A BRIEF PRIMER ON SUING AUDITORS
2ND EDITION
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Forward to 2nd Edition

Since our first edition of this Brief Primer in 2018, the American Law Institute has published the Third Restatement of the Law, Torts: Liability for Economic Harm (2020), which supersedes the 1977 Second Edition and clears up a significant amount of the potential confusion on the law of suing auditors.

Most states expressly or implicitly follow the Second Restatement, and we think the majority of jurisdictions will eventually adopt the Third Restatement, which is generally more helpful to the plaintiff suing an auditor for economic loss caused by negligent misrepresentation.

There are not a lot of published cases of sureties suing auditors for negligent misrepresentation, perhaps because of a range of factors, including:

1. difficulties of determining whether the auditor made a material misrepresentation that caused the surety to suffer legal damages;
2. time gap between the date of the audit and the damages caused to the surety (which can sometimes be several years);
3. mistaken belief of some states that the statute of limitations starts running from the date of the audit report;
4. lack of surety inhouse personnel to determine that the underwriters were misled by the audit of the prospective principal; and
5. reluctance of sureties to spend the time and the money to obtain outside help from counsel and experts to determine whether a plausible claim for negligent misrepresentation exists (but often this is extremely well-spent time and money, as there is a significant potential recovery from the accounting firm or generally its insurance company).

The authors believe that many cases of misrepresentation committed by auditors to the detriment of sureties exist — particularly in instances where the auditors also serve as “consultants” and financial advisors for the principal — but that few of these cases ever reach the litigation stages. This area presents a very valuable but often under-explored opportunity for salvage recovery by sureties when financial realities of principals deviate from the financial pictures portrayed to the underwriters.

I. Executive Summary

When there is a large insurance policy or a large financial ability of the accounting firm to pay up, one can pose a rhetorical question – should accountants who audit books and records of a contractor be held accountable? Accountable – subject to the obligation to report, explain, or justify something; responsible; answerable. The pragmatic answer to surety professionals is easy – yes, why not? The complications are with privity. The contract is between the contractor and the CPA firm. The surety is a third party relying upon the professional work of the auditor. Starting with Judge Cardozo, the courts, fearing a slippery slope and concern about common law exercise of power in the tort arena over accountants, decided to not impose a duty on the accountants. But of course, the very purpose of the audit is to present that work product to third parties who are intended to rely upon the work product. Accordingly, the courts needed to address the pragmatic reality and find a way to hold the provider of professional advice accountable. Similar developments have occurred in the area of certain work product and opinions of attorneys. Distinctions exist and need to be observed between these two professions. Accordingly, first evaluate whether a resource or case is dealing with attorneys or accountants. This accountability of auditors to a surety sounds in tort. When a cause of action sounds in tort, it carries a number of important areas of consideration that are quite different from contract considerations.

This paper will address six major issues that may be involved in a lawsuit against auditors: (1) standing of a surety to sue; (2) the statute of limitations for bringing suit (3) the nature of the false representation that must be proven; (4) the defense of "red flags" raised by the auditor; (5) purported disclaimer language in the audits; and (6) the interplay of contributory and comparative negligence principles.[1]

II. Overview of a Negligent Misrepresentation Claim

The history of the tort of negligent misrepresentation starts with Cardozo in 1922. Mark P. Gergen, *Negligent Misrepresentation as Contract*, 101 Cal. L. Rev. 953, 966 (2013) (citing *Glanzer v. Shepard*, 135 N.E. 275 (N.Y. 1922)). *Glanzer* was noteworthy because Cardozo chose not to base the decision solely on then-existing principles of contract law as the lower courts had done, but rather spoke of conduct that was "an 'act in the law' . . . intended to sway

[1] Some of the issues have broad application across jurisdictions. Others – like statute of limitations – will be focused primarily on Texas law.

cconduct . . . We state the defendants' obligation, therefore, in terms, not of contract merely, but of duty." 135 N.E. at 276-77. Nine years later, Cardozo rejected liability for an auditor in *Ultramares v. Touche* because

> [n]o one would be likely to urge there was a contractual relation, or even one approaching it, at the root of any duty that was owing from the defendants now before us to the indeterminate class of persons who, presently or in the future, might deal with the Stern Company in reliance on the audit.

174 N.E. 441 (N.Y. 1931). *Glanzer* and *Ultramares* were critical bookends in the development of the cause of action for negligent misrepresentation. To wit, the draft section on negligent misrepresentation for the Restatement of Torts in 1935 was prefaced by stating: "This Section is intended to express what the Reporter believed to be the law in New York as exhibited by the line of cases beginning with *Glanzer v. Shepard* and ending with the [sic] *Ultramares v. Touche*." RESTATEMENT OF TORTS §§ 633-36 (Preliminary Draft No. 79, 1935).

Ultramares came to be understood as requiring privity of contract in order to be able to assert a negligent misrepresentation claim against an information provider. Wise, 40 Tex. Tech L. Rev. at 848. By the 1950's, *Ultramares* was under attack in the legal community. While the Reporter's Note stated that the rewording of the Restatement was intended "to clarify meaning," debate in the American Law Institute indicates that the purpose was directly focused on expanding liability beyond the rule of *Ultramares* requiring privity. Feinman, 31 Fla. St. U.L. Rev. at 26 (citing 42 ALI Proc. 383-93 (1965)). Because of the restrictive nature of a privity requirement, courts and commentators developed a different approach and understanding of the reach of the cause of action. *See generally,* Feinman, 31 Fla. St. U.L. Rev. at 22-30. Three competing theories emerged, but time has shown that the rule favored by the majority, *Id.* at 41, was the one set forth by the American Law Institute when it "restated" the law of torts in 1977. *See* RESTATEMENT (SECOND) OF TORTS § 552 (1977).

To establish a negligent misrepresentation under Section 552, a surety must prove the following: (1) a representation made in the course of the auditor's business, or in a transaction in which it has a pecuniary interest; (2) false information supplied by the auditor for the guidance of others; (3) failure by the auditors to exercise reasonable care or competence in obtaining or communicating the information; and (4) pecuniary loss of the surety by justifiably relying on the representation. *See also Borneo Energy Sendirian Berhad v. Sustainable Power Corp.*, 646 F.Supp.2d 860, 869 (S.D. Tex. 2009).

III. Standing of a Surety to Sue

A plaintiff must have standing to bring suit. *Lujan v. Defenders of Wildlife*, 504 U.S. 555, 560 (1992). Auditors will argue that a surety does not have standing because it was not a client of the auditor, i.e., no privity. This is not correct under the law. The auditors will further argue that they did not intend for the surety to rely on the audit when issuing bonds. This argument, however, usually can be defeated through discovery.

Under Section 552 of the Restatement, "the defendant is subject to liability if he intends to supply the information to a small group of which the plaintiff is a member. He is also liable if he knows the recipient of the information he provides will pass it on to others in the limited group of people he expects would be influenced." DAN B. DOBBS, PAUL T. HAYDEN AND ELLEN M. BUBLICK, THE LAW OF TORTS § 681 (2d ed. 2014) (citing RESTATEMENT (SECOND) OF TORTS § 552(2)). A surety thus has standing to sue for negligent misrepresentation if the auditor has knowledge of: (a) the limited group of parties whose benefit the information is being supplied and (b) the purpose for which the information is being supplied. *Ervin v. Mann Frankfort Stein & Lipp CPAs, LLP*, 234 S.W.3d 172, 177 (Tex. App. – San Antonio 2007, no pet.).

In a good deal of cases, the auditor is aware of the limited group of sureties generally that would receive its audits, and in turn, use those audits to issue bonds. Most construction auditors have literature and other marketing tools that emphasize how the auditing firm can help contractors in their relationship with sureties and obtain bigger bond lines. This knowledge should be sufficient to establish standing of a surety to bring a claim. *See* RESTATEMENT (SECOND) OF TORTS § 552(2).

That said, if possible, a surety should try and establish that the auditor has more than just a general knowledge of sureties – rather, the auditor knows of the specific identity of the surety that is bringing the lawsuit. If this can be shown – and usually it will take depositions and targeted discovery – it should be more than sufficient to establish that for standing purposes the surety was a known party to the auditor. *See* Robert Wise & Heather Poole, *Negligent Misrepresentation in Texas: The Misunderstood Tort*, 40 Tex. Tech. L. Rev. 845, 873-74 (2008) (standing clearly exists if the defendant knew the misinformation would be provided to the plaintiff); Knox D. Nunnally & Ronald G. Franklin, *Texas Practice Guide Torts: Negligent Misrepresentation*, 1 Tex. Prac. Guide Torts § 2:188 (2013) (the potential plaintiff does not have to be specifically identified or even known to the defendant when the information is supplied) (citing *Willis v. Marshall*, 401 S.W.3d 689 (Tex. App.—El Paso 2013, no pet.)).

In some cases, the surety may even have standing to sue the individual auditors who performed the audit. *W. Sur. Co. v. Craine*, 2021 U.S. Dist. LEXIS 250987, **7-8 (E.D. Tenn. June 9, 2021) (denying individual accountants' motion to dismiss negligent misrepresentation claim by surety against them in their individual capacity where surety alleged that the individuals spent between 24 and 668 hours individually on the financial statements).

IV. Statute of Limitations

Statute of limitations is a very common defense for an auditor. The reason is that in many cases, a claim may seem untimely on its face given how long ago the audit may have been issued. This is to be expected in a standard case involving bonding a construction company. Often, a default does not occur – and losses are not suffered – until long after the audit is issued. Auditors often argue that the clock starts running the moment the audit is issued, which if correct, could mean a surety is time-barred. The surety usually will have to guide the Court through the intricacies of the law and explain why the key is not the issuance of the audit, but rather, the date the surety started losing money, as this is the first moment in time where the surety could have a claim.

Under Texas law, a cause of action for negligent misrepresentation must be brought "not later than two years after the day the cause of action accrues." TEX. CIV. PRAC. & REM. CODE ANN. §16.003(a) (Vernon 2002); *Milestone Properties, Inc. v. Federated Metals Corporation*, 867 S.W.2d 113, 118-19 (Tex. App.—Austin 1993). "When the legislature employs the term 'accrues' without an accompanying definition, the courts must determine when that cause of action accrues and thus when the statute of limitations commences to run." *Moreno v. Sterling Drug, Inc.*, 787 S.W. 2d 348, 351 (Tex. 1990). Such a determination by the Court "must be founded on reason and justice." *Id*. (citing *Fernandi v. Strully*, 35 N.J. 434 (1961)).

Reason and justice dictate that a cause of action does not accrue until there is "a complete and present cause of action." *Wallace v. Kato,* 249 U.S. 384, 388 (2007) (internal citations omitted). "A cause of action does not become 'complete and present' until the plaintiff can file suit and obtain relief." *Bay Area Laundry and Dry Cleaning Pension Trust Fund v. Ferbar Corp. of California, Inc.*, 522 U.S. 192, 192 (1997). To hold otherwise might bar a plaintiff's claim before the plaintiff could even sue, which is a result that is illogical on its face. Dan D. Dobbs, THE LAW OF TORTS §242 (2d ed. 2014); *see also Bay Area Laundry*, 522 U.S. at 200. In fact, the Fifth Circuit held that "[t]he accrual of a cause of action means the right to institute and maintain a suit, and whenever one person may sue another a cause of action has accrued." *In re Swift*, 129 F.3d 792, 795 (5th Cir. 1997); *see also In re Neely*, 2013 WL 3148676 (S.D. Tex. June 13, 2013).

In parsing out the law of torts, the Fifth Circuit delineated two categories: (1) torts where the act is not unlawful in and of itself, in which case accrual does not occur until there is damage; and (2) torts that are unlawful, which accrue the moment of the act. *In re Swift*, 129 F.3d at 797 (citing *Atkins v. Crosland*, 417 S.W. 150, 153 (Tex. 1967)). An illustration of the latter is when a defendant digs a trench across plaintiff's land without permission, thereby constituting trespass. In such a case, the plaintiff's cause of action accrues with the defendant's act even if there has not yet been a consequential injury. *See Stillwell v. City of Fort Worth*, 140 Tex. 560 (1943).

Negligent misrepresentation claims fall within the first category because they are not unlawful in themselves. Texas courts agree: "Because actual injury is an element of a negligence claim, an action for negligence cannot be maintained unless some damages result therefrom." *Deloitte & Touche v. Weller*, 976 S.W. 2d 212, 215 (citing *Johnson v. Sovereign Camp, W.O.W.*, 83 S.W.2d 605, 608 (Tex. 1935), *rev'd in part on other grounds, Doctors Hospital Facilities v. Fifth Court of Appeals*, 750 S.W.2d 177 (Tex. 1988)).

The Restatement agrees as well: "A cause of action for misrepresentation in a business transaction is complete when the injured person has been deprived of his property or otherwise has suffered pecuniary loss or has incurred liability as the result of the misrepresentation." RESTATEMENT (SECOND) OF TORTS §899 cmt. c (1979). Therefore, a plaintiff cannot file suit and obtain relief until it suffers economic loss. *Hardaway Co. v. Parsons, Brinckerhoff, Quade & Douglas*, 267 Ga. 424, 428 (Ga.1997) ("[plaintiff] could not successfully maintain its action until it had an action, and that required definite economic loss."); *see also Abilene Regional Medical Center v. United Indus. Workers Health and Benefits Plan*, 2007 WL 715247, at *5 n.5 (5th Cir. Mar. 6, 2007) (affirming summary judgment in favor of defendant because plaintiff failed to provide any evidence of pecuniary loss, which, in Texas, is "an element necessary to prevail on a negligent misrepresentation claim").

Commentators likewise concur that there must be damage before a negligent misrepresentation claim accrues. Brian J. Morrissey & Timothy N. Toler, *Construction Law*, 51

Mercer L. Rev. 181, 191-92 (1999) (discussing *Hardaway Co.*, *supra*); PROSSER AND KEETON, THE LAW OF TORTS §110 (5th ed. 1984) (some damages must exists before the statute begins). "Simple fear of future harm does not fit into the narrow situations where tort law has allowed recovery for negligent misrepresentations." Moin A. Yahya, *Necessity of Damages: Can I Sue Without Being Injured?*, 3 Geo. J. L. & Pub. Pol'y 83 (2005); *see also* Jill Wieber Lens, *Honest Confusion: The Purpose of Compensatory Damages in Tort and Fradulent Misrepresentations*, 59 U. Kan. L. Rev. 231, n. 211 (2011) ("If the plaintiff has no actual damages, the claim fails; the court cannot create damages where none exist."); Frank J. Cavico, *Fraudulent, Negligent, and Innocent Misrepresentation in the Employer Context: The Deceitful, Careless, and Thoughtless Employer*, 20 Campbell L. Rev. 1 (1997).

Therefore, the key for the surety is establishing its first payment under the bond(s) it issued in reliance on a particular audit. Prior to this time, the surety would have been unable to bring a cause of action against the auditors because until this date, the surety did not have the necessary element of pecuniary loss/damages.[2]

V. What False Representation Must Be Shown?

Another common defense of the auditor is that it is only offering an opinion, and as a result, it cannot be liable if a contractor fails after the audit is issued. In essence, the auditor will assert that it is not a fortune teller. A corollary of this argument is that the auditor can only be liable if the surety can show an express math error – basically, the auditor will claim that the surety must show exactly what the audit would have looked like if done correctly. Both of these arguments are invalid.

The starting point for this analysis is the actual language used in the audit. In most cases, the auditor will issue a "clean" opinion, i.e., an unqualified audit.[3] A clean opinion is the highest form of assurance an auditor can provide. In a clean opinion, the auditor usually states the following:

> We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform

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[2] A related issue outside the scope of this paper is the discovery rule. The discovery rule is a mechanism that can toll the accrual of limitations until the point where a party discovers its injury. Application of the discovery rule in a negligent misrepresentation case against an auditor is fairly complex. If you have several hours to kill, feel free to give the authors a call to discuss this in greater depth.

[3] The types of opinions that can be issued by an auditor is addressed in greater detail in the disclaimer section of this paper.

> the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. . . . . In our opinion, the consolidated financial statements [for the applicable year] present fairly, in all material respects, the financial position of [Contractor] as of [the applicable year] and the results of their operations and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

The clean, unqualified audit contained three factual assurances: (1) the audit was planned and conducted in accordance with generally accepted auditing standards ("GAAS"); (2) the financial statements of the contractor presented in the audit were in accordance with generally accepted accounting principles ("GAAP"); and (3) the financial statements of the contractor "present fairly" the financial position of the contractor as a whole. These are not mere opinions by a layman that only is tangentially involved with the contractor. These are presented as statements of fact – either GAAS and GAAP are met or they are not – and these statements are given by an entity whose specialty is construction auditing.

Thus, in the same way an expert in art is liable if he negligently "opines" that a painting is authentic, the auditor is liable if it incorrectly "opines" that GAAS and GAAP were met in the Audits. *See* Dobbs, LAW OF TORTS § 677. It is thus no surprise that "courts have expressly said that liability may be imposed for false and material misrepresentations of opinion when the defendant is a fiduciary, when he is a disinterested person or an expert upon whom the plaintiff can justifiably rely or when he has special knowledge, and when the opinion implies material facts." *Id.* The auditor typically meets each one of those criteria, as it (1) is disinterested by virtue of being an independent auditor; (2) is an expert in the field of construction accounting and auditing; (3) has special knowledge as a result of months spent examining the contractor's books and records; and (4) implied material facts as it pertains to GAAS and GAAP, as well as whether the contractor's financial picture is presented fairly.

An auditor attempting to avoid liability because the audit was only an opinion should also fail. This argument proves too much. If true, then an auditor would never be liable. Case law, however, is replete with examples of auditors being liable for their opinions. *See e.g., Travelers Cas. and Sur. Co. of Am. v. Ernst & Young LLP*, 542 F.3d 475 (5th Cir. 2008) (upholding jury award in favor of surety against auditor for negligent misrepresentation); *Blue Bell, Inc. v. Peat, Marwick, Mitchell & Co.*, 715 S.W.2d 408 (Tex. App.—Dallas 1986, no pet.) (upholding negligent misrepresentation suit against auditor even when the phrase "in our opinion" was in the audit); *Shatterproof Glass Corp. v. James*, 466 S.W.2d 873 (Tex. App.—Fort Worth 1971, writ ref'd, n.r.e.) (adopting Restatement (Second) of Torts § 552 in action against auditor for negligent audit opinion); *cf. In re Enron Corp. Securities, Derivative & ERIA Litigation*, 284 F.Supp.2d 511, 646 (S.D. Tex. 2003) (Harmon, J.) ("Under the Restatement (Second) of Torts § 552, which has been adopted by Texas courts, an accountant may be liable for negligent misrepresentations in financial statements to a third party. . . ."); *In re OSG Securities Litigation*, 971 F.Supp.2d 387, 399 (S.D.N.Y. 2013) (Scheindlin, J.) ("Defendants argue that the entire Audit Opinion is a statement of belief or opinion … because it contains the word 'opinion' in its title, and prefaces its conclusions with the phrase 'in our opinion.'. . . Auditors may not shield themselves from liability under Section 11 merely by using the word 'opinion' as a disclaimer."); *see also* RESTATEMENT (THIRD) OF TORTS: LIAB. FOR ECON. HARM § 5, cmt. d (2020) ("defendants who hold themselves out as having expertise in rendering opinions or predictions, as appraisers and auditors often do, may be held liable for negligence in forming or communicating them.").

Additionally, "[t]he meaning, not the form of the statement, determines whether it will be counted as non-actionable opinion." DAN B. DOBBS, PAUL T. HAYDEN AND ELLEN M. BUBLICK, THE LAW OF TORTS § 676 (2d ed. 2014); *see also Vulcan Metals Co. v. Simmons Mfg. Co.*, 248 F. 853, 856 (2d Cir. 1918) (Hand, J.) ("An opinion is a fact, and it may be a very relevant fact"). This is why Allstate is not liable to you simply by saying "you're in good hands" if you happen to disagree with that sentiment. *See Rodio v. Smith*, 587 A.2d 621 (N.J. 1991). But Johnson & Johnson can be sued when it falsely claims its products are "'clinically proven' to help babies sleep better." *See Lieberson v. Johnson & Johnson Consumer Companies*, 865 F. Supp. 2d 529 (D.N.J. 2011).

A clean, unqualified audit is not something as casual – and by extension unactionable – as "you're in good hands" for three reasons. First, in cases of an unqualified audit, the American Institute of Certified Public Accountants ("AICPA") does not give any leeway in how an auditor expresses its opinion; rather, the language is laid out in the standards and mandates that the auditor state "in our opinion." AU-C §700.A58. The auditor's proud tradition of using the term "opinion" (which dates back more than 100 years) is a way of showing the trustworthiness behind their assertion that "these financial statements present fairly" the whole financial picture of the audited company. *See* Stevan K. Olson and Charles W. Wootton, *Substance and Semantics* *in the Auditor's Standard Report*, 18 The Acct. Hist. J. 2, 106 (1991) (Dec. 1991) (auditor's use the word "opinion" to "emphasize the judgment element of the audit and the basis of the auditor's assurance."); Phil D. Wedemeyer, *A discussion of auditor judgment as the critical component in audit quality – A practitioner's perspective*, Internal Journal of Disclosure and Governance 7, 320-333 (Sep. 2010) (auditor's opinion is "based on informed judgments" following a vigorous investigation into the veracity of the financial statements). Thus, using the words "in our opinion" is the bedrock of clean, unqualified opinions that provide the highest level of assurance possible in the profession.

Second, auditors are positioned in a special place in the community:

> The certified public accountant acknowledges a moral responsibility (and … a legal and financial responsibility) to be as mindful of the interests of strangers who may rely on his opinion as of the interests of the client who pays his fee. This is at the same time a heavy burden and a proud distinction. It marks the certified public accountant as an individual of the highest integrity; a tough-minded technician whose judgment cannot be unbalanced by the strongest pressures, who stakes a hard-earned professional reputation on his ability to express a fair and just opinion on which all concerned may rely; in the broad sense, a highly useful servant to society as a whole …
>
> The certified public accountant, therefore, in providing accounting statements which all concerned may accept as disinterested expressions, based on technically sound procedures and experienced judgment, may serve as a kind of arbiter, interpreter, and umpire among all the varied interests. Thereby he can eliminate the necessity for costly separate investigations by each party at interest, as well as endless doubts, delays, misunderstandings, and controversies which are so much sand in the economic machine.

JOHN L. CAREY, PROFESSIONAL ETHICS OF PUBLIC ACCOUNTING, pp. 13-14 (1946).

Third, an audit itself is a special product: "The purpose of an audit is to determine if the statements fairly present the financial condition of the company by determining that they have been prepared in accordance with [GAAP], applied on a consistent basis." Feinman, 31 Fla. St. U. L. Rev. at 21; *see also United States v. Arthur Young & Co.*, 465 U.S. 805, 818 n. 13 (1984) (citing 1 AICPA, Statement on Auditing Standards §§ 510, 511.01 (1973)). Law and custom require audit opinions to be honest, carefully made, and accurate. *U.S. v. Benjamin*, 328 F.2d 854, 863 (2d Cir. 1964) (Friendly, J.) (careless audit opinions can be instruments "for inflicting pecuniary loss more potent than the chisel or the crowbar"); *Greenstein, Logan & Co. v. Burgess*

Marketing, Inc., 744 S.W.2d 170, 190 (Tex. App.—Waco 1987, writ denied) (auditors have a duty "to report the truth").

VI. The "Red Flags" Defense

As noted above, justifiable reliance is an element of a negligent misrepresentation claim.[4] This can come in the form of evidence from its underwriting team that the audits were relied upon in issuing bonds; that this reliance was justified in general in the industry; and/or that this reliance was justified because the auditor held itself out as an expert in construction accounting. The auditor may argue that the surety is not able to establish justifiable reliance because of purported "red flags." In support of this position, the auditor may point to a number of circumstances that the underwriters considered when deciding whether to issue surety credit (e.g., debt, reliance on a bank line, underbillings, profit fade). This is a fundamental misunderstanding of what a "red flag" is legally in the context of a negligent misrepresentation claim.

To understand how the existence of "red flags" impacts justifiable reliance, it is first necessary to examine the difference between reasonable reliance and justifiable reliance, as the relatively low threshold of establishing the latter is what led to the application of "red flags" to a negligent misrepresentation claim. As a starting point, "[t]he burden to show justifiable reliance is lighter than that for reasonable reliance." *In re Enron Corp. Sec., Derivative & ""ERISA" Litig.*, 490 F. Supp. 2d 784, 791 (S.D. Tex. 2007); *see also Field v. Mans*, 516 U.S. 59, 71 (1995). ("Although the plaintiff's reliance on the misrepresentation must be justifiable . . . this does not mean that his conduct must conform to the standard of the reasonable man."); RESTATEMENT (SECOND) OF TORTS §545A, cmt. b ("Justification is a matter of the qualities and characteristics of the particular plaintiff, and the circumstances of the particular case, rather than the application of a community standard of conduct to all cases.").

[4] This is currently in flux. Specifically, the Texas Supreme Court has spoken approvingly of the latest draft of the Restatement of Torts encompassing negligent misrepresentation. *See LAN/STV v. Martin K. Eby Const. Co., Inc.*, 435 S.W.3d 234, 235 n.3 (Tex. 2014). Unlike its predecessor, the Third Restatement removes justifiable reliance as an element. RESTATEMENT (THIRD), LIABILITY FOR ECONOMIC HARM 5, cmt. j (2020). Thus, if the Third Restatement applies, justifiable reliance is not an element and "red flags" in not applicable to the inquiry on whether the surety has a valid negligent misrepresentation claim.*Id*. If the Second Restatement applies, justifiable reliance remains an element. *Grant Thornton LLP v. Prospect High Income Fund*, 314 S.W.3d 913, 923 (Tex. 2010) ("negligent misrepresentation require[s] that the plaintiff show . . . justifiable reliance."); RESTATEMENT (SECOND) OF TORTS § 552 (1977).

Thus, in determining whether a plaintiff can establish justifiable reliance, courts look at the "plaintiff's individual characteristics, abilities, and appreciation of facts and circumstances at or before the time of the alleged [misrepresentation]." *In re Enron,* 490 F. Supp. 2d at 791 (internal quotations omitted). This further means that a person is justified in relying on a representation of fact "although he might have ascertained the falsity of the representation had he made an investigation." RESTATEMENT (SECOND) OF TORTS § 540. "This rule applies whether the investigation would have been costly and required extensive effort or could have been made without any considerable trouble or expense." *Sanford Institution for Savings v. Gallo,* 156 F.3d 71, 75 (1st Cir. 1998) *citing* RESTATEMENT (SECOND) OF TORTS §540 & cmt. a; PROSSER AND KEETON ON TORTS §108, p. 753.

The rationale for placing this relatively low burden on the victim of misrepresentation is that "[i]n such circumstances, the equities weigh in favor of giving the benefit of the doubt to the victim, careless as it may have been and even though it could have been more diligent and conducted an investigation." *Sanford Institution for Savings v. Gallo*, 156 F.3d 71, 74 (1st Cir. 1998). Thus, it is not very difficult for a plaintiff to establish that it justifiably relied on a negligent misrepresentation; indeed, this element is met even if the plaintiff could have easily investigated the merits of the representation, but chose not to.

Justifiability in negligent misrepresentation cases is not without bounds. This is where "red flags" comes in. Starting with the Fifth Circuit in 2001, courts rejected justifiable reliance if "falsity is obvious or there are 'red flags' indicating such reliance is unwarranted." *In re Mercer,* 246 F.3d 391, 418 (5th Cir. 2001) (applying Texas law); *see also In Re Whittington*, 2014 WL 41653589, *13 (Bkrt. W.D. Tex. 2012) (A plaintiff has "no duty to investigate unless the falsity of the representation is readily apparent or obvious or there are red flags indicating such reliance is unwarranted."); *Lewis v. Bank of Am. NA*, 343 F.3d 540, 546 (5th Cir. 2003) ("[A] person may not justifiably rely on a representation if there are red flags indicating such reliance is unwarranted.").

The idea is that while justifiable reliance is a low threshold, plaintiffs cannot recover "if he blindly relies upon a misrepresentation the falsity of which would be patent to him if he had utilized his opportunity to make a cursory examination or investigation." RESTATEMENT (SECOND) OF TORTS §541, cmt. a. (1977); *see also* Dean Prosser, *Law of Torts*, §108 pp. 715-16 (4th ed. 1978) ("If he is a person of normal intelligence, experience and education, he may not put faith in representations which any such normal person would recognize at once as preposterous, as, for example, that glasses, once fitted, will alter shape and adapt themselves to the eye, or which are shown by facts within his observation to be so patently and obviously false that he must have closed his eyes to avoid discovery of the truth.”).

The Reporter’s Note to Section 541 goes on to explain what is obvious to the senses upon cursory examination or investigation:

> where a party deceived can protect himself by ordinary care, it is his duty to do so, but it is with this qualification that he must have equal means of knowledge and be equally able to judge of the matter for himself and to stand upon an equal footing with the one using deceit or making the representations; then if he acts without exercising the means of knowledge open to him he does so at his own peril.

Id. (citing *Gallon v. Burns*, 101 A. 504, 505 (Conn. 1917)). In *Gallon*, “[t]here was no obligation on the part of the plaintiff to examine the books of the company to find out that the defendants were lying . . . .” *Id*.; *see also In re Holmes*, 414 B.R. 115, 126 (U.S.D.C. Mich. 2009) (“[t]his is not a case in which the creditor relied blindly on obviously false or suspicious information provided by the debtor in deciding to extend credit. Rather, the record shows that [the creditor] gathered a substantial amount of apparently reliable documentation to verify the information Holmes had submitted in his loan applications.”).

It likely will be difficult for the auditor to show that there is anything on the face of the Audits that is “so patently and obviously false that [the underwriter] must have closed his eyes to avoid discovery of the truth.” Prosser, *Law of Torts*, §108 pp. 716 (4th ed. 1978); *see* also *In re Dell Inc., Sec. Litig.,* 591 F. Supp. 2d 877, 896 (W.D. Tex. 2008) (analogizing red flags to “glaring accounting errors”). For instance, the clean audit is the highest level of assurance that can be provided. The auditor also likely will argue that there were no mistakes in the audits; if this is argued, then there could not also be things patently absurd with the audit that the underwriters should have recognized.

VII. Purported Disclaimers

A. When there is a clean audit opinion, it is impossible to also have a disclaimer of opinion

A “disclaimer of opinion” in the context of an audit is a term of art used by auditors when they are unable to obtain sufficient information necessary to form an opinion about the accuracy of the audited financial statement. A disclaimer of opinion exists when an opinion cannot be rendered. That is not what happens in the case of a clean, unqualified opinion. Thus, although auditors may insert "disclaimer" phrases throughout the audit in an attempt to limit liability, this should fail.

Audits of financial statements are governed by GAAS and the AICPA Professional Standards.[5] *Rhode Island Hospital Trust Nat'l Bank v. Swartz, Bresenoff, Yavner & Jacobs*, 455 F.2d 847, 852 (4th Cir. 1972) (In an auditor negligent representation case, stating: "Our conclusions with respect to the report and disclosure are reinforced by reference to industry standards of what should have been done in these circumstances. While industry standards may not always be the maximum test of liability, certainly they should be deemed the minimum standard by which liability should be determined.").

The purpose of an audit of a financial statement is "to provide financial statement users with an opinion by the auditor on whether the financial statements are presented fairly, in all material respects, in accordance with an applicable financing reporting framework, which enhances the degree of confidence that intended users can place in the financial statements." AU-C § 200.04. Accordingly, when performing an audit, "the auditor should form an opinion on whether the financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework." AU-C § 700.13.

To form that opinion, the auditor must "conclude whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error." AU-C § 700.14. This includes evaluating (1) the accounting policies the audited company selected and applied for the financial statement, (2) whether the accounting policies selected are appropriate, (3) whether the accounting estimates made by management are reasonable, (4) whether the information in the financial statements is reliable, (5) whether the financial statements provide adequate disclosure to enable users to understand material transactions and events, and (6) whether the terminology used in the financial statements is appropriate. AU-C § 700.16.

After evaluating financial statements, the auditor may render one of four types of opinions: (1) an unqualified opinion, (2) a qualified opinion, (3) an adverse opinion, or (4) a

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[5] AICPA Professional Standards, AU-C § 700.01 (June 1, 2012) ("This section addresses the auditor's responsibility to form an opinion on the financial statements. It also addresses the form and content of the auditor's report issued as a result of an audit of financial statements.") The AICPA Professional Standards will hereinafter be cited as "AU-C §____"

disclaimer of opinion. AU-C §§ 700.19, 705.08, 705.09. and 705.10. The United States Supreme Court has succinctly summarized each form of opinion:

> An ***unqualified opinion***, the most favorable report an auditor may give, represents the auditor's finding that the company's financial statements fairly present the financial position of the company, the results of its operations, and the changes in its financial position for the period under audit, in conformity with consistently applied generally accepted accounting principles. See 1 AICPA, Statement on Auditing Standards §§ 510, 511.01 (1973). Alternatively, the auditor may give a ***qualified opinion***, which states that the financial statements are fairly presented except for, or subject to, a departure from generally accepted accounting principles, a change in accounting principles, or a material uncertainty. *Id*., § 512. An ***adverse opinion*** is a reflection of the auditor's determination that the corporation's financial statements do not fairly present the financial position, results of operations, or changes in financial position of the company in conformity with generally accepted accounting principles; an adverse opinion is issued when the auditor determines that the corporation has materially misstated certain items on its financial statements. *Id*., § 513. Finally, a ***disclaimer of opinion*** expresses the auditor's inability to draw a conclusion as to the accuracy of the corporate financial records. A disclaimer of opinion is generally issued when the auditor lacks sufficient information about the financial records to issue an overall opinion. *Id*., § 514. See generally A. Arens & J. Loebbecke, Auditing: An Integrated Approach 643-660 (1976).

United States v. Arthur Young & Co., 465 U.S. 805, 818 n. 13 (1984) (emphasis in original); *see also* AU-C § 700.19; RAY WHITTINGTON AND KURT PANY, *Principles of Auditing & Other Assurance Services*, p. 658 (17th ed. 2010) ("Whittington and Pany") ("Auditors express an unqualified opinion on the client's financial statements when they have no material exceptions as to the fairness of the application of accounting principles, and there have been no unresolved restrictions on the scope of their engagement."). Thus, if the auditor does not obtain sufficient information to form an unqualified opinion or concludes that financial statements are materially misstated, the auditor will offer one of the other three forms of opinion, which may include a disclaimer of opinion.

The word "disclaimer" has a specific meaning when used in conjunction with an audit. Whittington and Pany summarize the uniqueness of "disclaimers" in the auditing world:

> A disclaimer of opinion is *no opinion*. Auditors issue a disclaimer whenever they are unable to form an opinion or have not formed an opinion as to the fairness of presentation of the financial statements. In an audit engagement, a disclaimer is issued when substantial or client-imposed scope restrictions preclude the auditors' compliance with generally accepted auditing standards . . . The wording of the

> opinion paragraph will change considerably, because the auditors are *not expressing an opinion* – rather, they are saying that *they have no opinion.*

Whittington and Pany, p. 169; *see also* AU-C § 705.10 (A disclaimer is appropriate only "when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.").

Thus, where an unqualified opinion exists, a disclaimer does not; the two are mutually exclusive. *Arthur Young*, 465 U.S. at 818 n. 13 (citing AICPA, Statement on Auditing Standards § 514); *see also Travelers Cas. & Sur. Co. of Am. v. Ernst & Young LLP*, 542 F.3d 475, 479 (5th Cir. 2008) ("[A]n auditor may issue … a 'disclaimer opinion,' which may be issued if the accountant is unable to reach an informed opinion because of limitations in the audit examination."); JAY M. FEINMAN, *Liability of Accountants for Negligent Auditing: Doctrine, Policy, and Ideology*, 31 Fla. St. U.L. Rev. 17, 22 (2003) ("a disclaimer of opinion is not an opinion at all; rather, the accountant states that the scope of the audit was not sufficient to enable it to render an opinion.").

B. <u>The idea of a legal disclaimer for auditors who use magic language is inconsistent with the role of auditors and their duty to the public</u>

The term "disclaimer" is also used outside the context of audits. It has been defined as "the repudiation or renunciation of a claim or power vested in a person or which he had formerly alleged to be his." Blacks Law Dictionary (16th ed. 1991). The Texas Supreme Court has used the term "disclaimer" to refer to a limitation "as to the scope and accuracy of the factual investigation or assumptions forming the basis of the representation or the representation itself." *McCamish v. F.E. Appling Interests*, 991 S.W.2d 787, 794 (Tex. 1999).

Implicit in any "disclaimer" defense is the notion that an auditor may issue an unqualified, clean, opinion but then limit by "disclaimer" any legal liability for such an opinion. This undercuts the very purpose served by auditors. As Whittington and Pany note:

> The contribution of the independent auditor is to provide credibility to information. Credibility, in this usage, means that the information can be believed; that is, it can be relied upon by outsiders, such as stockholders, creditors, government regulators, customers, and other interested third parties. These third parties use the information to make various economic decisions, such as decisions about whether to invest in the organization.

Whittington and Pany, p. 6.

The entire purpose of an audit is to have a certified public account independently critique the financial status of an entity for the benefit of the public. The auditor is a "public watchdog" who "assumes a public responsibility" to ensure that the financial statements offered by the audited entity are accurate:

> By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust. To insulate from disclosure a certified public accountant's interpretations of the client's financial statements would be to ignore the significance of the accountant's role as a disinterested analyst charged with public obligations.

Arthur Young, 465 U.S. at 817-818 (Emphasis added).

This coincides with AICPA Professional Standards which notes that the purpose of an audit of a financial statement is "to provide financial statement users with an opinion by the auditor on whether the financial statements are presented fairly, and all material respects, in accordance with an applicable financing reporting framework, which enhances the degree of confidence that intended users can place in the financial statements." AU-C § 200.04. As U.S. Supreme Court Justice Warren Burger explained, "If investors were to view the auditor as an advocate for the corporate client, the value of the audit function itself might well be lost." *Id.* at 819 n. 15. Thus, from an auditor's point-of-view, the very purpose of an independent audit is to provide credible and reliable information about the audited entity so that third-parties may rely when making business decision.

When the purpose of an auditor's opinion is to lend credibility to financial information for the benefit of the public, it is incongruous for the auditor to argue that the public-at-large cannot rely on the opinions due to legal disclaimers. If the auditor is concerned with the accuracy of the information contained in the audited financial statements, it has a professional obligation to issue an adverse opinion. It has no other option. Willis W. Hagen II, Certified Public Accountants' Liability for Malpractice: Effect of Compliance with GAAP and GAAS, 13 J. Contemp. L. 65, 71-72 (1987). What it cannot do is profess to the public that, after performing its public watchdog functions, there is no cause for concern because the information contained in the financial statements is credible, and then disclaim any liability associated with that opinion. It is perhaps for that reason that no case or scholarly paper known to the authors recognizes an auditor's ability to legally disclaim liability for an unqualified, clean opinion. Indeed, the opposite is true:

> "A disclaimer of opinion may be rendered by a CPA only when it is objectively impossible to ascertain whether the financial statements are presented in accordance with GAAP. This type of opinion may be given where a CPA is hired only for a limited assignment or where the organization's accounting methods or internal control is such that the CPA cannot form an opinion on the financial statements. **A disclaimer of opinion cannot be issued by a CPA merely to avoid liability for negligence. If the CPA knows that the financial statements do not present fairly the financial position, results of operations, or changes in financial position, the CPA may not disclaim an opinion; he must issue an adverse opinion**."

Id. (Emphasis added); *see also* JULIE FAUSSIE, *Limiting Liability in Public Accounting Suits*, 28 Val. U. L. Rev. 1041, 1071 (1994) ("A disclaimer of opinion can only be issued if the CPA cannot objectively identify that the financial statements are in accordance with GAAP, and cannot be issued merely to avoid liability."); *cf*. Whittington and Pany, p. 676 ("[T]he issuance of a disclaimer can never be used to avoid warning financial statement users about problems that the auditors know to exist in the financial information.") (18th ed. 2012).

VIII. Contributory and Comparative Negligence

A negligent misrepresentation claim presents a number of swirling, interconnected issues for the Court to decide, including: (1) whether the a state's proportionate responsibility statute applies to a claim for negligent misrepresentation; (2) whether the pure contributory negligence bar expressed by Section 552 of the Restatement trumps the state's statutory proportionate responsibility scheme; (3) whether concepts of comparative fault are essentially another way of looking at the fact that a plaintiff must establish justifiable reliance; and (4) whether it is even possible for a third-party to be contributorily negligent in connection with an audit since it could not impact the auditor's services (unlike a person that is contributorily negligent when they run a red light and are a partial cause of an accident even if the other party was driving drunk). Safe to say, the auditor will argue that the strict contributory negligence bar expressed by Section 552 applies. Most courts and commentators, however, that have looked at this issue conclude that if a state Legislature has passed a comparative or proportionate responsibility scheme, this will preempt the framework of Section 552.

Many states in their history adopted the English concept of contributory negligence. *See Butterfiled v. Forrestor*, 103 Engl. Rep. 926 (1809). Texas defined the rule as: "One who is injured by the mere negligence of another cannot recover at law or in equity any compensation for his injury, if he, by his own or his agent's ordinary negligence or willful wrong, proximately contributed to produce the injury of which he complains . . . ." *Houston & G. N. R. Co. v. Parker*, 50 Tex. 330, 342 (Tex. 1878). This rule – which was a complete bar to recovery – stood in Texas for more than 125 years.

In 1973, the Texas Legislature replaced the common law rule of contributory negligence with the Comparative Negligence Act. TEX. REV. CIV. STAT. ANN. art. 2212a (since repealed). At this time, only seven states had made the switch. W. Page Keeton, et al., PROSSER AND KEETON ON THE LAW OF TORTS § 67, at 471 (5th ed. 1984); *see also Alvis v. Ribar*, 421 N.E.2d 886, 891-92 (Ill. 1981). The reason for the shift was "to abolish the harsh effect of a contributory-negligence finding." *Kroger Co. v. Keng*, 23 S.W.3d 347, 350 (Tex. 2000); *see also* Keeton at 454 ("Criticism of the denial of all recovery was not slowing in coming, and it has been with us now for more than a century."). Although the Comparative Negligence Act has undergone several changes in the 40 years that have followed – culminating in the current proportionate responsibility statute – a common denominator has been that a plaintiff is barred from recovery if they are "more than fifty percent negligent." Greytok, 46 Baylor L. Rev. at 301.

As detailed in Sections II and III above, the distinguishing characteristic of the Restatement approach from other theories deals with the set of plaintiffs that have standing to bring a claim. The Restatement does, however, have other important attributes, including capturing the predominant liability-limiting doctrine of the day: contributory negligence. "The recipient of a negligent misrepresentation is barred from recovery for pecuniary loss suffered in reliance upon it if he is negligent in so relying." Restatement (Section) of Torts § 552A (1977).

While recognizing the winds of change flowing through the legal community in the 60s and 70s as it related to contributory negligence, the drafters of the Restatement were reticent to take an affirmative stance on whether principles of comparative fault would apply to the reasonableness of reliance, citing a lack of precedent to date. *Id.*, cmt. b; *see also* Michael D. Green, *Apportionment, Victim Reliance, and Fraud: A Comment*, 48 Ariz. L. Rev. 1027, 1032 n. 26 (2006). Essentially, the drafters elected to wait and see how courts might address the issue on a case-by-case basis; the drafters may have been surprised to find out with hindsight that the issue was largely ignored.

The State of Washington – whose court system is one of the few to directly address the idea of contributory negligence in a section 552 claim – found that the Washington comparative fault statute applies to Section 552 claims. *Id.* at 1232. This has been the case in other states as well. *See TBG, Inc. v. Bendis*, 841 F. Supp. 1538, 1568 (D. Kan. 1993) (citing Kan. Stat. Ann. § 60-258a) (noting that the Kansas comparative fault statute would apply to a 552 claim, but claims that accrued before the statute was enacted would be barred by any contributory negligence); *Williams Ford, Inc. v. Hartford Courant Co.*, 657 A.2d 212 (Conn. 1995) (holding that the Connecticut comparative fault statute applies to a 552 claim); *Gilchrist Timber Co. v. Itt Rayonier*, 696 So. 2d 334, 337 (Fla. 1997) (answering a certified question from the Eleventh Circuit, the Court held that the Florida comparative fault statute applies to a 552 claim; the Court also noted that this was the majority rule); *cf.* David A. Jaffee, *The Allocation Of Fault And Auditor Liability Lawsuits Brought By Sophisticated Third Party Users Of Financial Statements – A Plea For Proportionate Liability*, 54 U. Pitt. L. Rev. 1051, 1077 (1993) (arguing that comparative fault is consistent with the rationale of section 552).

It should also be noted that with contributory negligence now an "antique heritage of an older day," Keeton at 453, the drafters of the new, proposed Restatement of Torts have specifically (i) removed the requirement that reliance be "justifiable," and (ii) noted that recovery under a Section 552 claim "is subject to the same principles of comparative responsibility that apply to other claims of negligence." RESTATEMENT (THIRD) OF TORTS: LIAB. FOR ECON. HARM § 5(4) (2020). The drafters explain that this change is proposed because requiring "justifiable reliance" connotes an "all-or-nothing inquiry," which made sense when Section 552 was originally adopted in 1977 against the backdrop of contributory negligence. *Id.* at cmt. j. With the nearly uniform shift to comparative responsibility, the drafters are seeking to remove the "all-or-nothing" component, and instead, want to allow the courts to look at the degree to which a plaintiff may share the blame for its loss. *Id.*

VIII. Conclusion

Accountants and their insurance carriers should be held liable to sureties who rely upon negligently performed audits. Construction auditing is a specialized field of auditing, and construction auditors have an expectation that sureties will rely upon their audits to make underwriting decisions. The new Third Restatement of Economic Harm goes a long way in helping the surety recover its losses. Different jurisdictions have different rules, and new decisions could change the landscape of negligent misrepresentation, particularly in light of the publication of the new Restatement. When a surety suffers a significant loss, it should do a thorough review of what it relied upon in underwriting the principal, and should perform a cost-benefit analysis of engaging outside counsel and outside experts to help recover against accountants and their insurers. As this is such a specialized field, it is extremely important to hire counsel and experts who have experience and expertise in evaluating potentially negligent audits and pursuing negligent auditors.