The Audit Interference Doctrine — An Exception Without A Rule

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Under the audit interference doctrine, an auditor may assert the client's negligence as an affirmative defense to a claim for professional malpractice only where the client's negligence interfered with the performance of the audit itself. Originally adopted as an exception to ameliorate the all-or-nothing nature of the common law defense of contributory negligence, the audit interference doctrine should have no place in a jurisdiction that, like California, has discarded contributory negligence in favor of comparative fault. However, California courts have not yet ruled on the issue and there is a split among the states that no longer have a contributory negligence rule about whether to continue to apply the audit interference doctrine. The better approach is not to apply an exception without a rule.

The Contributory Negligence Rule Created Potential Inequities

The common law contributory negligence rule foreclosed recovery by any plaintiff who was the slightest bit negligent. The rule thus could potentially bar a slightly negligent plaintiff from recovery against a greatly negligent defendant. To address such inequities, courts fashioned exceptions to the rule, such as the audit interference doctrine.

One of the first cases to address an auditor's ability to assert contributory negligence was *National Surety v. Lybrand,* 256 A.D. 226 (1939). National Surety paid a claim relating to embezzlement by an employee of the client. As subrogee of the audit client, National Surety brought professional malpractice and breach of contract claims against the auditor who had not detected the embezzlement in the course of its audits. Had the auditor discovered and reported the embezzlement, National Surety contended that the audit client would have fired the employee and would not have sustained the subsequent loss. The auditor asserted as an affirmative defense that the audit client had conducted its business so as to make the embezzlement possible and was therefore contributorily negligent. The appellate court disallowed the defense on the theory that audit clients rely on their auditors to detect such wrongdoing:

> We are, therefore, not prepared to admit that accountants are immune from the consequences of their negligence because those who employ them have conducted their own business negligently. The situation in this respect is not unlike that of a workman injured by a dangerous condition which he has been employed to rectify. [Citations omitted.] Accountants, as we know, are commonly employed for the very purpose of detecting defalcations which the employer's negligence has made possible.... Negligence of the employer is a defense only when it has

> contributed to the accountant's failure to perform his contract and to report the truth.

Id. at 235-36 (emphasis added). The courts of other states have demonstrated similar reluctance to permit an otherwise negligent auditor to escape liability under the contributory negligence rule. *See, e.g., Lincoln Grain, Inc. v. Coopers & Lybrand,* 216 Neb. 433, 442 (1984) (auditor's contributory negligence defense would "render illusory the notion that an accountant is liable for the negligent performance of his duties" and would be allowed only where it "contributes to the accountant's failure to perform the contract and to report the truth"); *Cereal Byproducts Co. v. Hall,* 132 N.E. 2d 27, 29-30 (1956) *aff'd,* 155 N.E.2d 14 (Ill. 1958) (auditor not permitted to assert defense of contributory negligence where "[n]o fact or circumstance is cited contributing in the slightest degree to the negligence of defendants in making the audit"); *Shapiro v. Glekel,* 380 F. Supp. 1053, 1056 (S.D.N.Y. 1974) ("contributory negligence must be accepted as a theoretical defense, but it applies only if the plaintiff's conduct goes beyond passive reliance and actually affects defendant's ability to do his job with reasonable care").

The Audit Interference Doctrine Created New Inequities

The audit interference doctrine was at best a clumsy response to the draconian all-or-nothing regime of contributory negligence. Except where the client's negligence interfered with the audit, the doctrine simply shifted the entire responsibility for the loss from the client to the auditor.

Under the audit interference doctrine, then, even a grossly negligent audit client might obtain full recovery from a slightly negligent auditor. Obviously inequitable, such results also failed to recognize that the "fundamental and primary responsibility for the accuracy [of financial statements] rests upon management." *Bily v. Arthur Young & Co.,* 3 Cal. 4th 370, 399 (1992). By shifting responsibility for the loss entirely to the auditor, the audit interference doctrine allowed a free pass to the audit client that failed to fulfill these significant responsibilities. This was a fundamental flaw of the doctrine.

The California Supreme Court recognized thirty years ago that the better way to address the inequities of the contributory negligence rule was simply to replace it with a comparative fault system under which each party would bear responsibility for loss according to its relative negligence or fault. *See Li v. Yellow Cab Co. of California,* 13 Cal. 3d 804, 828-29 (1975). The Court considered at the time the continuing vitality of the "last clear chance" exception to the contributory negligence rule and stated that "the better reasoned position seems to be that when true comparative negligence is adopted, the need for last clear chance as a palliative of the hardships of the 'all-or-nothing' rule disappears and its retention results only in a windfall to the plaintiff in direct contravention of the principle of liability in proportion to fault." *Id.* at 825.

Comparative Fault Largely Eliminated the Inequities

No reported California decision has yet addressed whether the audit interference doctrine remains viable in the wake of comparative fault. In *Sagadin v. Ripper,* 175 Cal. App. 3d 1141 (1985), however, the Third District Court of Appeal abolished an analogous exception to the contributory negligence rule relating to a defendant's violation of a statute intended to protect plaintiff from his own negligence. If plaintiff sued defendant for negligence based on the statutory violation, contributory negligence was not available as a defense "because barring the plaintiff's action would thwart the purpose of the statute." *Id.* at 1165-1166. Noting that the purpose of comparative fault was to assign liability for damage in direct proportion to the amount of negligence of each of the parties and finding "no rational reason why the plaintiff's failure to exercise care for his own safety should not ... diminish his own recovery," the court held that the exception did not survive the demise of the contributory negligence rule. *Id.* at 1167-1168.

The same logic applies to the audit interference doctrine. Even if an audit may be intended to protect the client from its own negligence and errors, recovery by a client that has failed to exercise due care in the course of its business and in the preparation of its financial statements should diminish its recovery in proportion to its own fault. As with the last clear chance and *Sagadin* statutory exceptions, the audit interference doctrine is no longer required to mitigate the harsh effects of the now-defunct contributory negligence rule and would result only in windfalls to negligent audit clients. "[W]hen the rule falls, so should its exceptions." *Id.* at 1168.

Most jurisdictions that have considered the issue are in accord. For example, in *Scioto Mem'l Hosp. Ass'n v. Price Waterhouse,* 659 N.E.2d 1268 (1996), the Supreme Court of Ohio recognized that the adoption of comparative negligence obviated the need for the audit interference doctrine. Scioto alleged that Price Waterhouse failed adequately to assess and disclose the risks associated with an unsuccessful project and accurately to report the financial forecast of the underwriter. The trial court excluded Price Waterhouse's defense of comparative negligence. The Supreme Court of Ohio reversed, noting that the audit interference doctrine was created to soften the harshness of contributory negligence and was no longer necessary or appropriate in light of Ohio's comparative negligence statute. *Id.* "[A]ny negligence by a client, whether or not it interferes with the accountant's performance of its duties, can reduce the client's recovery." *Id.* (citations omitted).

The Supreme Court of Minnesota concluded similarly, in *Halla Nursery, Inc. v. Baumann-Furrie & Co.,* 454 N.W.2d 905 (Minn. 1990), that the audit interference doctrine was neither necessary nor desirable after adoption of comparative fault. *Id.* at 909. As that Court recognized, audit clients should be held accountable for their own conduct:

> Accountants, like other professionals, are held to a standard of care which requires that they exercise the average ability and skill of those who engage in that profession. Failure to exercise ordinary care in conducting accounting activities may expose an accountant to allegations of negligence. By the same token, the persons who hire accountants, usually businesspersons, should also be required to conduct their activities in a reasonable and prudent manner.

At least nine states have expressly considered and rejected continued application of the audit interference doctrine as inconsistent with a system of comparative negligence. *See Paul Harris Stores, Inc. v. PricewaterhouseCoopers, LLP,* 2006 WL 2859425 (S.D. Ind. Oct. 4, 2006) (after adoption of comparative fault, rationale for audit interference doctrine did not apply) (Indiana); *Standard Chartered PLC v. Price Waterhouse,* 190 Ariz. 6, 41-42, 945 P.2d 317, 352-53 (Ct. App. Ariz. 1996) (audit interference doctrine incompatible with Arizona law of comparative fault) (Arizona); *FDIC v. Deloitte & Touche,* 834 F. Supp. 1129, 1146-47 (E.D. Ark. 1992) (comparative fault approach, unrestricted by audit interference doctrine, capable of even-handed apportionment of liability) (Arkansas); *Resolution Trust Corp. v. Deloitte & Touche,* 818 F. Supp. 1406, 1408 (D. Colo. 1993) (audit interference doctrine would abrogate statement by legislature that liability should be apportioned by fault) (Colorado); *Devco Premium Fin. Co. v. N. River Ins. Co.,* 450 So. 2d 1216, 1220 (Fla. App. 1984) (where state had repudiated contributory negligence, better rule is that plaintiffs should not be allowed to recover for losses which they could have avoided by the exercise of reasonable care) (Florida); *Nat'l Credit Union Admin. Bd. v. Aho, Henshue & Hall,* 1991 WL 174671, *5 (E.D. La. 1991) (comparative fault scheme dictates that each party's fault be assessed and that plaintiff be allowed to recover only damages caused by defendant's negligence.) (Louisiana); *Capital Mortgage Corp. v. Coopers & Lybrand,* 142 Mich. App. 531, 537, 369 N.W.2d 922, 925 (1985) (under comparative negligence neither party is absolved of fault due to the other's negligence.) (Michigan).

There Remain a Few Pockets of Inequity Where States Have Continued to Apply the Doctrine

Courts in a few states continue to apply the audit interference doctrine, notwithstanding their respective states' shifts to comparative fault. The reasoning of these cases is flawed as they apply an exception to a rule (contributory negligence) that no longer exists.

In *Board of Trustees v. Coopers & Lybrand,* 775 N.E.2d 55 (Ill. App. Ct. 2002), for example, the court reasoned that, as a product of common law, the audit interference doctrine remained in full force absent its express abrogation by the Illinois comparative negligence statute. The rationale assumed incorrectly that the audit interference doctrine had an existence separate and apart from the contributory negligence rule to which it was an exception.

Other courts have been reluctant to abolish the audit interference doctrine on the theory that auditors would otherwise be rendered immune from the consequences of their own negligence. *See e.g. Fullmer v. Wohlfeiler & Beck,* 905 F.2d 1394 (10th Cir. 1990) (Utah); *Lincoln Grain, Inc. v. Coopers & Lybrand,* 345 N.W.2d 300 (Neb. 1984). The premise is incorrect because comparative fault requires that liability for damage be assigned in proportion to the amount of negligence of each of the parties. *See Li, supra.* 13 Cal. 3d at 829. Abolition of the audit interference doctrine under a comparative fault system therefore does not render auditors immune from the consequences of their negligence. Conversely, failure to abolish the doctrine under comparative fault would allow audit clients to escape all responsibility for their negligence.

Under the contributory negligence rule, the courts faced the prospect that a client that was even slightly negligent might be denied recovery against a greatly negligent auditor. The audit interference doctrine did not eliminate inequity — it simply shifted the inequity to allow greatly negligent clients to recover from even slightly negligent auditors.

With the demise of contributory negligence, courts are no longer faced with such all-or-nothing choices. Under comparative fault, responsibility can be allocated more equitably in proportion to relative fault. Continued application of the audit interference doctrine is at best unnecessary. At worst, the continued application of the doctrine is an impediment to the equitable allocation of responsibilities intended under comparative fault. There should therefore be no room for the audit interference doctrine under a system of comparative fault.