PRESERVING THE PRIVITY DEFENSE

April 8, 2010

Practices & Industries

Accountants Liability & Regulatory

When accountants conduct a financial statement audit, they undertake a duty to the party that has contracted for their services to exercise due care in the performance of the engagement. In New York State, even in the absence of a direct contractual relationship (the direct contractual relationship is known as privity of contract), accountants may also incur liability to injured third parties, such as lenders, trade creditors, and investors who rely on their work. Courts, however, have sought to circumscribe the instances in which an accountant may be liable to a third party with whom they are not in privity of contract.

A long line of New York Court of Appeals decisions has sought to refine the concept of privity and define the parameters of an accountant's liability to non-clients. In the Court of Appeals' seminal decision in *Ultamares Corporation v. Touche*, the court, through Chief Judge Benjamin Cardozo, declared that before a third party to a professional services contract may sue for negligence, he or she must first establish a contractual relationship with the professional or a relationship "so close as to approach that of privity" of contract. This strict limitation on the class of potential plaintiffs represents a policy determination by the New York courts that accountants should not be exposed to claims by all who could conceivably rely on the financial statement in question and thereby become exposed to "liability for an indeterminate amount for an indeterminate time to an indeterminate class."

Since the *Ultramares* decision, the court has sought to clarify when an accountant's relationship with a third party "approaches privity." In *Credit Alliance Corp. v. Arthur Andersen & Co.*, the court formulated a three-part test that sets forth the criteria for determining when a privity relationship exists between
a third party and an accountant. Under this test, the third party must establish:

- That the professional was aware his or her representationswere to be used for a "particular purpose or purposes,"
- That the professional "intended" for the representations to be relied upon by a "known party," and
- That the professional engaged in conduct "linking" him or her to the intended "known party," which evinces the professional's understanding of the known party's reliance.

Crucial to a determination of privity is this third prong of the test, which raises the question of the nature and extent of the "conduct on the part of the accountants" linking them to the third party. An understanding of the linking conduct that could create a privity relationship is, therefore, essential to preserving the privity defense.

In *Credit Alliance*, an accountant was found not liable to a non-privity plaintiff that had loaned money to the accountant's client in reliance on the accountant's erroneous audit report, which had been provided to it by the client. Even though the accountant was alleged to have had actual or constructive knowledge that the client showed the report to the lender to induce the loan, the court held that the linking conduct necessary to establish privity requires action by the professional "directed to plaintiffs." Since there was no allegation that the accountants had any "direct communications" or other direct dealings with the plaintiff, the linking conduct required by the third element of the *Credit Alliance* test was lacking.

By contrast, in the companion case *European American Bank and Trust Co. v. Strauhs & Kaye*, the accountant and the client's lender were in direct contact with respect to the client's affairs over a substantial period of time. They met for the purpose of discussing the client's financial condition, and the accountant made repeated in-person representations during these meetings about the value of the client's assets. The accountant was allegedly aware that the lender was relying on the accountant's audit in valuing the collateral for its loans and in otherwise assessing the financial status of the accountant's client. On these facts, the court held that the relationship between the parties was the practical equivalent of privity under the three part *Credit Alliance* test.

However, where direct contact between the accountant and the plaintiff has only been minimal, a third party cannot recover for negligence. In *Security Pacific v. Peat Marwick*, for example, during a telephone call from an officer of the third party who was lending money to the accountant's client, the accountant confirmed that the audit report was correct, that the income figures in the draft report would be the same as in the final report, and that the opinion would be unqualified. The court, nevertheless, noted that even though the accountant may have been aware of the lender's reliance, the only linking conduct was a single telephone conversation between the accountant and the lender, initiated by the lender, in which the lender announced its intended reliance and made certain inquiries regarding the audit then in progress. As a result, the court found this contact insufficient to establish liability, reasoning that the plaintiff could not, with one phone call, establish privity and thereby "create an extraordinary obligation" on the accountant's part.

Similarly, in its latest opinion concerning the linking conduct requirement, the court, in *SIPC v. BDO Seidman*, held that there was no linking conduct that put the accountant in a privity relationship with the third party since the "audits were not prepared for the specific benefit of" the non-client and "were not sent to the non-client." Therefore, the court reasoned, the third party was not in a relationship significantly different from anyone else in the investing public at large.

As can be seen from the foregoing, third parties may attempt to overcome the privity defense and establish the necessary link with an accountant through a wide variety of contacts, including telephone calls, letters, or both. Some have adopted procedures whereby they notify accountants that they intend to rely on the accountant's report and ask the accountant to acknowledge in writing their awareness of the intended reliance. Moreover, clients may attempt to pressure an accounting firm to respond to inquiries by third parties to facilitate the clients' credit or other transactions.

In response to these efforts to create a privity relationship, a few basic principles ought to be followed in order to preserve the privity defense. As a general matter, direct contact between the accountant and the plaintiff should be avoided, whether by telephone, face-to-face meetings, e-mails, letters, or other types communication between the parties. The accountant should also avoid sending or providing financial statements directly to third parties or sharing other documents.

Nevertheless, an accountant's decision regarding whether and how to respond to inquiries or otherwise involve itself in circumstances that may cause a loss of the privity defense may implicate business considerations, including client relations. On the other hand, if the risk of exposure to potential liability exceeds the rewards of continuing a particular engagement, an accounting firm may determine to resign the engagement. In the event, however, that an accounting firm determines that it does wish to communicate directly with the third party, careful consideration should be given to the nature of the communication, including whether the communication will be deemed to satisfy the *Credit Alliance* privity criteria. Finally, given the potential significance of the loss of the privity defense, an accounting firm may wish to consult with legal counsel to discuss an appropriate response under the particular circumstances.