CAST ART INDUSTRIES, LLC; SCOTT SHERMAN; GARY BARSELLOTTI; and FRANK COLAPINTO, Plaintiffs-Respondents/ Cross-Appellants, vs. KPMG LLP; JOHN QUINN; JOHN SHAW; ED LAZOR; FRANK CASAL; and JOHN DOES 1-10, Defendants-Appellant/ Cross-Respondent.	SUPERIOR COURT OF NEW JERSEY APPELLATE DIVISION DOCKET NO. A-2479-08T2 CIVIL ACTION ON APPEAL FROM A FINAL JUDGMENT OF THE SUPERIOR COURT OF NEW JERSEY, LAW DIVISION, MIDDLESEX COUNTY SAT BELOW: HON. PHILLIP L. PALEY, J.S.C. AND A JURY

BRIEF OF *AMICI CURIAE* NEW JERSEY SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS AND AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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PRELIMINARY STATEMENT

The New Jersey Society of Certified Public Accountants (the "NJSCPA") and The American Institute of Certified Public Accountants (the "AICPA") respectfully submit this brief pursuant to Rule 1:13-9 as *amici curiae*.

This appeal raises several issues that are of importance to the accounting profession. First, *amici* are concerned with the Trial Court's interpretation of the Accountant Liability Act, N.J. Stat. Ann. § 2A:53A-25 ("ALA" or the "Act"). The Trial Court interpreted the ALA to permit a third-party non-client to sue the accountant of a merger counterparty for alleged negligent failure to detect fraudulent misrepresentations in the client's financial statements when (1) the accountant had no more than an awareness that its client might send the accountant's audit report to the third-party non-client and (2) there is no record evidence that the accountant took any affirmative action to express its consent to the third-party non-client's reliance upon the audit report. The NJSCPA and AICPA believe that under such circumstances, neither the "agreement" nor "direct expression" requirements of the ALA are satisfied, and that the Trial Court's interpretation significantly undermines the New Jersey Legislature's intent in adopting the ALA.

Second, the Trial Court permitted the jury to consider plaintiffs' argument that certain selections from KPMG's training materials establish the standard of care for claims of auditor negligence and negligent misrepresentation, rather than Generally Accepted Auditing Standards ("GAAS") and Generally Accepted Accounting Principles ("GAAP"). It is indisputable that GAAS provides the standard of care for auditors in this State. The NJSCPA and AICPA believe that it is improper to permit one firm's internal training materials to set an objective standard of care for the profession.

Lastly, the Trial Court erred in allowing the plaintiffs to conflate transaction causation (i.e., causation in fact) with loss causation (i.e., proximate causation) and thereby recover damages for the claimed loss of their entire business without proving that the specific acts of alleged negligence caused the merged company to fail. The Trial Court's refusal to frame causation in terms of transaction causation and loss causation led to the conflation and also caused the jury to lose sight of the need for plaintiffs to prove that KPMG caused plaintiffs' losses. The NJSCPA and AICPA maintain that a plaintiff should be required to prove that the specific misstatements by the accountant actually and proximately caused the plaintiff's losses. If not, auditors will be subjected to substantially disproportionate liability, particularly in circumstances such

as those here, where the plaintiffs did not engage or compensate the accounting firm for the services upon which it sues (and in fact had their own set of financial and accounting advisers).

These issues are of great significance to the broad group of accounting firms that the NJSCPA and AICPA represent, and in particular the many firms and individual accountants who practice in New Jersey.

INTEREST OF THE NJSCPA AND AICPA AS *AMICI CURIAE*

The NJSCPA, founded in 1898, is the only statewide organization for certified public accountants in the State of New Jersey. The mission of the NJSCPA is to promote and maintain high professional and ethical standards of public accountancy in New Jersey; to develop and approve accountant education and research; and to protect the interests of the public and the members of the NJSCPA. The membership is currently over 15,500 members, representing approximately 65% of all licensed certified public accountants in New Jersey.

The AICPA is the national organization of the certified public accounting profession, with more than 340,000 members. Among the AICPA's purposes are the promotion and maintenance of high professional standards of practice. In pursuit of these ends, the AICPA has been a principal force in developing auditing standards, drafting model legislation, sponsoring

educational programs, and issuing professional publications to improve the quality of services provided by CPAs. Because of its historical role in formulating standards relating to audits, reviews, compilations, and attestation engagements, and the related reports, the AICPA maintains a strong interest in the scope and bases of civil liability sought to be imposed on accountants pursuant to those standards.

Neither the NJSCPA nor the AICPA has a direct pecuniary interest in this case. However, because of their extensive understanding of the accounting profession and commitment to the public interest, these organizations are deeply concerned about the ultimate outcome of this case, inasmuch as several errors made by the Trial Court threaten to broaden, without any basis, the circumstances under which an accountant may be liable to non-clients for alleged negligence.

This expansion of liability is of particular concern to the profession because accounting firms have increasingly been targeted as "deep pocket" defendants. In these instances, when a plaintiff claims to have suffered an economic loss as a result of a transaction with an entity, but finds that entity to be insolvent or otherwise unable to satisfy fully the alleged losses, the plaintiff fashions claims against the accounting firm that performed services for that entity, asserting

reliance, as a non-client, upon reports of the entity's accounting firm that the entity provided. These types of claims by non-clients are specifically of concern to the profession because of the general indeterminacy of such liability. That is, while the fee that the accountant receives from its client should enable the accountant to take into account such factors as the risk profile of that client, an accountant cannot know with certainty to whom the client may provide the report. The accountant therefore faces difficulty in properly assessing the extent of its potential liability to such other parties.

This litigation risk can be significant. While, as noted, accountants are frequently viewed as having deep pockets, most in fact do not. This is particularly the case for the many smaller firms and solo practitioners that provide services in this State. Even the few large firms are at risk. See U.S. Chamber of Commerce, Commission on the Regulation of U.S. Capital Markets in the 21st Century - Report and Recommendation at 104 (March 2007) ("The biggest threat facing audit firms today is that a single mega-claim or several such civil claims in succession could destroy an audit firm"); see also U.S. Treasury, Advisory Committee on the Auditing Profession Final Report at VII:25 (Oct. 6, 2008) (noting that the six largest firms were, as of September 2008, exposed to more than 120 private actions, each with claims of over $100 million, several

of which were over $1 billion). In adopting the ALA, the Legislature of this State has already determined to protect accountants against such frequently unquantifiable risk by putting in place specific requirements that must be met before accountant liability is permitted.

Without such protections, many companies may have trouble finding auditors at all. That is, accountants may feel forced to reject smaller or more entrepreneurial companies with less developed risk management and oversight systems to minimize the accountant's litigation risk. The failure to obtain such services may correspondingly affect those companies' investors, and ultimately the economy. See, e.g., Eric L. Talley, Cataclysmic Liability Risk Among Big Four Auditors, 106 Colum. L. Rev. 1641, 1689 (Nov. 2006) (to manage liability, "auditors can decide to sever relationships with their riskiest clients, altering their 'portfolio' of clients to a safer sub-population"); Carl Pacini, Mary Martin & Lynda Hamilton, At the Interface of Law and Accounting, 37 Am. Bus. L.J. 171, 173 (2000) (noting that increased litigation has caused accounting firms to be "more aggressive in refusing to render services to high-litigation-risk firms").

In addition to the obvious financial and reputational exposure caused by the filing of lawsuits, increased litigation risk affects the ability of the profession to recruit and retain

highly qualified personnel. <u>See</u> U.S. Chamber of Commerce, <u>Auditing: A Profession at Risk</u> at 8 (Jan. 2006) ("Qualified auditors face ever-growing incentives to exercise their professional options and may opt to leave the profession altogether."). This, in turn, may further reduce the availability, and therefore increase the cost, of accounting services necessary to the flow of commerce in New Jersey.

As shown below, several aspects of the Trial Court's decision conflict with this State's Legislative mandates and common law. It is important that the potential liability of an accounting firm for alleged misrepresentations in an audit report or similar client engagement be consistent with the Legislature's mandates. At a minimum, accountants' potential liability should be governed by a predictable set of standards so that they may understand their risk in undertaking professional engagements and, where permissible, mitigate that risk to acceptable levels through appropriate risk management.

BACKGROUND

Amici curiae AICPA and NJSCPA rely upon the Statement of Facts set forth in KPMG's opening appellate brief, dated May 20, 2009, at pages 6 through 12.

LEGAL ARGUMENT

I. THE ROLE OF THE AUDITOR

To appreciate fully the concerns of *amici* discussed below, it is important to understand the specific role of the auditor. An auditor's role with respect to the fair presentation of a client's financial statements is limited, and most importantly, secondary to that of the client. The auditor expresses an opinion on whether the financial statements of an entity are fairly stated, based on selective testing of transactions and controls. Corporate financial statements are prepared by, and the responsibility of, management, not the company's auditors. Bily v. Arthur Young & Co., 834 P.2d 745, 762 (Cal. 1992) (citations omitted); Responsibilities and Functions of the Independent Auditor, 1 AICPA Professional Standards AU § 110.03 (AICPA 1999) (hereinafter "Professional Standards") (referred to as "generally accepted auditing standards" or "GAAS") ("financial statements are management's responsibility"). Because the client typically prepares its own financial statements, "it has direct control over and assumes primary

responsibility for their contents." Bily, 834 P.2d at 762. The client, not its auditor, is also responsible for, among other things, "adopting sound accounting policies and for establishing and maintaining internal controls that will . . . process, summarize, and report transactions (as well as events and conditions) consistent with management's assertions embodied in the financial statements." Professional Standards, AU § 110.03.

Auditors must rely on management to provide them with financial information relevant to the audit. See, e.g., Bily, 834 P.2d at 762 ("the client necessarily furnishes the information base for the audit"). Additionally, management is required to provide specific representations to an auditor relating to, among other things, management's responsibility for the fair presentation of financial position, results and cash flow, and management's belief that the financial statements are fairly presented in accordance with "generally accepted accounting principles" ("GAAP"). Professional Standards, AU § 333.06.

That is not to say that an auditor blindly accepts management's information or representations. Of course, auditors test management's assertions. But in expressing an opinion as to whether the client's financial statements, taken as a whole, present fairly in all material respects the client's financial position, results of operations, and its cash flows in

conformity with GAAP, the auditor obviously cannot -- and does not -- reconstruct every transaction that the client entered into during the audit period, or independently value every one of the client's assets and liabilities. Rather, the auditor relies on a risk assessment and selective testing, as well as analytical procedures, to express its opinion on the assertions in the financial statements. See, e.g., Bily, 834 P.2d at 749, 751 ("For practical reasons of time and cost, an audit rarely, if ever, examines every accounting transaction in the records of a business."). As a result, auditors plan and perform their audit only to obtain "reasonable assurance" of detecting material "errors and irregularities." Professional Standards, AU § 316.05. That is, an audit cannot guarantee that every error will be identified through audit procedures.

Professional standards are also unequivocal that a properly planned and executed audit cannot guarantee discovery of management fraud. See Professional Standards, AU § 316.07-08 (because of characteristics of irregularities, "particularly those involving forgery and collusion," even a "properly designed and executed audit may not detect a material irregularity"). A "financial statement audit performed in accordance with [GAAS] is not a 'fraud audit' or a detailed forensic-style examination of evidence." Public Oversight Board

Panel On Audit Effectiveness, Report And Recommendations 76 (2000).

Because of these limitations, it is even more important that the law accurately reflect protections this state has determined to provide to accountants, including application of an appropriate standard of care and careful analysis of alleged losses arising from negligence claims.

II. THE ACCOUNTANT LIABILITY ACT PROVIDES SIGNIFICANT PROTECTION TO THE ACCOUNTING PROFESSION FROM NEGLIGENCE AND NEGLIGENT MISREPRESENTATION CLAIMS BY NON-CLIENTS.

A review of the record in this case convinces *amici* that the Trial Court misunderstood the ALA and as a result, permitted plaintiffs' claims to go to the jury despite their failure to satisfy the requirement of privity under the ALA.

A. The Decision Below Eviscerates The Standard For Accountant Liability In Contravention Of The ALA, Its Legislative History, And Case Law.

The AICPA and NJSCPA are greatly concerned that the decision below, if not reversed, will seriously undermine the Accountant Liability Act, N.J. Stat. Ann. § 2A:53A-25. By enacting the ALA, the New Jersey Legislature intended to provide the accounting profession more, not less, protection from the claims of non-clients in the wake of the decision in Rosenblum, Inc. v. Adler, 93 N.J. 324 (1983). Indeed, the current law in this State is that an accountant is not liable to a third party

non-client for negligence or negligent misrepresentation in performing its accounting services unless the claimant can satisfy each of the requirements of the ALA. E. Dickerson & Son, Inc. v. Ernst & Young, LLP, 179 N.J. 500, 502 (2004).

1. The Act

The Act's requirements underscore the clear intent of the Legislature to limit the circumstances in which an accountant can be liable to non-clients. The ALA bars a non-client's claims against an accountant for negligence unless the accountant:

> (a) knew at the time of the engagement by the client, or agreed with the client after the time of engagement, that the professional accounting service rendered to the client would be made available to the claimant, who was specifically identified to the accountant in connection with a specified transaction made by the claimant;
>
> (b) knew that the claimant intended to rely upon the professional accounting service in connection with that specified transaction;
>
> and
>
> (c) directly expressed to the claimant, by words or conduct, the accountant's understanding of the claimant's intended reliance on the professional accounting service.

N.J. Stat. Ann. § 2A:53A-25(b)(2) (emphasis added).

To understand better the significance of these requirements, a brief review of developments of the law in New Jersey and elsewhere is helpful.

2. The Traditional Privity Rule

Traditionally, privity was required between the accountant and the claimant to state a negligence-based claim. Ultramares Corp. v. Touche, 174 N.E. 441, 446-48 (N.Y. 1931), provided the common law basis for this doctrine in New Jersey and elsewhere. See Rosenblum, 93 N.J. at 333. The "privity rule" requires that the claimant and the accountant be in a contractual relationship, or have a relationship equivalent to, or approaching, privity before a court will impose liability on the accountant. Id. at 446-48. In Ultramares, Chief Judge Cardozo explained that the basis for the privity requirement was fairness and predictability:

> 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 amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences.

Id. at 444.

Indeterminate liability is especially a threat in accountant liability cases. Even where the accountant can

identify the investors, banks, and other third parties who might receive and rely upon the accountant's report, it is unduly burdensome to place the onus on the accountant to identify those third parties and inform them that the accountant has not extended its duty of care to include them. The accountant has no practical way of limiting or controlling those who might claim that they relied upon the accountant's report. Therefore, there needs to be a requirement that imposes liability only if there is some affirmative conduct indicating that the accountant agreed with the client to extend its duty of care and directly expressed its understanding to the third party that the latter would rely upon the accountant's report.

3. The Temporary Abrogation Of The Privity Standard In New Jersey

The New Jersey Supreme Court in H. Rosenblum, Inc. v. Adler, 93 N.J. 324 (1983), rejected the historic Ultramares privity standard, instead adopting a test of "reasonable foreseeability." In Rosenblum, an accountant from the defendant accounting firm had been present at some of the merger discussions between the firm's client, Giant, and the acquiring corporations. Id. at 330. Although the accountant did not participate in the merger negotiations, plaintiffs asserted that they received the auditor's report on the client's financial statements for the relevant time period at a meeting the

accountant attended. Id. Plaintiffs also alleged that the accountant stated that Giant was going to have "a very strong year," if not "the best in history." Id. at 330-31.

The Court ultimately held that an accountant's liability for negligence extended to non-clients whom the accountant "should reasonably foresee as recipients" of an accountant's work product, including those who receive that work product from the client. Id. at 352 (emphasis added). Accordingly, Rosenblum held that an accountant who prepares an audit report was liable to a non-client for negligence if it was reasonably foreseeable that such a non-client might obtain, and rely on, the accountant's work. This holding clearly rejected the privity approach adopted in such cases as Ultramares.

4. The New Jersey Legislature's Rejection Of Rosenblum And Its Return To The Privity Standard

Rosenblum prompted a very definitive response from New Jersey's Legislature, which, in 1995, legislatively reversed the Rosenblum decision by enacting the ALA. The Legislature was clearly concerned that the "reasonably foreseeable" standard had overextended an accountant's potential liability to non-clients.

The ALA was introduced by its sponsor for the specific purpose of limiting the effect of Rosenblum:

> This bill would limit accountants' liability to third parties for the accountants' negligent acts. Although accountants' civil liability has historically been limited by

> common law, which required that there must be privity (a direct relationship) between an accountant and any party bringing suit against him, recent case law has weakened this concept. In H. Rosenblum, Inc. v. Adler, 93 N.J. 324 (1983), the New Jersey Supreme Court expanded the scope of accountants' liability to include all "reasonably foreseeable" plaintiffs, such as stockholders and potential investors.
>
> Thus, an accountant providing professional services to a client is vulnerable to lawsuits by virtually any member of the investing public at large, regardless of whether the accountant had any previous relationship with that person or any knowledge that the person would rely on the services the accountant rendered.
>
> The sponsor believes that this situation is particularly unjust in light of the fact that an accountant is rarely the primary wrongdoer in negligence cases. Instead, the accountant is sued because he failed to detect the fraud of his client. In many cases, an accounting firm is sued because it has "deep pockets," in contrast to its client, which may have become insolvent by the time the investors realize they have been defrauded.
>
> This bill would restore the concept of privity to accountants' liability towards third parties.

Statement attached to S. 826 (March 10, 1994) (hereinafter "Sponsor's Statement") (as quoted in E. Dickerson & Son, Inc. v. Ernst & Young, LLP, 361 N.J. Super. 362, 367 (App. Div. 2003), aff'd, 179 N.J. 500 (2004)). *Amici* respectfully submit that Cast Art's claims against KPMG present exactly the circumstances

that the Legislature was seeking to prevent when it crafted the ALA's requirements and passed the statute.

5. The Trial Court Misunderstood The ALA's Requirements Of Agreement And Direct Expression.

The Trial Court's rulings reflect a fundamental misunderstanding of the ALA, effectively void the terms of the Act, and return accountants to a pre-ALA world, in which the Rosenblum standard leaves accountants uncertain as to the scope of their liability.

A court must apply a statue as written and consistent with the Legislature's purpose. As the Appellate Division recognized while interpreting the ALA,

> [w]hen called upon to interpret a statute, the overriding goal has consistently been to determine the Legislature's intent. When the language is clear, we generally rely on its plain meaning.

E. Dickerson & Son, Inc., 361 N.J. Super. at 366 (internal citations omitted, emphasis added). For those reasons, a court may not interpret a statute so as to ignore its requirements because the court disagrees with the policies behind the law. See, e.g., DiProspero v. Penn, 183 N.J. 477, 492 (2005) ("The Legislature's intent is the paramount goal when interpreting a statute . . .") (internal citations omitted).

The ALA requires, among other things, that (1) the accountant "knew at the time of engagement by the client," or

"agreed with the client" thereafter that its work product would be made available to a specific non-client for a specified transaction, and (2) the accountant "directly expressed to the claimant" its "understanding" that the non-client would rely upon its work product. N.J. Stat. Ann. § 2A:53A-25(b)(2)(a) & (c). These two distinct requirements reflected the Legislature's conclusion that an accountant should not be exposed to non-client liability unless the accountant manifests specific agreement to assume that potential responsibility. The Legislature recognized that, without such requirements, accountants would face significant and uncertain liability exposure. See Sponsor's Statement.

Thus, the ALA first requires the accountant to know at the time of engagement, or agree with its client subsequently that the accountant's work product would be made available to a specified third party for purposes of a specific transaction. Notice to the accountant that its work product might be sent to the third party does not constitute the necessary "agreement," because notice is not an agreement. See Pagnani-Braga-Kimmel Urologic Assoc., P.A. v. Chappell, 407 N.J. Super. 21, 27-28 (Law Div. 2008) ("A contract does not come into being unless there is a manifestation of mutual assent by the parties to the same terms.").

The ALA's additional requirement, that the accountant "directly express" its understanding to the third party that the third party was permitted to rely upon its work product, is also intended to ensure that the accountant is not undertaking a duty to a non-client unless the accountant agrees to do so. "Direct expression" accordingly requires an affirmative act by the accountant.[1] See N.J. Stat. Ann. § 2A:53A-25(b)(2)(c) (requiring a "direct[] express[ion]" by "words or conduct"); cf. LaSalle Nat'l Bank v. Ernst & Young LLP, 729 N.Y.S.2d 671, 675 (N.Y. App. 1st Dep't 2001) (lender-plaintiffs' allegations that their letters to accountant should have put accountant on notice of their intent to rely on audit report was unilateral conduct and, absent affirmative conduct on part of accountant evincing

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[1] The ALA has a similar standard to that set out by the New York Court of Appeals in Credit Alliance Corp. v. Arthur Andersen & Co., 65 N.Y.2d 536, 551 (1985). The Credit Alliance test requires: (1) the accountants must have been aware that the financial reports were to be used for a particular purpose or purposes; (2) in the furtherance of which a known party was intended to rely; and (3) there must have been some conduct on the part of the accountants linking them to that party, which evinces the accountants' understanding of that party's reliance. See id. at 551; see also Overland Leasing Group, LLC v. First Fin. Corp. Servs., Inc., No. 06-05850, 2007 WL 3349491, at *3 (D.N.J. Nov. 7, 2007) ("New Jersey's accountant liability statute and New York's Credit Alliance test substantially mirror each other."). "Moreover, subsection (c) of New Jersey's accountant liability statute and the third prong of New York's Credit Alliance test require an indication of an accountant's understanding of the claimant's intended reliance." Id. (citing N.J. Stat. Ann. § 2A:53A-25b(2)(c); Credit Alliance, 65 N.Y.2d at 551).

acknowledgment of such reliance, were insufficient to establish linking conduct). Otherwise, this carefully constructed statutory language would be rendered meaningless.

It is *amici's* understanding that KPMG neither knew at the time of its engagement by Papel, nor ever subsequently agreed with its client, Papel, that KPMG's 1999 audit report would be made available to Cast Art.[2] The only agreement with Papel on this topic, an "access letter" for KPMG's work product for the 1998 audit, including the 1998 audit report, specifically disclaimed any such liability.

The use of access letters is a common practice in the profession. These letters frequently permit access to an auditor's work product to facilitate a variety of business transactions, but, in doing so, may circumscribe or preclude the assumption of any duties by the accountant to the third party which the accountant is unwilling to assume.[3] See Thomas H. Lee Equity Fund V, L.P. v. Grant Thornton LLP, 586 F.Supp. 2d 119, 124, 127-28 (S.D.N.Y. 2008) (accountant used access letters to put plaintiffs on notice that accountant did not perform audit

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[2] In addition, the KPMG engagement letter for the 1999 Audit agreed only to perform an audit for the Board of Directors of Papel. The audit was not performed for purposes of the proposed merger between Cast Art and Papel, or for the benefit of Cast Art.

[3] The scope of the accountant's potential responsibility to the non-client can also be the subject of discussion or negotiation.

with their particular transaction in mind). Having obtained an access letter for the 1998 work product and having received the 1998 audit report pursuant to that access letter, Cast Art could have sought such an "access letter" from KPMG for the 1999 audit, but failed to do so.

It would be a paradoxical and unfair result of the case below if a non-client were allowed to ignore the usual process of obtaining an access letter and then sue for common law negligence and negligent misrepresentation because it had not sought the access letter. Such a result should not be countenanced, particularly in the face of the ALA, however. The record does not support that Cast Art has satisfied the ALA's first requirement that KPMG agreed with Papel that Cast Art could review and rely upon KPMG's audit reports in connection with the merger.

Furthermore, *amici* are unaware of any evidence that KPMG directly expressed its understanding to Cast Art that Cast Art could rely upon the 1998 or 1999 audit report to decide whether to go forward with the Papel merger or on what terms. KPMG was engaged only by Papel and sent its audit reports to its client, not Cast Art with the exception of the 1998 audit report that was sent pursuant to an access letter that disclaimed any potential liability. *Amici* understand that plaintiffs assert there was one conference call (during an eight-month

negotiation) in which plaintiff Sherman supposedly asked an unidentified KPMG representative when the 1999 audit report would be completed. A response about when the auditor intends to deliver the report to its client could not possibly satisfy the "direct expression" element of the ALA.[4] If these circumstances constitute the "direct expression" to the non-client required by the ALA, accountants will be unwilling to have any contact or communication with non-clients. This, in turn, will make it more difficult and expensive to close transactions where the potential acquiror desires or needs access to the auditor's work product.

The consequence of plaintiffs' argument is that if an accountant knows it is likely the accountant's work product will be sent to a non-client in connection with a specific transaction, the accountant should be deemed to have agreed that its work product can be relied upon by the non-client and the ALA requirements of "agreement" and "direct expression" have been satisfied. This, however, is inconsistent with the ALA which requires affirmative acts by the accountant manifesting its "agreement" and "direct expression."

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[4] It is not surprising that there is not evidence of direct expression, as Cast Art was advised and assisted throughout the merger negotiations, due diligence and closing by sophisticated accountants, investment bankers, and attorneys. In fact, these advisers appear to have raised serious questions about Papel and the merger.

Permitting the case to proceed to trial, and ultimately verdict, on these facts returns this State to the Rosenblum standard of "reasonable foreseeability." At most, the record evidence reflects that because KPMG was aware of the Cast Art transaction and participated in one conference call in which a question about the timing of its 1999 audit report was raised, it should have been "foreseeable" to KPMG that Cast Art might receive that report. But, under the plain terms of the ALA, mere foreseeability is not sufficient to ground liability.

B. New York Courts, Applying A Legal Standard Similar To The ALA, Have Rejected Claims Factually Analogous To This Case.

As discussed in more detail in footnote 1, supra, the standard for privity in New York under the Credit Alliance case is similar to that articulated in the ALA. For that reason, a review of the case law in New York under facts analogous to those presented in this case is instructive and supports the conclusion that there is no privity here.

In Thomas H. Lee Equity Fund V, L.P. v. Grant Thornton LLP, 586 F. Supp. 2d 119 (S.D.N.Y. 2008), for example, a federal court applying New York law held that the provision of audit work papers pursuant to access letters by Grant Thornton was not sufficient to establish the "linking conduct" required by New York's privity standard. Id. at 128. Rather, the court found that Grant Thornton had expressly disclaimed in its access

letter any additional liability that might arise out of its provision of work papers to plaintiffs' accountants. Id. at 128-29. Similarly, here, the extent of KPMG's expressed understanding of its relationship with Cast Art was an access letter for the 1998 work papers - substantially identical to that used by Grant Thornton in Thomas H. Lee - that disclaimed any liability.

In Security Pacific Business Credit, Inc. v. Peat Marwick Main & Co., 79 N.Y.2d 695 (1992), a lender to an accountant's client brought a negligence claim against Main Hurdman, the accountant. There was evidence that Main Hurdman was aware that its client and the lender were in negotiations for a line of credit, but there was no showing that Main Hurdman was aware that it was retained to prepare the audit report for the purpose of inducing the lender to extend credit to its client. The Court of Appeals observed that the lender, in attempting to establish a "relationship sufficiently approaching privity", relied primarily on a single unsolicited phone call from the lender's vice-president to the Main Hurdman audit partner. Id. at 705. The court rejected this attempt, noting that the facts fell far short of establishing a "linking relationship akin to privity." Id. The Court of Appeals specifically declined to permit the lender to acquire "deep pocket surety coverage" from the auditor for its loan through no more than a single phone

call to the auditor, as such conduct was insufficient to bring the auditor "within the ambit of liability promulgated and recognized in Credit Alliance." Id. at 706-07.

The decisions in Thomas H. Lee and Security Pacific illustrate how the New York courts apply the concept of privity to protect accountants from liability in negligence to third parties in circumstances where the accountants have not agreed to extend their duty of care to those third parties.[5] Because the ALA and New York law are similar, especially with respect to the crucial element of "direct expression" or "linking conduct,"

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[5] See also, e.g., BHC Interim Funding, L.P. v. Finantra Capital, Inc., 283 F. Supp. 2d 968, 985 (S.D.N.Y. 2003) ("[T]he plaintiff must show that the accountant was well aware that a primary, if not the exclusive, end and aim of auditing its client was to provide information to the plaintiff. In other words, it is insufficient to allege that the accountant's client sought to induce plaintiffs to extend credit, where no claim is made that the accountant was being employed to prepare the reports with that particular purpose in mind." (emphasis in original) (internal citations omitted)); Houbigant, Inc. v. Deloitte & Touche LLP, 753 N.Y.S.2d 493, 495 (App. Div. 2003) (no relationship approaching privity where task of accountant as auditor of licensee's financial statements, in course of assessing whether licensee was complying with contractual obligation to plaintiff, was conducted "pursuant to professional standards applicable in the context of any audit, and was not undertaken pursuant to any duty owed toward" plaintiff); see also Housing Works, Inc. v. Turner, 179 F. Supp. 2d 177, 217 (S.D.N.Y. 2001) (granting motion to dismiss and holding that phone call and correspondence between lender plaintiffs and accountant was "unilateral conduct by the lenders, and not affirmative conduct," as required for a claim against the accountant), aff'd, 56 Fed. Appx. 530 (2d Cir. 2003).

this precedent is instructive in connection with the Court's consideration of KPMG's appeal.

C. The Trial Court Further Diluted The Protection Of The ALA By Submitting To The Jury The Issue Of Whether KPMG Owed Cast Art A Duty.

The Trial Court ignored a long-standing principle of tort law: a court, not a jury, should decide the existence of a duty under New Jersey law. Because the ALA imposes a duty of care upon the accountant to a third party non-client, a court should decide whether the requirements of the ALA have been satisfied. The Trial Court erred when it did not grant KPMG summary judgment or a directed verdict on this issue, and instead delegated its judicial responsibility to the jury.

"A duty is an obligation imposed by law requiring one party to conform to a particular standard of conduct toward another. The recognition or establishment of a legal duty in tort law is generally a matter for a court to decide." Acuna v. Turkish, 192 N.J. 399, 413-14 (2007) (internal citations omitted), cert. denied, 129 S. Ct. 44 (2008); see also Fackelman v. Lac d'Amiante du Quebec, LTEE, 398 N.J. Super. 474, 488 (App. Div. 2008); Jarrah v. Trump Hotels & Casino Resorts, Inc., 487 F. Supp. 2d 522, 526 (D.N.J. 2007); Prosser and Keeton on Torts § 37, at 236 (5th ed. 1984).

Determining whether a duty exists here, moreover, involves the interpretation of a New Jersey statute -- also the

responsibility of the court, not the jury. See Bogue Elec. Co. v. Bd. of Review of the Div. of Employment Sec. of the Dep't of Labor and Indus., 21 N.J. 431, 435 (1956) ("The problem is one of statutory interpretation, and as we have stated our province is merely to interpret and apply this act to particular situations as they are presented . . ."); Ellis v. Caprice, 96 N.J. Super. 539, 554 (App. Div. 1967) (stating "[t]he interpretation of the statute [is] for the court" where the trial judge had "withdr[awn] the [interpretation of a statute requiring fire escapes] from the jury's consideration").

Allowing a jury to determine whether a duty exists will have many undesirable consequences, including potentially conflicting interpretations of the ALA, and the lack of reliable precedent.[6] This will simply contribute further to unpredictable liability for accountants in contravention of the Legislature's intent.

* * *

The implications of the Trial Court's errors are significant. In addition to ignoring a legislative mandate, the Trial Court has exposed accountants to potential liability

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[6] There may be instances where issues of fact need to be resolved in considering whether a duty exists; for example, whether a conversation between the accountant and claimant in fact occurred, or what was said. These fact questions could be handled through special jury interrogatories.

whenever they are aware that their work product may be obtained by a non-client. The decision below also exposes accountants to claims made by third parties who have received the accountants' work product from the accountants' client without the accountant's consent, and as part of a scheme that defrauded not only the third party but also the accountants. This creates substantial potential liability beyond what the accountant could reasonably expect, and would require the accountant to charge auditing fees beyond what a client could reasonably pay. This is an issue not only for large accounting firms but also, and especially, for small and medium-sized firms, for which such indeterminate liability may be a very serious threat to a firm's ongoing viability.

III. A JURY SHOULD NOT BE PERMITTED TO CONSIDER THE TRAINING MATERIALS OF AN ACCOUNTING FIRM IN DETERMINING THE APPLICABLE STANDARD OF CARE.

It is no surprise that accounting firms train personnel to follow what the firm considers to be "best practices" in rendering accounting services. They do so in the hopes that their personnel will provide superior services to their clients. They do not expect, however, that this aspirational effort will cause them to be held to a different or higher standard of care as a result of those materials.

In New Jersey, an auditor's standard of care is determined by GAAS and, when appropriate, GAAP. See, e.g., NCP Litigation

Trust v. KPMG LLP, 187 N.J. 353, 380 (2006) ("An auditor's professional duty to its corporate client requires the auditor to comply with GAAS and GAAP . . ."); Abella v. Barringer Resources, Inc., 260 N.J. Super. 92, 96 (Ch. Div. 1992) ("In order to express an opinion on the fairness of the financial presentation, the auditor examines the report in accordance with [GAAS]. Under GAAS, an auditor must obtain reasonable assurance as to whether the financial statement taken as a whole is free of material misstatement.") (citation omitted); N.J. Admin. Code § 13:29-3.5.

KPMG, like many (if not most) accounting firms, develops and presents training materials to its personnel. Rather than requiring the jury simply to assess whether KPMG complied with GAAS, *amici* understand that the Trial Court instructed the jury that it also could consider KPMG's training materials, in addition to GAAS, in determining the standard of care. Courts have routinely held that these types of materials should not be admissible as evidence of the applicable standard of care. Trump Plaza Associates v. Haas, 300 N.J. Super. 113, 124 (App. Div.) (holding that casino was not entitled to recover on negligence claim against bank arising from bank's alleged failure to adhere to its internal procedures, where bank

breached no statutory standard of care under the UCC), certif. denied, 151 N.J. 75 (1997).[7]

Permitting a jury to consider internal training materials in determining the standard of care will necessarily lead to inconsistent decisions regarding the standard of care, and potential prejudice to those accounting firms that invest in the preparation and use of such materials to improve the performance of their personnel. See supra at 28; see also, e.g., Gilson v. Metro. Opera, 5 N.Y.3d 574, 577 (2005) (internal guidelines that go beyond the standard of ordinary care cannot serve as a basis for imposing liability); see also Mayo v. Publix Super Markets, Inc., 686 So.2d 801, 802 (Fla. App. 1997) ("We reiterate . . . that a party's internal rule does not itself fix the legal standard of care in a negligence action, and that the party is entitled to appropriate jury instructions to that effect."); Wal-Mart Stores, Inc. v. Wright, 774 N.E.2d 891, 894-96 (Ind. 2002) (trial court erred in issuing jury instruction that invited jurors to deviate from the accepted objective standard of care).

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[7] New Jersey is not alone in adopting this rule. See, e.g., Sherman v. Robinson, 80 N.Y.2d 483, 489 n.3 (1992) ("[v]iolation of a company's internal rules is not negligence in and of itself, and where such rules require a standard that transcends reasonable care, breach cannot be considered evidence of negligence").

It would not be a wise policy for the public or any profession to allow a single firm's training materials or other internally utilized guidance to serve as the standard of care to which the entire profession would be held. First, the NJSCPA and the AICPA recognize that training materials enhance the quality of audit services delivered by individual firms; practices and tools above the minimal standards should be encouraged to ensure that audit quality continues to improve. If accountants are held to a higher standard of care because they aspire to a higher standard, then these aspirational training efforts will be discouraged throughout the profession. Second, allowing such materials to provide the basis of the duty will create uncertainty as to what standard applies, as the standard would vary depending on the defendant firm's own training and audit methodology. This circumstance will only contribute further to the lack of predictability for accountants practicing in this State. Finally, allowing the training materials to be considered in determining the standard of care is inconsistent with this State's recognition that GAAS and GAAP set the standard of care for auditors. See supra at 28. The Trial Court therefore erred in permitting these training materials (*in toto*) to be considered by the jury.[8]

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[8] There may be instances where certain internally prepared
(footnote continued...)

IV. TRANSACTION CAUSATION AND LOSS CAUSATION SHOULD NOT BE CONFLATED; BOTH MUST BE DEMONSTRATED TO PROVE CAUSATION.

A plaintiff should be required to prove that its losses were actually and proximately caused by an accountant's negligence. In the present case, this means plaintiffs must prove (1) they would not have proceeded with the merger if Cast Art had known of the material misstatements in Papel's financial statements; and (2) having gone through with the merger, that the merged company failed because of KPMG's failure to uncover those misstatements. Proof of both components of causation is critical for accountants, who can be exposed to substantial damages even if they had a minor role in a transaction. The same concerns that prompted the New Jersey Legislature to pass the ALA should guide the judiciary in determining a workable framework for causation in cases like that presented here. Otherwise, the judiciary will undermine, not fulfill, the purpose of the ALA. In the present case, the Trial Court permitted plaintiffs to recover despite their failure to present evidence that KPMG's alleged negligence caused their loss, i.e. the negligence caused the merged company to fail.

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materials could possibly be admissible -- for example, where they in fact articulate or explain the actual standard of care. Allowing their wholesale admission, however, and then letting the jury on its own determine what weight they should be given, as happened in the Trial Court, is clearly inconsistent with the law.

"Transaction causation" and "loss causation" represent a further refinement of the "substantial contributing factor" test, particularly applicable in complex business cases involving a failed transaction where there are a number of potential causes of the plaintiff's claimed loss. McCabe v. Ernst & Young, LLP, 494 F.3d 418, 438-39 (3d Cir. 2007); Conklin v. Hannoch Weisman, 145 N.J. 395, 420 (1996). "Loss causation," in particular, requires a court and jury to scrutinize the claimed loss and determine whether that loss was caused by the allegedly wrongful acts of the defendant - in this case, whether KPMG's alleged failure to identify material misstatements in Papel's 1998 and 1999 financial statements caused the merged entity to fail in 2003.

In a case involving a failed or disappointing transaction, such as a merger, framing the principles of causation in terms of "transaction causation" and "loss causation" is helpful in analyzing whether an act or omission was a substantial contributing factor. Using this framework ensures that the judge and jury adhere to traditional principles of causation by requiring the plaintiff to prove, not only that the defendant's negligence caused it to proceed with the transaction, i.e., transaction causation, but also that the negligence actually caused plaintiff's damages, i.e., loss causation. Therefore, identifying the causation standard in this manner to a jury is

appropriate. See Lamb v. Barbour, 188 N.J. Super. 6, 9 (App. Div. 1982), certif. denied, 93 N.J. 297 (1983).

In this regard, McCabe, with facts similar to those present here, is particularly instructive. There, plaintiffs, who had sold their company to a client of the defendant auditors, attempted to avoid proving loss causation in addition to transaction causation. 494 F.3d at 438. Plaintiffs contended they could prove causation solely through evidence that they would not have sold their company if the auditors had disclosed the purchaser's various problems before the sale. Id. at 436-38.

The Third Circuit, however, rejected this approach, and held that such proof was not sufficient to prove plaintiffs had actually suffered an economic loss as a result of the auditor's misconduct, rather than other events or causes. Id. at 438. The court recognized that loss causation is part of the proximate causation analysis, and plaintiffs' "failure to create a factual issue as to loss causation also constitutes a fatal failure to create a genuine issue as to the proximate causation required for their claims of common law fraud and negligence under New Jersey law." Id. While McCabe primarily involved a claim arising under Section 10(b) of the Securities Exchange Act of 1934, the Third Circuit properly recognized that causation

under Section 10(b) derives from principles of tort causation. McCabe, 494 F.3d at 438.

To the same effect, in Water Street Leasehold LLC v. Deloitte & Touche LLP, 796 N.Y.S.2d 598, 599 (App. Div. 1st Dep't 2005), leave to appeal denied, 6 N.Y.3d 706, 845 N.E.2d 467 (2006), a landlord alleged that it would not have entered into an amendment to the lease without the assurance provided by tenant's financial statements, which had been audited by Deloitte, that the tenant was capable of fulfilling its financial obligations. As the court noted, "[a]n essential element of any fraud or negligent misrepresentation claim is that there must be reasonable reliance, to a party's detriment, upon the representations made. Plaintiff must show both that defendant's misrepresentation induced plaintiff to engage in the transaction in question (transaction causation) and that the misrepresentations directly caused the loss about which plaintiff complains (loss causation)." Id. at 599-600. In affirming the dismissal of the complaint, the court held that the landlord's purported reliance on the audited financial statements did not cause its loss. Id. at 600; see also Meyercord v. Curry, 38 A.D.3d 315, 832 N.Y.S.2d 29 (App. Div. 1st Dep't 2007) (same).

Similarly, the articulation of the "substantial contributing factor" standard in terms of "transaction

causation" and "loss causation" is appropriate here, where the allegation is that a plaintiff suffered damages following a transaction and where it is alleged that the auditor failed to detect the fraud of one of the parties to the merger. Indeed, as the Supreme Court recognized in Conklin, supra, proximate causation should be analyzed in the manner appropriate for a specific dispute and the alleged misconduct; it is not a static concept. 145 N.J. at 418-20. Thus, in cases such as this, where the underlying circumstance giving rise to the litigation was a merger, and plaintiffs allege they suffered loss approximately two years later as a result of the negligence of the auditor of the merger party, "transaction causation" and "loss causation" provide a useful articulation of relevant principles. The application of this framework increases the likelihood that both the court and a jury will understand the two crucial steps in causation analysis that they should take in these complicated circumstances.

This framework properly focuses the court and jury on the critical issue of whether the plaintiff has proven that its economic damages were proximately caused by the accountant's misconduct, i.e., loss causation. In a case like this, where the plaintiff's damages did not occur until years after KPMG's alleged negligence, it is only fair and even more important that a plaintiff demonstrate this causal relationship. Otherwise,

the accountant could be exposed to liability for substantial damages that are remote from its negligent acts. If a merger does not turn out as expected, when does the potential liability for the accountant end?

Here, plaintiffs avoided the requirement of loss causation by conflating transaction causation and loss causation. Plaintiffs presented evidence only that they would not have proceeded with the merger if the 1998 and 1999 audit reports had identified the alleged but unquantified misrepresentations in the 1998 and 1999 Papel financial statements. The case law and principles of causation, however, require a plaintiff to prove through expert or other competent evidence that a merged company failed as a result of specific, material misrepresentations in the relevant financial statements that were a result of the auditor's negligence.

Permitting plaintiffs in cases such as this to avoid an exacting, yet traditional, causation test would render accountants liable for all damages occurring after a failed or disappointing transaction, no matter how remote the loss is from the negligence of the accountant. We respectfully submit that plaintiffs should be required to establish how the accountant's specific negligence <u>caused</u> their actual loss. Absent a proper showing of loss causation, a trial court or jury may ignore the role of other, perhaps more influential factors -- such as

declining interest in the product, a poor business environment, and managerial errors -- and focus unduly on the conduct of the accountant. That focus could result in the imposition of enormous liability that would be both unfair and unreasonable.

As explained previously, analyzing causation in terms of "transaction causation" and "loss causation" in this case does not change traditional principles of causation, but articulates those principles in a manner easily understood and applied by a judge and jury. *Amici*, therefore, urge this Court to analyze the evidence here in these terms and instruct lower courts to do so in similar cases in the future.

CONCLUSION

For the reasons set forth above, this Court should identify and correct the errors of the Trial Court in (1) applying the ALA, (2) allowing training materials to be used in establishing the appropriate standard of care for an accountant, and (3) in analyzing the causation issue, particularly loss causation.

Respectfully submitted,

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