privacy as an initial warrantless search for a specific item would have been.[62] This is not to mention the questionable legality of the procedure or the futility of the procedure if one officer remains and two persons return or five officers are present and six persons return to the house. In effect, *Vale* strictly limits the flexibility of the police officer in his fight against crime, in spite of the Court's guarantee in *Rabinowitz* that some flexibility will be accorded law officers engaged in daily battle with criminals.[63]

The Court in *Vale* seems determined to maintain the *Chimel* and *Shipley* rules at all costs, including the release of criminals caught committing the crime in the presence of an officer of the law. It can only be hoped that in the Court's tradition of inconsistency displayed as late as 1969,[64] it will revert to the rule of reasonableness in light of the circumstances as espoused by the founding fathers in the fourth amendment and by earlier Courts.

DOYLE D. SANDERS

Torts—ACCOUNTANTS ARE LIABLE TO THIRD PARTIES FOR NEGLIGENT MISREPRESENTATION WHEN BOTH THE NATURE OF THE TRANSACTION AND THE GROUP TO WHICH THE THIRD PARTY BELONGS ARE KNOWN TO THE ACCOUNTANT—*Ryan v. Kanne* (Iowa 1969).

Defendant Kanne owned two lumber companies and sought to reorganize his operations. At the insistence of a creditor, Mid-States Enterprises, Inc., Kanne contracted with the plaintiff, a certified public accountant, to prepare financial statements. The plaintiff negligently understated "Accounts Payable—Trade," in excess of $23,000 and as a result the defendants refused to pay the accounting fees. Plaintiff brought this action to recover his fees against Kanne, Kanne Lumber and Supply, Inc. and Mid-States Enterprises, Inc. and Kanne Lumber and Supply, Inc. counterclaimed against plaintiff for damages. The trial court rendered a judgment in favor of Kanne Lumber and Supply, Inc. for the damages resulting from the negligent misrepresentation by the plaintiff. The court also rendered a judgment against all defendants for the fees, since plaintiff's services were not, as a matter of law, so negligently performed as to be completely valueless. All parties appealed. *Held*, modified and affirmed, one justice dissenting. Certified public accountants who are negligent in the preparation of accounting statements are liable to third parties who have relied on those statements to their detriment, though such parties are not in privity. The accountant, however, must have known before the statement was submitted that

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[62] Chimel v. California, 395 U.S. 752, 774 (1969) (dissenting opinion); Comment, *Scope Limitations for Searches Incident to Arrest*, 78 YALE L. REV. 433, 446 (1969).

[63] 339 U.S. 56, 67 (1950).

[64] *See* authorities cited note 48 *supra*. *See also* 395 U.S. 752, 770 (1969) (dissenting opinion).

such statement was intended for the guidance of the injured party. *Ryan v. Kanne*, 170 N.W.2d 395 (Iowa 1969).

In 1842, Lord Abinger announced that where the parties had a contract, and a third party was injured as a result of the negligent performance of the contract, the injured third party could not sue on the contract. He held that there was a lack of privity and, therefore, a lack of duty, which is required for negligence.[1] Subsequently, courts found that recognition of privity as a condition to recovery in tort often led to placing an unjustifiable burden on innocent third parties. Consequently, a series of increasingly liberal "exceptions" evolved so that by 1960, the requirement of privity had been "relaxed" to the point of extinction with regard to products liability suits for personal injuries.[2] By 1968, the requirement was abandoned with regard to suits for negligence involving simple pecuniary losses.[3] The principal reason for limiting recovery to plaintiffs in privity with the accountant is a practical consideration. Lack of privity would open the door to potentially large and unpredictable liability of the negligent party.[4] Although some courts still find this rationale persuasive,[5] a majority of other courts, and the Iowa court in the instant case, have rejected it.[6] Apparently, these courts feel that they have been able to define a limited group to whom it is reasonable to hold the negligent party liable without potentially unlimited liability.[7] This group definition did not occur, however, without a substantial history of gradual judicial development.

In 1889, an English court[8] established an action for deceit which allowed recovery for fraudulant misrepresentations. The English courts reasoned that fraud could be based on either knowingly false statements or statements made with a reckless disregard for the truth.[9] An American court, however, pointedly observed that fraudulant misrepresentations were not the same as negligent misrepresentations, and therefore, where there was no allegation of fraud, recovery was barred.[10] Subsequently, another American court, nevertheless, allowed recovery for negligent misrepresentations based on the concept of a third party beneficiary contract. In *Glanzer v. Shepard*,[11] a bean merchant contracted with a public weigher to weigh bean bags to be sold to the plaintiff. The

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1 Winterbottom v. Wright, 152 Eng. Rep. 402, 405 (Ex. 1842).

2 Henningsen v. Bloomfield Motors, 32 N.J. 358, 161 A.2d 69 (1960); *see* Prosser, *The Assault Upon the Citadel (Strict Liability to the Consumer)*, 69 YALE L.J. 1099 (1960); Prosser, *The Fall of the Citadel (Strict Liability to the Consumer)*, 50 MINN. L. REV. 791 (1966).

3 Rusch Factors, Inc. v. Levin, 284 F. Supp. 85, 91 (D.R.I. 1968). *See generally* Annot., 54 A.L.R.2d 324 (1957).

4 Hedley, Byrne & Co., Ltd. v. Heller & Partners, Ltd. (1964) A.C. 465, 482-83. *See* Levitin, *Accountants' Scope of Liability for Defective Financial Reports*, 15 HASTINGS L.J. 436 (1964).

5 *See, e.g.*, Investment Corp. of Florida v. Buckman, 208 So. 2d 291, 296 (Fla. 1968).

6 *See, e.g.*, Ryan v. Kanne, 170 N.W.2d 395, 401 (Iowa 1969).

7 *Id.* at 401.

8 Durry v. Peek, 14 A.C. 337 (1889).

9 *Id.* at 340.

10 Landell v. Lybrand, 264 Pa. 406, 107 A. 783 (1919).

11 233 N.Y. 236, 135 N.E. 275 (1922).

defendant weigher negligently performed the contract. In allowing recovery, the court held that since the defendant knew both the plaintiff and the purpose of the contract, the plaintiff was a third party beneficiary entitled to relief for the negligent misrepresentation.[12]

Justice Cardozo explained the third party beneficiary contract theory and the fraudulant misrepresentations theory in the leading case of *Ultramares Corp. v. Touche*.[13] In that case he explaind that the plaintiff had recovered in *Glanzer* only because of the proximity of the third party to the negligent party.[14] He rejected negligent misrepresentation as a theory of recovery, because at the time the contract was executed, the particular plaintiff was unknown to the accountant and, thus, there was no duty. The court allowed recovery for fraudulant misrepresentation, however, since there was sufficient evidence to establish a fraudulent intent.[15] In an action for misrepresentation, if the plaintiff failed to prove a fraudulent intent, recovery was denied.[16] The following year the New York court further broadened the concept of intent and no longer required active or deliberate fraud.[17] If the negligence was so gross as to raise the implication of fraud, the court would find intent.[18] As if to answer an English court which had not allowed recovery because the negligence was not sufficient to imply fraud,[19] the New York court again broadened the scope of recovery by holding that "heedlessness and wanton disregard of the consequences of . . . incorrect financial statements . . ." could also take the place of a deliberate attempt to defraud.[20]

Recently, decisions have both adopted and rejected the proposition that ordinary negligence alone is not sufficient for recovery.[21] The underlying reason for the two positions was similar in that the courts were unable to define precisely the limits of liability which should attach for an accountant's negligent misrepresentation. Recovery has been denied on the basis that it would create an unbearable liability for not only this profession but every other profession whose business involves the making of technical representations.[22] In *Ryan*, on

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12 *Id.* at 239, 135 N.E. at 275-76.

13 225 N.Y. 170, 174 N.E. 442 (1931). *See generally* W. PROSSER, LAW OF TORTS, § 102 (3d ed. 1964).

14 *Id.* at 182-83, 174 N.E. at 445-46.

15 *Id.* at 186, 174 N.E. at 449.

16 O'Connor v. Ludlam, 42 F.2d 50, 53 (2d Cir. 1937).

17 State Street Trust Co. v. Ernst, 278 N.Y. 104, 15 N.E.2d 416 (1938).

18 *Id.* at 108, 15 N.E.2d at 420.

19 Candler v. Crane, Christmas & Co., 2 K.B. 164, 185 (C.A. 1951). *See* Seavey, *Candler v. Crane, Christmas & Co., Negligent Misrepresentation by Accountants*, 67 LAW Q. REV. 466 (1952).

20 Duro Sportswear, Inc. v. Cogen, 131 N.Y.S.2d 20, 25 (Sup. Ct. 1954). For criticism, *see* Bradley, *Liability to Third Persons for Negligent Audit*, 1966 J. BUS. LAW 190.

21 *See, e.g.*, Investment Corp. of Florida v. Buckman, 208 So. 2d 291, 296 (Fla. 1968). *Contra*, Rusch Factors, Inc. v. Levin, 284 F. Supp. 85, 91 (D.R.I. 1968) and Ryan v. Kanne, 170 N.W.2d 395, 401 (Iowa 1969).

22 As stated by Justice Cardozo in Ultramares Corp. v. Touche, 255 N.Y. 170, 172, 174 N.E. 442, 444 (1931), "if liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate class." For criticism *see* Goodhart, *Lia-*

the other hand, the court stressed the need for professional responsibility and for protecting the innocent third party from an unreasonable burden.[23] *Rusch Factors, Inc. v. Levin*[24] also is opposed to limiting liability and would support an interpretation of broad liability for the accountant.

Ryan v. Kanne[25] is a case of first impression, and offered the Iowa supreme court an opportunity to define the limits of an accountant's liability for negligent misrepresentation. As principle authority for its finding of liability, the court used the reasoning in the *Rusch* and *Glanzer* decisions.[26] In defining the limits of liability for negligent misrepresentation, the court relied heavily on the *Restatement (Second) of Torts*.[27] As stated in the *Ryan* case and recognized in the *Rusch* decision:

> [R]efusal to allow recovery to those so situated [actually known third parties] would constitute an unwarranted inroad upon the principle that the risk reasonably to be perceived defines the duty to be obeyed. . . . When the accountant is aware that the balance sheet to be prepared is to be used by a certain party or parties who will rely thereon in extending credit or in assuming liability for obligations of the party audited, the lack of privity should be no valid defense to claim for damages due to the accountant's negligence. We know of no good reason why accountants should not accept the legal responsibility to known third parties who reasonably rely upon financial statements prepared and submitted by them.[28]

It can be concluded from these decisions that both courts are of the philosophy that since an accountant plays such an important role in modern society, he should be held to a high degree of professional responsibility. While this last statement is unquestionably true, there are certain economic restraints on the degree of liability that should be imposed on accountants. As the *Rusch* court pointed out, if the limits of liability for negligent misrepresentation are set too broad, one or both of the following reactions may occur. Either the accounting

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bility for Innocent but Negligent Misrepresentation, 74 YALE L.J. 886 (1964); Meek, *Liability of the Accountant to Parties Other than His Employer for Negligent Misrepresentation*, 1942 WIS. L. REV. 371.

[23] Ryan v. Kanne, 170 N.W.2d 395, 401 (Iowa 1969).

[24] 284 F. Supp. 85 (D.R.I. 1968). *See* 53 MINN. L.R 1375 (1969).

[25] 170 N.W.2d 395 (Iowa 1969).

[26] The court also used a case note on the *Rusch* decision in 53 MINN. L. REV. 1375 (1969).

[27] RESTATEMENT (SECOND) OF TORTS, § 552 (Tent. Draft No. 11 1965) states:

(1) One who, in the course of his business, profession or employment, or in a transaction in which he has pecuniary interest, supplies false information for the guidance of others in their business transaction, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.

(2) . . . [T]he liability stated in subsection (1) is limited to the loss suffered:

(a) By the person or one of the persons for whose benefit and guidance he intends to supply the information; or knows the recipient intends to supply it; and

(b) Through reliance upon it in transaction which he intends the information to influence, or knows that the recipient so intends, or in a substantially similar transaction.

[28] Ryan v. Kanne, 170 N.W.2d 395, 401 (Iowa 1969).

firms will be forced to purchase, if possible, more liability insurance to protect themselves[29] or they will put such extensive qualifications as to the accuracy of their work so as to render them unreliable and consequently valueless.

The Iowa supreme court based its decision in *Ryan* on the need for professional responsibility, on the one hand, and the need for reasonable limits on liability for negligent misrepresentation, on the other. The court noted that "the same rule may be applicable in other recognized professions . . . ."[30] It then concluded that "the rule of no liability should be relaxed . . . as to those who were actually known to the author as prospective users of the report and take into consideration the end aim of the transaction."[31] To understand this statement adequately, it is helpful to look at the comments and illustrations in the tentative draft of *Restatement (Second) of Torts,* especially comment j which states: "The maker of the negligent misrepresentation is subject to liability *only* to those persons for whose guidance he knows the information to be supplied *and* to them *only* for the loss incurred in the kind of transaction in which it was intended to influence them."[32] Applying this statement to the accounting profession would mean that if an accountant, A, were hired by B Corporation to produce financial statements so that B could obtain a $100,000 loan from the banks in the town, A would be liable for any negligent misrepresentation only to a member of the limited class of "banks in the town," but not banks "outside of the town," insurance companies, finance companies, or private investors who might make the loan, and only for an amount reasonably approximating a maximum of $100,000. In other words, the accountant is cognizant of the fact that his report will be used by his employer to influence a third party who is a member of a definite, ascertainable and limited group for a specific transaction. That accountant then could be subject to liability for negligent misrepresentation to such a third party. This would be true even though the name of the third party may have been personally unknown to the accountant at the time the report was completed, and no privity existed between the parties.

The limits stated above are broader than those set in *Glanzer* because there is no requirement that the third party be personally known to the accountant.[33] As modified by the Iowa supreme court, these limits do not, however, appear as broad as those potentially set out in the *Rusch*[34] decision and

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[29] In 1966 The Wall Street Journal reported that there were 100 actions pending against accountants for misrepresentation. The Wall Street Journal, Nov. 15, 1966, at 13, col. 2. It has recently been observed that the number of actions pending against accountants has increased substantially. Kurland, *Accountants Legal Liability*—Ultramares *to BarChris (Escott v. BarChris Constr. Corp., 283 F. Supp. 643),* 25 BUS. LAW 155 (1969). Also, as was noted in Wise, *The Auditor Has Arrived, Pt. 1,* liability insurance has become increasingly hard to purchase and the rates for such insurance have greatly increased in the past few years. FORTUNE MAGAZINE, Nov. 1960, at 151.

[30] Ryan v. Kanne, 170 N.W.2d 395, 402 (Iowa 1969).

[31] *Id.* at 403.

[32] RESTATEMENT (SECOND) OF TORTS, Explanatory Note § 552 comment j, at 67 (Tent. Draft No. 11, 1965) (emphasis added).

[33] *Id.* Explanatory Note h, at 63.

[34] Rusch Factors, Inc. v. Levin, 284 F. Supp. 85, 92 (D.R.I. 1968).

some of the illustrations given in the tentative draft.[35] From the emphasis placed by the Iowa court on the fact that the accountant must know the persons to whom his report will be given, as opposed to all foreseeable plaintiffs, it appears that if, in the illustration above, B would have said "banks" instead of "banks in town," the court would have limited liability to a reasonably small group rather than all the banks in the world. Although the language is not clear on this point, it appears that the court is trying to define the limits of an accountant's liability to (1) the type and amount of transaction which is communicated to the accountant, and (2) that group of potential plaintiffs which is limited by the accountant's reasonable knowledge of their existence. If, in fact, future courts find that the limitations apparently given by this case for an accountant's liability for negligent misrepresentation are bounded by the accountant's reasonable knowledge of both the group to whom the representation will be made and the nature of the transaction, this opinion is to be commended. These limitations appear to be both usable to the accountants and the court and yet remain fair to the accountants and innocent third parties. If, however, the courts interpret this holding as authority for substantially increased liability for not only the accounting profession but also "other recognized professions,"[36] then perhaps a return to the protection of privity would be advisable.

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[35] RESTATEMENT (SECOND) OF TORTS, § 552, at 59, 64-66 (Tent. Draft No. 11, 1965).
[36] Ryan v. Kanne, 170 N.W.2d 395, 402 (Iowa 1969).