 670 F. Supp. 115, 118 (S.D.N.Y. 1987), *aff'd*, 869 F.2d 175 (2d Cir. 1989); Gale v. Value Line, Inc., 640 F. Supp. 967, 971 (D.R.I. 1986); *Daniel*, 520 N.Y.S.2d at 336; Jaillet v. Cashman, 189 N.Y.S. 743 (Sup. Ct. 1921), *aff'd*, 194 N.Y.S. 947 (App. Div. 1922), *aff'd*, 139 N.E. 714 (N.Y. 1923); Gutter v. Dow Jones, Inc., 490 N.E.2d 898, 902 (Ohio 1986).

negligence[39] where the disseminated information is false.[40] That the rule is applicable to financial information, according to the courts, has been established by "the rule enunciated in *Jaillet* . . . immunizing disseminators of financial information from tort liability for non-defamatory negligent misstatements."[41]

The rationale for this rule is one of (rare for the law in the area of financial reporting) common sense and "practical expediency."[42] The economic reality, the courts seem to recognize, is that "the potential number of persons to whom a publication might become available is without limit," and the existence of claims sounding in negligence would cause the disseminator to face "the spectre of unlimited liability" which would "have a staggering deterrent effect on the dissemination" of information.[43] The doctrinal soundness of the rule is in part demonstrated by its intellectual consistency with a fundamental principle of negligence as embodied in the Restatement, which limits a claim for negligent misrepresentation to the "loss suffered . . . by the person or one of a limited group of persons for whose benefit and

39. A claim predicated upon the negligence of an accountant will typically take one of two forms: a claim for negligent misrepresentation or a claim for negligence. The elements of each claim are in substance the same, *see* Standard Chartered PLC v. Price Waterhouse, Nos. 1 CA-CV 93-0461, 1 CA-CV 93-0442, 1996 WL 640702, at *24 (Ariz. Ct. App. Nov. 7, 1996) ("We have stated that the gravamen of [plaintiff's] auditor negligence claim is negligent misrepresentation."), though—depending on the law of the particular state at issue—other differences between the two claims may exist. In California, for example, only the accountant's client or a third-party beneficiary of the accountant's engagement contract may state a claim for negligence, whereas a somewhat broader class may state a claim for negligent misrepresentation. *See* Bily v. Arthur Young & Co., 834 P.2d 745 (Cal. 1992). The rule articulated in *Jaillet* would appear to apply to both negligence and negligent misrepresentation claims.

40. *See First Equity Corp.*, 869 F.2d at 180 ("The publication at issue is a source of information disseminated to a wide public. . . . In such circumstances, we believe that a user is in the best position to weigh the danger of inaccuracy and potential loss . . . . That being the case, the user should bear the risk of failing to verify the accuracy of a summary in the absence of proof of a knowing misstatement."); *First Equity Corp.*, 670 F. Supp. at 118 (applying *Jaillet* rule to Standard & Poor's, where "it is the fact that the size of [the user class] is indeterminate which raises the potential for unlimited liability, which concern is the foundation of the *Jaillet* rule"); *Gale*, 640 F. Supp. at 971 (holding that the publisher of a fairly widespread investment advisory newsletter would not be liable for an incomplete description of a warrant when "the information was simply and inadvertently omitted from the publication for a period of time"); *Gutter*, 490 N.E.2d at 902 (finding the *Wall Street Journal* not liable for an inaccuracy, stating that "we . . . conclude that a complaint alleging that a newspaper reader or subscriber relied to his detriment in making securities investments based on a negligent and inaccurate report in a newspaper does not state a cause of action in tort against the newspaper's publisher for 'negligent misrepresentation'").

41. *First Equity Corp.*, 869 F.2d at 178. Although the *Jaillet* decision has been adopted by a number of jurisdictions outside New York, in *In re* Taxable Municipal Bond Sec. Litig., No. Civ. A. MDL No. 863, 1993 WL 591418, at *5 (E.D. La. Dec. 29, 1993), the United States District Court for the Eastern District of Louisiana observed that the Fifth Circuit had not adopted the doctrine.

42. *First Equity Corp.*, 670 F. Supp. at 117.

43. *Id.* (quotations omitted).

guidance" the information is intended to be provided.[44] When a publicly-accessible vehicle of transmission is used—whether it be a newspaper, a ticker-tape, a financial newsletter, or a global computer network—the information is not being disseminated to "a limited group."[45] It is being disseminated to everybody.

Nor does it appear to be a prerequisite to the *Jaillet* rule that the media vehicle be of any particular type, be particularly well known, or have a particularly large number of subscribers. The *Jaillet* rule has been found applicable to interactive computer services,[46] newspapers,[47] a Standard & Poor's publication called "Value Line Convertibles"[48] (which ranked convertible securities and evaluated warrants), and newsletters.[49] It has been applied when the number of subscribers has been as little as 2200.[50] And, to anticipate an important issue, the *Jaillet* rule limits negligent misrepresentation claims even by those who have entered an explicit agreement with the disseminator. "A subscriber is not significantly different from other purchasers of a publication merely because he pays for it on a more or less regular basis."[51]

D. *So Will It Apply to Accountants?*

The key question that emerges from all this, of course, is: Would the *Jaillet* rule apply to an accountant providing assurance services transmitted over the Internet?

An understandable reaction might be that the *Jaillet* rule, in the context of accountants' liability, is too good to be true—a reaction that could become self-fulfilling if the courts feel the same way. Still, there are some compelling reasons that the *Jaillet* rule should be just as applicable to accounting professionals as to other disseminators of financial information. The core underpinning of the *Jaillet* rule—that traditional principles of negligence limit liability to, in the words of

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44. *Id.* at 118 (quoting Torts Restatement, *supra* note 34, § 552(2)(a)); *see also* Bily v. Arthur Young & Co., 834 P.2d 745, 757-58 (Cal. 1992) (applying Restatement rule to negligent misrepresentation claim).

45. *First Equity Corp.*, 670 F. Supp. at 118 ("The subscribers and readers of a newspaper or similar publication hardly constitute a limited class.").

46. Daniel v. Dow Jones & Co., 520 N.Y.S.2d 334, 336-38 (Civ. Ct. 1987).

47. Gutter v. Dow Jones, Inc., 490 N.E.2d 898, 901-02 (Ohio 1986).

48. Gale v. Value Line, Inc., 640 F. Supp. 967, 969, 971-72 (D.R.I. 1986).

49. First Equity Corp. v. Standard & Poor's Corp., 869 F.2d 175, 179 (2d Cir. 1989).

50. *Gale*, 640 F. Supp. at 969 (involving investment advisory newsletter—between 2200 and 4400 subscribers); *see also First Equity Corp.*, 869 F.2d at 176 (involving loose-leaf summaries of business operations and finances—7500 subscribers); *Gutter*, 490 N.E.2d at 899 (involving the *Wall Street Journal*).

51. First Equity Corp. v. Standard & Poor's Corp., 670 F. Supp. 115, 117 (S.D.N.Y. 1987); *see also Gale*, 640 F. Supp. at 972 (holding the publisher of *Value Line*, a publication that ranks convertible securities and includes purchase recommendations and warrant evaluations, not liable to a subscriber); *Gutter*, 490 N.E.2d at 902 (finding the publisher of the *Wall Street Journal* not liable to a subscriber).

the Restatement, "a limited group"—is every bit as applicable to accountants as to everybody else. If anything, experience suggests that the staggering implications for liability are even more of a problem in the context of accountant liability. And the law has no interest in constructing differing standards of liability for accountants and non-accountants, such that the computer-dissemination of financial information would be left exclusively to those least qualified to do it. It would be ironic indeed if the imposition of uniquely harsh standards of liability upon the accounting profession increased its level of exposure, or increased the pricing of its services, to the point where the computer dissemination of financial information was left exclusively to nonfinancial journalists.

Nor would the law's interest in truthful information support a distinction between the function of an accountant and the function of a non-accountant in assessing the applicability of the principles of *Jaillet*. When Dow Jones describes for its subscribers the terms of a corporate bond, that description carries with it an implicit representation that Dow Jones has conformed to the standards of its profession in determining that the information being provided is entirely truthful. An accountant performing an attest function does in substance the same thing, though the representation of conformity to professional standards is typically more than implicit. For example, one case before the Second Circuit involved loose-leaf summaries "of the business operations and finances of a large number of corporations" without investment recommendations or any general news.[52] If the description of "business operations and finances" contains a blatant factual error, it is hard to see why it should be isolated from liability while an accountant making a much more subtle error (testing a reserve for bad debts, for example) should be held liable. In substance, both the loose-leaf service and the attest-performing accountant are performing similar tasks: reporting with ostensible accuracy financial information relevant to the instruments of commerce.[53]

It is interesting to note, moreover, that some courts have explicitly stated that the immunization of media-disseminators of information from negligence claims is entirely consistent with well-established principles of accountant liability. In declining to permit a negligence claim against Standard & Poor's for a false description of convertible securities, for example, the Second Circuit observed that its holding

52. *First Equity Corp.*, 869 F.2d at 176. The court did distinguish a summary of such information from the actual information itself. *Id.* at 180.

53. Similarly, it is hard to distinguish, for the purpose of assessing the scope of the *Jaillet* rule, between an incorrect financial report that results in an overstated value of a company's stock, such as a negligent accountant might produce, and an incorrect description of (say) the terms of convertibility of a bond which results in an overstatement of bond value, a situation in which no liability for negligence has been imposed. *See Gale*, 640 F. Supp. at 971-72. If anything, the latter is arguably more obvious and egregious.

was supported in part by "New York caselaw regarding the liability of accountants," insofar as the New York Court of Appeals had "carefully avoided exposing accountants to liability to a potentially 'indeterminate class of persons who, presently or in the future, might . . . rel[y]' on a negligently inaccurate audit."[54] The obvious implication is that, if the principles of law are entirely consistent, when accountants start disseminating information over computer networks, they should get the same immunization from negligence as everyone else.[55]

Almost anyone familiar with the history of accountants' liability, however, might have a nagging sense that the courts would find some way to impose liability on accountants to a greater extent than on everyone else. And anyone stepping back and considering the apparent distinction between media and non-media mechanisms for disseminating information might question whether the distinction really makes sense. It is far from clear, for example, that the class of persons relying on financial information obtained through an obscure bond newsletter is that much broader than, say, the class of persons using EDGAR[56] to review a Form 10-K. Nonetheless, for reasons owing more to history than logic, the latter may give rise to a claim for negligent misrepresentation[57] while the former apparently will not. (To cloud the issue further, EDGAR is now available on the Internet.)

54. *First Equity Corp.*, 869 F.2d at 179 (quoting Ultramares Corp. v. Touche, Niven & Co., 174 N.E. 441, 446 (N.Y. 1931)).

55. To anticipate a potential issue, it is not the case that the immunization of a media-disseminator from a negligence claim is limited to those jurisdictions following New York's conservative *Ultramares* rule, which allows only those in privity or those known to the disseminator to state a negligent misrepresentation claim. *See* Credit Alliance Corp. v. Arthur Andersen & Co., 483 N.E.2d 110, 118 (N.Y. 1985); *Ultramares*, 174 N.E. at 446. The rationale for the *Jaillet* rule is conceptually tied more to the Restatement than to *Ultramares*, and the *Jaillet* rule has been applied where the *Ultramares* rule has not. *See Gutter*, 490 N.E.2d at 900-01 (applying *Jaillet* rule). Incidentally, legal scholars may find interesting that a key New York decision on which Judge Cardozo based his opinion in *Ultramares* was the 1920 ticker-service case of *Jaillet*. *See Ultramares*, 174 N.E. at 446.

56. EDGAR is the SEC-owned database which contains the filings of SEC documents.

57. *See* Simpson v. Specialty Retail Concepts, Inc., 908 F. Supp. 323, 332 (M.D.N.C. 1995) (stating that whether an auditor owed a duty of care to public market investors was a "question of fact"); Grove Holding Corp. v. First Wisconsin Nat'l Bank, 803 F. Supp. 1486, 1504 (E.D. Wis. 1992) (shareholder stated claim for negligent misrepresentation); Boykin v. Arthur Anderson & Co., 639 So. 2d 504, 510-11 (Ala. 1994) (holding that individual shareholders may state a claim for negligence); Northwest Racquet Swim & Health Clubs, Inc. v. Deloitte & Touche, 535 N.W.2d 612, 619 (Minn. 1995) (allowing a claim for "very specific incidences of misrepresentation in [an] audit report on which [plaintiff] directly relied"). *See generally* Wayne Baliga, *Courts Rule in Different Directions on Class Actions Against Accountants*, J. Acct., Oct. 1996, at 27, 27 (comparing the holding in *Specialty Retail Concepts*, 908 F. Supp. 323, which found that an accounting firm could be liable to potential investors, to the holding in Scottish Heritable Trust v. Peat Marwick Main & Co., 81 F.3d 606 (5th Cir.), *cert. denied*, 117 S. Ct. 182 (1996), which dismissed a potential investor's claims against an accounting firm). The existence of these cases permitting a claim is not to suggest that they are correctly decided. For the reasons discussed above, the doctri-

A California case illustrates the danger. In *Hanberry v. Hearst Corp.*,[58] a woman slipped while wearing new shoes and sued the publisher of *Good Housekeeping* magazine because the shoes' soles were slippery.[59] *Good Housekeeping* was at fault for the woman's injury, the complaint alleged, because the shoes had been advertised as "meeting the Good Housekeeping's Consumers' Guaranty Seal," which included an assertion that "[w]e satisfy ourselves that products advertised in Good Housekeeping are good ones and that the advertising claims made for them in our magazine are truthful."[60] The seal itself contained the statement that, "[i]f the product or performance is defective, Good Housekeeping guarantees replacement or refund to consumer."[61] The woman with slippery shoes alleged that the publisher (Hearst) had in fact done nothing to investigate the quality of the shoes, and that the representations to the contrary were deliberately and negligently false.[62]

The court permitted a claim for both deliberate and negligent misrepresentation. The court was, it conceded, "influenced more by public policy than by whether such cause of action can be comfortably fitted into one of the law's traditional categories of liability."[63] Implicit in the *Good Housekeeping* seal of approval, the court said, was "the representation [that the publisher] has taken reasonable steps to make an independent examination of the product endorsed, with some degree of expertise, and found it satisfactory."[64] Thus, "having in effect loaned its reputation to promote and induce the sale of a given product," the court found the publisher should not escape liability.[65]

The court's willingness to ignore the principles of *Jaillet* and uphold a claim in negligence is disturbing. Even worse, it is easy to see how the court's language about *Good Housekeeping*'s undertaking an "independent examination"[66] of the product could be turned against the accounting profession, insofar as the nomenclature of the profession

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nally correct view would seem to be that "the liability of auditors and accountants for negligence or negligent misrepresentation does not exten[d] . . . to the general investing public." Biben v. Card, No. 84-0844-CV-W-6 (W.D. Mo. 1985), *quoted in* Cammer v. Bloom, 711 F. Supp. 1264, 1298 (D.N.J. 1989); *see also Scottish Heritable Trust*, 81 F.3d at 613 (accountant owed no duty to an open-market investor); *In re* Crazy Eddie Sec. Litig., 812 F. Supp. 338, 360 (E.D.N.Y. 1993) (finding that an accountant's duty of care did not extend to "as-yet unidentified future open-market buyers of publicly-traded securities").

58. 81 Cal. Rptr. 519 (Ct. App. 1969).

59. *Id.* at 521.

60. *Id.*

61. *Id.*

62. *Id.*

63. *Id.*

64. *Id.* at 522.

65. *Id.*

66. *Id.*

involves an independent examination of financial information.[67] Still, the case is distinguishable on several grounds, among them that it is premised on section 311 of the Restatement, which is careful to limit its applicability to "[o]ne who negligently gives false information" that results in "physical harm."[68] An accountant performing assurance services, moreover, is not seeking to endorse the purchase of the subject company's stock or bonds, but to give assurance as to the fairness of the presentation (be it good or bad) of the financial information at issue. Additional comfort is in the fact that the cases considering the analysis of this California court have generally found a way not to follow it.[69]

To summarize, then, as the accounting profession makes the leap into computer-disseminated financial information, it may qualify under established principles of law as one who is thereby immunized from a claim rooted in negligence. The rationale is one steeped in public policy: a rule to the contrary would foreseeably result in an exposure to liability that would drive every public-media provider of information out of business.[70] At the moment there is not, however, any case so holding in the context of accountant liability. And the immunization itself would run counter to an intuitive tradition of broad accountant liability for financial misreporting.

E. *The First Amendment*

There is an additional measure of protection that may be available against negligence claims, beyond the long-established protection of the *Jaillet* rule. That measure is constitutional: as a disseminator of information through the means of public media, accountants may be entitled to First Amendment protection.

Even those who might not be considered traditional media publishers may come under the umbrella of the First Amendment. A provider of information who gathers data from a variety of sources, undertakes independent analysis amounting to editorial control over form and content, and provides this analysis to the general public on a regular basis may be characterized as a "publisher" for First Amendment purposes.[71] Thus, courts have determined that Standard &

67. AICPA, 1 AICPA Professional Standards, at AU § 508.08 (June 1, 1996).

68. *Hanberry*, 81 Cal. Rptr. at 523 n.1 (quoting Torts Restatement, *supra* note 34, § 311).

69. *See, e.g.*, Winter v. G.P. Putnam's Sons, 938 F.2d 1033, 1037 & n.7 (9th Cir. 1991) (distinguishing *Hanberry* on facts); Yanase v. Automobile Club, 260 Cal. Rptr. 513, 518-19 (Ct. App. 1989) (same).

70. *See, e.g.*, Gutter v. Dow Jones, Inc., 490 N.E.2d 898, 901 (Ohio 1986) ("More importantly, we believe that public policy . . . constraints support protection to newspapers for a negligent misstatement of fact . . . .").

71. *See In re* Scott Paper Co. Sec. Litig., 145 F.R.D. 366, 369-70 (E.D. Pa. 1992) (finding that Standard & Poor's, under the factors cited in the text, qualified for a journalist's privilege under the First Amendment); Daniel v. Dow Jones & Co., 520

Poor's, for example, is entitled to First Amendment protection in connection with its ratings process.[72] It may seem something of a stretch to conclude that CPA-associated financial information should be accorded First Amendment protection when it is disseminated over a computer network. Of course, in the same vein, it seems something of a stretch to conclude that Standard & Poor's is entitled to First Amendment protection in connection with its bond ratings.[73]

The applicability of First Amendment protection to one who inadvertently provides false financial information was illustrated in *Daniel v. Dow Jones & Co.*[74] That was the case, discussed earlier,[75] in which a law student investor had allegedly relied upon an incorrect report of a Canadian corporate restructuring provided by the Dow Jones News/Retrieval Service.[76] Although the court disposed of the claim based

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N.Y.S.2d 334, 340 (Civ. Ct. 1987) (holding that the Dow Jones News/Retrieval, an on-line financial news service, was entitled to "the same [First Amendment] protection as more established means of news distribution").

72. *See In re* Pan Am Corp., 161 B.R. 577, 581-82 (Bankr. S.D.N.Y. 1993) ("The record allows no other conclusion but that S & P functions as a journalist when gathering information in connection with its ratings process . . . with the intent to use the material to disseminate information to the public . . . ."); In re *Scott Paper*, 145 F.R.D. at 370 ("[W]hatever the definitional limits of the press for First Amendment purposes, S & P falls within its umbrella of protection.").

73. It certainly seems something of a stretch to the SEC. In the 1970s and early 1980s, the SEC unsuccessfully sought to require certain newsletter authors to register as investment advisors. *See* Lowe v. SEC, 472 U.S. 181 (1985). Now, the spurt of investment information into the Internet, by all appearances, has given the SEC a whole new set of problems. The early indications are that the SEC will view Internet disseminators of financial information as potentially less worthy of First Amendment protection than those who disseminate financial information in print. Thus, a *Wall Street Journal* article observed last year:

> Once reluctant to impose its antifraud powers on newsletter authors and other journalists, the SEC is now scrutinizing media mavens of all sorts—and with greater success than in the past.
>
> The SEC has brought actions recently against an array of people whose media status once might have protected them, from newsletter editor Stephen Leeb and radio commentator Irwin "Sonny" Bloch to promulgators of cyberspace communiques on the Internet. . . .
>
> . . . .
>
> In particular, regulators worry that the proliferation of media activity, in newsletters and on the Internet, allows people who are bearish on a stock to grind their axes in print and provide a road map for other bears to sell the stock as well.

Taylor, *supra* note 20, at C1. Roger Lowenstein notes:

> But Kenneth Israel Jr., the SEC's district administrator in Salt Lake City, says, "Obviously, there is some concern with what is going on over the Internet generally—not to say there is anything illegal going on. This is a new world for everybody." What should the SEC look at? For starters, is aggressive and possibly manipulative promotion—an activity rightly regulated in traditional "public" forums—getting a free ride on the info highway?

Lowenstein, *supra* note 20, at C1.

74. 520 N.Y.S.2d 334 (Civ. Ct. 1987).

75. *See supra* notes 28-37 and accompanying text.

76. 520 N.Y.S.2d at 335.

on the *Jaillet* rule, it went on to observe that Dow Jones's report of the restructuring was entitled to "the fullest protection of the First Amendment."[77] Services such as Dow Jones's computerized database, the court explained, "are instruments for the free flow of all forms of information, and should be treated as unquestionably within the First Amendment's guarantee of freedom of the press."[78]

Lest anyone get too carried away with this, the level of First Amendment protection accorded to disseminators of financial information is a matter of substantial uncertainty and dispute. In a Supreme Court case, for example, the extent to which Dun & Bradstreet was entitled to First Amendment protection in connection with a false credit report sent to five subscribers resulted in a fractured Court (a plurality opinion of three, two separate concurrences, and four united in dissent), and to this day it is unclear what the Court's decision actually means.[79]

Whatever the case, as a practical matter, the existence of First Amendment protection may not add much to the protections already provided by the *Jaillet* rule. The First Amendment generally acts as a shield from liability in the absence of "actual malice"—knowledge that the statement is false or reckless disregard as to its truth.[80] The *Jaillet* rule already provides such protection, insofar as it does not permit liability for a claim of mere negligence. But, if nothing else, the potential applicability of First Amendment protections may help keep pro-liability courts in line.

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77. *Id.* at 340.

78. *Id.*

79. Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc., 472 U.S. 749, 750, 762-63 (1985); *see In re* Pan Am Corp., 161 B.R. 577, 584 (Bankr. S.D.N.Y. 1993) (distinguishing *Greenmoss* and observing that the *Greenmoss* opinion had explicitly noted that "[t]he protection to be accorded a particular credit report depends on whether the report's content, form, and context indicate that it concerns a public matter" (quoting *Greenmoss*, 472 U.S. at 762 n.8)).

The level of First Amendment protection applicable to a provider of financial information was recently thrown into more uncertainty by events occurring in the wake of the Orange County bankruptcy. Five months ago, the United States Bankruptcy Court for the Central District of California denied Standard & Poor's motion to dismiss the county's suit against it, holding that the First Amendment does not protect it from a $500 million lawsuit brought by Orange County. County of Orange v. McGraw-Hill Cos., 203 B.R. 983 (C.D. Cal. 1996). The bankruptcy court found S & P's argument that it was entitled to First Amendment protection to be "off target," because Orange County had complained that S & P had failed to fulfill its contractual obligations with the county in connection with a number of bond issues the county was considering, rather than asserting any claim relating to S & P's published ratings. *Id.* at 990.

80. *See, e.g.*, New York Times Co. v. Sullivan, 376 U.S. 254, 279-80 (1964) (holding in the defamation-of-a-public-official context that "[t]he constitutional guarantees require, we think, a federal rule that prohibits . . . recover[y] . . . unless . . . the statement was made with 'actual malice'—that is, with knowledge that it was false or with reckless disregard of whether it was false or not").

F. *The Use of Disclaimers*

In the event that a court should decline to extend the *Jaillet* rule to CPA-associated financial information disseminated over the Internet, and that First Amendment protections are found to be inapplicable, there remains a third level of protection from liability. Accountants should have the same legal right to do what Moody's, Dow Jones, and other computer-based providers of financial information do: limit responsibility as a matter of disclaimer. In the context of information provided over a computer network, there are two potential opportunities: (1) in a subscription agreement, if one is to be entered; and (2) as part of the "on-line" sign-up procedures at the outset of a transmission.[81]

Indeed, it is common for those providing financial information over the Internet to include in the transmission some form of disclaimer. Moody's, for example, begins its transmission with a full page entitled "Copyright," including assertions that: (1) the information is copyrighted; (2) the information may not be copied, reproduced, or otherwise disseminated without prior written consent; (3) Moody's believes its sources of information to be accurate and reliable, but the information is provided "without warranty of any kind"; (4) Moody's shall not be liable for "any loss or damage in whole or in part" in connection with the information; (5) Moody's is only giving "statements of opinion and not statements of fact or recommendations"; and (6) Moody's is being paid by the issuers of the debt securities it is rating.[82]

From the perspective of risk management, the inclusion of such disclaimers is a sound idea. A prohibition against reproduction, for example, may pose a constraint upon those to whom the information may be given and, thereby, upon those who may obtain legal redress for its inaccuracy.[83] More broadly, absent violations of public policy or express statutory rules,[84] courts will generally honor and enforce commercial relationships as the parties have expressly defined them. Either a subscription agreement, if there is to be one, or a computer sign-up procedure gives the accounting profession an important opportunity to set forth precisely the limits on its responsibilities. It can also place a limitation upon liability should those responsibilities inadvertently not be fulfilled.

81. *See Daniel*, 520 N.Y.S.2d at 337 n.1.

82. Moody's Investors Service (visited Nov. 1996) <http://www.moodys.com/mdycpyrt.htm>.

83. *See* Strong v. Retail Credit Co., 552 P.2d 1025, 1028 (Colo. Ct. App. 1976) ("[Plaintiff] must still establish that she was entitled to rely upon those misrepresentations. . . . One who makes a misrepresentation is not liable to those persons whom he has no purpose to reach or influence and when there is no special reason to expect that the misrepresentation will influence such persons.").

84. *See infra* notes 94-97 and accompanying text.

The potential significance of such language was illustrated by a Rhode Island district court in a case against Value Line. In *Gale v. Value Line, Inc.*,[85] a Value Line subscriber read a description of warrants that did not accurately describe the warrants' terms.[86] He sued Value Line for breach of contract and negligent misrepresentation.[87] In defense, Value Line pointed to the front page of each issue, which disclaimed that "[f]actual material is obtained from sources believed to be reliable but cannot be guaranteed."[88] Value Line contended that the disclaimer precluded liability.

The court gave every indication that the terms of the disclaimer would determine Value Line's responsibility.[89] Unfortunately for Value Line, the court in that particular case found that Value Line's disclaimer was not very effective—it only protected Value Line from errors by others, not from errors by itself.[90] The court stated: "Had the defendant wished to protect itself from its own errors as occurred in this instance, it could have said it so much more clearly, for example: 'The publisher is not responsible for any errors or omissions.'"[91]

Even with this poor drafting, though, the court did not find Value Line liable, because Value Line—under the terms of the agreement—had not assumed responsibility for complete accuracy to start with.[92] The court stated:

> Plaintiff has pointed to no language in any of the solicitations by defendant for subscriptions under which defendant assumes the responsibility of 100% accuracy. There is no assurance or guarantee that the publisher, among the myriad of detail to be reported, will not somehow make a mistake as occurred in this instance. . . .
>
> In short, there is no express[ ] contract to be breached as a basis for the plaintiff[']s action. Nor is there any implied agreement. Plaintiff can point to no circumstances which impose a particular duty upon the defendant as a matter of law, hence no implied contractual remedy is available to plaintiff.[93]

The usefulness of express language to limit responsibility and damages, however, is subject to important qualifications. First, contractual exemption from liability for intentional or reckless misconduct may be

85. 640 F. Supp. 967 (D.R.I. 1986).
86. *Id.* at 969-70.
87. *Id.* at 970.
88. *Id.*
89. *Id.* By noting that the disclaimer was "not adequate," the court intimated that other disclaimers would be.
90. *Id.*
91. *Id.*
92. *Id.*
93. *Id.*; *see also* Fidelity Leasing Corp. v. Dun & Bradstreet, Inc., 494 F. Supp. 786, 788 (E.D. Pa. 1980) (exculpatory clause in subscription agreement with Dun & Bradstreet is "valid and enforceable"); Hong Kong Export Credit Ins. Corp. v. Dun & Bradstreet, 414 F. Supp. 153, 157-58 (S.D.N.Y. 1975) (same).

unenforceable on grounds of public policy.[94] Second, contractual exemption from liability for even negligent misconduct may be unenforceable on grounds of public policy under particular circumstances as defined by state law, such as where an employer seeks to exempt itself from liability for an employee's injury, one of the parties is part of a protected class, or the agreement seeks to exempt one charged with a duty of public service from liability to one to whom the duty is owed.[95] Third, aspects of disclaimers may not be effective because of peculiarities imbedded in the law of a particular state. For example, because of the peculiar way that California defines fraud, a contract which exempts a party from liability for even negligent misrepresentation is potentially "void as against the policy" of California.[96] A Massachusetts case, though somewhat ambiguous, raises the possibility that Massachusetts law may provide the same result.[97]

Any undertaking to draft such disclaimer language, therefore, need be done with care and keen sensitivity to the requirements of state law. As a general proposition, though, such disclaimers will be enforced.

G. *Claims Premised on Fraud*

The above will prove less effective when it comes to protecting an accountant from a claim based on fraud. The *Jaillet* rule precludes only claims based on negligence.[98] The First Amendment does not protect deliberate falsehoods.[99] And a disclaimer, while potentially limiting exposure from negligent misstatements, may be less effective where the accountant has deliberately lied.[100]

It is not the case, therefore, that the use of a computer network to disseminate financial information will make an accountant completely impervious to legal liability where a fraud claim can be stated. Nonetheless, a fraud claim will normally be much more difficult to sustain

94. Restatement (Second) of Contracts § 195(1) (1981). *But see* Torts Restatement, *supra* note 34, § 496B (providing for express assumption of risk).

95. Restatement of Contracts, *supra* note 94, § 195(2).

96. Blankenheim v. E.F. Hutton & Co., 266 Cal. Rptr. 593, 599 (Ct. App. 1990).

97. *See* Burten v. Milton Bradley Co., 763 F.2d 461, 465 (1st Cir. 1985). The ambiguity regarding a claim for negligent misrepresentation stems from the court's declaration that it is "clearly against [Massachusetts] public policy" to allow one to disclaim for "its own misrepresentations," accompanied by its observation that "Massachusetts [law] has permitted individuals to contractually disclaim liability for mere negligence" if "the disclaimer has been clear and unambiguous to that effect." *Id.*; *see also* Bouvier Bros., Inc. v. Baker Protective Servs., No. 93421, 1994 WL 879634, at *3 (Mass. Super. Ct. Apr. 15, 1994) (finding that exculpatory clause protected alarm service company from liability for negligent misrepresentations).

98. *See supra* parts I.C-D.

99. *See supra* part I.E.

100. *See supra* part I.F. On the other hand, to the extent a disclaimer may preclude proof of justifiable reliance, it may operate to impede a fraud claim. *See infra* part II.F.

and prove than a claim for negligence. Further, if the relationship is structured whereby the professional is paid by the subscriber, rather than by the company on whose financial information the professional is attesting, the plausibility of a fraud claim would seem to be seriously diminished.[101] In most of the reported cases against the conventional providers of financial information—such as Dow Jones, Standard & Poor's, Value Line, etc.—it does not appear that a fraud claim is generally even alleged. Dismissal of the negligence claim thus results in a termination of the litigation.[102]

II. MOVING FROM TORT TO CONTRACT THEORIES OF LIABILITY

A. *The Increasing Availability of Contract Theories*

Tucked away in the shift to computer-disseminated financial information is an important change that, instead of posing new risks, may present an opportunity to reduce old ones. The opportunity grows out of a key difference between transmission by paper and transmission by computer.

One characteristic of transmission by paper is that, once the financial information has been delivered (typically to the reporting entity), the professional has completely lost control. From that point on, the information can be made available to virtually anyone; and virtually anyone is free to use it, misuse it, or not use it at all, but still to commence a lawsuit if the information turns out to be wrong. Such a lawsuit, once commenced, need not always meet its deserved fate. As a practical matter, the only constraints upon recovery may be the common sense of the jury and the persuasiveness of counsel.

Information transmitted by a computer network is different. The professional can target the audience, disclaim certain uses,[103] or condition access upon a willingness to accept specified terms and conditions. Most important, the professional and the user may also, through a subscription agreement, enter a contract. Even without a written subscription agreement, a user can "sign" a contract electronically by computer.[104]

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101. The basic theme of virtually any fraud claim against an accountant is that the accountant knuckled under to its client and issued a false report on misstated financial information. To the extent the "client" is the user of the financial information, that underlying theme is substantially dissipated. Though the precise configuration of these relationships is yet to be established by the profession, the Elliott Committee Report includes as an entirely foreseeable, if not likely, relationship one in which the professional is paid by the user. *See* Elliott Committee Report, *supra* note 9, at <http://www.aicpa.org/assurance/scas/comstud/effect/constr.htm>.

102. *See, e.g.*, First Equity Corp. v. Standard & Poor's Corp., 670 F. Supp. 115 (S.D.N.Y. 1987), *aff'd*, 869 F.2d 175 (2d Cir. 1989); Gale v. Value Line, Inc., 640 F. Supp. 967 (D.R.I. 1986); Daniel v. Dow Jones & Co., 520 N.Y.S.2d 334 (Civ. Ct. 1987).

103. *See supra* part I.F.

104. The legal implications of computer "signatures" are being explored in a variety of contexts. *See* David Bank, *Social Security, Pitney Bowes to Test Filing of W-2 Forms*

For risk management, one implication stands above all others. The profession, as the systems of financial reporting shift from paper to computer, may have the historic opportunity to change the avenues of professional liability from those rooted in tort to those rooted in contract. That opportunity, moreover, may be furthered by another shift. The focus of financial information is moving from the desires of the reporting entity to the needs of users, particularly as key groups of financial information users—such as analysts and institutional investors—become increasingly powerful by way of an aging population that is accumulating wealth.[105] Even less-significant users, through the conveyance of their combined desires by the workings of the market, can create a force to be reckoned with. The net result may be an increased opportunity to define liability in contract and users with the economic power to constitute someone with whom the professional can bargain.

It is not necessarily the case, therefore, that the profession's historic exposure to liability in tort need continue unabated. To a significant extent, it can be controlled by shifting to liability in contract. One consequence, though, is that the profession must come to grips with a question that it has never before had the luxury to ask. Given the opportunity to choose between liability in tort and liability in contract, which theory of liability—tort or contract—does the profession actually prefer?[106]

B. *Liability Rooted in Contract*

Conceptually, the choice should not make a big difference. The end result of a professional impropriety, whether pursued in tort or in con-

on the Internet, Wall St. J., Oct. 25, 1996, at A9C ("The project will also test critical elements of electronic commerce on the World Wide Web, including the validity of digital 'signatures,' which haven't yet been accepted as legal by the agency.").

105. It is an important theme of both the Jenkins Committee and the Elliott Committee reports that financial statements be reconfigured to better accommodate the needs of users rather than the desires of reporting entities. *See* Elliott Committee Report, *supra* note 9, at <http://www.aicpa.org/assurance/scas/majtheme/focus/index.htm>; Jenkins Committee Report, *supra* note 2, at 4.

106. Interests of economic efficiency plainly seem to favor a shift from tort to contract theories of liability. The reason is that precisely-defined responsibilities and remedies—the sort found in a negotiated contract, but utterly lacking in a relationship defined by tort—allow for an allocation of resources precisely consistent with the economic interests of those concerned. It has even been suggested that an underlying rationale to Judge Cardozo's opinion in Ultramares Corp. v. Touche, 174 N.E. 441 (N.Y. 1931), involved "the advantages of using private ordering as a supplemental means of allocating risk." John A. Siliciano, *Negligent Accounting and the Limits of Instrumental Tort Reform*, 86 Mich. L. Rev. 1929, 1941 (1988). *See generally* Victor P. Goldberg, *Accountable Accountants: Is Third-Party Liability Necessary?*, 17 J. Legal Stud. 295 (1988) (criticizing the expansion of third-party liability as to accountants and discussing the merits of the *Ultramares* doctrine); Siliciano, *supra*, at 1957-58 ("For most third parties, then, tort law might sensibly view private ordering as a viable alternative to a foreseeability-based negligence rule.").

tract, should be the same: the professional must remedy the harm caused, normally by paying money. Nonetheless, tort theories of liability have historically been preferred by plaintiffs and have, not coincidentally, generally resulted in the largest verdicts and settlements. The principal reasons are that tort theories, speaking very generally, allow a broader group to sue and, in some instances, to collect more money than under contract.

At a conceptual level, the substitution of liability in contract for liability in tort would therefore permit the professional some ability to control its exposure to risk. In the United States, two parties have the commercial freedom, with certain exceptions, to establish in contract whatever terms upon which they can agree.[107] If a professional and his or her client want to agree to limit those who may sue, the damages to be recovered, or other aspects of their business relationship, they can do that.[108] An important exception precludes them from agreeing to things that would violate public policy,[109] but the fundamental freedom to agree on things is generally given fair latitude.[110]

A starting point for consideration of a preferred system of professional liability, therefore, is to evaluate the merits of a system that substitutes contract theories for those in tort. That is not to say that the substitution of contract for tort is without disadvantages: under a contract theory you need not demonstrate scienter or even negligence, as you typically must to prove a tort, and the statute of limitations may be longer in contract than in tort, to give just two important examples. Still, a liability system premised in contract may offer potential advantages over one premised in tort.

107. *See* Bremen v. Zapata Off-Shore Co., 407 U.S. 1, 11 (1972) (referring to "ancient concepts of freedom of contract"); Winterstein v. Wilcom, 293 A.2d 821, 824 (Md. Ct. Spec. App. 1972) ("[T]here is ordinarily no public policy which prevents the parties from contracting as they see fit . . . ."); Torts Restatement, *supra* note 34, § 496B cmt. b (freedom to contract in the assumption-of-risk context); W. Page Keeton et al., Prosser and Keeton on the Law of Torts § 68, at 482 (5th ed. 1984) [hereinafter Prosser on Torts] ("There is in the ordinary case no public policy which prevents the parties from contracting as they see fit . . . .").

108. Torts Restatement, *supra* note 34, § 496B cmt. b ("There is no general policy of the law which prevents the parties from agreeing that the defendant shall be under no such general or specific duty to the plaintiff."); Prosser on Torts, *supra* note 107, § 68, at 482 ("It is quite possible for the parties expressly to agree in advance that the defendant is under no obligation of care for the benefit of the plaintiff, and shall not be liable for the consequences of conduct which would otherwise be negligent."). *But see* FDIC v. Schoenberger, 781 F. Supp. 1155, 1157 (E.D. La. 1992) (holding that a professional's breach of duty constitutes a tort, and that a professional could not avoid liability by having contracted not to be liable for negligence).

109. *See generally* Torts Restatement, *supra* note 34, § 496B (stating that an agreement limiting a defendant's liability is valid "unless the agreement is invalid as contrary to public policy"); Prosser on Torts, *supra* note 107, § 68, at 482-83.

110. An important exception to the freedom of parties to contract as they desire limits the ability of agreements to exculpate one of the parties from willful, wanton, reckless, or gross misconduct or conduct that constitutes an intentional tort. *See* Prosser on Torts, *supra* note 107, § 68, at 484.

At this point, the discussion must become more precise. First, as to the distinction between tort and contract, there is no entirely satisfactory definition of a "tort," but for this purpose we can use the generally unsatisfactory definition of "a civil wrong, other than breach of contract, for which the court will provide a remedy in the form of an action for damages."[111] As a practical matter, most accountant liability torts involve some form of misrepresentation, either fraud or negligent misrepresentation. A contract theory of liability, in contrast, generally refers to a theory pursuant to which a court will seek to remedy a civil wrong based upon breach of an explicit or implied agreement between the parties.

With these definitions in mind, it is useful to isolate those aspects of tort liability that historically have proved most economically inefficient, and assess the extent to which economic efficiency can be enhanced through contract. There are at least nine such issues:

- Who may sue;
- The content of the professional statement;
- The professional's level of culpability;
- Proximate cause;
- Damages;
- The statute of limitations;
- Contributory and comparative negligence;
- Third-party practice; and
- The cost of litigation.

Each is discussed in turn.

C. *Who May Sue?*

The issue of those who may sue an accountant has plagued the profession for more than a half-century.[112] It was this issue that Judge Cardozo was addressing when he uttered his prescient phrase that liability in negligence (a tort) would result in a mechanism by which "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."[113]

Today, that phrase comes close to describing the exposure of the profession in some jurisdictions. The basic problem is that, under traditional tort principles, the world of potential litigants is limited only by those who are "foreseeable."[114] In the context of personal injury, in which the concept of foreseeability has its historical roots,

111. *Id.* § 1, at 2.

112. *See* Siliciano, *supra* note 106, at 1933-41 (tracing the history of the privity issue in accountant liability cases from 1931 to 1988).

113. Ultramares Corp. v. Touche, 174 N.E. 441, 444 (N.Y. 1931).

114. Prosser on Torts, *supra* note 107, § 43, at 280.

this makes some sense, insofar as, for example, the universe of foreseeable people who may slip on a patch of ice and injure themselves is fairly ascertainable and discrete.[115] In the context of financial information, in contrast, the world of foreseeable litigants is almost without limit. In the context of financial information, you can "foresee" just about anything.[116]

The courts have struggled with this issue at length—this is the so-called "privity" issue that is such a common topic within the profession. Basically, three rules have emerged. The most favorable for the profession is the "*Ultramares*"[117] or (more recently) "*Credit Alliance*"[118] rule, pursuant to which only a "known" party who was intended by the professional to rely on the information may allege a claim for negligence. At the other end of the spectrum, some jurisdictions have hung on to the "foreseeability" rule, pursuant to which any person whose use of financial information was reasonably foreseeable may allege a claim.[119] In the middle is the so-called "Restatement" rule.[120] Under that rule, claims against the professional are limited to "the person or one of a limited group of persons for whose benefit and guidance [the professional] intends to supply the information or knows that the recipient intends to supply it."[121]

The last decade has witnessed a notable shift away from the "foreseeability" rule in the direction of either the *Credit Alliance* rule or,

115. *See* Siliciano, *supra* note 106, at 1943 ("[T]he laws of physics generally limit the degree of physical harm caused by a tortious act."); *cf. Ultramares*, 174 N.E. at 445 ("In either view, however, what is released or set in motion is a physical force. We are now asked to say that a like liability attaches to the circulation of a thought or a release of the explosive power resident in words.").

116. The shortcomings of foreseeability as a useful concept to limit damages in the context of financial information were outlined by the California Supreme Court in Bily v. Arthur Young & Co., 834 P.2d 745 (Cal. 1992). The court stated:

> [F]oreseeability . . . is endless because [it], like light, travels indefinitely in a vacuum. . . . [It] proves too much. . . . Although it may set tolerable limits for most types of physical harm, it provides virtually no limit on liability for nonphysical harm. . . . It is apparent that reliance on foreseeability of injury alone in finding a duty, and thus a right to recover, is not adequate when the damages sought are for an intangible injury.

Id. at 762 (quoting Thing v. La Chusa, 48 Cal. 3d 644, 659, 663-64 (1989)) (alterations in original).

117. *See Ultramares*, 174 N.E. 441.

118. *See* Credit Alliance Corp. v. Arthur Andersen & Co., 483 N.E.2d 110, 118-19 (N.Y. 1985) (reaffirming the *Ultramares* rule in New York).

119. *See, e.g.*, Touche Ross & Co. v. Commercial Union Ins. Co., 514 So. 2d 315, 318-23 (Miss. 1987) (considering both the *Ultramares/Credit Alliance* and the Torts Restatement rules and rejecting both, approving instead a "reasonably foreseeable" rule, but also noting that "the auditor remains free to limit the dissemination of his opinion through a separate agreement with the audited entity"); Citizens State Bank v. Timm, Schmidt & Co., 335 N.W.2d 361 (Wis. 1983).

120. *See Bily*, 834 P.2d at 747, 767-74 (adopting the Torts Restatement rule for identifying prospective plaintiffs in negligent misrepresentation cases, but following the *Ultramares* rule for general negligence cases).

121. Torts Restatement, *supra* note 34, § 552.

more frequently, the Restatement rule.[122] At present, only two states apply the foreseeability rule to claims of negligence: Mississippi and Wisconsin.[123] Until recently, a third state—New Jersey—followed the foreseeability rule as established by the New Jersey Supreme Court in *H. Rosenblum, Inc. v. Adler*.[124] Two years ago, *Rosenblum*, and the foreseeability rule in New Jersey, were unceremoniously dumped by the legislature.[125]

Still, the foreseeability rule is alive and well in several other contexts. Most notably, those states by which it has been abandoned have only abandoned it as to claims for negligence. It still applies to claims for fraud.[126]

One of the biggest benefits of substituting contract-based liability for that of tort is the potential for elimination of the foreseeability rule and, for that matter, the Restatement rule—at least in the absence of the professional's explicit knowledge and consent. Under a contract-based system, the issue of those who may rely upon the professional's work would ideally become, in the context of an engagement or ongoing relationship, a focused-upon matter of agreement. To the extent a widespread audience was desired, the professional could reach agreement or agreements to that effect. Where a limited audience was the goal, the range of the audience could be appropriately narrowed, with access by others precluded by use of a subscription agreement, electronic limitation to access, warnings given as part of the sign-on procedure, or by all three.[127] Economic efficiency

122. *See, e.g.*, *Bily*, 834 P.2d 745; N.J. Stat. Ann. § 2A:53A-25 (West Supp. 1996).

123. *See, e.g.*, *Touche Ross & Co.*, 514 So. 2d at 318-23; *Citizens State Bank*, 335 N.W.2d at 365-67.

124. 461 A.2d 138 (N.J. 1983).

125. *See* N.J. Stat. Ann. § 2A:53A-25.

126. *See* Ultramares Corp. v. Touche, 174 N.E. 441, 448 (N.Y. 1931). The *Ultramares* court held:

> 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. It does no more than say that, if less than this is proved, if 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, and is to be enforced between the parties by whom the contract has been made.

Id.; *see* Denzil Y. Causey, Jr. & Sandra A. Causey, Duties and Liabilities of Public Accountants 5-7 (5th ed. 1995 & Interim Supp. May 1996) ("Some courts hold that auditors are liable for fraud to foreseeable users of their reports since such uses should have been contemplated.").

127. To the extent access or justifiable reliance can be precluded either through electronic means or disclaimers, non-contractual but foreseeable users may thereby be prevented from recovery even on claims of fraud. *See* Union Bank v. Ernst & Whinney, 278 Cal. Rptr. 490, 499 (Ct. App. 1991) ("In this case, E & Y specifically disclaimed the type of reliance the Bank now argues that it placed on the review report. . . . Under these circumstances, it is inherently unreasonable for the Bank, as an experienced user of financial statements, to rely on the E & Y review report as an assurance that Z Best was financially sound."); Strong v. Retail Credit Co., 552 P.2d

would be enhanced, insofar as the professional could assess the risk associated with the engagement in the context of engagement planning and terms.[128]

It may be that, under a contract-based system, the professional in many engagements would end up no differently than he would under, say, a foreseeability rule, only now as a matter of agreement. The point is that the professional would have the opportunity to address the issue as a threshold matter, assess the risk, and ensure that the risk was reflected in the terms of the engagement. This is one area that plainly favors contract theories over tort theories of liability.

D. *The Content of the Professional Statement*

The issue here is the extent to which the professional can control the risk of a misunderstanding of the professional's role as well as a misunderstanding of the substantive content of the professional's report or other communication.

This issue involves what is commonly referred to as the "expectation gap": the gap between the perception of the professional's responsibility and the professional's responsibility in fact.[129] Historically, a principal cause of the expectation gap has been some lack of sophistication on the part of users of financial information, who have failed to understand the professional's limited role and the limited assurance that the professional was providing. The liability problem was frequently exacerbated by the fact that, in a litigation, the finder of fact might not understand the limited role of the professional either.

This problem may always be with the profession, but it may be mitigated where liability is based in contract. The reason is that contractual identification of the end users of the financial information permits the professional to understand the audience, assess its level of sophis-

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1025, 1028 (Colo. Ct. App. 1976) ("[Plaintiff] must still establish that she was entitled to rely upon those misrepresentations.... One who makes a misrepresentation is not liable to those persons whom he has no purpose to reach or influence and when there is no special reason to expect that the misrepresentation will influence such persons."); Evans v. Israeloff, Trattner & Co., 617 N.Y.S.2d 899, 900 (App. Div. 1994) ("Evans has not shown justifiable reliance on alleged misrepresentations made by the defendants in the compilations in making his investment decisions.").

128. *See* Goldberg, *supra* note 106, at 296 ("If the parties want assurance, they can expressly contract for it.").

129. The "expectation gap" in the accounting profession has been the focus of considerable attention. *See* Robert S. Kay & D. Gerald Searfoss, Handbook of Accounting and Auditing 45-24 (2d ed. 1989); Michael R. Young, *The Liability of Corporate Officials to Their Outside Auditor for Financial Statement Fraud*, 64 Fordham L. Rev. 2155, 2159 (1996); Eric R. Dinallo, Note, *The Peculiar Treatment of Contributory Negligence in Accountants' Liability Cases*, 65 N.Y.U. L. Rev. 329, 332 (1990) ("Accountants even have coined a term—'expectation gap'—to describe the difference between the responsibilities auditors believe they assume in conducting an audit, and what the public and the courts perceive such an undertaking to entail.").

tication, and, within the bounds of professional standards, modify the substance of the professional's communication accordingly. Contractual identification of the users also permits the professional to preclude dissemination to those whose lack of sophistication creates the greatest risk of a misunderstanding.

The practical operation of a contract in this context is illustrated by an exposure draft published by the AICPA on the Assembly of Financial Statements for Internal Use Only.[130] Unlike a standard audit report in its present form, the exposure draft contemplated limited circulation of the information, thereby giving the accounting professional the opportunity in a way otherwise unavailable to tailor the level of assurance to the particular audience. The proposed engagement letter thus contemplated written acknowledgment, within the terms of the engagement itself, that the financial statements "may contain departures from generally accepted accounting principles" but that the user might still find them useful insofar as the user had "knowledge of the business' day-to-day affairs that will allow you to place that information in the proper context."[131] The engagement letter went on to limit distribution of the financial statements "to those internal persons with similar knowledge."[132]

The risk of some unintended, unsophisticated user being able to claim a lack of understanding of the professional's role or level of assurance is thereby reduced.

E. *The Professional's Level of Culpability*

If consideration of the first two issues favors claims based on contract, consideration of this third issue does not. The third issue involves the extent to which the professional must possess some level of culpability in connection with a failure to perform.

In tort, some level of culpability must generally be established. To prove fraud, one must prove an intent to make a false statement or, in some cases, recklessness in doing so.[133] To demonstrate negligence, neither intentional nor reckless misconduct is required; but a failure to conform to a reasonable standard of care must still be shown.[134]

None of that is required to prove a claim based on breach of contract. In the context of a contract claim, the issue is: did the professional perform in accordance with the contract's terms? If the

130. AICPA, Proposed Statement on Standards for Accounting and Review Services: Assembly of Financial Statements for Internal Use Only (Exposure draft Sept. 6, 1995).

131. *Id.* at app. A.

132. *Id.*

133. *See* Prosser on Torts, *supra* note 107, § 107, at 740-42. The significance of the Supreme Court's decision more than twenty years ago in Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976), is that it established the prerequisite of scienter for claims pursuant to section 10(b).

134. *See* Prosser on Torts, *supra* note 107, § 32, at 173-74.

professional did not, the purest motives and the most vigorous effort will not excuse the professional from liability.[135] If there has been a breach, the professional will be liable, and will be called upon to remedy the breach through the payment of damages.

While the disparity seems significant in the abstract, however, as a practical matter it is much less so. The reason is that, given the nature of financial information and the professional's role, in all likelihood an agreement will rarely seek to make the professional a guarantor of accuracy, the result being that some standard of professional culpability is likely to be drafted into a normal agreement. That standard of culpability, in all likelihood, would involve a failure to adhere to professional standards—precisely the same standard that applies to tort claims for negligence. Moreover, to the extent a different standard of culpability were desired, it would become the subject of negotiation and agreement, and the professional would be placed on notice thereby. If the professional were prepared to guarantee the accuracy of the financial information at issue, that would be the standard against which his performance would be measured, and the terms of the engagement could be adjusted accordingly.

Although consideration of the professional's culpability suggests, in the first instance, the preferability of claims based in tort, the practical answer, therefore, is less clear. One caveat should be kept in mind. In a contract-based relationship, it is likely that a professional would be liable at least for any failure to conform to professional standards. Substitution of contract liability for liability in tort may thus eliminate a tort defense based upon a lack of scienter, which is presently required, as mentioned above, to prove fraud.

F. *Proximate Cause*

The concept of "proximate cause" is a principle of common law which, in the context of financial information, addresses the level of scrutiny and degree of reliance a user must establish as a predicate to a recovery for any harm caused thereby.[136] The common articulation is that the user must establish "justifiable reliance" upon the financial information in order to state a tort claim.[137]

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135. *Cf.* Holland v. Arthur Andersen & Co., 469 N.E.2d 419, 429 (Ill. App. Ct. 1984) ("Andersen contracted with ARC for a specific result, namely, disclosing any known irregularities, and breached that contract when it failed to provide that promised result."). *See generally* 3A Arthur L. Corbin, Corbin on Contracts § 707, at 327-28 (1960) ("The cause of a contractor's breach of his contract is seldom, if ever, material in determining whether or not his incomplete performance deserves to be described as 'substantial.'").

136. *See generally* Prosser on Torts, *supra* note 107, § 108, at 749-50.

137. Eldred v. McGladrey, Hendrickson & Pullen, 468 N.W.2d 218, 219-20 (Iowa 1991) ("While privity is not required, all three of plaintiffs' misrepresentation theories require that the plaintiffs justifiably rely to their detriment on some misrepresentation."); *see also* Causey, Jr. & Causey, *supra* note 126, at 194-97 (analyzing issue of

Exactly what a showing of "justifiable reliance" requires is a matter of almost endless dispute, and one of the most frustrating issues that a professional will typically encounter arising out of tort claims.[138] At one end of the spectrum, courts will interpret the prerequisite of justifiable reliance to require affirmative proof that the user has read the financial information, studied it, understood it, and acted sensibly as a result thereof.[139] At the other end of the spectrum, some courts will permit purported users of financial information to claim "justifiable reliance" on financial information they have never even seen.[140] In

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reliance in accountant liability cases); Prosser on Torts, *supra* note 107, § 108, at 749 ("Not only must there be reliance but the reliance must be justifiable under the circumstances.").

138. The underlying problem is that

> [o]bviously, a third party who suffers harm when an audited client becomes insolvent has a strong incentive, *ex post*, to feign or exaggerate its reliance on the audit in an effort to recover losses from the accountant. Such claims are particularly difficult to test in the adjudicative process because they often consist of nothing more than the third party's oral representation that it relied on the audit rather than other factors in deciding to deal with the client.

Siliciano, *supra* note 106, at 1947. *See generally* Prosser on Torts, *supra* note 107, § 108, at 749 ("There has been a vast amount of misunderstanding regarding the basis for the requirement of justifiability of reliance . . . .").

139. *See, e.g.*, Smolen v. Deloitte, Haskins & Sells, 921 F.2d 959, 964 (9th Cir. 1990) (finding that, to avoid summary judgment, "[a]ppellants must present some evidence establishing the element of causation, in the sense of actual and justifiable reliance"); Comeau v. Rupp, 810 F. Supp. 1127, 1143 (D. Kan. 1992); *In re* Wyse Tech. Sec. Litig., 744 F. Supp. 207, 210 (N.D. Cal. 1990) (dismissing plaintiffs' claim because "plaintiffs have not alleged that they received and relied on the financial statements prepared by Arthur Young"); Chrysler Credit Corp. v. Ruwart, 114 B.R. 725, 728-29 (Bankr. D. Colo. 1990) ("[T]here is little evidence that either creditor actually relied on the financial information contained in the statements. . . . [T]he creditor must demonstrate actual and reasonable reliance as to the false statements."); Cammer v. Bloom, 711 F. Supp. 1264, 1297-98 (D.N.J. 1989) (claims of fraud and deceit dismissed as to plaintiffs who could not allege direct reliance on audit report); Stratton v. Sacks, 99 B.R. 686, 696 (Bankr. D. Md. 1989) ("Plaintiff has not in this case been able to point to evidence in the record showing that there is a reasonable probability or reasonable certainty that the acts complained of caused the losses suffered."), *aff'd*, 900 F.2d 255 (4th Cir. 1990); E.F. Hutton Mortgage Corp. v. Pappas, 690 F. Supp. 1465, 1475 (D. Md. 1988) ("Hutton as a sophisticated business entity can hardly claim losses allegedly resulting from its reliance on the audit reports when ordinary diligence on its part would have caused it to stop buying mortgage loans . . . ."); Stagen v. Stewart-West Coast Title Co., 196 Cal. Rptr. 732, 735 (Ct. App. 1983); Capell Assocs., Inc. v. Central Valley Sec. Co., 67 Cal. Rptr. 463, 468 (Ct. App. 1968); McGregor v. Wright, 3 P.2d 624, 627 (Cal. Dist. Ct. App. 1931); Bank of St. Helena v. Lilienthal-Brayton Co., 264 P. 546, 548 (Cal. Dist. Ct. App. 1928) (no justifiable reliance on financial information in a circular merely because "a copy of this circular was in possession of the bank"); Eldred v. McGladrey, Hendrickson & Pullen, 468 N.W.2d 218, 220 (Iowa 1991) ("We hold that this sort of vicarious reliance is too weak to support a finding of tortious misrepresentation."); Delmar Vineyard v. Timmons, 486 S.W.2d 914, 919 (Tenn. Ct. App. 1972) ("In the absence of any showing the complainants relied upon the defendants' audit, it becomes impossible to show complainants' damages were a direct consequence of defendants' negligence or breach of contract.").

140. *See* Bonhiver v. Graff, 248 N.W.2d 291 (Minn. 1976) (accountant's alleged representation made to state insurance commissioner rather than to plaintiff); Resolution Trust Corp. v. Castellett, No. 92-4635 (D.N.J. 1994) ("Because Colonial and federal

the context of failed savings & loan and bank litigation, for example, the FDIC and the RTC would allege "justifiable reliance" by lending institutions whether the lending institutions had seen the financial information or not.[141] In the context of efficient public securities markets, justifiable reliance frequently may now be presumed.[142]

Contract-based theories to some extent can limit hypothetical claims of justifiable reliance. The terms of an agreement can, for example, either explicitly or implicitly establish the manner in which the financial information is to be used. If the terms of the engagement make clear that the financial information is to be used in a particular way or for a particular business purpose, a failure to use the information in the specified manner may make a contention of proximate cause difficult. At a minimum, such contractual terms may call into question uncorroborated testimony that the financial information was effectively used in a way not contemplated by the written agreement.

G. *Damages*

There is a definite advantage to the use of contract theories of liability when it comes to the issue of damages.

The benefit arises from the fundamental ability of the parties, within certain limits, to agree to whatever they want. This means that, at the time the engagement is agreed upon, the parties can address as a threshold matter the consequence of any breach and the extent to which the professional will be responsible in damages therefor.

The possibilities are limited only by public policy and the negotiating strengths of the parties. Possible remedies for a breach of the professional engagement might theoretically include: (1) no damages, but merely corrective performance; (2) a return of the professional fee; (3) liquidated damages of a specified amount (to the extent permitted by law); (4) out-of-pocket loss; (5) lost profits; or (6) anything remotely foreseeable. In all instances, the parties would be free contractually to seek to eliminate any prospect of punitive damages, thus potentially reducing that risk from the professional engagement.[143] The parties might even agree to the "English rule" of fee shifting,

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regulators relied on the financial statements in the course of a proper business purpose, they were foreseeable users of the information, and BDO could be liable to them for their inaccuracy.").

141. *See, e.g.*, FDIC v. Ernst & Young, 967 F.2d 166, 170 (5th Cir. 1992). The court rejected the argument that the institution had justifiably relied, however, after imputing an agent's knowledge to the institution.

142. Basic Inc. v. Levinson, 485 U.S. 224, 247 (1988) ("Because most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action.").

143. *See* Kinnebrew v. Gulf Ins. Co., 67 Fair Empl. Prac. Cas. (BNA) 189, 190 (N.D. Tex. 1994) (enforcing an agreement limiting punitive damages); John D. Calamari & Joseph M. Perillo, Contracts § 14-3, at 589 (3d ed. 1987) ("Traditionally . . . punitive damages are not awarded in contract actions, no matter how malicious the breach.").

thereby permitting the winner in any necessary litigation to recover its legal fees.[144] Indemnification agreements might also be used.[145]

The benefits to such negotiated damage terms are difficult to overstate, not only from the perspective of risk management, but from the perspective of economic efficiency. Agreed-upon damages would allow the parties to address up front the foreseeable risks of non-performance, and to allocate those risks in accordance with the economics of the transaction—before litigators have the opportunity to start exaggerating in opposite directions. For the user, this means he could understand precisely the level of risk the professional was assuming and conduct his affairs accordingly. The professional, for his part, could not only understand the risks, but appropriately plan, conduct, and price the engagement.

The user, the professional, and society would all benefit.

H. *The Statute of Limitations*

In the first instance, the issue of the statute of limitations—the time period in which an adversary must bring a claim—seems to favor liability in tort over liability in contract. The reason is straightforward. The statutes of limitations for breach of contract tend to be longer than the statutes of limitations for a tort.[146] Under section 10(b), for example, the statute of limitations is at most three years.[147] Under the law of one midwestern state, in contrast, the victim of a contract breach has fifteen years in which to assert a claim.[148]

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144. Werner F. Ebke, *In Search of Alternatives: Comparative Reflections on Corporate Governance and the Independent Auditor's Responsibilities*, 79 Nw. U. L. Rev. 663, 687 (1984) (citations omitted).

145. While their utility is without dispute, there is some question as to the circumstances in which indemnification clauses will be permitted. Since the 1930s, the SEC has held that a complete indemnification agreement impairs an auditor's independence in attest engagements. *See* Securities Act of 1933, Release No. 2498, 11 Fed. Reg. 10922 (1941); SEC Accounting Series, Financial Reporting Release No. 1, [1982] 7 Fed. Sec. L. Rep. (CCH) ¶ 73,274, at 62,910. The SEC has stated a belief that the threat of liability provides an incentive for auditors to perform work diligently, and that complete indemnification provides for an inappropriate mutuality of financial interest.

The Ethics Committee of the AICPA has ruled that one form of limited indemnification is acceptable. Specifically, the Ethics Committee has concluded that an agreement to release, indemnify, defend, and hold harmless a member from any liability and costs resulting from knowing misrepresentations by management would not impair independence. *See* AICPA, 2 AICPA Professional Standards, at ET § 191.188-89 (June 1, 1996). The SEC has not precluded this position. *See, e.g.*, SEC Release No. 2498, *supra* (focusing on impairment caused by immunity from "liability for his *own negligent acts*" (emphasis added)).

146. Howard M. Garfield & Thomas Weathers, *A Survey of Accountant Malpractice: Breach of Contract or Tort?*, *in* Accountants' Liability 1995, at 271, 274 (PLI Litig. & Admin. Practice Course Handbook Series No. H-526, 1995).

147. Lampf v. Gilbertson, 501 U.S. 350, 364 (1991).

148. Ohio Rev. Code Ann. § 2305.06 (Anderson 1991).

This does not completely end the analysis, though, because the statutory time period is not the only consideration. Another consideration is the triggering event—that which causes the statute of limitations to begin to run. A common aspect of tort law, for example, is that a statute of limitations on a claim for misrepresentation does not commence to run until the victim "knew or should have known" that a misrepresentation has been made.[149] Such a provision (and it is fairly common) can potentially keep a statute of limitations from running almost indefinitely.

The event triggering the statute of limitations as to a contract claim is generally more clear: it is the breach.[150] Though the laws of the states are not entirely consistent, the statute of limitations in many states commences to run even if the victim of the breach is unaware of it.[151] On the one hand, therefore, tort claims generally have shorter limitations periods; on the other, the contract statute may be easier to trigger. In the abstract, without focusing upon the precise law of a particular state, it is difficult to generalize whether one is more advantageous than the other.

But here, again, the ability of the parties in a contract-based system to agree upon the terms of the engagement can constitute an important advantage. By agreement, the parties can address both the length of the limitations period and the events triggering its commencement.[152]

What at first blush seems a clear preference for tort, therefore, on a more detailed analysis becomes a closer call. To the extent that contract-based liability gives the professional an opportunity to define the statute of limitations and the triggering event, contract-based liability seems optimal. In the absence of a contractual provision on the point, it may be that a generalization outside the context of the law of a particular state is too broad to be useful.

149. *E.g.*, N.Y. Civ. Prac. L. & R. § 213.8 (McKinney 1990). *See generally* Prosser on Torts, *supra* note 107, § 30, at 166-67.

150. *See* 18 Samuel Williston, Williston on Contracts § 2021A (3d ed. 1978).

151. *See* Ely-Cruikshank Co. v. Bank of Montreal, 615 N.E.2d 985, 987 (N.Y. 1993) ("[T]he statutory period of limitations begins to run from the time when liability for wrong has arisen even though the injured party may be ignorant of the existence of the wrong or injury." (citing Schmidt v. Merchants Despatch Transp. Co., 200 N.E. 824 (N.Y. 1936))). *But see* Cambridge Plating Co. v. Napco, Inc., 991 F.2d 21, 25 (1st Cir. 1993) (observing that generally, in the absence of a specific UCC rule to the contrary, a statute of limitation will not begin to run until notice of a claim in tort or contract), *aff'd in part, vacated in part*, 85 F.3d 752 (1st Cir. 1996).

152. 6A Corbin, *supra* note 135, § 1445, at 483 ("[P]arties can by agreement in advance limit the bringing of suit upon a contract to a shorter period than that fixed by the otherwise applicable statute of limitations, if the period agreed upon is not so short as to be unreasonable.").

I. *Contributory and Comparative Negligence*

The defenses of contributory and comparative negligence rest upon the premise that the professional should not be liable in negligence (it does not apply to fraud) to the extent the user of financial information has caused his own harm.[153] Where the user of financial information contributed to his harm through his own negligence, the professional's liability should be reduced or eliminated. Since accountant malpractice litigation almost always involves some level of wrongdoing by the client, this defense can be very important.[154]

In the context of this defense, though, whether liability is premised in tort or in contract will not necessarily make a big difference. The law recognizes the conduct of a plaintiff as a defense both to negligence and contract claims. In tort, the concept is that the plaintiff's negligence will generally either eliminate or (in comparative negligence states) reduce proportionately the liability of the defendant.[155] In contract, although the plaintiff's contributory negligence is technically not a defense,[156] the plaintiff's conduct may nevertheless limit

153. *See generally* Cenco Inc. v. Seidman & Seidman, 686 F.2d 449, 454 (7th Cir.) ("If the [auditor's] misrepresentation is negligent rather than intentional, contributory negligence plays the same role it would play in an ordinary negligence case."), *cert. denied*, 459 U.S. 880 (1982); Halla Nursery, Inc. v. Baumann-Furrie & Co., 454 N.W.2d 905, 909 (Minn. 1990) ("[T]he persons who hire accountants, usually businesspersons, should also be required to conduct their business activities in a reasonable and prudent manner."); Causey, Jr. & Causey, *supra* note 126, at 197-99 (discussing the availability of contributory and comparative negligence defenses in accounting malpractice cases); David L. Menzel, *The Defense of Contributory Negligence in Accountant's Malpractice Actions*, 13 Seton Hall L. Rev. 292 (1983) (discussing the two factual variations where the defenses are available in accountant liability cases).

154. *See, e.g.*, Stratton v. Sacks, 99 B.R. 686, 695 (D. Md. 1989) ("[T]he doctrine of contributory negligence is a complete bar to any recovery by the Trustee."), *aff'd*, 900 F.2d 255 (4th Cir. 1990); Coopers & Lybrand v. Trustees of the Archdiocese, 536 So. 2d 278 (Fla. Dist. Ct. App. 1988) (affirming jury apportionment of 40% of defalcation loss to client); Devco Premium Fin. Co. v. North River Ins. Co., 450 So. 2d 1216, 1219-20 (Fla. Dist. Ct. App. 1984) (recounting the trial court's finding that management, and not the auditor, had the primary responsibility to establish and maintain a system of internal accounting control, and approving the trial court's apportionment of 80% of the total damages to the company); Capital Mortgage Corp. v. Coopers & Lybrand, 369 N.W.2d 922, 925 (Mich. Ct. App. 1985) (upholding jury allocation of more than 68% of embezzlement loss to client).

155. *See* Causey, Jr. & Causey, *supra* note 126, at 197-99. Where the plaintiff is the accountant's client, the contributory negligence issue is sometimes complicated by the so-called "*National Surety* doctrine" providing that contributory negligence is only a defense where the client's conduct directly contributes to the accountant's failure to perform. *See* National Sur. Corp. v. Lybrand, 9 N.Y.S.2d 554, 563 (App. Div. 1939).

156. Becker v. Bancohio Nat'l Bank, 478 N.E.2d 776, 781 (Ohio 1985) (holding that contributory negligence was not a defense to an action for breach of contract); Dobson & Johnson, Inc. v. Von Weiland, 644 S.W.2d 394, 397 (Tenn. 1982) (same); *cf.* Robertson v. White, 633 F. Supp. 954, 971 (W.D. Ark. 1986) ("The court suspects that plaintiffs fear that if they are forced into a cause of action sounding in negligence, they will face defenses, i.e., contributory negligence, not ordinarily available to [an] action on a contract.").

recovery where the defendant's performance "was prevented or substantially hindered by the plaintiff."[157]

In some contexts, though, the extent to which the claim is in tort as opposed to contract may be important. First, as indicated above, on a contract claim a defense premised on the plaintiff's misconduct may be limited to conduct that hinders the auditor's performance, while the defense in tort may not be so limited[158] (though in contract the

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157. 4 Corbin, *supra* note 135, § 947, at 814; *see* Cenco Inc. v. Seidman & Seidman, 686 F.2d 449, 453-54 (7th Cir.), *cert. denied*, 459 U.S. 880 (1982); Restatement (Second) of Contracts § 245 (1979). In *Cenco*, the court stated:

> Because these theories of auditors' misconduct are so alike, the defenses based on misconduct of the audited firm or its employees are also alike, though verbalized differently. A breach of contract is excused if the promisee's hindrance or failure to cooperate prevented the promisor from performing the contract. See Restatement (Second) of Contracts § 245 (1979). The corresponding defense in the case of negligence is, of course, contributory negligence.

Cenco, 686 F.2d at 453.

158. Actually, the extent to which the plaintiff's conduct need hinder the auditor's performance to constitute contributory negligence in tort is a subject of notorious confusion. Two cases illustrate the problem: Craig v. Anyon, 208 N.Y.S. 259 (App. Div. 1925), *aff'd*, 152 N.E. 431 (N.Y. 1926), and National Sur. Corp. v. Lybrand, 9 N.Y.S.2d 554 (App. Div. 1939).

In *Craig v. Anyon*, a brokerage house employee embezzled a large amount of money over a five-year period from the brokerage house commodities department. 208 N.Y.S. at 260. The brokerage house sued its auditors for negligence in failing to discover the theft. *Id.* The auditors asserted the brokerage house's negligence in its failure to supervise the embezzling employee. *Id.* at 260-61. The New York Appellate Division permitted the defense:

> The plaintiffs in effect contend that defendants are chargeable with negligence because of failure to detect Moore's wrongdoing, wholly overlooking the fact that, although they were closely affiliated with Moore, who was constantly under their supervision, they were negligent in failing properly to supervise his acts, or to learn the true condition of their own business and to detect his wrongdoing.

Id. at 269.

But the same court reached a different result under seemingly similar facts. In *National Surety Corp. v. Lybrand*, a cashier embezzled money from a brokerage house's petty cash account over a nine-year period. 9 N.Y.S.2d at 556. The cashier concealed the theft by "kiting" checks. *Id.* The brokerage house sued its auditors, claiming that, had the cashier's thefts been discovered during the audit, he would have been fired and further losses prevented. *Id.* at 557. The auditors claimed that the brokerage house's own negligence constituted contributory negligence. *Id.* at 557, 563. The court refused to permit the defense. Finding that auditors "are commonly employed for the very purpose of detecting defalcations which the employer's negligence has made possible," the court held that the employer's negligence is a defense "only when it has contributed to the accountant's failure to perform his contract and to report the truth." *Id.* at 563; *see* Shapiro v. Glekel, 380 F. Supp. 1053, 1056 (S.D.N.Y. 1974) ("The later cases, both in New York and elsewhere, do not attempt to clarify the apparent conflict between *Craig v. Anyon* and *Lybrand* or to reconcile their holdings. Indeed, these cases have been cited, perhaps erroneously, for the same legal proposition."); Dinallo, *supra* note 129, at 343-51 (discussing the confusion regarding the availability of a contributory negligence defense in accounting malpractice cases); Travis M. Dodd, Note, *Accounting Malpractice and Contributory Negligence: Justifying Disparate Treatment Based upon the Auditor's Unique Role*, 80 Geo. L.J. 909, 924-

factual points relevant to the negligence of the plaintiff might be raised in the context of causation or foreseeability).[159] Second, where the plaintiff is not a party to the engagement contract, but is nonetheless a third-party beneficiary (an identified bank, say, in the context of a lending decision), the plaintiff's contributory negligence would not appear to be a defense to a contract claim absent a contractual provision to that effect, though the negligence of such a person may be a defense to a claim in tort.

Whatever the case, here, too, principles of contract would allow the parties to allocate between themselves the precise responsibilities of each.[160] Again, economic efficiency would be served thereby, insofar as the parties would have a precise understanding of their responsibilities and could tailor their conduct accordingly. In the absence of an

27 (1992) (same); *see also* Hall & Co. v. Steiner & Mondore, 543 N.Y.S.2d 190, 191-92 (App. Div. 1989) (citing both *Anyon* and *Lybrand* for the *Anyon* rule). Other jurisdictions outside New York have adopted the so-called *National Surety* rule. *See* Lincoln Grain, Inc. v. Coopers & Lybrand, 345 N.W.2d 300, 307 (Neb. 1984); Jewelcor Jewelers & Distribs., Inc. v. Corr, 542 A.2d 72, 79 (Pa. Super. Ct. 1988).

Mercifully, the modern trend, at least in comparative negligence states, is simply to permit the defense and leave it up to the jury. *See, e.g.*, Standard Chartered PLC v. Price Waterhouse, Nos. 1 CA-CV 93-0461, 1 CA-CV 93-0442, 1996 WL 640702, at *38 (Ariz. Ct. App. Nov. 7, 1996) ("We hold, therefore, that the National Surety doctrine does not apply in Arizona . . . ."); Scioto Mem. Hosp. Ass'n v. Price Waterhouse, 659 N.E.2d 1268, 1272-73 (Ohio 1996) (rejecting *National Surety* as inapplicable in a comparative negligence jurisdiction); *see also* Devco Premium Fin. Co. v. North River Ins. Co., 450 So. 2d 1216, 1220 (Fla. Dist. Ct. App. 1984) ("We decline to adopt [the *National Surety*] holding because [it] was decided on principles of contributory negligence, a doctrine which has been repudiated in this State."); Capital Mortgage Corp. v. Coopers & Lybrand, 369 N.W.2d 922, 925 (Mich. Ct. App. 1985) (rejecting a contributory negligence defense, stating "[w]ith comparative negligence the result is not so harsh and the policy considerations that accountants should not be allowed to avoid all liability due to some negligence on the part of the client are not present. We find the application of comparative negligence to be proper").

159. Causation: *see* Haven Assocs. v. Donro Realty Corp., 503 N.Y.S.2d 826, 830 (App. Div. 1986) ("It was Donro's burden to show that Haven's breach contributed in a substantial measure to its damages, whereupon the burden shifted to Haven to prove that some intervening cause . . . contributed to the damages."). *But see* Williams Enters., Inc. v. Strait Mfg. & Welding, Inc., 728 F. Supp. 12, 23 (D.D.C. 1990) ("Even if . . . other causes had made some contribution to the particular delay charged, defendants would remain liable because Smoot has proved that the action of defendants was a 'substantial factor' in causing injury to plaintiff."), *aff'd in part*, 938 F.2d 230 (D.C. Cir. 1991).

Foreseeability: Kenford Co. v. County of Erie, 537 N.E.2d 176, 180 (N.Y. 1989) ("[D]amages which may be recovered by a party for breach of contract are restricted to those damages which were reasonably foreseen or contemplated by the parties during their negotiations or at the time the contract was executed." (citing Hadley v. Baxendale, 9 Exch. 341, 156 Eng. Rep. 145 (1854))); 5 Corbin, *supra* note 135, §§ 1007, 1009 (damages are recoverable only for injury that there was reason to foresee at the time of contracting).

160. For example, an engagement letter could provide that any third-party beneficiary could recover for breach of contract only to the extent that the third-party beneficiary acted reasonably.

agreed-upon allocation, the law will fill the void, though rarely with the economic precision of the parties doing so themselves.

While a more precise analysis probably requires a state-by-state discussion, suffice it to say that, to some extent, negligence on the part of a client will generally be a defense in both tort and contract,[161] though the extent to which the misconduct of third parties is a defense is less clear.

J. *Third-Party Practice*

Another important consideration is the professional's ability to bring into an adversary proceeding a non-party who may also be culpable for the victim's harm. To an accountant, this ability to bring such third-party claims can be critical, because the accountant will frequently be the focus of litigation not because he or she was the primary wrongdoer, but because he or she is the deep pocket. In such an instance, the accountant will want to commence third-party claims against the primary wrongdoer and thereby permit the fact-finder to allocate blame accordingly.

This consideration plainly militates in favor of liability based in tort, because the commencement of third-party litigation arising out of tort claims is easy. The normal device is a claim for "contribution," pursuant to which the professional essentially alleges that some other wrongdoer, not presently a participant in the litigation, should share in the blame.[162] The result is that the fact-finder may then allocate blame between the professional and the third-party defendant according to the proportionate fault of each.

Where liability is based in contract, it will be more difficult to bring in such third-party wrongdoers, because there is no claim for contribution in contract. The issue is simply whether the professional breached or not.

This does not, however, necessarily mean that the professional may not commence third-party litigation where the claim is based in contract rather than tort. While a contribution claim is not available, there may be available independent claims by the professional against these other wrongdoers for breach of contract or misrepresentation, insofar as the typical scenario will involve a failure by the wrongdoer

161. *See* Robertson v. White, 633 F. Supp. 954, 972 (W.D. Ark. 1986) ("Interestingly, the resolution reached by *Lincoln Grain*—that the contributory negligence of the audited client is a defense only where it has contributed to the accountant's failure to perform the contract—bears strong resemblance to the contract doctrine that one is not responsible for his failure to perform if he was frustrated in doing so by the plaintiff.").

162. *See* Prosser on Torts, *supra* note 107, § 50, at 337-38; *see also* Musick, Peeler & Garrett v. Employers Ins., 508 U.S. 286, 288 (1993) (defendants in a Rule 10b-5 action have a right to contribution, or to collect "from other joint tortfeasors who have paid no damages or paid less than their fair share").

to provide the professional with accurate information.[163] Also, to the extent the wrongdoer is an official or employee of the client company, as will frequently be the case, a defense based on the hindrance of performance of the professional's contractual obligation may be available.[164]

Nonetheless, few procedural devices can match the simplicity and ease of commencement of third-party claims based on contribution. The unavailability of contribution, therefore, is a disadvantage to a liability scheme premised in contract.

K. *The Cost of Litigation*

No discussion of risk management would be complete without some mention of the cost of litigation itself, putting aside the prospects for success. For the simple fact is that the litigation process can be enormously expensive, both in terms of money and in terms of distraction to the professional organization and its members.

Here, a liability system premised in contract may have a real advantage, insofar as the parties can agree at the outset that any dispute will

163. *See* Alexander Grant & Co. v. Tiffany Indus., Inc., 770 F.2d 717, 718-19 (8th Cir. 1985) ("Grant, a public accounting firm, alleges that it was injured as the result of a pervasive scheme of mail and wire fraud designed by Tiffany to obtain a favorable audit for the fiscal year 1977 . . . . Grant has standing to assert its claims."), *cert. denied*, 474 U.S. 1058 (1986); Cenco Inc. v. Seidman & Seidman, 686 F.2d 449 (7th Cir.), *cert. denied*, 459 U.S. 880 (1982); *In re* Leslie Fay Cos. Sec. Litig., 918 F. Supp. 749, 766 (S.D.N.Y. 1996) ("BDO does not simply seek indemnification for its attorneys fees. BDO has identified other harms that it has suffered due to [the directors'] alleged negligent misrepresentation in connection with this lawsuit."); Coopers & Lybrand v. Shapira, No. 92-1938, slip op. at 14-16 (W.D. Pa. Jan. 11, 1993) ("[Coopers & Lybrand] contends that Shapira, in his position as Chief Executive Officer and Treasurer of Phar-Mor, had a duty to supervise the other defendants, to verify that the statements made by him and others in the comfort letters were accurate, and to take steps to ensure that the statements were in fact accurate. . . . [T]he motion to dismiss . . . will be denied at this stage of the proceedings."); *In re* Sunrise Sec. Litig., 793 F. Supp. 1306, 1321 (E.D. Pa. 1992) ("This case is similar to In re *Cenco*."); Alvarado Partners, L.P. v. Mehta, 723 F. Supp. 540, 554 (D. Colo. 1989) ("[S]uch claims are independently viable pendent state claims."); *In re* Wedtech Corp., 87 B.R. 279, 287 (Bankr. S.D.N.Y. 1988) ("The *Cenco* court . . . . understandably drew a distinction between the indemnity and tort claims."); *cf.* Cullen v. Riley, 957 F.2d 1020, 1033 (2d Cir. 1992) (holding that "although judgment reduction compensates a nonsettling defendant for his lost rights of indemnity and contribution, it does not necessarily compensate him for other lost claims"). *See generally* Seidman & Seidman v. Cenco Inc., 642 F. Supp. 539, 541 (N.D. Ill. 1986) (finding that a claim for fraud was not barred by a waiver of a right to seek indemnity, and stating that "[i]n the law, 'recovery under principles of contribution or indemnity' is, quite simply, a different animal from 'recovery under principles of direct tort liability.'"); Seidman & Seidman v. Cenco Inc., 601 F. Supp. 336, 340-41 (N.D. Ill. 1984) (holding that a waiver of a right to seek indemnity did not bar a claim for fraud); Young, *supra* note 129, at 2169-72 (discussing the viability of independent claims by accountants).

164. *See* Causey, Jr. & Causey, *supra* note 126, at 197-99; 4 Corbin, *supra* note 135, § 947, at 814 ("To one who is sued for non-performance of his promise it is a defense if he can prove that his performance was prevented or substantially hindered by the plaintiff.").

be resolved not through state or federal litigation, but through some private mechanism of alternative dispute resolution.[165] The engagement may also provide for, within certain limits, indemnification of costs and attorneys' fees.

L. *Overall*

While there is a need to understand the limits of broad generalizations, particularly as to matters of state law, the advantages of a contract-based system of liability for the accounting profession may be significant. The principal reason, broadly stated, is that a system of contract permits the opportunity for the parties to address, negotiate, and allocate responsibility for the various matters that may arise subsequent to the professional engagement.

That is not to say, however, that there are no practical difficulties compromising the implementation or effectiveness of a contract-based liability system. Important ones would include:

- Though it is quite true as a matter of law that parties are, with certain exceptions, free to agree on whatever they want, there is a practical limit within the confines of a competitive, commercial relationship to the extent to which a professional may insert into the engagement terms limitations on liability, disclaimers as to damages, reductions in the limitations period, etc. While in theory there does exist a freedom of contract, its practical usefulness therefore may be something less than the law would permit.
- The law will always be sensitive to the cause of justice, even where the parties to an agreement are sophisticated commercial enterprises. That is particularly the case in the context of CPA involvement with financial information, the public interest in which is well established.[166] There

165. For an overview of alternative dispute resolution ("ADR") techniques potentially applicable to accountant malpractice litigation, see American Arbitration Ass'n, Resolving Professional Accounting and Related Services Disputes: A Guide to Alternative Dispute Resolution (Dec. 1993); AICPA, Alternative Dispute Resolution, A Guide for State Societies (1993); CPR Institute for Dispute Resolution, *The ABCs of ADR: A Dispute Resolution Glossary*, 13 Alternatives 147 (1995) (describing the various forms of ADR); Richard C. Reuben, *The Lawyer Turns Peacemaker*, A.B.A. J., Aug. 1996, at 55 (describing current trends in ADR, specifically regarding mediation and arbitration); Hans U. Stucki, *Measuring the Merit of ADR*, 14 Alternatives 81 (1996) (providing hard data demonstrating the cost savings of ADR over a multi-year period).

166. *See* United States v. Arthur Young & Co., 465 U.S. 805, 817-18 (1984). In *Arthur Young*, the Supreme Court stated:

> 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 CPA] owes ultimate allegiance to the corporation's creditors and stockholders, as well as

should be an expectation, therefore, that the law will not permit a system of liability which permits the professional to be exonerated to an extent the law deems unjust.
- There are very practical impediments to the implementation of a contract system of liability in the context of public companies and securities trading on the open markets. Among other things, implementation of such a system is likely to require some level of cooperation by the SEC.[167]

If a contract system could be implemented, however, there appear to be, broadly stated, some very real benefits. Not the least of these is increased efficiency in the allocation of responsibility between the professional and the client, and a corresponding decrease in professional fees. Both would be of substantial benefit to society as a whole.

III. Forward-Looking Information and the "Bespeaks Caution" Doctrine

A. *From the Past to the Future*

As the systems of computer-based financial reporting evolve, a predictable effect may be that the information they produce will be used less to understand the past, and more to predict the future.[168] At the same time, the demands of computerized real-time financial reporting may not allow ample opportunity for an "audit" in the traditional sense to take place,[169] so that the accounting profession will be in-

> to the investing public. . . . [The CPA fills a] role as a disinterested analyst charged with public obligations.

Id.

167. The SEC appears to be following closely the work of both the Jenkins and the Elliott Committees. Last April, Commissioner Steven Wallman, who has taken a strong interest in the evolution of financial reporting systems, commented: "The work of both the AICPA special committee on financial reporting and the special committee on assurance services strongly influences thoughts on providing additional relevance to financial statements." *SEC Sponsors Discussions on Future of Financial Reporting*, J. Acct., Apr. 1996, at 15, 15.

168. A reorientation of financial reporting more toward "a forward looking perspective" is a common theme of modern financial analysis. Jenkins Committee Report, *supra* note 2, at 5, 22-23.

It is not difficult to conceptualize a financial reporting system in which financial information users are plugged directly into the reporting entity's MIS and receive, over a computer network, real-time information as to sales or other activity and, at the same time, immediate translation of reporting-entity transactions into bottom-line earnings per share. In such a context, three-month old financial data probably would seem ancient.

169. In his September 1994 article entitled *The Future of Audits*, Robert Elliott observed:

> Once capital suppliers have real-time access to an enterprise's databases, they will have little interest in annual financial statements—and, by extension, auditors' opinions on them—issued well after the entity's fiscal yearend. What they might be far more interested in is real-time assurance from the auditor that either the information in the enterprise's databases is reliable or the system itself is highly likely to produce reliable data.

creasingly called upon to provide assurance not as to historical financial information itself, but as to the systems by which future financial information will be provided.[170]

A consequence of both trends may be to place increased emphasis upon the forward-looking components of a professional engagement. For the accounting professional, the hazards are many. Forward-looking data is inherently subjective, it never turns out to be exactly correct, and the prescience of hindsight can make the prognosticator look foolish. It is the presentation of forward-looking information that can give rise to some of the biggest risks in litigation.[171]

It is for these reasons that the so-called "bespeaks caution" doctrine may play an increasingly important role. In instances in which the disclosure of forward-looking information falls within the umbrella of the doctrine's protection, the doctrine can preclude a claim even where forward-looking information turns out to be materially incorrect. This section discusses the development of the "bespeaks caution" doctrine, the doctrine as now embodied in the Private Securities Litigation Reform Act of 1995[172] ("Reform Act"), and the doctrine's potential applicability—both as a matter of common law and now as

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Robert K. Elliott, *The Future of Audits*, J. Acct., Sept. 1994, at 74, 76; *see* Elliott Committee Report, *supra* note 9, at <http://www.aicpa.org/assurance/scas/comstud/effect/constr.htm> ("The profession's information-technology competencies will have to broaden and deepen even to provide traditional services let alone to provide new assurance services. Real-time auditing, for example, will require a far better understanding of systems and systems reliability.").

170. The practical implications of such a transformation are many, including the potential elimination of "disappointing earnings" cases premised upon earnings that unexpectedly do not fulfill analysts' expectations.

171. The risks associated with forward-looking information were illustrated graphically last year when, faced with a now-defeated California ballot initiative that would have made easier the prosecution of securities class actions based on forward-looking information, Intel Corporation simply announced the elimination of forward-looking statements in its financial disclosures and abruptly cancelled a meeting with analysts. *See Intel Eliminates Forward-Looking Statements and Cancels Analyst Meeting Due to California Ballot Initiative*, Bus. Wire, Oct. 7, 1996, *available in* LEXIS, News Library, BSWIRE File. The *Wall Street Journal* described Intel's action as follows:

> Technology stocks got a boost three weeks ago when Intel said its future looked brighter than analysts had forecast.
>
> But if California voters approve a measure slated for the November ballot, that may be the last rosy outlook Wall Street hears from the leading computer-chip maker.
>
> Intel is following the lead of another Silicon Valley technology company, Novellus Systems, in refusing to discuss its prospects with investors for fear of the potential effect of Proposition 211.
>
> Intel, which Wall Street counted on for the best forward view of the semiconductor industry, on Monday canceled an Oct. 31 meeting with analysts and announced it will report on its results only after the fact.

Patrick McGeehan, *California Measure Causes Silence in Silicon Valley*, Wall St. J., Oct. 9, 1996, at C1.

172. Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended in scattered sections of 15 U.S.C.A. (West Supp. 1996)).

embodied in the Reform Act—to systems assurance reports and financial statements.

B. *An Overview of the "Bespeaks Caution" Doctrine*

The "bespeaks caution" doctrine is not fully developed, and its precise boundaries have yet to be completely shaped. In its most basic form, however, it provides that forward-looking statements about anticipated financial performance may not constitute the basis for a misrepresentation claim if the risks are described plainly and honestly. Thus, assuming that statements concerning projections and expectations are coupled with adequate cautionary language (and, at least according to some courts, made in good faith), they are not actionable as fraud.

1. Unremarkable Beginnings

The bespeaks-caution concept was first articulated twenty years ago, in a footnote and without fanfare, by the Eighth Circuit in *Polin v. Conductron Corp.*[173] In that case, an investor brought an action against a company whose stock he had purchased, and against some of the company's officers and directors, claiming that the company's annual reports and other documents contained fraudulent statements.[174] Among other things, the investor attacked statements regarding "anticipated" losses, "expected" improvements, and a "possibility" of a future break-even.[175] The court held that these statements were not actionably fraudulent, because they "bespeak caution in outlook and fall far short of the assurances required for a finding of falsity and fraud."[176]

The doctrine received little subsequent attention over the next nine years. In 1986, however—as a plethora of securities suits hit the federal courts arising from the investment and acquisition activity of the 1980s—the doctrine established an important beachhead in the Second Circuit. The case was *Luce v. Edelstein*,[177] and it involved an investor who claimed, among other things, that an offering memorandum contained intentional misrepresentations as to the investment's potential cash and tax benefits.[178] The offering memorandum had cautioned, however, that its projections of these potential benefits were mere predictions that would not necessarily come to fru-

173. 552 F.2d 797, 806 n.28 (8th Cir.), *cert. denied*, 434 U.S. 857 (1977).

174. *Id.* at 803.

175. *Id.* at 806 n.28.

176. *Id.*

177. 802 F.2d 49 (2d Cir. 1986).

178. *Id.* at 56.

ition.[179] The Second Circuit held that these statements were not fraudulent as a matter of law.[180] The reason was that

> the Offering Memorandum made it quite clear that its projections of potential cash and tax benefits were "necessarily speculative in nature" and that "[n]o assurance [could] be given that these projections [would] be realized." Indeed, the Offering Memorandum warned prospective investors that "[a]ctual results may vary from the predictions and these variations may be material."[181]

The court concluded that "[w]e are not inclined to impose liability on the basis of statements that clearly 'bespeak caution.'"[182]

With the imprimatur of the Second Circuit, judicial acceptance of the bespeaks-caution doctrine began to expand, first among courts within the Second Circuit and then into the other circuits as well. As things stand today, the doctrine has been adopted, in some form or another, by nine of the twelve federal judicial circuits: the First Circuit,[183] Second Circuit,[184] Third Circuit,[185] Fourth Circuit,[186] Fifth Circuit,[187] Sixth Circuit,[188] Eighth Circuit,[189] Ninth Circuit,[190] and Eleventh Circuit.[191] In addition, the Seventh Circuit appears to have recognized the validity of the doctrine, though it has yet to use it to dismiss a case.[192] The Supreme Court has not explicitly accepted the doctrine. The Court has, however, declined to review one case dismissing a complaint based on the doctrine,[193] and there is no reason to presume the Court would reject it out of hand.[194]

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179. *Id.*
180. *Id.*
181. *Id.* (alterations in original).
182. *Id.*
183. Romani v. Shearson Lehman Hutton, 929 F.2d 875 (1st Cir. 1991).
184. I. Meyer Pincus & Assocs. v. Oppenheimer & Co., 936 F.2d 759 (2d Cir. 1991).
185. *In re* Donald J. Trump Casino Sec. Litig.—Taj Mahal Litig., 7 F.3d 357 (3d Cir. 1993), *cert. denied*, 510 U.S. 1178 (1994).
186. Hillson Partners Ltd. Partnership v. Adage, Inc., 42 F.3d 204 (4th Cir. 1994).
187. Rubinstein v. Collins, 20 F.3d 160 (5th Cir. 1994).
188. Mayer v. Mylod, 988 F.2d 635 (6th Cir. 1993).
189. Moorhead v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 949 F.2d 243 (8th Cir. 1991).
190. *In re* Worlds of Wonder Sec. Litig., 35 F.3d 1407 (9th Cir. 1994), *cert. denied*, 116 S. Ct. 277 (1995).
191. Saltzberg v. TM Sterling/Austin Assocs., Ltd., 45 F.3d 399 (11th Cir. 1995).
192. *See* Harden v. Raffensperger, Hughes & Co., 65 F.3d 1392, 1404-06 (7th Cir. 1995); *see also* United States v. Morris, 80 F.3d 1151, 1167 (7th Cir.) ("Although *Harden* implicitly recognizes the viability of the 'bespeaks caution' doctrine in this circuit as a defense in securities fraud cases, we have yet to encounter a case where the doctrine applied to negate the materiality of a misleading statement as a matter of law."), *cert. denied*, 117 S. Ct. 181 (1996).
193. *See* Gollomp v. Trump, 510 U.S. 1178 (1994).
194. In fact, the bespeaks-caution doctrine is entirely consistent with the Court's recent observation that otherwise-actionable misstatements will not support liability if accompanied by sufficient objectively true statements, so that the true statements "would exhaust the misleading conclusion's capacity to influence" a reasonable investor. Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1097-98 (1991). In its most

2. The Doctrine in Operation: The Trump Taj Mahal

One of the most well-publicized of the bespeaks-caution cases,[195] and one that vividly shows the doctrine's power to bring to an abrupt halt potential securities claims based on forward-looking information, arose out of Donald Trump's attempt to finance and complete construction of his Taj Mahal casino and hotel in Atlantic City.

The circumstances were these. Trump needed to raise $675 million to purchase, complete construction on, and open the Taj Mahal.[196] The investment would, however, be high risk: the hotel and casino obviously had no track record; construction was not even finished; and the industry was exceedingly competitive.[197] Trump chose to raise money through a public offering of investment bonds. Reflective of the risk, the bonds bore an interest rate of 14%—a full 5% higher than the yield offered on quality corporate bonds at the time.[198] Investors were given a prospectus that vividly described the risks involved, including those arising from the intense competition in the Atlantic City casino and hotel market and anticipated restraints on growth of the casinos' win from gaming.[199] Other disclosed risks included: that the Taj Mahal had absolutely no operating history, that its debt service would depend completely on still-untried operations, and that interest payments would come due before the casino could generate peak season cash flow.[200] Investors snapped it up.[201]

As it turned out, the Taj Mahal did not perform as hoped. And when press reports and industry gossip raised the specter of bank-

basic form, moreover, the bespeaks-caution doctrine is a fairly straightforward application of well-established principles of law regarding the elements of a fraud claim. It is one of the most basic prerequisites, for example, that the statement at issue be materially false or misleading. *See* 17 C.F.R. § 240.10b-5 (1996). The central inquiry is "whether defendants' representations, taken together and in context, would have misled a reasonable investor." McMahan & Co. v. Wherehouse Entertainment, Inc., 900 F.2d 576, 579 (2d Cir. 1990), *cert. denied*, 501 U.S. 1249 (1991). In addition, a plaintiff must show that he relied on the false statement or omission to his detriment and that such reliance was reasonable. *See* Central Bank v. First Interstate Bank, 511 U.S. 164, 180 (1994). At its root, the bespeaks-caution doctrine is the logical application of these principles in the context of forward-looking information. *See Worlds of Wonder*, 35 F.3d at 1414 ("[T]he doctrine, when properly construed, merely represents the pragmatic application of two fundamental concepts in the law of securities fraud: materiality and reliance.").

195. *See* Floyd Norris, *Junk Bond Ruling Could Aid Companies in Fraud Suits*, N.Y. Times, Oct. 16, 1993, at 39.

196. *In re* Donald J. Trump Casino Sec. Litig.—Taj Mahal Litig., 7 F.3d 357, 364-65 (3d Cir. 1993), *cert. denied*, 510 U.S. 1178 (1994). *See generally* Michael R. Young, *When Investors Rely on Financial Projections: Ruling Gives New Protection from Lawsuits*, J. Acct., Feb. 1994, at 26, 26 (discussing the potential significance of the *Trump* decision to the accounting profession).

197. *Trump*, 7 F.3d at 370.

198. *Id.* at 364.

199. *Id.* at 370.

200. *Id.*

201. *Id.* at 364.

ruptcy, investors sued.[202] The main allegation was that the prospectus falsely stated that the defendants believed the funds generated by Taj Mahal operations would be sufficient to cover debt service.[203]

The Third Circuit refused to find a claim. The reason, the court explained, was that any statements in the prospectus as to anticipated financial performance had to be considered in light of the "total mix" of information available.[204] According to the court, the total mix was such that "no reasonable investor could believe anything but that the Taj Mahal bonds represented a rather risky, speculative investment which might yield a high rate of return, but which alternatively might result in no return or even a loss."[205] Given this, the court continued, the suing investors would be unable to prove the materiality of the alleged misrepresentation—that the defendants believed the Taj Mahal's funds from operations would be sufficient to cover debt service.[206] The court laid down the principle of law as follows:

> [W]hen an offering document's forecasts, opinions or projections are accompanied by meaningful cautionary statements, the forward-looking statements will not form the basis for a securities fraud claim if those statements did not affect the "total mix" of information the document provided investors. In other words, cautionary language, if sufficient, renders the alleged omissions or misrepresentations immaterial as a matter of law.[207]

The court thereby issued one of the clearest and most straightforward articulations of the bespeaks-caution doctrine.[208]

3. The Doctrine Has Its Limits

While the bespeaks-caution doctrine is significant in limiting potential claims against accounting professionals, it has some important limitations. One is that it generally only applies to forward-looking

202. *Id.* at 365.
203. *Id.* at 366.
204. *Id.* at 371.
205. *Id.* at 369.
206. *Id.*
207. *Id.* at 371.
208. Courts have also applied the bespeaks-caution doctrine to "fraud on the market" claims, in which the plaintiff claims to have relied not on any particular statement but rather on the integrity of the market. *See, e.g.*, Sinay v. Lamson & Sessions Co., 948 F.2d 1037 (6th Cir. 1991).

information.[209] Those drafting prospectuses must still get the history right.[210]

Another important limitation is that vague or blanket warnings—that is to say, boilerplate—may not be enough. The Third Circuit in the Trump case, for example, made the observation that boiler-type disclosures "ordinarily [would] be inadequate."[211] To "bespeak caution" most effectively, cautionary statements should be substantive and tailored to the specific statements being challenged.

Another potential limitation—and a particularly difficult one—involves the extent to which the bespeaks-caution doctrine will preclude a claim based on forward-looking projections, where the allegation is that the defendant knew to a virtual certainty that the projections could not be attained. The Sixth Circuit, for example, has raised the possibility that investors should be given an opportunity to prove that allegedly-fraudulent forward-looking statements were not genuinely believed.[212] Similarly, a New York district court has suggested that

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209. *See In re* ZZZZ Best Sec. Litig., 864 F. Supp. 960, 974-75 (C.D. Cal. 1994). The *ZZZZ Best* court noted:

> Logically, the doctrine would best apply to predictions and statements that are speculative in nature because of the inherent risk in predicting the future. . . .
>
> The information . . . had nothing to do with future predictions or speculative conclusions. . . .
>
> . . . [T]his Court finds that the bespeaks caution doctrine is not applicable in this case.

Id.

210. The clarity of the proposition that the bespeaks-caution doctrine applies only to forward-looking information has recently been muddied. Last December, the Fourth Circuit issued an opinion suggesting that the doctrine may apply to misstatements of historical fact. Gasner v. Board of Supervisors, 103 F.3d 351 (4th Cir. 1996). In *Gasner*, the state government issued municipal bonds to finance the purchase of equipment for a new waste treatment facility. *Id.* at 354. Revenue from the facility fell short of expectations; the project was abandoned; and the issuer defaulted on the bonds. *Id.* Investors sued. *Id.* at 355. They claimed that the prospectus's assurance that the facility would employ "proven" technology was an actionable misrepresentation because the technology was in fact experimental. *Id.* at 356-57.

The Fourth Circuit concluded that, even to the extent the assertion as to "proven" technology was false, it was rendered immaterial by cautionary language concerning the future viability of the project. *Id.* at 359. The court reached this conclusion even though the cautionary language did not concern the track record of the technology being used. *Id.* The dissent argued that the bespeaks-caution doctrine did not apply to such misrepresentations of historical fact, and that "cautionary language regarding predictions of the Facility's future success does not excuse the [issuer's] alleged misrepresentation of current and existing facts regarding the nature of the technology." *Id.* at 364-65.

211. *Trump*, 7 F.3d at 371. SEC chairman Arthur Levitt has recently observed that reporting entities appear to be relying too heavily on boilerplate, and that "[g]ood cautionary language should provide the reader with disclosure through the eyes of management, not litigation counsel." *Levitt Outlines Ideas for Modernizing the 1933 Act*, SEC Today, Jan. 27, 1997, at 1.

212. Mayer v. Mylod, 988 F.2d 635, 639 (6th Cir. 1993). The court stated:

> Material statements which contain the speaker's opinion are actionable under Section 10(b) of the Securities Exchange Act if the speaker does not

the doctrine would not render immaterial forward-looking statements about expected profits and tax benefits that the speaker knew to be false.[213] And when the Seventh Circuit[214] was asked to determine whether the doctrine was triggered by the cautionary statement that "[i]f [the company's] plans to restore profitability to its day-to-day operations are not successful . . . the Company's stockholder's equity will continue to erode,"[215] the court held that the statement was not protected, since the plaintiff contended that no such plans in fact existed.[216]

There is intuitive appeal, at least in the first instance, to the proposition that the bespeaks-caution doctrine should not protect forward-looking projections the defendant does not believe to be attainable. To conclude otherwise is arguably to invite nefarious schemers to commit fraud. The problem is that, to the extent that exception is permitted, it will immediately swallow the rule. The plaintiffs' bar will quickly come to realize that, to circumvent the doctrine, it need only include an allegation that the defendant did not believe in the achievability of projected performance. Since the Rule 9(b)[217] particularity requirements are more relaxed for pleading state of mind, such an allegation would presumably be made in every instance. The bespeaks-caution doctrine—at least at common law—would meet an abrupt and unceremonious end.

Perhaps the answer is that the Third Circuit got it right in the *Trump* case when it rejected precisely this kind of allegation—that the defendants did not sincerely believe that projected performance was

> believe the opinion and the opinion is not factually well-grounded. *See, e.g., Hanon v. Dataproducts Corp.*, 976 F.2d 497 (9th Cir. 1992); *cf. Virginia Bankshares* [*v. Sandberg*, 501 U.S. 1083] (1991) (opinions are actionable under Section 14(a) of the Securities Exchange Act). Whether the statements here were true or false is not an issue to be decided under Rule 12(b)(6). Ehrenberg and Mayer assert as a fact, in paragraph twenty of their complaints, that numerous Michigan National statements, which were either purely factual or which contained the speaker's opinion, were false, or were misleading due to material omissions. These assertions are sufficient for purposes of Rule 12(b)(6) because material statements of opinion, if not truly believed and not supported by available facts, are actionable under Section 10(b) of the Securities Exchange Act.

988 F.2d at 639.

213. Griffin v. McNiff, 744 F. Supp. 1237 (S.D.N.Y. 1990), *aff'd*, 996 F.2d 303 (2d Cir. 1993).

214. Harden v. Raffensperger, Hughes & Co., 65 F.3d 1392 (7th Cir. 1995).

215. *Id.* at 1405 (quoting *Raffensperger*'s application of the defense) (first alteration in original).

216. *Id.* at 1405-06.

217. Fed. R. Civ. P. 9(b). Rule 9(b) provides that "[m]alice, intent, knowledge, and other condition of mind of a person may be averred generally." *Id.* A number of states, including Delaware, Florida, Massachusetts, Michigan, New Jersey, and Ohio, have enacted similar provisions. *See* Del. Super. Ct. R. 9(b); Fla. R. Civ. P. 1.120(b); Mass. R. Civ. P. 9(b); Mich. Ct. R. 2.112(B)(2); N.J. Ct. R. 4:5-8(a); Ohio R. Civ. P. 9(B).

attainable—as a proper predicate for a claim.[218] A different rule would only further the expansion of litigation whenever forward-looking projections were not attained, and exacerbate the horrific economic inefficiency that results from capital markets in which, in substance, the reward of a risky investment is captured by the investor but the risk is spread to everyone.[219] As long as investors know the rules before hand, they can seek a return on their investment they believe to be commensurate with the risk.

4. The Private Securities Litigation Reform Act of 1995

Almost twenty years after its footnote debut,[220] the bespeaks-caution doctrine was elevated to marquee status in the "tort reform" legislation enacted by Congress in the Private Securities Litigation Reform Act of 1995.[221] In essence, the Reform Act amended the Securities Act of 1933[222] and the Securities Exchange Act of 1934[223] to implement legislatively the salient features of the common law doctrine[224]—referred to in the statute as a "safe harbor" for forward-looking statements.[225] A critical consideration is that, according to the legislative history,[226] the Reform Act safe harbor was intended to supplement, not replace, the doctrine at common law.[227] Also, significant areas are left unaddressed by the Reform Act—such as state law.[228] It appears that both the Reform Act safe harbor, and the com-

218. *In re* Donald J. Trump Casino Sec. Litig.—Taj Mahal Litig., 7 F.3d 357, 372 (3d Cir. 1993) (citing Virginia Bankshares v. Sandberg, 501 U.S. 1083 (1991)), *cert. denied,* 510 U.S. 1178 (1994).

219. Ebke, *supra* note 144, at 682 ("The process of expanding auditor's liabilities therefore appears to be one of socializing losses and individualizing profits.").

220. *See supra* note 173 and accompanying text.

221. Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended in scattered sections of 15 U.S.C.A. (West Supp. 1996)).

222. 15 U.S.C. § 77a-*ll* (1994).

223. *Id.* § 78a-*ll*.

224. *See* H.R. Conf. Rep. No. 369, 104th Cong., 1st Sess. 31, 43 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 742 *and in* James Hamilton, CCH, *Private Securities Litigation Reform Act of 1995: Law & Explanation* 59, 68 (1996) ("The Conference Committee safe harbor . . . is based on aspects of SEC Rule 175 and the judicial created 'bespeaks caution' doctrine.").

225. The Reform Act has other provisions of direct interest to the accounting profession. *See generally* Quinton F. Seamons, *Audit Standards and Detection of Fraud Under the Private Securities Litigation Reform Act of 1995*, 24 Sec. Reg. L.J. 259 (1996).

226. As one commentator has noted, however, it is not certain that courts will give effect to such statements of legislative intent. *See* John C. Coffee, Jr., *The Future of the Private Securities Litigation Reform Act: Or, Why the Fat Lady Has Not Yet Sung*, 51 Bus. Law. 975, 975-76 (1996).

227. *See* H.R. Conf. Rep. No. 369, at 46, *reprinted in* 1995 U.S.C.C.A.N. at 745 *and in* Hamilton, *supra* note 224, at 70 ("The Conference Committee does not intend for the safe harbor provisions [of the Reform Act] to replace the judicial 'bespeaks caution' doctrine or to foreclose further development of that doctrine by the courts.").

228. Modern watchers of securities litigation are familiar with a new phenomenon, in which securities cases of the sort that traditionally would have been brought in

mon law bespeaks-caution doctrine, will both play an important role in future litigation.

The Reform Act defines a statement as "forward-looking" if it contains projections, plans and objectives, or predictions of future economic performance.[229] The Reform Act then provides two alternative safe harbors for such statements. Under the first, a forward-looking statement will not form the basis for liability if it is "identified as a forward-looking statement, and is accompanied by meaningful cautionary statements[230] identifying important factors that could cause actual results to differ materially from those in the forward-looking statement," or is otherwise immaterial.[231] Under the second, a forward-looking statement will not form the basis for liability if the plaintiff fails to prove that the forward-looking statement, if made by a natural person, was made with actual knowledge that the statement was false or misleading, or, if made by a business entity, was made or approved by an executive officer with actual knowledge that it was false or misleading.[232]

The Reform Act has some important exceptions. For instance, the "safe harbor" does not apply to, among other things, (1) statements that are "included in a financial statement prepared in accordance with generally accepted accounting principles,"[233] (2) statements made in connection with a tender offer,[234] (3) statements made in connection with an initial public offering,[235] or (4) statements concerning a partnership or a limited liability company.[236] And the Reform Act's safe-harbor provisions only apply to forward-looking information concerning established issuers subject to the reporting requirements of section 13(a) or section 15(d) of the 1934 Act.[237]

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federal court are now shifting into state courts with the federal claims having been jettisoned completely. *See* Coffee, *supra* note 226, at 999. One possible effect may be that state courts, though theoretically left unaffected by the Reform Act, will show an increasing willingness to incorporate the bespeaks-caution doctrine into state common law. *See, e.g.*, Rubin v. SI Management L.P., No. 10893/92 (N.Y. Sup. Ct. June 23, 1993).

229. *See generally* 15 U.S.C.A. §§ 77z-2(i)(1), 78u-5(i)(1) (West Supp. 1996).

230. According to the legislative history of the Reform Act,

> boilerplate warnings will not suffice as meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those projected in the statement. The cautionary statements must convey substantive information about factors that realistically could cause results to differ materially from those projected in the forward-looking statement, such as, for example, information about the issuer's business.

H.R. Conf. Rep. No. 369, at 43, *reprinted in* 1995 U.S.C.C.A.N. at 742 *and in* Hamilton, *supra* note 224, at 68.

231. 15 U.S.C.A. §§ 77z-2(c)(1)(A), 78u-5(c)(1)(A) (West Supp. 1996).

232. *Id.* §§ 77z-2(c)(1)(B), 78u-5(c)(1)(B).

233. *Id.* §§ 77z-2(b)(2)(A), 78u-5(b)(2)(A).

234. *Id.* §§ 77z-2(b)(2)(C), 78u-5(b)(2)(C).

235. *Id.* §§ 77z-2(b)(2)(D), 78u-5(b)(2)(D).

236. *Id.* §§ 77z-2(b)(2)(E), 78u-5(b)(2)(E).

237. *Id.* §§ 77z-2(a), 78u-5(a).

C. *The Applicability of the Doctrine to Systems Assurance Reports*

In its typical form, the bespeaks-caution doctrine precludes claims based on particular types of financial data—financial projections being a quintessential example. Fundamental to the development of financial reporting, though, is not simply assurance directed to static sets of financial data, but assurance directed to the systems by which financial data is generated. This development in financial reporting thus corresponds to a broader development in management theory generally, which directs attention to the systems by which output is generated,[238] rather than simply to the output itself.[239] In the context of financial information, the importance of a trend from "data assurance" to "systems assurance" is found in the need to increase the timeliness of financial information, and the fact that, as mentioned above, the demands of timeliness may not allow ample opportunity for an "audit" of particular data in the traditional sense to take place. It may be that, rather than waiting for a Form 10-K with months-old financial information, future users will find themselves by way of computer able to plug directly into the reporting entity's management information system.[240]

If financial reporting systems are to develop in this direction—and it is almost inevitable that they will—it may be critical that the bespeaks-caution doctrine develop in this direction with them. The issue is thus presented: to what extent may the bespeaks-caution doctrine be applicable not merely to practitioner reports on forward-looking financial data, but to practitioner reports on the adequacy of a reporting entity's system by which future financial data is to be generated?

238. *See* W. Edwards Deming, Quality, Productivity and Competitive Position 22 (1982) ("Quality comes not from inspection, but from improvement of the process."); John O. Whitney, The Economics of Trust: Liberating Profits and Restoring Corporate Vitality 22 (1994) ("The challenge to leaders is to understand fully the system they are managing, to understand the interdependence of the various components, to spend their creative energy improving the interface between the components as well as improving the components themselves."). One text notes:

> Deming's system, known as the Fourteen Points, ties together disparate process-oriented management ideas into a single, holistic vision of how companies can anticipate and meet the desires of the customer by fostering a better understanding of "the process" and by enlisting the help of every employee, division, and supplier in the improvement effort.

Andrea Gabor, *supra* note 1, at 5.

239.
> Modern manufacturing quality assurance has moved away from an inspection-and-rework strategy and now relies heavily on a strategy of product and/or process redesign to eliminate all possible sources of defects. This proves to be both more effective (creating higher and continuously improving levels of quality) and more cost effective. Similarly, modern data quality assurance will move away from data assurance and toward system assurance.

Elliott Committee Report, *supra* note 9, at <http://www.aicpa.org/assurance/scas/comstud/effect/newopps.htm>.

240. *See The CPA Journal Symposium on the Future of Assurance Services*, 66 CPA J., May 1996, at 14, 16; *see also* Wallman, *Regulating in a World of Technological and Global Change*, *supra* note 16, at 64, 65 nn.1-2.

At one level, such a system assurance report falls easily within the same category of forward-looking information that is subject to the bespeaks-caution doctrine. Whether the subject happens to be the future data itself, or the future operation of a financial reporting system by which the data will be generated, the essence of both is projection into the future. On an intellectual level, a practitioner who issues a forward-looking report on such a system should be every bit as entitled to the benefit of the bespeaks-caution doctrine as a practitioner who reported on a projection of the numbers themselves.

In fact, one court has come close to making exactly this connection. Three years ago, the United States Court of Appeals for the Ninth Circuit faced a failed-investment case brought by investors in junk bonds issued by the toy manufacturer Worlds of Wonder ("WOW").[241] The investors sued, among others, WOW's outside auditor, Deloitte & Touche.[242] One of the key allegations was that WOW's internal control system had been misleadingly described in the junk bond prospectus.[243] Among other things, the plaintiffs attacked the following statement contained in the prospectus concerning WOW's internal controls:

> *Information Systems and Control Procedures.* The Company's business has grown dramatically in the last year, and the Company's development of its management information system and other systems and control procedures has at times lagged behind this growth. While the Company continues to upgrade its systems, procedures and controls to meet the demand of its expansion, there can be no assurance that the Company can successfully implement these enhancements or that these enhancements will keep pace with the growth.[244]

The plaintiffs argued that this statement was misleading because WOW's internal controls in truth had "crippling deficiencies," and that "no reasonable investor reading the Prospectus would have concluded that there were any *existing* problems with controls."[245]

The district court rejected this claim, stating:

> Plaintiffs ignore the fact the Prospectus included an express disclaimer that "there can be no assurances" that WOW's existing internal controls would continue to be adequate given the rapid pace at which the company was growing. The Prospectus made no predictions to the contrary. Thus, the Prospectus adequately bespoke

241. *In re* Worlds of Wonder Sec. Litig., 35 F.3d 1407 (9th Cir. 1994), *cert. denied*, 116 S. Ct. 277 (1995).
242. *Id.* at 1412.
243. *Id.* at 1416-17.
244. *Id.* at 1417.
245. *Id.*

caution regarding this potential risk to WOW's investors. As a matter of law, Plaintiffs cannot have been misled.[246]

The Ninth Circuit affirmed, implicitly recognizing the applicability of the bespeaks-caution doctrine to systems assurance. The court stated:

> [C]ontrary to the plaintiffs' assertions, the Debenture Prospectus did not state or imply that WOW's internal control problems were "in the past" and not ongoing. Rather, the prospectus clearly warned that the company's attempt to improve internal controls could prove to be inadequate. Second, the plaintiffs presented no evidence that WOW's internal controls at the time of the offering were materially deficient. Indeed, the allegedly "devastating" management letter issued by Deloitte (two-and-a-half months *after* the Debenture Offering) concluded that, although "significant problems" existed, WOW's internal controls had no material weaknesses. And, third, WOW probably would not have needed to disclose even serious internal-control deficiencies. *Cf. Monroe v. Hughes*, 31 F.3d 772, 776 (9th Cir. 1994) (holding that an auditor need not disclose internal controls).
>
> The Debenture Prospectus, which noted that WOW had struggled to maintain sufficient internal controls, clearly erred on the side of *over* disclosure and was therefore not misleading. We affirm the district court on this point.[247]

It may be that the Ninth Circuit, in so deciding, implicitly recognized a potentially critical distinction between two types of systems assurance reports. One type would provide assurance as to the performance of the system at a point of time in the past. The other would provide assurance as to the performance of the system into the future. As to the former, an argument might be made that the inclusion of cautionary language triggers bespeaks-caution protection, but it is far from clear that that argument would be accepted by a discerning court, insofar as the inquiry would likely focus more on the adequacy of the internal control system at a particular point in time rather than prospectively. As to the latter, the bespeaks-caution doctrine would very much appear to be applicable, as the Ninth Circuit appeared to accept.

To take full advantage of the doctrine as to systems assurance reports that speak to the future, however, the profession should be mindful that generic, vague, or blanket disclaimers (at least under common law) may not be enough.[248] In the context of systems assurance as to a particular reporting entity, therefore, the practitioner

246. *In re* Worlds of Wonder Sec. Litig., 814 F. Supp. 850, 865 (N.D. Cal. 1993), *aff'd in part, rev'd in part*, 35 F.3d 1407 (9th Cir. 1994), *cert. denied*, 116 S. Ct. 277 (1995).

247. *Worlds of Wonder*, 35 F.3d at 1417.

248. *See, e.g., id.* at 1414 (quoting the district court opinion, 814 F. Supp. at 858); *see also* 15 U.S.C.A. § 78u-5(c)(1)(A)(i) (West Supp. 1996) (stating that a forward-looking statement must be "accompanied by meaningful cautionary statements identifying

would do well to ensure the inclusion of detailed information as to specific potential vulnerabilities of the system at issue. The inclusion of such detailed and specific information, of course, to some extent cuts against the goal of report standardization. It is possible that the conflicting goals of adequate cautionary disclosure and report standardization could be reconciled by ensuring the inclusion of detailed and specific cautionary disclosure within management's written assertion rather than in the practitioner's report itself.

A final consideration is that, with the exception of the litigation involving Worlds of Wonder in the Ninth Circuit, the applicability of the bespeaks-caution doctrine to systems assurance is largely untested. While the jurisprudential justification for the doctrine would appear to be applicable to systems assurance, that applicability has yet to gain any degree of broad judicial acceptance—or even to be widely confronted.

D. *The Applicability of the Doctrine to Financial Statements*

A remaining issue is the extent to which the bespeaks-caution doctrine may be applicable to financial statements. As presently configured, the doctrine's applicability to financial statements is far from clear. As a general matter, the bespeaks-caution doctrine applies only to forward-looking information—not to matters of historical fact. For that reason, the court in In re *ZZZZ Best Securities Litigation*[249] held that the bespeaks-caution doctrine did not apply to a review report by Ernst & Young. The court explained: "Logically, the doctrine would best apply to predictions and statements that are speculative in nature because of the inherent risk in predicting the future. The doctrine loses its logical purpose when applied to statements made about already existing information like the Z Best audited financials covering an already completed quarter."[250]

Still, the intellectual underpinnings of the doctrine would appear to justify its applicability to at least certain aspects of financial statements. Aspects of financial statements—with receivables and reserves being two good examples—include a significant element of prediction. In substance, such items are frequently determined through careful assessment of what is expected to happen in the future. To the extent such financial statement items are accompanied by meaningful cautionary disclosure, the bespeaks-caution doctrine would appear to be every bit as applicable as to, say, a prediction of future revenues.

This intellectual justification appears to have been identified in the new Reform Act.[251] It also appears to have been rejected. The Re-

important factors that could cause actual results to differ materially from those in the forward-looking statement").

249. 864 F. Supp. 960 (C.D. Cal. 1994).

250. *Id.* at 974.

251. 109 Stat. 737.

form Act specifically provides that the safe harbor is not available for statements that are "included in a financial statement prepared in accordance with generally accepted accounting principles."[252] A congressional intent to foreclose judicial application of the bespeaks-caution doctrine—at least in the Reform Act—to traditional financial statements seems fairly clear.

But that is not to say that Congress intended to preclude applicability of the doctrine to financial statements beyond those it had in mind when it passed the Reform Act. For one thing, there is no indication that Congress intended to render the doctrine inapplicable to the financial reporting systems of the future. Indeed, it was the explicit purpose of Congress to open up the systems of financial reporting to innovation and "to enhance market efficiency by encouraging companies to disclose forward-looking information."[253] The financial statements of the future may be quite different than the financial statements contemplated by Congress in 1995, particularly if, for example, the recommendations of the Jenkins Committee are implemented.

And even today's financial statements, if not protected by the Reform Act's safe harbor, may still be protected by common law. It is thus important that Congress, in statutorily enacting a safe harbor for forward-looking information, intended to discourage "[a]busive litigation," not to encourage it.[254] Congress was accordingly careful to make clear that it did not, in the Reform Act, "intend for the safe harbor provisions to replace the judicial 'bespeaks caution' doctrine or to foreclose further development of that doctrine by the courts."[255]

It is therefore very much a relevant area of inquiry to consider the extent to which the judicial underpinnings of the bespeaks-caution doctrine under common law are relevant to claims based on the forward-looking elements of financial statements. And those underpinnings appear very much to be applicable. As mentioned earlier, the doctrine is simply a particular application of the well-established materiality and reasonable-reliance prerequisites.[256] If the notes to the financial statements adequately apprise the user of the attendant risks to realizing financial statement amounts, the bespeaks-caution doctrine should arguably preclude a finding of both materiality and reasonable reliance on the forward-looking elements, and thereby preclude a claim.

252. 15 U.S.C.A. §§ 77z-2(b)(2)(A), 78u-5(b)(2)(A) (West Supp. 1996).

253. *See* H.R. Conf. Rep. No. 369, 104th Cong., 1st Sess. 31, 43 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 742 *and in* Hamilton, *supra* note 224, at 59, 67.

254. Hamilton, *supra* note 224, at 70.

255. *See* H.R. Conf. Rep. No. 369, at 46, *reprinted in* 1995 U.S.C.C.A.N. at 745 *and in* Hamilton, *supra* note 224, at 70.

256. *See supra* note 194.

At the moment, the law in this area is in a state of flux. Some court decisions support the proposition that forward-looking elements of historical financial information should be entitled to bespeaks-caution protection. A California court, for example, applied the doctrine to reject a fraud claim based on an alleged overstatement of accounts receivable.[257] In that case, the California court explained that the prospectus

> specifically warned that "a material portion" of [the company's] accounts were over 90 days old, and that "excessive aging" of these accounts would adversely affect [the company's] liquidity. Any reasonable investor was able to interpret "excessive aging" as meaning inability to collect payment, forcing [the company] to take a write-off. In short, the IPO Prospectus adequately bespoke caution on the risks concerning [the company's] accounts receivable.[258]

Little justification exists for finding the bespeaks-caution doctrine applicable to such things as accounts receivable or loan loss reserves in a prospectus, but not applicable when set forth in financial statements.[259] The information is, after all, the same.

But prudence would caution against undue optimism as to the prospect of easily convincing the courts. In the past year, the First Circuit[260] and the Third Circuit[261] have each reversed a lower-court decision applying the bespeaks-caution doctrine to forward-looking statements about reserves.[262] Those decisions at least raise a question

257. *In re* Worlds of Wonder Sec. Litig., 814 F. Supp. 850 (N.D. Cal. 1993), *aff'd in relevant part, rev'd in part*, 35 F.3d 1407 (9th Cir. 1994), *cert. denied*, 116 S. Ct. 277 (1995).

258. *Id.* at 862.

259. *See* Delta Holdings, Inc. v. National Distillers & Chem. Corp., 945 F.2d 1226, 1250 (2d Cir. 1991) (noting that "loss reserves are not like a debt with fixed payments of principal and interest," and that "[i]nformed guesswork is an accepted basis for determining such reserves"), *cert. denied*, 503 U.S. 985 (1992); First Nationwide Bank v. Gelt Funding, Corp., 820 F. Supp. 89, 95-96 (S.D.N.Y. 1993) ("[T]he taking of loan loss reserves is based on managerial guesswork" and is "an inherently speculative and unreliable measure of actual [losses] because reserves do not represent realized losses, but rather a contingent estimate of anticipated future losses."), *aff'd on other grounds*, 27 F.3d 763 (2d Cir. 1994), *cert. denied*, 115 S. Ct. 728 (1995).

260. Shaw v. Digital Equip. Corp., 82 F.3d 1194 (1st Cir. 1996).

261. *In re* Westinghouse Sec. Litig., 90 F.3d 696 (3d Cir. 1996).

262. In *In re* Westinghouse Sec. Litig., 832 F. Supp. 948 (W.D. Pa. 1993), *aff'd in part, rev'd in part*, 90 F.3d 696 (3d Cir. 1996), the United States District Court for the Western District of Pennsylvania applied the bespeaks-caution doctrine to dismiss a fraud claim based on a prospectus' alleged misrepresentation that loan loss reserves "*should* be adequate to cover future losses that may occur." *Id.* at 986 (quoting Westinghouse's prospectus). The district court's treatment of such a statement as forward-looking, and therefore within the ambit of the bespeaks-caution doctrine, was hardly unreasonable—as the court noted, loss reserves are "a type of 'soft information,' consisting essentially of predictions about the future performance of receivables." *Id.* at 970-71. Nevertheless, the Third Circuit—the same court that decided the *Trump* case—reversed this aspect of the district court's decision. *Westinghouse*, 90 F.3d at 710. The rationale was that the cautionary statements did "not sufficiently counter the alleged misrepresentations, i.e., that the defendants knowingly or recklessly mis-

as to whether courts might be uneasy about extending the doctrine to items that are not solely predictive of future events. Whatever the case, the inclusion of meaningful cautionary language with the forward-looking elements of historical financial statements would help make clear their inherent uncertainty, even where the bespeaks-caution doctrine may not technically be applied. But it looks like the extent to which the bespeaks-caution doctrine is found applicable to such information will have to await further judicial development.

IV. Risk Management and Financial Reporting Outside the United States

A. *Overview*

Among the important considerations arising out of computer-transmitted financial information is that, in all likelihood, transmission will not be confined by the territorial boundaries of the United States.[263] Even now, the International Accounting Standards Committee[264] is

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represented the adequacy of the loan loss reserves and compliance with GAAP." *Id.* at 709.

The First Circuit reversed a Massachusetts district court's decision that the bespeaks-caution doctrine applied to a statement in a prospectus that a company believed "the remaining restructuring reserve . . . is adequate to cover presently planned restructuring actions." Wilensky v. Digital Equip. Corp., 903 F. Supp. 173, 177 (D. Mass. 1995) (emphasis omitted) (quoting prospectus supplement), *aff'd in part, rev'd in part sub nom.* Shaw v. Digital Equip. Corp., 82 F.3d 1194 (1st Cir. 1996). The First Circuit recognized that the statement about the "adequacy" of the reserves had "both a forward-looking aspect and an aspect that encompasses a representation of present fact." *Shaw*, 82 F.3d at 1213. The court also noted that the plaintiffs' fraud claim was not premised upon a forward-looking statement; rather, the plaintiffs alleged that the statement about the adequacy of reserves was a misrepresentation of a present fact, because the defendants allegedly knew that the reserves were in fact inadequate. Accordingly, the court found that the accompanying cautionary language did not render the misrepresentation immaterial as a matter of law. *Id.* at 1213-14.

263. *See* Wallman, *Regulating in a World of Technological and Global Change*, *supra* note 16, at 64 ("Technology also has had a profound effect on the globalization of the financial markets. Simply put, the walls between competitors built by geographic boundaries and time zones which once dictated and furthered nationalistic views toward commerce are now generally nonexistent."); Wallman, *Regulation for a New World*, *supra* note 1, at 8, 10 ("Nothing is changing more rapidly today than information technology, and new communications vehicles like the Internet know no borders. Consequently, the premise of our regulatory framework—controlling information flows grounded in a sovereign right based on geographic jurisdiction—becomes more tenuous."); *see also* Glenn Cheney, *FEI Panel Warns Risk Management Will Get Harder*, Acct. Today, Nov. 11-24, 1996, at 17, 17 ("Risk is created by the complexity of doing business in a global world where technology and speed create a more intense business environment."); Peter Huber, *Cyberpower*, Forbes, Dec. 2, 1996, at 142, 142 ("Virtual establishments on the Web already offer incorporation in Belize, bank accounts in Switzerland, currency trading in Germany, brokerage accounts in New Zealand. International 800 numbers are proliferating.").

264. The International Accounting Standards Committee ("IASC") is a private-sector organization whose members consist of 116 accountancy organizations from 86 countries. The IASC-U.S. Comparison Project: A Report on the Similarities and Differences Between IASC Standards and U.S. GAAP 39-41, 49, 74-78 (Carrie Bloomer

hard at work on formulating international accounting standards and, with their completion and acceptance,[265] the globalization of capital markets, already underway,[266] may increase exponentially.[267] The world comprises 185 nations that are members of the United Nations and a handful of non-member nations (such as Switzerland) as well.[268] The international dissemination of financial information over the Internet may give rise to potential liability in any number or all of them.

This section therefore broadens the discussion of risk management to isolate important procedural and substantive issues arising out of the dissemination of financial information throughout the world. As a departure point, the section assumes a New York-based accounting firm that disseminates false financial information about a New York-based company throughout the world over the Internet. The conclu-

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ed., 1996). "IASC['s] mission is to formulate accounting standards, to promote their worldwide acceptance and observation, and to work generally for the improvement and harmonization of accounting regulations, standards, and procedures worldwide." *Id.* at 41. IASC's United States members are the AICPA, The Institute of Internal Auditors, and the Institute of Management Accountants. *Id.* at 78.

265. IASC's present goal is to develop a core set of international accounting standards by March 1998. Once those core standards are developed, IASC intends to present them to the International Organization of Securities Commissions ("IOSCO") to be considered for acceptance by IOSCO members, including the United States SEC, for cross-border securities listings. The expectation is that the SEC's acceptance of those standards would result in foreign firms that prepare financial statements based on IASC standards competing in United States capital markets with United States firms whose financial statements are based on United States GAAP. One unresolved question is the extent to which "IASC standards could eventually enter the hierarchy of U.S. GAAP for U.S. companies." *See id.* at 6; *see also* Cheney, *Cook Defends Independence*, *supra* note 19, at 16 ("Within a year and a half we'll have . . . an assessment of international standards in the U.S., and it's very possible that the rules of the game could change.").

266. "'Increasingly, you have domestic deals placed overseas, and foreign deals in the U.S.,' says Mark Seigel, the head of world-wide bond syndication at Morgan Stanley. 'So capital markets, and more particularly new issues, are increasingly global by nature, which in itself leads to more transactions.'" Gregory Zuckerman, *Bond Professionals Go 'Round-the-Clock*, Wall St. J., Nov. 25, 1996, at C1; *see also* Elizabeth MacDonald, *Universal Accounting Rules Seem Elusive*, Wall St. J., Dec. 6, 1996, at B9E ("Even with the tough U.S. accounting rules, the number of foreign companies listing on the Big Board has nearly tripled in the last five years to 285 today. Since 1990, the number of foreign companies registering with the SEC has risen to 856 from 434.").

267. Congress has recently demonstrated a fairly strong interest in the facilitation of global capital markets through the standardization of international accounting standards. Section 509(3) of the recently-enacted National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416, 3449-50 (1996), provides that "establishment of a high-quality comprehensive set of generally accepted international accounting standards in cross-border securities offerings would greatly facilitate international financing activities." *Id.* § 509(3). Pursuant to the Act, the SEC is to report to Congress on progress in the development of international accounting standards "not later than 1 year after the date of enactment of this Act," i.e., by October 1997. *Id.* § 509(5). *See generally SEC Must Report on Writing of Core International Accounting Standards*, 28 Sec. Reg. & L. Rep. (BNA) No. 43, at 1360 (Nov. 1, 1996) (discussing the obligations under and ramifications of section 509 of the Act).

268. 1 The Europa World Y.B. 1996, at 3-4 (Europa Publications Ltd.).

sion is that, while the prospect of world-wide litigation is intimidating, it is also manageable. The issues addressed are: (1) the jurisdiction of foreign courts over the accounting firm; (2) the law the foreign court may apply; (3) procedural issues of strategic significance in foreign courts (class actions, contingent fees, fee-shifting, jury trials, punitive damages); (4) the elements of the substantive accountant liability claim in foreign courts; (5) the enforcement of foreign judgments in United States courts; and (6) the effectiveness of arbitration, forum selection, and loss-limiting clauses in international agreements.[269]

B. *The Jurisdiction of Foreign Courts*

The first step in assessing international risk management is to recognize that the international dissemination of false financial information may indeed expose a United States accounting firm to litigation and liability in foreign courts.

International law on the point is fairly straightforward. As a general matter, international law recognizes the ability of foreign nations to assert jurisdiction over nonresidents where the assertion of jurisdiction under the particular circumstances would be "reasonable."[270] The criteria for "reasonableness" are roughly analogous to the criteria used in the various "long-arm" statutes within the United States to address when, for example, a court of one state may assert jurisdiction over the resident of another.[271] In the international context, a foreign court may be "reasonable" in asserting judicial jurisdiction over a nonresident person where (among other things)—

- the person regularly carries on business in the foreign state;
- the person carried on activity in the foreign state (but only in respect of such activity);

269. One caveat is in order. This discussion does not seek to set forth all law applicable to the international dissemination of financial information in each of the nations of the world. Nor would such a discussion make sense—simply understanding the laws of the United States requires individual consideration of both federal law and the law of each of the fifty states (plus territories). What this section does seek to do is to identify important issues that may be encountered in foreign courts and their potential significance to international risk management.

270. Restatement (Third) of the Foreign Relations Law of the United States § 421(1) (1987) [hereinafter Foreign Relations Restatement] ("A state may exercise jurisdiction through its courts to adjudicate with respect to a person or thing if the relationship of the state to the person or thing is such as to make the exercise of jurisdiction reasonable."). *See generally* Andreas F. Lowenfeld, International Litigation and Arbitration 147 (1993) [hereinafter Lowenfeld, International Arbitration] (discussing generally the subject of a foreign court's "jurisdiction to adjudicate").

271. *Compare* Foreign Relations Restatement, *supra* note 270, § 421(2) *with* N.Y. Civ. Prac. L. & R. § 302 (McKinney 1995) ("Personal jurisdiction by acts of nondomiciliaries").

- the person carried on outside the foreign state an activity having a substantial, direct, and foreseeable effect within the foreign state (but only in respect of such activity); or
- the thing that is the subject of adjudication is owned, possessed, or used in the foreign state (but only in respect of a claim reasonably connected with that thing).[272]

It is certainly foreseeable that a foreign court would find it reasonable under these criteria to assert jurisdiction over a United States accounting firm disseminating financial information internationally over the Internet.[273] The court might find that such dissemination constituted "business in the state" or "activity in the state" or activity

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272. Foreign Relations Restatement, *supra* note 270, § 421(2)(h)-(k).

To put aside a potential issue, a foreign court ought not to assert jurisdiction over a United States-based accounting firm based exclusively on the activities of the United States firm's affiliate within the foreign court's nation. Courts—at least courts in the United States—have repeatedly declined to uphold personal jurisdiction under analogous circumstances. *See* Young v. Jones, 816 F. Supp. 1070, 1075-77 (D.S.C. 1992), *aff'd sub nom.* Young v. FDIC, 103 F.3d 1180 (4th Cir. 1997); Flair Resources Ltd. v. Peat Marwick Int'l, No. 87-105-RE, 1988 U.S. Dist. LEXIS 17481 (D. Or. Feb. 8, 1988), *aff'd*, 891 F.2d 294 (9th Cir. 1989); Reingold v. Deloitte Haskins & Sells, 599 F. Supp. 1241, 1253-54 (S.D.N.Y. 1984); Cocklereece v. Moran, 500 F. Supp. 487, 489 (N.D. Ga. 1980); Express One Int'l, Inc. v. Certified Dive Travel, Inc., No. 93-19297(18) (Fla. Mar. 21, 1996); Hotel Partners v. Streit, No. 90-08081-M (Tex. Aug. 7, 1991).

273. *See* CompuServe, Inc. v. Patterson, 89 F.3d 1257, 1268 (6th Cir. 1996) ("Someone . . . who employs a computer network service like CompuServe to market a product can reasonably expect disputes with that service to yield lawsuits in the service's home state."); Inset Systems, Inc. v. Instruction Set, Inc., 937 F. Supp. 161, 164 (D. Conn. 1996) ("The court concludes that advertising via the Internet is solicitation of a sufficient repetitive nature to satisfy . . . the Connecticut long-arm statute . . . thereby conferring Connecticut's long-arm jurisdiction . . . ."); Maritz, Inc. v. CyberGold, Inc., 947 F. Supp. 1328, 1334 (E.D. Mo. 1996) ("[T]he Court concludes that defendant CyberGold, through its internet activities, has purposefully availed itself of the privilege of doing business with this forum such that it could reasonably anticipate the possibility of being ha[u]led into court here."); Susan J. Kohlmann & Kerry A. Brennan, *Internet: Electronic Contacts May Lead to Court*, Metropolitan Corp. Couns., Oct. 1996, at 8, 8 (reviewing *CompuServe* decision); David E. Rovella, *Internet Use Can Confer Jurisdiction*, Nat'l L.J., Aug. 12, 1996, at B1 (same). *But see* Bensusan Restaurant Corp. v. King, 937 F. Supp. 295 (S.D.N.Y. 1996). In finding that the establishment of a Web site did not confer jurisdiction, a New York district court stated:

> As set forth above, King has done nothing to purposefully avail himself of the benefits of New York. King, like numerous others, simply created a Web site and permitted anyone who could find it to access it. Creating a site, like placing a product into the stream of commerce, may be felt nationwide—or even worldwide—but, without more, it is not an act purposefully directed toward the forum state. *See Asahi Metal Indus. Co. v. Superior Court*, 480 U.S. 102, 112, 107 S. Ct. 1026, 1032, 94 L. Ed. 2d 92 (1992) (plurality opinion). There are no allegations that King actively sought to encourage New Yorkers to access his site, or that he conducted any business—let alone a continuous and systematic part of its business—in New York. There is in fact no suggestion that King has any presence of any kind in New York other than the Web site that can be accessed worldwide. Bensusan's argument that King should have foreseen that users could access the site in New York and be confused as to the relationship of the two Blue Note clubs is insuffi-

outside the state with a "substantial, direct, and foreseeable effect within the state."[274]

For purpose of risk management, therefore, prudence would militate strongly in favor of an assumption that the international dissemination of financial information via computer would subject a United States accounting firm to the jurisdiction of foreign courts.

C. *The Nation's Law to Be Applied*

Assuming such jurisdiction, the question then arises: what nation's law would the foreign court apply? In the language of international law, this issue involves the foreign nation's "jurisdiction to prescribe"—the extent to which the foreign nation would have the "jurisdiction to prescribe" the applicability of its own law.[275] In the context of a United States firm's dissemination of financial information into a foreign nation, a foreign court would face two bodies of potentially

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> cient to satisfy due process. *See* [*Fox v. Boucher*], 794 F.2d at 37; *Beckett v. Prudential Ins. Co. of Am.*, 893 F. Supp. 234, 239 (S.D.N.Y. 1995).
>
> Although *CompuServe Inc. v. Patterson*, 89 F.3d 1257 (6th Cir. 1996), a recent decision of the United States Court of Appeals for the Sixth Circuit, reached a different result, it was based on vastly different facts. In that case, the Sixth Circuit found personal jurisdiction proper in Ohio over an Internet user from Texas who subscribed to a network service based in Ohio. The user, however, specifically targeted Ohio by subscribing to the service and entering into a separate agreement with the service to sell his software over the Internet. Furthermore, he advertised his software through the service and repeatedly sent his software to the service in Ohio. *Id.* at 1264-65. This led that court to conclude that the Internet user "reached out" from Texas to Ohio and "originated and maintained" contacts with Ohio. *Id.* at 1266. This action, on the other hand, contains no allegations that King in any way directed any contact to, or had any contact with, New York or intended to avail itself of any of New York's benefits.
>
> Accordingly, the exercise of personal jurisdiction over King in this case would violate the protections of the Due Process Clause.

Id. at 301 (footnote omitted). The court noted that "[i]n *CompuServe*, the Sixth Circuit explicitly wrote that it was not addressing the issue of whether the Internet user 'would be subject to suit in any state where his software was purchased or used . . . .'" *Id.* at 301 n.3 (quoting *CompuServe*, 89 F.3d at 1268); *see* Paul M. Barrett, *Suit Involving Internet Site Is Dismissed*, Wall St. J., Sept. 10, 1996, at B10 (discussing the *Bensusan* decision).

274. Foreign Relations Restatement, *supra* note 270, § 421(2)(h)-(j). *See generally* Andreas F. Lowenfeld, International Litigation and the Quest for Reasonableness 82 (1994) [hereinafter Lowenfeld, The Quest for Reasonableness] ("If I rent a car here in The Hague and run down a pedestrian crossing the Mauritskade, there can be no doubt that the court in The Hague will have jurisdiction in a civil claim for damages against me arising out of the accident, even if I am long back in New York . . . ."); Linda J. Silberman, *Judicial Jurisdiction in the Conflict of Laws Course: Adding a Comparative Dimension*, 28 Vand. J. Transnat'l L. 389, 396-400 (1995) (providing two examples of foreign countries' grounds for establishing "specific jurisdiction": England's Order 11 of the Rules of the Supreme Court, and the European Community's Brussels Convention on Jurisdiction and the Enforcement of Judgments).

275. *See* Lowenfeld, International Arbitration, *supra* note 270, at 46.

applicable law: the law of the foreign nation and the law of the United States.[276]

Here, again, an analogy may be drawn to the principles of law applied by United States courts in seeking to determine which state's law should control a dispute between citizens of different states.[277] Generally, international law will recognize a nation's jurisdiction to prescribe its own law with respect to such things as—

> (1) (a) conduct that, wholly or in substantial part, takes place within its territory;
> (b) the status of persons, or interests in things, present within its territory;
> (c) conduct outside its territory that has or is intended to have substantial effect within its territory; [and]
> (2) the activities, interests, status, or relations of its nationals outside as well as within its territory.[278]

United States lawyers are fully aware of the difficulty of determining the applicable law in disputes between residents of different states;[279] suffice it to say that the task becomes no easier in disputes between citizens of different nations.[280] The prudent assumption would be that, depending on the circumstances, it is entirely possible that a foreign court would find that it had jurisdiction to prescribe the applicability of its own nation's law to the United States firm's activity.

For example, the dissemination into a nation of false financial information may be found to constitute conduct that "takes place within [the foreign nation's] territory" or that constitutes "conduct outside [the foreign nation's] territory that has or is intended to have substantial effect within its territory."[281] Under traditional choice-of-law principles, it is well established that the place in which a person relies upon false information may be significant in determining the law applicable to the person's claim.[282] Indeed, an analogy might be drawn

276. The lack of any governing treaties is discussed *infra* part IV.E.

277. *See generally* Russell J. Weintraub, Commentary on the Conflict of Laws (2d ed. 1980).

278. Foreign Relations Restatement, *supra* note 270, § 402.

279. *See* William L. Prosser, *Interstate Publication*, 51 Mich. L. Rev. 959, 971 (1953) ("The realm of the conflict of laws is a dismal swamp, filled with quaking quagmires, and inhabited by learned but eccentric professors who theorize about mysterious matters in a strange and incomprehensible jargon. The ordinary court, or lawyer, is quite lost when engulfed and entangled in it."), *quoted in* Weintraub, *supra* note 277, at 3.

280. *See* Ebke, *supra* note 144, at 698 ("[T]he choice of law principles in cases of auditors' liability are rather blurred and far from uniform.").

281. *See* Foreign Relations Restatement, *supra* note 270, § 402; *see also id.* § 402 cmt. d (stating that "[j]urisdiction with respect to activity outside the state, but having or intended to have substantial effect within the state's territory," may be sufficient to give a foreign nation jurisdiction to prescribe).

282. *See* Restatement (Second) of Conflict of Laws § 148 (1971); *see also* Rhode Island Hosp. Trust Nat'l Bank v. Swartz, 455 F.2d 847, 851 (4th Cir. 1972) (finding that

to the international dissemination of a false statement giving rise to a claim for libel. There is little question in such an instance as to the power of a foreign nation to apply its own law.[283]

That is not to say that the law applicable in the United States would never apply in a foreign court. For example, a United States accounting firm's international dissemination of false information upon which a foreign citizen relies to invest United States funds in United States securities would not necessarily justify the application of the foreign nation's law. In such an instance, the contacts with the United States may be sufficiently prevalent that the foreign court would decide that United States law should control.

Even where United States law is found applicable by a foreign court, however, it is not clear that all United States law would be treated equally. Most notably, it is doubtful that a foreign court would apply the Securities Act of 1933[284] or the Securities Exchange Act of 1934[285] (the latter of which provides the authority for Rule 10b-5).[286] The United States securities acts are "public law" (law that takes on governmental enforcement overtones) and, as a general matter, foreign courts are reluctant to apply the public law of a foreign state.[287] Over time, this tradition against the international enforcement of public law may break down.[288] At present, though, even where United States law is found to apply, the securities acts may not.

Ultimately, this area of international law, like its domestic counterpart, is "highly controversial" and "leaves considerable room for the

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where "reliance on [statements] and subsequent injury took place" in Rhode Island, "[u]nder such circumstances . . . the law of Rhode Island governs" (citation omitted)).

283. *See* Foreign Relations Restatement, *supra* note 270, § 402 cmt. d ("The effects principle is not controversial with respect to acts such as shooting or even sending libelous publications across a boundary."); *cf.* United States v. Aluminum Co., 148 F.2d 416, 444 (2d Cir. 1945) ("Both agreements would clearly have been unlawful, had they been made within the United States; . . . both were unlawful, though made abroad, if they were intended to affect imports and did affect them."). *See generally* Lowenfeld, International Arbitration, *supra* note 270, at 46 (discussing the concept of "jurisdiction to prescribe," which "explore[s] the extent and limits of the reach of a nation's laws").

284. 15 U.S.C. § 77a-*ll* (1994).

285. *Id.* § 78a-*ll*.

286. 17 C.F.R. § 240.10b-5 (1994).

287. *See, e.g.*, Schemmer v. Property Resources Ltd., [1975] Ch. 273. In *Schemmer*, the court stated:

> The 1934 Act is . . . a penal law of the United States of America and, as such, unenforceable in [English] courts. . . . [I]t was passed for public ends . . . enacted not merely in the interest of the nation as an abstract or political entity, but to protect a class of the public. . . . [I]n the absence of specific legislation founded on treaties, preventive criminal justice is no more a proper subject of international enforcement than retributive criminal justice.

Id. *See generally* Lowenfeld, The Quest for Reasonableness, *supra* note 274, at 30 ("States don't apply the public law of other States.").

288. *See* Lowenfeld, The Quest for Reasonableness, *supra* note 274, at 171-72.

skilled advocate."[289] The important point is to recognize the distinct possibility, if not likelihood, that United States accounting firms forced to litigate in foreign courts will find their liability determined as a matter of foreign law.

D. *Aspects of Foreign Procedure*

None of this is to suggest, however, that a United States accounting firm potentially subject to the jurisdiction of a foreign court and to foreign law is necessarily at greater financial risk than in a court in the United States. In fact, some aspects of foreign law and procedure may make a foreign court more attractive than a court at home.

One such aspect is the general unavailability of class actions outside the United States. As a general matter, class actions may not be commenced under the laws of foreign nations.[290] That is not to say that class actions do not exist anywhere—for example, three provinces in Canada (British Columbia, Ontario, and Quebec) have some form of class action legislation,[291] as does Australia. But, on the whole, class action procedural mechanisms outside the United States are almost nonexistent.

This unavailability of class action litigation is significant because, in the absence of class action mechanisms, the economics of investor litigation may substantially impede the successful prosecution of a claim. A study by the Toronto Stock Exchange illustrates the difficulty.[292] The Toronto study, in assessing the viability of investor claims under present Canadian law, observed that, in the absence of an effective class action procedure, "[u]nless an investor suffered a very large loss . . . it would not be economically rational for the investor to commence an action against those believed to be responsible, even if a sound basis in law existed for pursuing such a claim."[293] One consequence for Canada, according to the Toronto study, is that "the remedies available to investors in secondary trading markets who are injured by misleading disclosure are so difficult to pursue and to establish that they are, as a practical matter, largely academic."[294] The solution? "[T]he Committee believes that statutory civil liability for misleading disclosure would be a meaningful enforcement mechanism or deterrent, and a realistic means of compensating injured investors, only in the context of viable class actions."[295] The study's recognition of the importance of class action litigation to the protection of inves-

289. Lowenfeld, International Arbitration, *supra* note 270, at 46.
290. *See, e.g.*, Ebke, *supra* note 144, at 705 (in the context of German law).
291. *See* The Toronto Stock Exchange, Toward Improved Disclosure: A Search for Balance in Corporate Disclosure 45 (Dec. 1995) [hereinafter Toronto Exchange Report].
292. *See id.* at 44-50.
293. *Id.* at 45.
294. *Id.* at iv.
295. *Id.* at 45.

tors does not mean that Canada is prepared to plunge headlong into United States class action-type practice—far from it. But the conclusions of the Toronto study illustrate the importance of class action procedures to the prosecution of foreign investor claims.

The general absence of class actions in foreign courts is accompanied by another aspect of foreign law that can operate to the advantage of defendants—the absence of contingent fees. Indeed, in some countries (England and Germany, for example) contingent fees are considered unethical and are illegal.[296] Here, too, it is not the case that contingent fees are not available anywhere—it may be, for example, that some form of contingent fee is available in British Columbia and several of the Australian states. But, in the overwhelming number of nations, contingent fees are not available at all.[297]

Not only are contingent fees not available in most nations; some nations require "fee-shifting" pursuant to which the loser must pay the winner's legal fees.[298] As to fee-shifting, the law outside the United States is not nearly as uniform as with regard to the absence of contingent fees. England and most Canadian provinces, for example, require fee-shifting; France does not; and Germany requires fee-shifting, but based on a schedule that is substantially behind the economics of present-day litigation.[299] Where it exists, fee-shifting imposes still another impediment to the prosecution of a claim based on the dissemination of false financial information.[300]

Still another procedural consideration is that, in accountant liability cases outside the United States, jury trials are for the most part unavailable.[301] Isolated exceptions could exist; hypothetically, a plaintiff might end up with a jury trial where civil and criminal claims happened to be combined. It is safe to assume, though, that a United States accounting firm facing claims in foreign courts based on false financial information will almost always have its liability determined by a judge or panel of judges, not a jury.[302]

296. *See* Ebke, *supra* note 144, at 687, 705 (England and Germany, respectively); Bernhard Grossfeld & Werner Ebke, *Controlling the Modern Corporation: A Comparative View of Corporate Power in the United States and Europe*, 26 Am. J. Comp. L. 397, 419 (1978); Hans Smit, *The Explosion in International Litigation*, Metropolitan Corp. Couns., Oct. 1996, at 59, 59 ("[C]ontingency fee arrangements . . . are largely forbidden abroad.").

297. *See* Eugene J. Silva, *Practical Views on Stemming the Tide of Foreign Plaintiffs and Concluding Mid-Atlantic Settlements*, 28 Tex. Int'l L.J. 479, 480 n.4 (1993) (citing examples); *see also* Rudolph B. Schlesinger et al., Comparative Law: Cases-Text-Materials 352-54 (5th ed. 1988).

298. *See* Smit, *supra* note 296, at 59.

299. *See* Ebke, *supra* note 144, at 687, 704-05.

300. *See* Toronto Exchange Report, *supra* note 291, at 44-46.

301. *See* Smit, *supra* note 296, at 59 ("[A] foreign forum may be selected because it has no jury in civil cases . . . .").

302. *Cf.* Ebke, *supra* note 144, at 688-89.

And a judge or judges in the foreign court will not have the same discretion to award damages for egregious conduct as a jury in the United States, because punitive damages are almost never available in accountant liability cases in foreign courts.[303] Indeed, outside the United States punitive damages are frowned upon and, in some nations, explicitly against public policy.[304] In a recent case, the German Supreme Court would not even enforce the punitive damage component of a United States judgment.[305]

All of these aspects of foreign law and procedure can make foreign prosecution of investor claims against a United States accounting firm exceedingly difficult. Such an investor cannot enjoy the benefit of class action representative status; he cannot finance the litigation through a contingent fee; he cannot look forward to a run-away jury award; he has no realistic hope of punitive damages; and, if he loses, he may find himself having to pay not only his own costs but the costs of the defendant accounting firm. It is small wonder that the Toronto

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303. *See* Smit, *supra* note 296, at 59.

304. *See generally* Hans Stoll, *Consequences of Liability: Remedies, in* 11 International Encyclopedia of Comparative Law, Torts §§ 8-107 to -116 (André Tunc ed., 1983) (comparing the role of "exemplary damages" in English and American law, as well as in other countries' legal systems). In discussing punitive damages under English law, for example, one commentator has observed:

> In ENGLAND exemplary damages have never played the same role as in the UNITED STATES. Recently the House of Lords sharply curtailed the whole institution in the case of *Rookes v. Barnard* .... In this case *Lord Devlin* observed at the outset that the House of Lords had never approved an award of exemplary damages. However, in *Lord Devlin's* view, this legal institution could not be completely abandoned in light of the fact that it had been theretofore employed by the courts and recognized in various statutes. Yet he emphasized that, except for the cases governed by statute, exemplary damages should be awarded only in two special situations. The first involves arbitrary excess of state authority. Depending upon the circumstances, it may be proper to give the particular state official a reminder in the form of exemplary damages. The second situation concerns a wrongdoer's willingness to assume the risk of liability in view of the prospect of benefits exceeding the loss. In this case the award should be assessed so as to foil the tortfeasor's calculation. Finally, the severe remedy of exemplary damages, in any event, should be invoked only if the award of compensatory damages does not adequately sanction the tortfeasor's misdeed.
>
> It appears that these limitations imposed by ENGLISH law reduce exemplary damages to virtual insignificance.

Id. § 8-112 (citation omitted) (footnote omitted); *see also* Lowenfeld, The Quest for Reasonableness, *supra* note 274, at 187-89 (comparing the American tradition of awarding civil punitive damages to German law's refusal to do so).

305. *See* G.D.S. v. E.S., 118 BGHZ 312, 312-13 (Bundesgerichshof 1X Civ. Sen. 4 June 1992) (translation: "A United States judgment of punitive damages in a not-inconsiderable amount that is granted along with an award of damages for material and immaterial injury cannot, in Germany in the regular course, be declared enforceable."); *see also* Lowenfeld, The Quest for Reasonableness, *supra* note 274, at 187 (discussing the *G.D.S.* decision and its merits in light of other alternatives); Harald Koch & Joachim Zekoll, *Zweimal amerikanische 'punitive damages' vor deutschen Gerichten*, IPRax, No. 5, 288 (1993) (discussing the treatment of American courts' awards of punitive damages in German enforcement actions).

Stock Exchange concluded that "a statutory provision for civil liability for misleading continuous disclosure would have little effect without provision for class actions."[306]

None of this, it bears mention, is fixed in stone. If anything, there may be an awareness on the part of commercially-developed nations that, with all its problems, United States class action and other pro-investor legal mechanisms enhance the quality of disclosure and thereby the efficiency of United States capital markets.[307] It is possible, therefore, that commercially-developed nations will show an increased willingness to consider such possibilities as class actions and contingent fees. Still, the disadvantages of the United States approach are plain for all to see. While recognizing the potential benefits of class action litigation, the Toronto study, for example, is keenly sensitive to the need to make sure that any such procedures adopted in Canada "are sufficiently different from those in the United States that there is no practical risk that the establishment of statutory civil liability in Canada will give rise to 'strike suit' litigation in Canada."[308]

E. *The Substantive Claim in Foreign Courts*

There is no treaty to which the United States is a party that would determine the substantive elements of a claim against an accounting firm for a failure to adhere to professional standards. That is not to say that treaties regarding the liability of accountants have not been attempted. The European Economic Community ("EEC"), for example, in 1972 issued a draft directive that would have provided some uniform standards applicable to accountant litigation.[309] That effort, however, failed. The present consensus in Europe seems to be that the laws of the member nations, rather than EEC law, should establish the standards pursuant to which liability upon accountants should be imposed.[310]

As to the standards of liability themselves, even without a treaty they tend to be fairly consistent, both with each other and with standards in the United States. They typically can be expected to involve a breach of the standard of professional care (either through negligence, gross negligence, recklessness, or by intent) resulting in a false statement upon which someone justifiably relies thereby suffering

306. Toronto Exchange Report, *supra* note 291, at 44. *See generally* Ebke, *supra* note 144, at 687-89, 704-05 (comparing accountant liability in the United States to that in Germany).

307. *See* Toronto Exchange Report, *supra* note 291, at 21-22.

308. *Id.* at iv.

309. *See* 1972 O.J. (C 131) 49; 1 Common Mkt. Rep. (CCH) ¶ 1401 (1983).

310. *See* 1983 O.J. (C 240) 2, *discussed in* Ebke, *supra* note 144, at 666-67. *See generally* Werner F. Ebke & Dirk Struckmeier, The Civil Liability of Corporate Auditors: An International Perspective 25-26 (1994) (describing the failed attempts to unify the laws regarding accountant liability in the European Union).

harm.[311] Not all nations go as far as the United States in allowing recovery from an accountant based on mere negligence. Thus, Germany, for example—which "has probably the most conservative body of law in this regard"—appears to limit accountant liability to instances of either intentional misconduct or gross negligence.[312] Still, the basic elements are the same.

An issue that tends to bedevil the commercially-developed nations, just as it does the United States, is the class of potential plaintiffs that should be permitted to file a claim.[313] Somewhat surprisingly, given the less litigious nature of non-U.S. societies, some commercially-developed countries (e.g., France, Italy, Switzerland) ostensibly apply a "foreseeability" rule—the rule that permits any foreseeable user of the financial information to sue.[314] This is more liberal than the rule generally followed in the United States, where either the conservative *Ultramares* rule[315] or the middle-ground "limited group" rule of the Restatement[316] are the overwhelming favorites.[317] In the United States, the foreseeability rule now applies in only two states.[318]

The broader acceptance of the foreseeability rule outside the United States may not, however, reflect a more expansive view of an accountant's responsibility as much as the fact that other nations, owing to the procedural impediments to a claim discussed above, have had much less experience with run-away accountants' litigation than the United States. That lack of experience is important, because it is a

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311. Ebke, *supra* note 144, at 665-66.

312. Ebke & Struckmeier, *supra* note 310, at 27-29, 39.

313. A German scholar has observed:

> The question of accountants' liability to third parties is now a favorite subject in the law of both common law and civil law countries. The United States has perhaps the most advanced body of law in this area. The development of the law in other English-speaking jurisdictions, such as England, Canada, Australia, New Zealand, and South Africa, has been, however, by no means less vital. In Japan, too, there is considerable discussion of the subject. In Western Europe, the law of the independent auditor's liability to third parties is currently in an evolving and experimental phase. The law in some countries, such as the Federal Republic of Germany, allows recovery only if the auditor acted with the intent to mislead the third person. However, the law of other countries, such as France, Italy, the Netherlands, and Switzerland, is, at least as far as substantive rules are concerned, more favorable to the injured third party, although the number of cases that have been tried under these laws is very small.

Ebke, *supra* note 144, at 665-66 (footnotes omitted).

314. *See* Ebke & Struckmeier, *supra* note 310, at 29-31; Ebke, *supra* note 144, at 666. *But see* Caparo Indus. PLC v. Dickman, [1990] 2 W.L.R. 358, 1 All E.R. 568 (appeal taken from Q.B.) (refusing to impose liability on accountants unless plaintiff could prove accountants knew of the plaintiff and its reliance for a specific purpose).

315. *See* Ultramares Corp. v. Touche, 174 N.E. 441 (N.Y. 1931).

316. Torts Restatement, *supra* note 34, § 552(1).

317. These different rules regarding who may sue are discussed *supra* part II.C.

318. *See* Touche Ross & Co. v. Commercial Union Ins. Co., 514 So. 2d 315, 318-24 (Miss. 1987); Citizens State Bank v. Timm, Schmidt & Co., 335 N.W.2d 361, 366 (Wis. 1983).

natural inclination of courts in fashioning the rules of professional liability to borrow concepts (such as foreseeability) from the personal injury area in which tort law has its roots. It takes substantial experience with accountant liability claims (or at least heroic foresight) to recognize that, in the area of accountants' liability, a foreseeability standard simply does not work. The ostensible acceptance of a foreseeability standard may simply reflect that non-U.S. courts are somewhat behind in the learning (or at least experience) curve.

The issue of precisely who may sue an accounting firm is worthy of attention in the context of Internet-disseminated financial information[319] because United States courts, in essentially exempting disseminators of information over the public media from liability for negligence, have relied upon the Restatement's middle-ground rule to conclude that users of the public media are not part of a "limited group" and therefore are not entitled to state a claim.[320] It is not clear that that rationale would hold up where a court were seriously committed to the foreseeability standard. Somewhat ominously, German courts—though generally conservative as to accountant liability—have shown an inclination to impose non-fraud liability on rating agencies, such as Moody's and Standard & Poor's.[321] That is an imposition of liability with which United States courts, with their strong tradition of protecting the First Amendment freedom of speech, would probably disagree.[322]

Exactly how far foreign courts might go in permitting claims based upon Internet-disseminated financial information is difficult to discern, at least based on the law as presently developed, simply because the law outside the United States has not developed very far. In Japan, Spain, and Sweden, for example, there are virtually no cases that come anywhere close to the area. Even in those nations where courts have addressed the issue, moreover, the resulting rule is not always clear.[323] In England, the High Court of Justice has recently issued a decision permitting Lloyd's "names" to sue Ernst & Young, thereby

319. *See* discussion *supra* parts I.B-C.

320. *See, e.g.*, First Equity Corp. v. Standard & Poor's Corp., 670 F. Supp. 115, 117-18 (S.D.N.Y. 1987), *aff'd*, 869 F.2d 175 (2d Cir. 1989) (discussed *supra* part I.C).

321. Carsten Thomas Ebenroth & Thomas Daum, *Die rechtlichen Aspekte des Ratings von Emittenten und Emissionen*, 5 Wertpapier-Mitteilungen (Oct. 1992).

322. *See* First Equity Corp. v. Standard & Poor's, 869 F.2d 175, 178 (2d Cir. 1989) ("[T]he First Amendment require[s] appellants to demonstrate that [Standard & Poor's] had published the allegedly false summary [with malice] . . . ."). *See generally* discussion *supra* part I.E. The SEC, in contrast, would probably feel more at home in Germany. The recent tidal wave of investor information onto the Internet may be causing the SEC to take a harder look at those whose media status has historically resulted in First Amendment protection. *See* Taylor, *supra* note 20, at C14 ("[T]he SEC has filed many media-related cases lately, including at least one newsletter case, a radio case and five involving the Internet . . . .").

323. *See* Ebke & Struckmeier, *supra* note 310, at 26 ("The law of the member states of the European Union concerning the independent auditors' liability to third parties is still in an evolving and experimental phase.").

throwing into uncertainty what was previously viewed as a fairly conservative body of law.[324] The decision itself is not a model of clarity. It runs for more than 400 pages.[325]

It is important, though, not to lose sight of the procedural impediments to prosecution of an accountant liability claim, which would apply every bit as much to a claim premised on foreseeability as to a claim premised on a stricter standard. In France and Switzerland, both of which appear to apply a foreseeability standard, one article has thus observed that "the procedural difficulties to demonstrate and prove the necessary elements of a liability action against an auditor and the financial risk of bringing a law suit seem to have shielded auditors from litigation on a large scale."[326] It is the procedural impediments, more than the substantive claim, that distinguish foreign accountant liability litigation from its United States counterpart.

In the end, it may be that the relative lack of litigiousness outside the United States, accompanied by a more conservative approach to accountant liability generally, would lead foreign courts to reject a standard of liability, which, in essence, would make accountants potentially liable to an indeterminate class of Internet users. That may particularly be the case if the United States, with its long history of expansive accountant liability, itself draws a line in the sand that even United States courts are not prepared to cross.

F. *Enforcement of a Foreign Judgment*

It is not enough for a foreign plaintiff, seeking to recover investment or credit losses, to obtain a judgment against a United States accounting firm in a foreign court. That judgment, if it is to do the foreign plaintiff any good, must then be enforced. To the extent enforcement seeks assets located in the United States, the foreign plaintiff will ordinarily have to resort to a proceeding in United States courts.

Thus it happens that the United States judicial system will frequently play a critical role even in cases adjudicated entirely outside of the United States. A question immediately leaps to mind: If the accounting firm loses in a foreign court, will it get a second opportu-

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324. *See* Henderson v. Merrett Syndicates Ltd., 1992 Folio 1496 (Oct. 31, 1995). *Compare* Caparo Indus. PLC v. Dickman, [1990] 2 W.L.R. 358, 1 All E.R. 568 (appeal taken from Q.B.) (judgment by Lord Jauncey of Tullichettle) ("[F]oreseeability of likely harm is not in itself a sufficient test of liability in negligence."); James McNaughton Papers Group Ltd. v. Hicks Anderson & Co., [1991] 2 W.L.R. 641, 1 All E.R. 134 (C.A.) (following *Caparo* reasoning) *and* Morgan Crucible Co. PLC v. Hill Samuel Bank Ltd., [1991] 2 W.L.R. 655, 1 All E.R. 148 (C.A. 1990) (same). *See generally* Ebke & Struckmeier, *supra* note 310, at 17-19 (discussing, prior to *Henderson*, the *Caparo* ruling and its implications).

325. *See Henderson*, 1992 Folio 1496.

326. Ebke & Struckmeier, *supra* note 310, at 31.

nity to present its defense when the foreign plaintiff seeks to enforce the foreign judgment in a court in the United States?

The answer is: probably not. In the United States, foreign judgments are enforced as a matter of course. While Congress has not exercised its power to facilitate the recognition and enforcement of foreign court judgments, many states (such as New York) have adopted the Uniform Foreign Money-Judgments Recognition Act,[327] which specifically recognizes the validity of foreign judgments and makes available to foreign plaintiffs streamlined procedures to see that justice, as determined by the foreign court, is swiftly carried out.[328] In New York, for example, enforcement of a foreign judgment may be sought by filing a motion for summary judgment in lieu of a complaint.[329]

But it is not always so easy. The Uniform Foreign Money-Judgments Recognition Act calls into question the enforceability of a foreign judgment that was obtained under circumstances potentially violative of fundamental notions of fair play and justice.[330] For example, New York law calls into question a foreign judgment: where the judgment was rendered under a system that does not provide "tribunals or procedures compatible with the requirements of due process"; where the foreign court "did not have personal jurisdiction over the defendant"; where the foreign court "did not have jurisdiction over the subject matter"; where the defendant "did not receive notice"; where the judgment was "obtained by fraud"; or where the underlying cause of action "is repugnant to the public policy of this state."[331]

Five years ago, the potential significance of these protections was vividly illustrated in *Bachchan v. India Abroad Publications, Inc.*[332] In that case, a lower New York state court declined to enforce a judgment entered by an English court in a libel action brought by an Indian national against the New York operator of a news service.[333] The

327. 13 U.L.A. 265 (1986); *see also* N.Y. Civ. Prac. L. & R. §§ 5301-5309 (McKinney 1995) (sections spanning Article 53 of New York's Civil Practice Law and Rules, entitled "Recognition of Foreign Country Money Judgments"). *See generally* 6 Jack B. Weinstein et al., New York Civil Practice: CPLR 53-1 to -34 (1996) (discussing N.Y. Civ. Prac. L. & R. Article 53).

328. *See generally* Briane N. Mitchell, *Foreign Judgments*, Litig., Summer 1996, at 43 (discussing the uniform act along with related issues of jurisdiction and public policy defenses).

329. N.Y. Civ. Prac. L. & R. § 5303 (McKinney 1995).

330. *See* Weinstein et al., *supra* note 327, at 53-17 to -22 (discussing New York's application of this requirement); *see also* Mitchell, *supra* note 328, at 44-45 (discussing the high standard required to invalidate a foreign judgment on the basis of proceedings that might implicate due process concerns).

331. N.Y. Civ. Prac. L. & R. § 5304 (McKinney 1995). *See generally* Mitchell, *supra* note 328, at 44-45 (providing examples where due process implications factored into the decision of whether to disregard a foreign judgment, and concluding that only in rare instances will such arguments prevail).

332. 585 N.Y.S.2d 661 (N.Y. Sup. Ct. 1992).

333. *Id.*

court refused to enforce the judgment based on key differences between the libel law of the United States and the libel law of England, the latter of which, the court found, did not provide free speech protections adequate under the First Amendment of the United States Constitution.[334] The court stated:

> [I]f, as claimed by defendant, the public policy to which the foreign judgment is repugnant is embodied in the First Amendment to the United States Constitution or the free speech guaranty of the Constitution of this State, the refusal to recognize the judgment should be, and it is deemed to be, "constitutionally mandatory."[335]

The court based its decision upon the provisions of New York procedural law that may preclude recognition of a foreign judgment if the procedures employed were not "compatible with the requirements of due process of law" or if the underlying cause of action "is repugnant to the public policy of this state."[336]

This New York decision is not irrelevant to foreign liability arising out of Internet-disseminated financial information, insofar as an underlying principle in fashioning liability in the United States may be the applicability of First Amendment protection.[337] It is conceivable, therefore, that a foreign judgment premised on misrepresentation claims more lenient than under United States law would be of questionable enforceability in United States courts.

While that is conceivable, however, it does not seem terribly likely. As a matter of international law, the *Bachchan* decision has been described as possessing "serious flaws."[338] And, in fact, an argument can be made that the case was wrongly decided. While that view is not universal, it is demonstrably true that the *Bachchan* case involved facts that were nothing short of compelling—a claim by a foreign national against a United States news operator that directly invaded the core of First Amendment protections. The enforcement of a judgment against an accounting firm based on the international dissemination of false financial information is less likely to be perceived as invading the core of the freedom of speech.[339]

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334. *Id.* at 665.
335. *Id.* at 662.
336. *Id.*; *see* N.Y. Civ. Prac. L. & R. § 5304 (McKinney 1995).
337. *See* Daniel v. Dow Jones & Co., 520 N.Y.S.2d 334 (Civ. Ct. 1987) (discussed *supra* part I.E).
338. Jeremy Maltby, *Juggling Comity and Self-Government: The Enforcement of Foreign Libel Judgments in U.S. Courts*, 94 Colum. L. Rev. 1978, 1981-82 (1994).
339. *See generally* Charles Platto & William G. Horton, Enforcement of Foreign Judgments Worldwide (2d ed. 1993) (setting forth the requirements for enforcing a foreign judgment in more than 35 jurisdictions around the world).

G. *Arbitration Agreements, Forum Selection Clauses, and Other Contractual Means to Control Risk*

As in the United States, those uncomfortable with the uncertainty inherent in international litigation may desire to minimize that uncertainty through contract. In particular, the uncertainty of international litigation can be mitigated through arbitration agreements, forum selection clauses, and contractual provisions that operate to place parameters on available damages in the event of a dispute.[340]

Probably among the most desirable means of mitigating the uncertainty of international disputes is the inclusion in international contracts of an arbitration clause. A well-drafted international arbitration clause will typically provide for the place of arbitration, the subjects to be arbitrated, the manner of selecting the arbitrators, the administering institution,[341] the rules under which the arbitration is to be governed, and the nation's law to be applicable to the dispute.[342]

Such an arbitration clause has many benefits. One is that, in virtually all commercially-developed nations, arbitral awards are "easy to enforce."[343] Indeed, as of August 1992, some eighty-nine nations, including nearly all major commercial nations, had become parties to the so-called "New York Convention," the fundamental purpose of which was to make arbitral awards enforceable among citizens of nations that are parties to the convention.[344] Another benefit to an arbitration clause is that it makes the law applicable to any dispute a

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340. *See generally* Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 615 (1985) ("The mere appearance of an antitrust dispute does not alone warrant invalidation of the selected forum on the undemonstrated assumption that the arbitration clause is tainted."); Scherk v. Alberto-Culver Co., 417 U.S. 506, 519-20 (1974) ("For all these reasons we hold that the agreement of the parties in this case to arbitrate any dispute arising out of their international commercial transaction is to be respected and enforced by the federal courts in accord with the explicit provisions of the Arbitration Act."); Bremen v. Zapata Off-Shore Co., 407 U.S. 1, 15 (1972) ("Thus, in the light of present-day commercial realities and expanding international trade we conclude that the forum clause should control absent a strong showing that it should be set aside."); Lowenfeld, International Arbitration, *supra* note 270, at 281-367.

341. Most international commercial arbitrations . . . are conducted under the auspices of institutions that are either devoted entirely to arbitration and related means of dispute settlement, such as the London Court of International Arbitration (LCIA) and the American Arbitration Association (AAA), or have arbitration as one of their important functions, such as the International Chamber of Commerce (ICC) or the Stockholm Chamber of Commerce.

Lowenfeld, International Arbitration, *supra* note 270, at 333.

342. *Id.* at 282.

343. *Id.* at 332. An important qualification is that a country may have "the right to refuse enforcement of an award where the 'recognition or enforcement of the award would be contrary to the public policy of that country.'" *Mitsubishi Motors Corp.*, 473 U.S. at 638 (quoting the Convention on the Recognition and Enforcement of Foreign Arbitral Awards, Art. V(2)(b), 21 U.S.T. 2517, 2520).

344. Lowenfeld, International Arbitration, *supra* note 270, at 343-44; *see also* David W. Rivkin, *Avoiding the Uncertainty of Foreign Courts*, CCM Am. Law. Corp. Couns. Mag., Aug. 1996, at 52A, 53A ("Arbitration awards are final and binding, and, under

virtual certainty. "If the agreement to arbitrate contains a choice-of-law clause, it is virtually always followed."[345]

To the extent a judicial resolution is desired, an alternative to an arbitration clause is a clause selecting the forum in which any dispute will be litigated. A typical forum selection clause might provide that "all (or specified) disputes arising out of or related to this agreement shall be resolved in the High Court of Justice in London" or "in the Supreme Court of New York County" or in some other named forum.[346] Such a clause has two effects. First, it constitutes consent by each party to be sued in the chosen forum.[347] Second, it deprives courts that would otherwise have jurisdiction over the parties and the controversy of jurisdiction to hear the case.[348]

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the New York Convention, it is exceedingly difficult to set aside an arbitration award.").

345. Lowenfeld, International Arbitration, *supra* note 270, at 338.

346. *Id.* at 281.

347. *Id.*

348. *Id.*; *see, e.g.*, Bremen v. Zapata Off-Shore Co., 407 U.S. 1, 15 (1972) ("[W]e conclude that the forum clause should control absent a strong showing that it should be set aside."); Unterweser Reederei G.M.B.H. v. Zapata Off-Shore Co., [1968] 2 Lloyd's Rep. 158 (C.A.) ("It is always open to parties to stipulate . . . that a particular Court shall have jurisdiction over any dispute arising out of their contract.").

The level of certainty normally associated with choice-of-law and choice-of-forum clauses in international agreements was recently thrown into some level of chaos due to a Virginia district court's decision, in the context of a proposed settlement involving Lloyd's of London, that an agreement providing for British courts and British law was unenforceable. Allen v. Lloyd's of London, No. CIV. A. 3:96CV522, 1996 WL 490177, at *22-26 (E.D. Va.), *rev'd*, 94 F.3d 923 (4th Cir. 1996).

In a brief order, the Fourth Circuit reversed. The circuit court stated: "[T]he court's decision rests on its determination, to be articulated in a later opinion, that the contractual provisions among the parties selecting the law of and a forum in the United Kingdom should be enforced . . . ." Allen v. Lloyd's of London, 94 F.3d 923, 926 (4th Cir. 1996). The Fourth Circuit remanded the case to the district court with instructions to dismiss. *Id. See generally* Rachel Witmer, *Reversal of Injunction Removes Threat to Lloyd's Reorganization, Lloyd's Says*, 28 Sec. Reg. & L. Rep. (BNA) 1060-61 (Aug. 30, 1996) (discussing the *Allen* decision); John J. Fialka, *SEC Claims Parts of Lloyd's Pact Violate Securities Laws of the U.S.*, Wall St. J., Aug. 13, 1996, at B7 (describing the *Allen* controversy generally, including the dispute over the exclusive jurisdiction provision).

Subsequently, a fractured three-judge panel in the Ninth Circuit, in a different case involving Lloyd's, held that choice-of-law and choice-of-forum provisions would not be given effect insofar as they would operate as an improper waiver of the protection of the United States securities laws. The court stated: "The Securities Acts' antiwaiver provisions themselves render the Choice Clauses void, making it unnecessary to examine whether enforcement of the clauses would be reasonable . . . ." Richards v. Lloyd's of London, Nos. 95-55747, 95-56467, 1997 WL 94054, at *7 (9th Cir. Mar. 6, 1997). While conceding that its holding would likely cause Lloyd's to be "more circumspect in raising capital in the United States," the court explained that it did "not believe that we should turn the clock back to 1929 or introduce caveat emptor as the rule governing the solicitation in the United States of investments in securities by residents of the United States." *Id.* at *8.

In a strongly-worded dissent, one member of the Ninth Circuit panel asserted "[t]he same reasoning would bring protections under our securities laws to anyone who loses his or her savings betting on chicken fights in Zamboanga." *Id.* at *10 (Goodwin, J., Where a forum selection clause is desired, though, the parties to the contract need be careful. Though forum selection clauses are generally enforceable as a matter of international law, the law of the forum selected may be resistant to the acceptance of jurisdiction absent some level of contact between that forum and either the parties or the underlying dispute.[349] Before a particular forum is selected, therefore, its law as to the acceptance of jurisdiction over international disputes needs to be investigated.

Finally, aside from arbitration or forum selection clauses, parties to a contract may agree to reasonable limitations upon their obligations and damages. As in the United States, such provisions will generally be enforced in foreign courts.[350]

H. *So It Is Not So Bad*

Though the prospect of potential liability in more than 185 separate nations may seem somewhat daunting, the reality is that, owing largely to the procedural constraints placed upon litigation in foreign courts, the overall risk of substantial losses may be less than the analogous risk in the United States.[351] That is an irony, of course, that is not likely to be lost on international litigants.

For that reason, it is entirely possible that a United States accounting firm transmitting financial information throughout the world may never have to experience litigation in foreign courts at all. It is entirely possible that foreign litigants, considering the procedural and

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concurring and dissenting). Pointing out that the "implications of this holding on international business transactions are not likely to lubricate commerce," the dissent concluded that the majority's holding was "strange, and troubling." *Id.* at *11.

According to one press report, Lloyd's intends to seek a rehearing before the full Ninth Circuit. *See* John J. Fialka, *Appeals Court Rules Americans Can Sue Lloyd's of London in U.S.*, Wall St. J., Mar. 10, 1997, at B9.

349. *See* Lowenfeld, International Arbitration, *supra* note 270, at 281-82.

350. *See generally* Domke on Commercial Arbitration, § 44:01 (Gabriel M. Wilner ed., 3d ed. 1995 & Supp. 1996) (discussing arbitration agreements for international transactions, noting that "[o]ther matters that, depending on the circumstances, might usefully be indicated in the arbitration clause include . . . possible acceptable remedies such as liquidated damages"). *But cf.* St. Luke's Hosp. v. SMC Computer Sys., Inc., Nos. 92-1205, 92-1206, 1993 WL 188457, at *10 (6th Cir. June 1, 1993) ("There is no doubt that an arbitrator, if he so decides, may indeed refuse to enforce such a damage limitation clause on the ground of unconscionability or on other grounds . . . .").

351. As one scholar on international litigation has said:

> For a variety of reasons, an American forum has proven to be especially attractive to foreign litigants. Among the factors that have attracted foreign litigants are contingency fee arrangements that are largely forbidden abroad, strict liability rules, the ability to obtain punitive damages which are generally not provided for abroad, the possibility of having a jury, broad pre-trial discovery, and the rule that unlike the rule prevailing abroad, a loser need not pay the attorney's fees of its opponent. Conversely, a foreign forum may be selected because it has no jury in civil cases, there is no pre-pre-trial discovery, and the losing party must pay its opponent's attorney's fees.

Smit, *supra* note 296, at 59.

substantive issues discussed above, will elect to file their claims in the United States.

Conclusion

In the new century of financial reporting, both lawyers and accountants may be fairly busy. Those structuring financial reporting relationships will find themselves grappling with new principles of law to be fashioned in technological contexts in which precedent is adaptable only with the exercise of considerable intellectual effort. Litigators will face a particular challenge in presenting to courts not only the intricacies of innovative financial reporting systems, but the need for the court to think through the business and economic implications of each new decision.

In this new world, everyone will need to keep a careful watch. It is critical to innovation in financial reporting that the rules of liability be driven not by the desire to spread risk, the availability of insurance, or sympathies for a particular plaintiff—but by a realistic system of liability in which wrongdoers are held accountable, but financial reporting systems are free to evolve. Experience has taught that unsophisticated courts can give rise to short-sighted liability determinations that send the law careening in particularly unfortunate directions, incapable of being yanked back for years or even decades to come. It is far better to set the law out on the correct path at the outset.

The next century of financial reporting, therefore, will ask much of both the accounting and the legal professions. There is every reason to believe that both are up to the challenge.