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THE FATE OF SHAREHOLDERS OF CLOSELY HELD CORPORATIONS IN THE WAKE OF *BILY V. ARTHUR YOUNG*

I. INTRODUCTION

In 1992, the California Supreme Court struck a blow to notions of equity and fairness¹ when it narrowed the scope of duty owed by independent auditors to certain affiliated third parties.² In *Bily v. Arthur Young & Co.*, the court required strict privity of contract in professional negligence actions against independent auditors.³ The unfortunate result is that, at least in California, shareholders of small closely held corporations⁴ may be barred from suing an auditor hired by their corporation to independently audit the corporation's financial statements.⁵ While the court's reasoning in *Bily* may apply to some types of third parties,⁶ the reasoning does not support its ap-

1. By equity and fairness, I mean that in certain circumstances, the court should look to "what is fair in a particular situation" rather than following "strictly formulated rules of common law." See BLACK'S LAW DICTIONARY 540 (6th ed. 1990).

2. See *Bily v. Arthur Young & Co.*, 834 P.2d 745, 767 (Cal. 1992). In deciding *Bily*, the court reversed its earlier decision in *International Mortgage v. John P. Butler Accountancy Corp.*, 223 Cal. Rptr. 218, 227 (Cal. Ct. App. 1986) (holding an auditor owes a duty of care to anyone who "reasonably and foreseeably" relies on the audited financial statements). "Third party" refers to any party not in privity of contract with the independent auditor.

3. See *Bily*, 834 P.2d at 767. Independent auditors are outside accountants, generally Certified Public Accountants ("CPA"), hired by corporations to audit their financial statements. An audit is an independent verification of the financial statements and accounting practices of the business entity consisting of a thorough "examination of the underlying accounting records and supporting evidence." *Bily*, 834 P.2d at 749 (citing Willis W. Hagan, *Certified Public Accountant's Liability for Malpractice: Effect of Compliance with GAAP and GAAS*, 13 J. CONTEMP. LAW 65, 66 (1987)). Independent auditors review the financial statements prepared by a company and issue opinions indicating whether the financial statements accurately represent the financial status of the company. *Bily*, 834 P.2d at 749 (citing John A. Siliciano, *Negligent Accounting and the Limits of Instrumental Tort Reform*, 86 MICH. L. REV. 1929, 1931 (1988)).

4. Generally, closely held corporations are corporations with a small number of shareholders whose shares are not bought or sold in a market. Of course, there is no single definition of them. See *infra* Part III for a more detailed discussion of closely held corporations. Here, the term "small" refers to the number of shareholders.

5. The *Bily* court indicated in its opinion that shareholders not in privity may sue under a theory of "negligent misrepresentation." *Bily*, 834 P.2d at 767. The court recognized the distinctions, both statutory and practical, between the torts of negligence and negligent misrepresentation. *Id.* This article focuses only on the tort of negligence.

6. For example, the reasoning makes sense when applied to shareholders of publicly held corporations, like the investor shareholders in *Bily*. The differences between publicly held and closely held corporations are the focus of this paper. See *infra* Part III.

plication to shareholders of small closely held corporations.⁷ As this paper will discuss, there are major differences between the shareholders of public and small closely held corporations that justify different treatment.⁸

One case that illustrates the inherent unfairness of the *Bily* decision is the case of Mr. and Mrs. Smith. Mr. and Mrs. Smith (the "Smiths") along with the Smith Family Trusts ("Family Trusts") (collectively referred to as "Plaintiffs") were the only shareholders of a closely held Subchapter S⁹ corporation called Re-Comp.¹⁰ After owning and operating Re-Comp for five years and generating millions of dollars in sales, Plaintiffs decided to sell their company. Knowing most potential buyers would require audited financial statements, Re-Comp engaged the services of a "Big Six"¹¹ accounting firm ("Accountants") to audit Re-Comp's financial statements. Accountants and Re-Comp entered into a written audit agreement. Re-Comp informed Accountants that the purpose of the audit was to prepare Re-Comp for sale. Re-Comp was not a public corporation and was therefore not required to have audited financial statements for SEC filings.¹² Therefore, Accountants knew, or should have known, that the reason for auditing the financial statements was in connection with the impending sale of Re-Comp. Additionally, Accountants knew Re-Comp was a Subchapter S corporation. It is reasonable to infer that Accountants knew the Smiths, as

7. The Court's rationale in *Bily* is discussed *infra* Part II.D.

8. See *infra* Part III for a discussion of the differences.

9. Subchapter S is a tax election status available to closely held corporations that meet the statutory criteria. Basically, the corporation's profits and losses "pass through" the shareholders and are taxed at the individual rate, rather than the corporate rate. See 1 WILLIAM H. PAINTER, PAINTER ON CLOSE CORPORATIONS §§ 1.10.1-3 (3d ed. 1991); ZOLMAN CAVITCH & MATTHEW P. CAVITCH, TAX PLANNING FOR CORPORATIONS AND SHAREHOLDERS §§ 3.00, 3.01 (2d ed. 1996 & Supp 1997).

10. The situation involving the Smiths describes a case filed in San Diego County Superior Court (the "Smith case"). The names of all parties have been changed. The background information and the court's findings were taken both from the court's files (i.e., Plaintiffs' Opposition to the Motion for Summary Judgment) and from conversations with Plaintiffs' attorneys.

11. At the time the Smith case was pending, the six largest accounting firms, in terms of size, were referred to as the "Big Six." Those firms were: Arthur Anderson LLP, Ernst & Young LLP, DeLoitte & Touche LLP, KPMG Peat Marwick, Coopers & Lybrand and Price Waterhouse. However, in September 1997, Coopers & Lybrand and Price Waterhouse announced plans to merge. See *Accounting's Colossus*, MACLEAN'S, Sept. 29, 1997, at 53. Additionally, in October 1997, Ernst & Young and KPMG Peat Marwick announced plans to merge. See James Bernstein, *Peat Marwick to Join With Ernst & Young*, NEWSDAY, Oct. 21, 1997, at A54. If both mergers go through, the remaining firms would be known as the "Big Four."

12. The Federal Securities Act of 1933 (15 U.S.C. § 77a (1994)) (the "1933 Act") and the Securities and Exchange Act of 1934 (15 U.S.C. § 78a (1994)) (the "1934 Act") were created to protect the public from fraud and misrepresentation in the sale of securities. These statutes require the corporation to file a "registration" statement with the Securities and Exchange Commission ("SEC") before the stock can be sold. Full disclosure is the ultimate goal. As a result, publicly traded companies are required to file their audited financial statements with the SEC annually and quarterly, unless they qualify for an exemption under the 1934 Act. SEC regulations are extremely complex and are beyond the scope of this article.

individuals, would rely on the accuracy of the audited financial statements for preparation of their individual and Family Trust tax returns. Accountants then conducted three separate audits and represented each time, without exception, that Re-Comp's financial statements conformed to GAAP.¹³

Based on Accountants' representations, Plaintiffs represented and warranted to Re-Comp's purchasers ("Purchasers") that Re-Comp's financial statements conformed to GAAP and sold Re-Comp for \$25 million. After the sale, Purchasers' auditors (another "Big Six" firm), while attempting to audit Re-Comp's financial statements, discovered that the prior audited financial statements were not in accordance with GAAP.

Purchasers then sued Plaintiffs for breach of warranty. In binding judicial arbitration, Purchasers were awarded almost \$5 million in damages. Plaintiffs then sued Accountants for professional negligence. Amazingly, the trial court granted Accountants' Motion for Summary Judgment against Plaintiffs. The trial court, citing *Bily*, held that Plaintiffs lacked privity of contract and therefore could not maintain a cause of action for malpractice against Accountants.¹⁴

As a result, Accountants were completely exonerated from liability for their professional negligence. The sole reason: lack of strict privity of contract between Accountants and Plaintiffs. While Accountants and Re-Comp were in privity of contract, Accountants could not be held liable to Re-Comp because Re-Comp suffered no loss.¹⁵ Notwithstanding the fact that Accountants and Purchasers were not in privity of contract, Purchasers have already "been made whole" by collecting the judgment against Plaintiffs. As a consequence, Accountants could not be liable to Purchasers either. It

13. Generally, in the audit report or opinion, the auditing firm states that it has examined the financial statements in accordance with generally accepted accounting standards ("GAAS"). GAAS sets out the audit standards and general principles and procedures "that guide the audit function." The audit opinion also includes a statement that the audited financial statements conform with generally accepted accounting principles ("GAAP") and accurately represent the financial position of the corporation. "GAAP include[s] broad statements of accounting principles" which range from "aspirational norms" to "more specific guidelines." *Bily v. Arthur Young & Co.*, 834 P.2d 745, 750 (Cal. 1992). The auditor should "qualify" the opinion if any aspects of the financial statements do not conform to GAAP or if there are "uncertainties which might affect a fair evaluation of the statements". The audit opinion should also contain a disclaimer if the auditor is unable to express an opinion. Finally, the audit opinion may affirmatively state that the financial statements do not fairly represent the financial position of the corporation in conformance with GAAP. *Id.* at 751.

14. Plaintiffs also sued Accountants for negligent misrepresentation. Under a separate motion, the trial court granted Accountants' Motion for Summary Judgment on the negligent misrepresentation cause of action, finding there was no triable issue of fact regarding the issue of reliance. Plaintiffs are appealing this issue on other grounds and it will not be discussed in this article.

15. A dissolved corporation continues to exist for purposes of prosecuting and defending lawsuits. See CAL. CORP. CODE § 2010 (West 1990 & Supp. 1997). However, in this case, Re-Comp, the business entity, suffered no loss because only Plaintiffs were liable to Purchasers for the breach of warranty. Therefore, Re-Comp could not maintain an action for damages.

is unfair that Accountants are not responsible for their negligence merely because of the fiction of the corporate entity.

This article addresses the special concerns of independent auditor liability to shareholders of closely held corporations. First, this article explores the history of independent auditor liability and the California Supreme Court's reasoning behind the *Bily* decision. By distinguishing the "Smith case" from *Bily*, this article explores the prospect that *Bily* does not apply to the shareholders of closely held corporations. The *Bily* rationale makes no sense when applied to the Smith case. Second, this article examines the differences between closely held corporations and publicly held corporations. It is precisely because of these differences that the *Bily* decision should not apply to the shareholders of close corporations in denying standing to sue. Third, this article explores the prospect that *Bily* may apply to the shareholders of closely held corporations, but that the equitable doctrine of "reverse" piercing of the corporate veil allows the shareholders to disregard the corporate entity so that the shareholder is in privity of contract.

II. HISTORY OF AUDITOR LIABILITY

Before analyzing the implications of *Bily* to shareholders of closely held corporations, it is best to examine the history of auditor liability.¹⁶ A

16. There have been numerous scholarly articles written on the issue of auditor liability since the California Supreme Court's decision in *Bily*. These articles mainly discuss the history of auditor liability and offer alternative approaches to liability. However, none of these articles recognize or consider the distinctions between shareholders of closely held and publicly held corporations which justify different treatment under the rule espoused in *Bily*. See, e.g., Jodi S. Scherl, Comment, *Evolution of Auditor Liability to Noncontractual Third Parties: Balancing the Equities and Weighing the Consequences*, 44 AM. U. L. REV. 255, 265-77 (1994) (urging adoption of reasonably foreseeable approach and calling for legislation); Denise M. Orlinski, *An Accountant's Liability to Third Parties: Bily v. Arthur Young & Co.*, 43 DEPAUL L. REV. 859, 871-87 (1994) (urging adoption of reasonably foreseeable approach); Anne T. Prillman, Comment, *Countering Unrealistic Expectations: Limiting Auditors' Liability to Investors*, 32 DUQ. L. REV. 849, 853-56 (1994) (arguing *Bily* was correctly decided); Thomas G. Mackey, Note, *Accountants' Liability After Bily v. Arthur Young & Co.: A More Equitable Proposal for Third Party Recovery*, 45 HASTINGS L.J. 147, 152 (1993) (urging adoption of reasonably foreseeable and proportional liability and also calling for legislation); Scott Vick, *Bily v. Arthur Young & Co.: Is Limiting Auditor Liability to Third Parties Favoritism or Fair Play*, 26 LOY. L.A. L. REV. 1335, 1346-50 (1993) (arguing *Bily* was correctly decided); John M. Gibson, *The Delineation of Accountants' Legal Liability to Third Parties: Bily & Beyond*, 68 ST. JOHN'S L. REV. 609, 617-29 (1994) (arguing *Bily* was correctly decided); Richard S. Panttaja, *Accountants' Duty to Third Parties: A Search for a Fair Doctrine of Liability*, 23 STETSON L. REV. 927, 938-45 (1994) (urging adoption of reasonably foreseeable approach and proportional liability); David A. Jaffe, Comment, *The Allocation of Fault in Auditor Liability Lawsuits Brought by Sophisticated Third Party Users of Financial Statements—A Plea for Proportionate Liability*, 54 U. PITT. L. REV. 1051, 1061-64 (1993) (urging adoption of proportional liability); Lewis P. Checchia, *Accountants' Liability to Third Parties Under Bily v. Arthur Young & Company: Does a Watchdog Need Protection*, 38 VILL. L. REV. 249, 256-67 (1993) (urging adoption of reasonably foreseeable approach); Doria Bonham-Yeaman & James John Jurinski, *Auditors' Liability to Third Parties: Can the*

review of the history is important because of the complex nature and economic implications of the audit function.¹⁷

The jurisdictions determine auditor liability using one of three basic approaches: (1) Privity of Relationship; (2) Negligent Misrepresentation,¹⁸ and (3) Reasonable Foreseeability.

A. *Privity of Relationship*

At least twelve jurisdictions require privity of relationship as a basis for finding independent auditor liability.¹⁹ The Court of Appeals of New York first referenced privity of relationship in its decision in *Ultramares v. Touche*.²⁰ In his majority opinion, Justice Cardozo expressed concern about exposing accountants to "liability in an indeterminate amount for an indeterminate time to an indeterminate class."²¹ In following *Ultramares* and its progeny, that court has found the equivalent of a privity relationship between an independent auditor and the plaintiff.²² In *White v. Guarente*, a limited partnership hired an auditor to perform auditing and tax return services.²³ The plaintiff, one of a group of many limited partners, sued the auditor in negligence for failing to report that various partners were withdrawing funds "from their capital accounts in violation of the partnership agreement."²⁴ The court held that the limited partner could sue the auditors for malpractice because he was "one of a settled and particularized class" and not a member of the public at large.²⁵ While not expressly finding privity per se, the court focused on the fact that the auditing services were not rendered to a "faceless" group of people, but were rendered to a "known group . . . marked by a definable limit."²⁶

However, in *Credit Alliance v. Arthur Anderson & Co.*, the court modi-

States Adopt a Unified Approach?, 22 W. St. U. L. Rev. 37, 45-55 (1994) (urging adoption of uniform approach arguing privity is theoretically the best, but reasonably foreseeable approach is practically better).

17. See *Bily*, 834 P.2d at 752.

18. This is also referred to as the "Restatement approach" or the "actual foreseeability" approach. See *infra* Part II.B.

19. Jurisdictions which require privity or near privity rules include: Colorado, Delaware, Idaho, Nebraska, New York, and Pennsylvania (by judicial opinion) and Arkansas, Illinois, Kansas, New Jersey and Utah (by statute). See *Bily*, 834 P.2d at 755 & nn. 4-5. See also *First Nat'l Bank of Commerce v. Monco Agency, Inc.*, 911 F.2d 1053, 1059 n. 8 (5th Cir. 1990). Alabama operated under privity rules until 1994. See Scherl, *supra* note 16, at 264. New Jersey recently adopted a statute requiring privity. See *infra* note 40 and accompanying text.

20. *Ultramares Corp. v. Touche, Niven & Co.*, 174 N.E. 441 (N.Y. 1931).

21. *Id.* at 444. See also Mackey, *supra* note 16.

22. See *White v. Guarente*, 372 N.E.2d 315, 319-20 (N.Y. 1977).

23. See *id.* at 317.

24. *Id.* at 317-18.

25. *Id.* at 318-20.

26. *Id.* at 318.

fied *Ultramares* and *White* and developed a three-prong test for determining when a third party not in strict privity may recover.²⁷ The test required that: (1) the accountants know that the financial reports are to be used for a particular purpose; (2) the accountants know the third party who intends to rely on the report; and (3) there be presence of some "linking conduct" on the part of the accountants which manifests the auditor's understanding of the known third party's reliance on the audited material.²⁸ If all three elements are met, the relationship is "sufficiently approaching privity"²⁹ and the third party may maintain a cause of action against an auditor.

B. Negligent Misrepresentation

At least seventeen³⁰ jurisdictions follow the Restatement (Second) of Torts approach, making it the majority view.³¹ Under the majority approach,

27. See Mackey, *supra* note 16, at 153 (citing *Credit Alliance v. Arthur Anderson & Co.*, 483 N.E.2d 110, 118 (N.Y. 1985)).

28. See *Credit Alliance*, 483 N.E.2d at 118. "Linking conduct" includes "direct dealings" with the third party, or "word or action" by auditor toward the third party. It also refers to any reference to the third party in the retainer agreement. See *id.* at 119. While the court did not find the requisite "linking conduct" in the *Credit Alliance* case, it did find such "linking conduct" in the companion case *European American Bank and Trust Co. v. Strauhs & Kaye*, 483 N.E.2d 110, 120 (N.Y. 1985). In *European Bank*, the court found that the auditors were aware that the primary, if not exclusive, end aim of the audit was to provide the third party with financial information. Additionally, the auditor and third party were in direct communications, both orally and in writing, and met together numerous times to discuss the client's financial condition. The court concluded that "the parties' direct communications and personal meetings resulted in a nexus between them sufficiently approaching privity" to permit a cause of action. See *id.* at 120.

29. *Security Pacific Business Credit v. Peat Marwick*, 597 N.E.2d 1080, 1081 (N.Y. 1992). In *Security Pacific*, the court found that a lender who relied on an auditor's valuation of the lender's client in making a loan did not have privity with the auditor. See *id.* Using the *Credit Alliance* factors, the court found: (1) no evidence that auditor was hired for the purpose of inducing the lender to extend credit; (2) one phone call to the auditor was not akin to "multiple, direct, and substantive communications and personal meetings" which would "sufficiently approach privity"; (3) no evidence that the auditor shaped its opinion to meet any specific needs of the lender; and (4) no evidence that auditor agreed to furnish or directly furnished the lender with a copy of the audit report. See *id.* at 1085-86.

30. Jurisdictions that follow this approach include: Alabama, Alaska, Florida, Georgia, Hawaii, Iowa, Kentucky, Michigan, Minnesota, Missouri, Montana, New Hampshire, North Carolina, North Dakota, Ohio, Oregon, Rhode Island, Tennessee, Texas, Washington, and West Virginia. See *First Nat'l Bank of Commerce v. Monco Agency, Inc.*, 911 F.2d 1053, 1060 n.12 (5th Cir. 1990); *Bily v. Arthur Young*, 834 P.2d 745, 757 n.7 (Cal. 1992). See also Scherl, *supra* note 16, at 264 & n.56.

31. RESTATEMENT (SECOND) OF TORTS § 552 (1977). Section 552 of the Restatement provides:

- (1) One who, in the course of his business, profession or employment, or in any other transaction in which he has a 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.

a third party may recover under the theory of negligent misrepresentation when the auditor either (1) intended to influence a third party to rely on the audit, or (2) knew his client intended to influence a specific third party to rely on the audit.³² A growing number of states follow this approach because they view the privity approach as too restrictive.³³ For example, the Ohio Supreme Court finds the privity approach too restrictive because it ignores the fact that accountants “make reports on which people other than their clients foreseeably rely in the ordinary course of business.”³⁴ In addition, the Supreme Court of North Carolina finds privity too restrictive because of the need to hold independent auditors accountable.³⁵ Under this view, privity is not required and as long as the Restatement elements are met, the third party can sue an independent auditor.

C. Reasonable Foreseeability

Finally, some jurisdictions follow the “reasonable foreseeability” approach.³⁶ Under this approach, the court considers whether the harm done to the third party was reasonably foreseeable to the auditor.³⁷ The rationale is that if accountants have “such an important role in the financial community, the artificial privity requirement cannot stand and the limitations on third party recovery under Restatement (Second) are arbitrary and unnecessary.”³⁸

Until recently, New Jersey followed this approach. In *Rosenblum v.*

(2) Except as stated in Subsection (3), the liability stated in Subsection (1) is limited to loss suffered (a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it; and

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

(3) The liability of one who is under a public duty to give the information extends to loss suffered by any of the class of persons for whose benefit the duty is created, in any of the transactions in which it is intended to protect them.

32. *See id.*

33. *See Mackey, supra* note 16, at 155.

34. *Id.* at 155 (citing *Haddon View Inc. Co. v. Coopers & Lybrand*, 436 N.E.2d 212, 214 (Ohio 1982)) (holding limited partners belonged to a limited group of persons whose reliance on auditor’s representations was foreseen).

35. *Id.* at 155 (citing *Raritan River Steel Co. v. Cherry, Bekaert & Holland*, 367 S.E.2d 609, 617 (N.C. 1988)) (holding liability of accountants should extend to any “person, or one of a group of persons, whom the accountant or his client intends the information to benefit”).

36. Wisconsin and Mississippi are currently the only two jurisdictions that follow this approach. The court in *Bily* referred to four states who explicitly rejected this approach in lieu of the Restatement Second approach. These states are: Florida, North Carolina, West Virginia and Washington. *See Bily v. Arthur Young*, 834 P.2d 745, 757 n.7 (Cal. 1992).

37. *See Mackey, supra* note 16, at 155.

38. *Id.* at 155-56 (citing *International Mortgage v. John P. Butler Accountancy Corp.*, 223 Cal. Rptr. 218, 224-25 (Cal. Ct. App. 1986)).

*Adler*³⁹ the Supreme Court of New Jersey found no reason to deny third party users of financial statements recovery for economic loss resulting from an auditor's negligent misrepresentation. The court commented that the basis for holding auditors liable to those who foreseeably rely on audited financial statements includes the ability of the accounting firm to obtain malpractice insurance and the public policy of encouraging diligence in conducting audits.⁴⁰ This was also the law in California until August 1992, when the California Supreme Court took a step (or even two) back in time.⁴¹

In the years before *Bily*, California followed the "reasonably foreseeable" approach circumscribed by the California Court of Appeal in *International Mortgage v. John P. Butler Accountancy Corp.*⁴² In deciding *International Mortgage*, the court departed from the long-standing privity requirement and found that the rule was no longer applicable in light of more recent decisions⁴³ and the modern role of the independent auditor in

39. *Rosenblum v. Adler*, 461 A.2d 138 (N.J. 1983).

40. *See id.* at 151-52. However, in 1995, the New Jersey legislature statutorily created a duty of care for auditors which does not comport with the judicial decision in *Rosenblum*. *See* N.J. STAT. ANN. § 2A:53A-25 (West Supp. 1997). The statute appears to mimic the language of the Court of Appeal of New York's decision in *Credit Alliance*.

41. The California Supreme Court decided *Bily* on August 27, 1992. As a matter of interest, the California Trial Lawyers Association ("CTLA") and banking lobby anticipated the *Bily* decision and engaged the help of a California state senator to introduce a bill that would reverse *Bily*. *See* Vick, *supra* note 16. The proposed amendment to California Business & Professions Code § 5024 provided: "[a] licensee owes a duty of ordinary care and shall be liable to reasonably foreseeable persons for his or her negligence or other tortious conduct." S. 1900, 1991-92 Reg. Sess. (Cal. 1992) (amended in Assembly August 31, 1992). Unfortunately, the bill was an amendment to a bill dealing with mosquito abatement. While the bill seemed to be on its way to passage, it died in the Senate after one senator objected because the amendment violated a state law that amendments must be germane to the original bill. *See* Vick, *supra* note 16, at 1372. Reportedly, there were plans to introduce another bill, but apparently there have been no such recent efforts. *See id.* at 1372 (citing Bill Ainsworth, *Capitol Abuzz Over Accountants: Trial Lawyers Acted Fast to Restore Auditor Liability Following Thursday Ruling but Lost on Technicality*, THE RECORDER, Sept. 3, 1992, at 1).

42. *International Mortgage*, 223 Cal. Rptr. at 218. In *International Mortgage*, the court held that as long as the client was using the audit for a "proper business purpose" the auditor's lack of knowledge of the "precise use" did not erase their duty. *Id.* at 226.

43. *See id.* at 221 (citing *Biakanja v. Irving*, 320 P.2d 16 (Cal. 1958)). In *Biakanja*, the court abandoned the privity rule, opting instead for a balancing test when determining liability of a notary public to the intended beneficiary of a will. The court looked at the following factors: (1) extent to which the transaction was intended to affect the plaintiff; (2) foreseeability of harm to the plaintiff; (3) degree of certainty that plaintiff suffered injury; (4) closeness of the connection between defendant's conduct and the injury; (5) moral blame attached to defendant's conduct; and (6) policy of preventing future harm. *See id.* at 221 (citing *Biakanja*, 49 Cal.2d at 650). *See also* *Lucas v. Hamm*, 364 P.2d 685 (Cal. 1961) (recognizing the "liberalization" of liability for negligence committed in the performance of a contract).

The ultimate demise of the privity rule in California was recognized in *Heyer v. Flaig*, 449 P.2d 161 (Cal. 1969) (*overruled on other grounds by* *Laird v. Blacker*, 828 P.2d 691 (Cal. 1992)); *see International Mortgage*, 223 Cal. Rptr. at 222. In *Heyer*, the court held that an attorney was liable to the intended beneficiaries of an improperly drafted will. *Heyer*, 449 P.2d at 161; *see International Mortgage*, 223 Cal. Rptr. at 222. The court found that "public

society.⁴⁴ Two California district court decisions subsequently limited the *International Mortgage* decision to independent auditors and only in situations where the plaintiff actually received and relied on the information in the audit.⁴⁵

D. *The Bily Decision*

Under the *Bily* decision, only the "client" who signs the auditing agreement with the independent auditor may file an action for professional negligence.⁴⁶ In *Bily*, Osborne Computer Corporation hired the defendant, Arthur Young, to prepare an audit in connection with the issuance of warrants.⁴⁷ Osborne offered warrants to investors in order to raise money until its public offering.⁴⁸ One of the plaintiffs, Bily, was a director of the company who had purchased stock from the company's founder.⁴⁹ Due to changes in the market, sales plummeted and the public offering never happened.⁵⁰ As a result, Bily and other investors lost money.⁵¹ Bily and the other investors then sued Arthur Young for professional negligence, negligent misrepresentation and fraud.⁵² The investors were denied recovery because they were not "clients" of Arthur Young.⁵³

In *Bily*, the California Supreme Court limited independent auditor liability for professional malpractice (general negligence) in conducting audits "to the client [,] i.e., the person who contracts for or engages the audit services."⁵⁴ In so holding, the court required strict privity of contract be-

policy requires that attorneys exercise their positions of trust and superior knowledge responsibly so as not to affect adversely persons whose rights and interests are certain and foreseeable." *International Mortgage*, 223 Cal. Rptr. at 222 (citing *Heyer*, 449 P.2d at 165).

44. See *International Mortgage*, 223 Cal. Rptr. at 221.

45. See *Moskowitz v. Vitalink Comm. Corp.*, 751 F. Supp. 155, 161 (N.D. Cal. 1990) (*International Mortgage* does not extend to "aftermarket" statements made by officers of public corporations and is limited to independent auditors because of independent auditors' unique public function which is not parallel to corporations' obligations towards prospective shareholders); *In re Wyse Technology*, 744 F. Supp. 207, 209-10 (N.D. Cal. 1990) (plaintiff must allege actual receipt of and reliance on auditor's opinion).

46. *Bily v. Arthur Young*, 834 P.2d 745, 767 (Cal. 1992).

47. These warrants were sold to investors in return for loans or lines of credit. "The warrants entitled [the] holders to purchase blocks of the company's stock at favorable prices . . . when the public offering took place." *Id.* at 747.

48. *Id.* In a public offering, shares of a corporation are offered for sale to the general public. Public offerings are governed by state and federal securities regulations (e.g., the 1933 Act and 1934 Act).

49. See *id.*

50. See *id.* at 748.

51. Bily invested \$1.5 million. The jury awarded \$4.3 million in compensatory damages, which was approximately 75% of all investments made. See *id.* at 747-49.

52. See *id.* at 748-49.

53. See *id.* at 767.

54. *Industrial Indemnity v. Touche Ross*, 17 Cal. Rptr. 2d 29, 33 (Cal. Ct. App. 1993) (citing *Bily*, 834 P.2d at 767).

tween the client and the auditor. In a footnote, the *Bily* court further stated that an auditor could be liable to an “express” third party beneficiary of the engagement letter (i.e., contract) under certain circumstances.⁵⁵

In its decision, the *Bily* court distinguished an action for professional negligence from an action for negligent misrepresentation.⁵⁶ Although the *Bily* court required strict privity to maintain an action for professional negligence, the court followed section 552 of the Restatement (Second) Torts in assessing liability for negligent misrepresentation.⁵⁷ Under section 552, an auditor is liable to a third party if the auditor had actual knowledge of the third party intended to rely on the audit.⁵⁸

In its decision, the *Bily* court identified three public policy reasons for holding that an action for professional negligence lies only with one in privity with the professional: (1) the potential for disproportionate liability; (2) typical third parties are sophisticated enough to conduct their own audits; and (3) the advantages of the foreseeability approach are unlikely to occur.⁵⁹ These policy considerations are not relevant when applied to the Smith case and actions involving other closely held business entities.

First, the *Bily* court was concerned with the potential for liability to be out of proportion to fault.⁶⁰ The *Bily* court found that limiting third party negligence suits only by foreseeability raised the potential for “multibillion dollar professional liability” which is out of proportion to (1) the fault of the auditor and (2) the connection between the auditor’s conduct and the third party’s injury.⁶¹ The *Bily* court also focused on the secondary aspect of the auditor (i.e., the auditor reviews only already prepared financial statements⁶²) and the possibility that the auditor may not have been aware of the existence, nature or scope of the third party transaction that gave rise to the claim.⁶³ In the Smith case, however, there is a direct connection between Accountants’ negligence and the Plaintiffs’ injury.⁶⁴ Not only were Accountants aware of the existence of the third party transaction, they knew the proposed sale transaction was the express purpose of the audit contracts.

55. The court will consider these “certain circumstances” only when the third party is expressly identified in the contract. Since the contract in *Bily* did not identify any third party beneficiary, the court did not consider the circumstances that would permit recovery as “clients.” See *Bily*, 834 P.2d at 767 n.16.

56. “Negligent misrepresentation is a separate and distinct tort, a species of the tort of deceit.” *Bily*, 834 P.2d at 768.

57. The *Bily* court also cited the factors stated in *Biakanja v. Irving* in assessing negligent misrepresentation. See *Biakanja v. Irving*, 320 P.2d 16, 16 (Cal. 1958); see also *supra* note 43.

58. RESTATEMENT (SECOND) TORTS §552 (1977); see *supra* note 31 for the full text.

59. See *Orlinski*, *supra* note 16, at 891-92.

60. *Bily*, 834 P.2d at 762.

61. *Id.* at 764.

62. See *id.* at 749.

63. See *id.* at 763.

64. This information was taken from “Plaintiffs’ Opposition to Accountants’ Motion for Summary Judgment” filed in the San Diego Superior Court. See *supra* note 10.

As a direct cause of Accountants' negligent audit, Plaintiffs lost \$5 million.

Second, the *Bily* court felt that third parties should be encouraged to obtain their own independent audits of companies prior to their investment.⁶⁵ In the Smith case, this notion of "private ordering"⁶⁶ is ludicrous because the alleged third parties, Plaintiffs, *were* the company.⁶⁷ There were only four shareholders. It would be absurd to require Plaintiffs to obtain a second independent audit of their own company when, in essence, they hired Accountants to do the audit.⁶⁸

Third, the *Bily* court felt that the advantages of the "foreseeability approach" were not likely to occur if liability was expanded.⁶⁹ The "foreseeability approach" fosters the policy of encouraging the careful preparation of audits.⁷⁰ The *Bily* court discounted this view based on a lack of empirical evidence and the belief that "deleterious economic effects" were just as likely to occur.⁷¹ However, like the Smith case, if no liability is imposed, then Accountants will be immune from all liability because no one has privity. As a result, Accountants will have less incentive to carefully prepare audits. Accountants will know that if a corporation hires it for the purpose of selling the corporation and the corporation's shareholders do not sign the engagement letter, then Accountants will have no liability for negligently prepared audits.

In the Smith case, Re-Comp suffered no loss. Only Plaintiffs were liable for breach of warranty to Purchasers. Under *Bily*, Re-Comp is the only entity that would have a valid claim, yet it suffered no loss.⁷² On the other hand, Plaintiffs suffered a \$5 million loss, but do not have a claim under *Bily*. It is neither fair nor equitable to deny Plaintiffs the right to seek re-

65. *Bily*, 834 P.2d at 764.

66. The court refers to "private ordering" as the ability of third parties to use their own resources to verify the client's financial statements by hiring their own independent auditor to perform an audit on their behalf. *See id.* at 765.

67. *See supra* note 64.

68. *See supra* note 64.

69. The major advantage of the foreseeability approach is that it deters negligent conduct by holding auditors liable to all who are foreseeably injured by the negligent audit. *See Bily*, 834 P.2d at 765-66.

70. *See id.* at 765.

71. In focusing on the deterrent effect of a rule of greater liability, the court cites a legal economist stating: "The deterrent effect of liability rules is the difference between the probability of incurring liability when performance meets the required standard and the probability of incurring liability when performance is below the required standard. Thus, the stronger the probability that liability will be incurred when performance is adequate, the weaker is the deterrent effect of liability rules." *Id.* at 765-66 (citing Daniel R. Fischel, *The Regulation of Accounting: Some Economic Issues*, 52 BROOK. L. REV. 1051, 1055 (1987)).

72. As one British court stated when dealing with privity in estate planning contracts, "[t]he only person who has a valid claim has suffered no loss, and the only person who has suffered a loss, has no valid claim." JESSE DUKEMINIER & STANLEY M. JOHANSON, *WILLS, TRUSTS AND ESTATES* 65 (5th ed. 1995) (citing *Ross v. Caunters*, 1 Ch. 297, 299, 3 All. E.R. 580, 582 (1980)). While this refers to attorney malpractice in estate planning, it is equally relevant here.

covery of their damages from Accountants whose negligence caused their injury.

While it is clear that *Bily* should not preclude a finding of liability under the specific facts of the Smith case, the Smith analysis would apply to all shareholders of closely held corporations. As I will discuss below, there are major differences between closely held corporations and larger publicly held corporations. It is because of these differences that courts should consider shareholders of closely held corporations to be either clients or express third party beneficiaries, both of which would have standing to sue auditors for professional negligence. This is especially true when there are a small number of individual shareholders or family members who comprise the group of shareholders.⁷³ However, even if not considered "clients" under *Bily*, equity would require a reverse "piercing of the corporate veil" to protect such shareholder interests.

III. CLOSELY HELD VS. PUBLICLY HELD CORPORATIONS

A review of California's auditor liability history does not reveal a single case involving facts similar to the Smith case described above. In no instance has a California appellate court been asked to consider either the vast difference between small closely held corporations and large publicly held corporations or the significantly different relationships of shareholders in each. Because of these differences, it is more equitable to hold independent auditors liable for their actions, at least in instances where the shareholders are easily identifiable and limited in number.

Closely held corporations⁷⁴ differ from publicly held corporations in many ways.⁷⁵ The major functional differences are found in the number of shareholders and in the degree of involvement of shareholders in the management of the corporation.⁷⁶ While there is no consensus as to a definition

73. This is contrasted to closely held corporations wherein the shareholders consist of other corporate entities. Although the same arguments for different treatment could be made, the possibility of finding privity is more attenuated because of the corporate nature of the shareholders. As a result, the issue of corporate shareholders of closely held corporations will not be addressed in this article.

74. There is a distinction between statutory "close corporations" and "closely held" corporations. Statutory "close corporations" are corporations that incorporate under California Corporations Code § 158 that have thirty-five or less shareholders, and who designate themselves as a "close corporation" in their articles of incorporation. CAL. CORP. CODE § 158(a) (West 1990). "Closely held" corporations have thirty-five or less shareholders, but have not designated themselves as a "close corporation" in their articles of incorporation. Don Berger, *Protection of Shareholder Interests in California Closely Held & Statutory Close Corporations: A Practitioner's Guide*, 20 PAC. L.J. 1127, 1128-29 n.1 (1989). However, for the purposes of this article "close corporation" and "closely held corporation" refers to the same type of business entity.

75. Berger, *supra* note 74, at 1128-29 n.1.

76. *Id.* See also 1 F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S CLOSE CORPORATIONS §§ 1.02, 1.08 (3d ed. 1996).

of a closely held corporation, all such entities have the following basic characteristics: (1) a small number of shareholders; (2) no ready market for the company's stock; and (3) heavy involvement by majority shareholders in the management, direction and operation of the corporation.⁷⁷ The shareholder in a closely held corporation generally feels as if he is in a partnership and considers himself an owner.⁷⁸ A common situation resulting in the formation of a close corporation is the incorporation of the "family" business.⁷⁹ Because of the unity of management and ownership in a closely held corporation, both decision making and economic risks fall on the shareholders.⁸⁰

Publicly held corporations, on the other hand, have a large number of shareholders whose shares are either traded on a national securities exchange⁸¹ or regularly traded on the "over-the-counter"⁸² market.⁸³ The corporate shareholders are generally only investors and do not manage the day to day operations of the company.⁸⁴ Those shareholders are not personally responsible for the business decisions made by the company.⁸⁵ Rather, they only bear an economic risk of loss of their investment. Only the directors and officers, who may or may not be shareholders, bear the personal risk of their business decisions.⁸⁶ As a result, shareholders of closely held corporations bear greater overall personal risk than shareholders of publicly held corporations due to the unity of management and ownership.⁸⁷ Because of this increased risk-bearing responsibility, shareholders of closely held corporations should not be limited in their actions against independent auditors for their negligence by the same rules of privity as the shareholders of publicly held corporations.

Indeed, in other instances the courts recognize the special considera-

77. See JAMES D. COX ET AL., 2 CORPORATIONS, § 14.1 (1995).

78. O'NEAL & THOMPSON, *supra* note 76, §1.08.

79. See *id.* § 1.05.

80. See *id.*

81. See, e.g., National Association of Securities Dealers Automated Quotations, Inc. ("NASDAQ"); NASDAQ is an automated "information system which gives [stock] price quotations on securities traded over-the-counter to brokers and dealers." BLACK'S LAW DICTIONARY 1024 (6th ed. 1990).

82. The "over the counter" market is a "broad securities market consisting of brokers who [buy] or sell securities by computer hook-up or telephone rather than through the facilities of a securities exchange." BLACK'S LAW DICTIONARY 1105 (6th ed. 1990).

83. See COX ET AL., *supra* note 77, § 1.20.

84. See O'NEAL & THOMPSON, *supra* note 76, § 1.08.

85. See *id.*

86. See *id.*

87. Generally, the risks are greater in a closely held corporation because most, if not all, of the shareholder's income is derived through his or her employment with the company. See O'NEAL & THOMPSON, *supra* note 76, § 1.08. If the company fails, then the shareholder's livelihood also fails. Compare this to the shareholder of the publicly held corporation who is, for the most part, merely an investor and only concerned with profits. See *id.*

tions of closely held corporations.⁸⁸ In the mid-1960s, most courts thought that all corporations should be governed by the same rules set forth in the corporation statutes and that no special rules should be developed for closely held corporations.⁸⁹ However, shortly thereafter several dissenting opinions urged a more “realistic treatment” of closely held corporations.⁹⁰ These decisions recognized the need for (1) heightened fiduciary duty⁹¹; (2) enactment of special statutes; and (3) recognition of partnership qualities.⁹²

Additionally, the California legislature recognizes the need to treat close corporations differently than other corporations.⁹³ The Legislative Committee Comment to California Corporations Code section 158 states the legislature’s intent in creating statutory close corporations under section 158 was to “recognize the unique characteristics” of close corporations.⁹⁴ The Comment also requires unanimous shareholder approval to become a statutory close corporation after initial shares are issued because the shareholders of close corporations “may be subject to burdens and liabilities not imposed on other corporations.”⁹⁵

Additionally, since close corporations are more like partnerships, there are certain instances when shareholders should be treated like partners. For

88. See ROBERT W. HAMILTON, CORPORATIONS 373 (3d. ed. 1992).

89. See *id.*

90. See *id.* See also *Kruger v. Gerth*, 210 N.E.2d 355, 356 (N.Y. 1965) (Desmond, C.J., dissenting) (“small corporations, being really partnerships . . . should be treated by a court of equity as partnerships in many respects”) and (Fuld, J., dissenting, concurring with Desmond, C.J.) (“there is no inherent reason why a court of equity cannot treat the participant in a genuine close corporation . . . as partners”).

91. This “heightened fiduciary duty” was recognized by the California Supreme Court in *Jones v. H.F. Ahmanson*, 460 P.2d 464 (Cal. 1969). In *Jones*, the court held “majority [shareholders] have a fiduciary responsibility to the minority shareholders and to the corporation to use their ability to control the corporation in a fair, just and equitable manner.” Any use to which the majority puts its power “must benefit all shareholders proportionately and must not conflict with the proper conduct of the corporation’s business.” *Id.* at 471.

92. See HAMILTON, *supra* note 88, at 373-74 (citing *Kruger*, 210 N.E.2d at 356-57). See also *Galler v. Galler*, 203 N.E.2d 577, 586 (Ill. 1964) (“[C]ourts can no longer fail to . . . distinguish between the close and public corporation when confronted with problems relating to either.”; recognizing need for separate statutory scheme governing close corporations); *Donahue v. Rodd Electrotype*, 328 N.E.2d 505, 516 (Mass. 1975) (“[t]he more rigorous duty of partners” extends to shareholders in close corporations).

93. CAL. CORP. CODE § 158 (West 1990). Subsection (g) defines statutory close corporations and refers to eleven other Corporation Code sections that specifically relate to close corporations.

94. CAL. CORP. CODE § 158 cmt. (West 1990). This comment recognizes that shareholders of close corporations wish to treat the corporation as if it were a partnership or to allocate management responsibilities in a way that was previously only appropriate between partners.

95. *Id.* One example of an additional burden imposed on shareholders of close corporations is the frequency of “disregarding the corporate entity,” discussed in greater detail, *infra* Part IV. Basically, when the corporate entity is disregarded, shareholders may be held personally liable for the corporation’s liabilities. Another example of an additional burden is the increased fiduciary relationship owed to minority shareholders. See *supra* note 91.

example, if a corporation is a Subchapter S⁹⁶ corporation, the corporation is taxed like a partnership.⁹⁷ As a result, in a Subchapter S corporation, corporate profits and losses “pass through” to the shareholders and are taxed at the shareholders’ individual tax rate.⁹⁸ Each shareholder reports his or her share of the corporate profits and losses.⁹⁹ The corporation is not taxed as an entity.¹⁰⁰ As a result, the accuracy of the audit of a Subchapter S corporation is more important to its shareholders than audits performed for the purpose of valuing a non-Subchapter S corporation.

Because of the enormous differences between shareholders of closely held corporations and publicly held corporations and the judicial and legislative recognition of the need to treat each entity differently, the *Bily* decision should not be binding on all corporate entities. The rules of privity should apply only when dealing with large, publicly held corporations where the shareholders are mere investors and have no involvement in the daily operations of the business. Because closely held corporations, by their nature, usually consist of a small and identifiable group of individuals, the shareholders should be considered “clients” of the independent auditors with standing to sue for professional negligence. At the very least, the differences should give rise to other equitable considerations.

IV. REVERSE PIERCING OF THE CORPORATE VEIL

Considering the differences between closely held and publicly held corporations, the California courts may find that the policies underlying the rules of privity do not apply to shareholders of all types of corporations. Courts should recognize and appreciate these differences and allow the shareholders of small closely held corporations to disregard their corporate entity where allowing the corporate fiction to remain would result in injustice. This equitable doctrine is referred to as “reverse” piercing of the corporate veil.¹⁰¹

96. A closely held corporation may elect Subchapter S status for tax purposes under I.R.C. §§ 1362, 1372. In addition to being a closely held corporation, certain other criteria must be met. These criteria are not important for purposes of this article and will not be discussed.

97. Although there are numerous differences between taxing partnerships and taxing Subchapter S corporations, they are generally the same for purposes of this article. In taxing a partnership, the partnership as an entity is not taxed, but rather the profits and losses “pass through” the partners. The result is that individual partners are taxed based on their pro-rata share of the business. See PAINTER, *supra* note 9, §1.10; CAVITCH & CAVITCH, *supra* note 9, §§ 3.00, 3.01.

98. See PAINTER, *supra* note 9, § 1.10; CAVITCH & CATVICH, *supra* note 9, §§ 3.00, 3.01.

99. See PAINTER, *supra* note 9, § 1.10; CAVITCH & CATVICH, *supra* note 9, §§ 3.00, 3.01.

100. See PAINTER, *supra* note 9, § 1.10; CAVITCH & CATVICH, *supra* note 9, §§ 3.00, 3.01.

101. As will be discussed *infra* Part IV, a “reverse” pierce allows the shareholder to disregard the corporate entity so that the corporate entity no longer exists and all that remains is the individual. Generally, “piercing the corporate veil” is reserved for the benefit of third

Before discussing the mechanics of a reverse pierce, it is appropriate to discuss the traditional "piercing of the corporate veil." One of the basic purposes of corporate law is to protect corporate shareholders from personal liability for the actions of the corporation beyond the shareholders' initial capital contributions.¹⁰² Nevertheless, piercing the corporate veil is generally used to hold corporate shareholders personally liable for the acts of the corporation.¹⁰³

There are two alternate doctrines¹⁰⁴ that allow a plaintiff to pierce the corporate veil in order to collect personally from the shareholder: (1) the "instrumentality" doctrine, and (2) the "alter-ego" doctrine.¹⁰⁵ Under the instrumentality doctrine the plaintiff must prove: (1) excessive control by the defendant shareholder; (2) wrongful or inequitable conduct by the defendant shareholder; and (3) a causal relationship between the control and wrongful conduct and plaintiff's loss.¹⁰⁶ Complete ownership of stock is not sufficient, in and of itself, to pierce the corporate veil.¹⁰⁷ Rather, there must be "complete domination" of business practices regarding the specific transaction such that the corporate entity has no existence or mind of its own.¹⁰⁸

parties who have been injured by the directors or officers of a corporation who are protected from personal liability by the corporate entity.

102. See MODEL BUS. CORP. ACT § 6.22(b) (1985).

103. See Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036 (1991). When courts "pierce the corporate veil," they disregard the separate entity that is the corporation and hold the shareholders personally responsible for the corporation's actions.

104. There is also a third doctrine, the "identity" doctrine, but it adds little to the other two theories. The "identity" doctrine requires a showing that there was: such unity of interest and ownership that the independence of the corporation has ceased, and adherence to the fiction of separate identity would serve only to defeat justice and equity by permitting the economic entity to escape liability arising out of one corporation for the benefit of the whole enterprise. See PHILLIP I. BLUMBERG, *THE LAW OF CORPORATE GROUPS (SUBSTANTIVE LAW)*, §6.04 (1987) (citing *Zaist v. Olson*, 227 A.2d 552, 558 (Conn. 1967)).

105. See BLUMBERG, *supra* note 104, § 6.01 at 111 & n.21.

106. See BLUMBERG, *supra* note 104, § 6.02 at 114.

107. See *Steven v. Roscoe Turner Aeronautical Corp.*, 324 F.2d 157, 160 (7th Cir. 1963). See also *U.S. v. Jon-T Chemical*, 768 F.2d 686, 691 (5th Cir. 1985) ("one hundred percent ownership and identity of directors and officers, even together, are an insufficient basis for applying alter-ego theory to pierce the corporate veil").

108. See BLUMBERG, *supra* note 104, § 6.02 at 114; *Jon-T Chemical*, 768 F.2d at 691. In determining the requisite degree of control, the court looks at numerous factors, including: (1) parent corporation owns all or most of the subsidiary's stock; (2) parent and subsidiary corporations have common directors or officers; (3) parent corporation finances the subsidiary; (4) parent corporation subscribes to all the capital stock of the subsidiary or otherwise causes its incorporation; (5) subsidiary has grossly inadequate capital; (6) subsidiary has substantially no business except with parent corporation or no assets except those conveyed to it by the parent; (7) in the papers of the parent corporation, the subsidiary is described as a department or division of the parent corporation, or its business or financial responsibility is referred to as the parent corporation's own; (8) parent corporation uses the property of the subsidiary as its own; (9) directors of the subsidiary do not act independently in the interest of the subsidiary, but take their orders from the parent corporation in the parent corporation's interest; and (10) subsidiary does not follow the formal legal requirements. See *Steven*, 324

The control must be used to commit fraud or some other dishonest or unjust act in violation of plaintiff's legal rights.¹⁰⁹ Further, the control and resulting breach of duty must proximately cause the plaintiff's injury or unjust loss.¹¹⁰

The "alter-ego" doctrine is widely used in "intragroup"¹¹¹ liability cases. Under this doctrine, piercing the corporate veil is proper when (1) such unity of ownership and interest exists between the parent and subsidiary that the two affiliated corporations are no longer separate and the subsidiary has become an "alter-ego" of the parent, and (2) recognizing the companies as separate entities would result in an injustice.¹¹² Because the issue of control is generally considered under the first prong, this test is virtually indistinguishable from the test under the "instrumentality" doctrine.¹¹³

Although the "instrumentality" and "alter-ego" doctrines are defined and discussed separately, they are basically the same and most courts use the terms interchangeably.¹¹⁴ In a recent decision in *Brenelli Amedeo v. Bakara Furniture, Inc.*,¹¹⁵ one California Court of Appeal stated that the purpose behind the alter ego doctrine was to declare the individual and the corporation the same entity. The *Brenelli* court reiterated the rule originally stated in *Wenban Estate, Inc. v. Hewlett*.¹¹⁶

While it is the general rule that a corporation is an entity separate and distinct from its stockholders, with separate, distinct liabilities and obligations, nevertheless there is a well-recognized and firmly settled exception

F.2d at 160-61.

109. See BLUMBERG, *supra* note 104, § 6.02 at 114-15. A "wrong" can range from asset stripping (*C.M. Corp. v. Oberer Dev. Co.*, 631 F.2d 536 (7th Cir. 1980)) to creating a subsidiary to insulate the parent corporation from liability (*Parker v. Bell Asbestos*, 607 F. Supp. 1397 (E.D. Pa. 1985)). Sometimes, though, a "wrong" is construed so broadly as require no further finding than the cause of action itself. See *Gorrill v. Icelandair/Flugleidir*, 761 F.2d 847 (2d Cir. 1985).

110. Generally, defendant's insolvency satisfies this requirement. See BLUMBERG, *supra* note 104, § 6.02 at 114.

111. See *id.* § 6.03 at 118. Intragroup refers to situations involving a parent corporation and its subsidiary. A parent corporation is a corporation that owns more than fifty percent of the voting shares, or other controlling interest in another corporation, called the subsidiary. See BLACK'S LAW DICTIONARY 1114 (6th ed. 1990).

112. See *RRX Industries, Inc. v. Lab-Con, Inc.*, 772 F.2d 543, 545 (9th Cir. 1985).

113. See BLUMBERG, *supra* note 104, § 6.03.

114. While most courts and commentators treat "instrumentality" and "alter-ego" the same, there is a distinction. "The difference is between saying that a corporation is the mere department or instrument of its shareholder and saying that a shareholder and his corporation are one." Richard S. Kohn, Comment, *Alternate Methods of Piercing the Corporate Veil in Contract and Tort Cases*, 48 B.U.L.REV. 123, 137 and n.58 (1968). California adopted the "alter-ego" theory in *Minifie v. Rowley*, 202 P. 673 (Cal. 1921). See Kohn, *supra* at 137. *Minifie* distinguished between the "alter-ego" and "instrumentality," but no other California cases recognize such a distinction. *Id.*

115. *Brenelli Amedeo, S.P.A. v. Bakara Furniture, Inc.*, 35 Cal. Rptr. 2d 348, 355 (Cal. Ct. App. 1994).

116. *Wenban Estate, Inc. v. Hewlett*, 227 P. 723, 731 (Cal. 1924).

to this general rule, that, when necessary to redress fraud, protect the rights of third persons, or prevent a palpable injustice, the law and equity will intervene and cast aside the legal fiction of independent corporate existence, as distinguished from those who hold and own the corporate capital stock, and deal with the corporation and stockholders as identical entities with identical duties and obligations.¹¹⁷

Robert Thompson, a Professor of Law at Washington University, conducted a study of approximately 1600 piercing of the corporate veil cases.¹¹⁸ Thompson analyzed the nature of the corporations¹¹⁹ and reasons given by the courts in deciding to allow or disallow piercing of the corporate veil.¹²⁰ Thompson's study revealed that in those 1600 case studies, piercing occurred only in close corporations and not in public corporations.¹²¹

In deciding whether or not to allow piercing of the corporate veil, the courts seemed to look at (1) the number of shareholders,¹²² and (2) the role of the shareholder.¹²³ As a result, it appears that an individual shareholder who is active in the management of a close corporation is infinitely more likely to be subject to personal liability for corporate acts than the passive investor of a public corporation. This is further evidence of the enormous risks that shareholders of close corporations bear, and which shareholders of public corporations do not similarly bear. Since the burdens and risks are different, it seems unfair to subject close corporation shareholders to the same rules regarding independent auditor's liability for negligent audits as public corporation shareholders, especially when those rules result in a severe injustice. Because a close corporation is more likely to have its corporate veil pierced, equity should allow a shareholder of a close corporation to disregard the corporate entity when not allowing it would result in a grave injustice.¹²⁴

117. *Brenelli*, 35 Cal. Rptr. 2d 355.

118. Thompson, *supra* note 103, at 1036-37 n.1, 1044 & n.47. Cases were selected by searching WESTLAW through 1985 using the terms "piercing the corporate veil" and "disregard! the corporate entity" as well as certain WESTLAW "key" numbers. A similar search was conducted in LEXIS in 1990 with similar results. From an initial set of 2000 cases, those that did not address corporate law were eliminated. Factual data compiled from the cases include: whether or not the court pierced the corporate veil; year; court; jurisdiction of law being applied; number of shareholders in the corporation being pierced; whether a person or an entity was behind the veil; the person or entity seeking the piercing; the substance of the claim (i.e., contract, tort, criminal law or other statute). *See id.*

119. Close corporations versus public corporations.

120. *See* Thompson, *supra* note 103, at 1038-39.

121. *See id.*

122. *See id.* at 1055 (where corporation had one shareholder, corporate veil pierced in 49.64% of cases; where corporation had two or three shareholders, corporate veil pierced in 46.22% of cases).

123. *See id.* at 1056 (where defendant was a passive investor rather than active in the business as a director/officer, courts "almost always" found no liability).

124. *See* BLUMBERG, *supra* note 104, § 22.09 (recognizing "an enterprise treatment should be available whenever it would implement the underlying policies of the law, including implementation of the intent of the parties, and not be confined exclusively to protecting

Unfortunately, courts rarely allow the corporate entity to be disregarded for the benefit of its shareholders.¹²⁵ The underlying policy is that since the shareholders chose the form of doing business, they should be held to the consequences of their own choice.¹²⁶ Nonetheless, the courts have applied "reverse" piercing of the corporate veil in some cases. The classic case of "reverse" piercing of the corporate veil is *Cargill v. Hedge*.¹²⁷ In *Cargill*, the trial court denied corporate shareholders a farm homestead exemption because title to the farm was held in the corporate name. In allowing a reverse pierce of the corporate veil, the court looked at (1) the degree of identity between the shareholder and the corporation, (2) public policy and (3) whether a pierce would harm others, such as creditors or other shareholders.¹²⁸ The *Cargill* court allowed a "reverse" pierce so the individual shareholder could claim the homestead exemption.¹²⁹

There are three general approaches to the doctrine of "reverse" piercing of the corporate veil.¹³⁰ The majority view is that the corporation may not disregard the entity for any reason.¹³¹ One minority view allows a "reverse" piercing of the corporate veil using the jurisdiction's traditional corporate pierce test.¹³² Under this view, the court does not consider that the corporation is the party seeking to disregard its own entity.¹³³

Another minority view allows for a "reverse" piercing of the corporate veil only if equity or public policy requires.¹³⁴ In *Barium Steel Corp. v. Wiley*,¹³⁵ the court held that the corporation and the individuals who own all

third parties"). See also COX ET AL., *supra* note 77, § 7.18 ("the overall question is not to mechanically estop the corporation's stockholders from raising their own deficiencies as a basis to disregard the entity they have created but to inquire whether a fairer resolution of the dispute before the court is achieved if the corporation's shareholders are permitted to pierce the veil").

125. See O'NEAL & THOMPSON, *supra* note 76, § 1.10.

126. See *id.* See also Thompson, *supra* note 103, at 1058.

127. *Cargill v. Hedge*, 375 N.W.2d 477 (Minn. 1985).

128. See *id.* at 479.

129. Corporations are not entitled to homestead exemptions because they are artificial entities with no need for a dwelling. The court placed significance on the shareholders operating the farm as individuals, rather than as a business entity. The family lived on the farm. Therefore, the only way to further the public policy behind the homestead exemption was to disregard the corporate entity and allow the shareholders to claim the exemption. Furthermore, the court allocated the risk of default to the creditor, finding that he should have been aware of the possibility of the homestead exemption when he extended the credit. See *id.*

130. See Michael J. Gaertner, Note, *Reverse Piercing the Corporate Veil: Should Corporation Owners Have It Both Ways?*, 30 WM. & MARY L. REV. 667, 681 (1989).

131. See *id.* at 683 (citing *T.V.A. v. Exxon Nuclear Co.*, 570 F. Supp. 462 (E. D. Tenn. 1983), *aff'd* 753 F.2d 493 (6th Cir. 1985)) (where court refused to pierce the corporate veil between the two corporate entities, requiring them to "abide by their choice" of organization).

132. See *id.* at 685-86 (citing *Crum v. Krol*, 425 N.E.2d 1081, 1088-89 (Ill. App. Ct. 1981)) ("reverse" pierce allowed because the same equitable considerations of preventing injustice should apply when a third party attempts to use the corporate veil as a shield).

133. See *id.* at 681.

134. See *Barium Steel Corp. v. Wiley*, 108 A.2d 336 (Pa. 1954).

135. *Id.*

of its stock and assets may be treated as identical in appropriate cases where "justice to all parties requires it."¹³⁶ In *Barium Steel*, plaintiff purchased all of the stock of defendant's corporation after defendant warranted that the corporation owed no taxes.¹³⁷ Subsequently, one of plaintiff's subsidiary companies paid the taxes owed by the defendant's corporation.¹³⁸ The defendant claimed plaintiff could not recover from him because plaintiff suffered no damages. However, the court held that plaintiff could sue defendant for the taxes paid by plaintiff's subsidiary company.¹³⁹ The court stated:

If no recovery can be had in the instant case against defendants, defendants never will be liable for their breach . . . because if [plaintiff's subsidiary] sues defendants to recover [the money it paid to clear the tax lien], the defendants can avoid liability by pleading there is no privity of contract between [plaintiff's subsidiary] and themselves.¹⁴⁰

The *Barium* case is so factually similar to the situation presented in the Smith case that the court should apply the reverse pierce in the Smith case because, like Pennsylvania, California courts have also applied the reverse pierce "broadly to protect the interests of shareholders or officers of the corporation."¹⁴¹

In *Cooperman v. California Unemployment Insurance Appeals Board*,¹⁴² the court disregarded the corporate entity so the sole shareholder of the corporation would be eligible to receive unemployment benefits. In *Cooperman*, plaintiff was the president and sole shareholder of a corporation he created on the advice of his attorney.¹⁴³ The corporation sold the talents and expertise of its sole shareholder.¹⁴⁴ During a time of unemployment, Cooperman sought unemployment benefits from the state, was denied, and appealed the denial.¹⁴⁵ The court, while recognizing the separateness of the

136. *Id.* at 341.

137. *See id.* at 338-39.

138. *See id.* at 341.

139. *See id.*

140. *Id.* at 343. It is worth noting that Pennsylvania also follows "near privity" rules in independent auditor liability. *See, e.g.,* *Landell v. Lybrand*, 107 A. 783 (Pa. 1919).

141. 9 WITKIN SUMMARY OF CALIFORNIA LAW *Corporations* § 23 (9th ed. 1989) (citing *Conway v. Citrus Belt Land Co.*, 271 P. 525, 527 (Cal. Ct. App. 1928)) (corporate entity disregarded to absolve corporation and directors from liability for violation of statute). *But see* *Western States Bankcard Assn. v. San Francisco*, 561 P.2d 273, 279 (Cal. 1977) (corporate entity not "disregarded to facilitate tax avoidance").

142. *Cooperman v. California Unemployment Ins. Appeals Bd.*, 122 Cal. Rptr. 127 (Cal. Ct. App. 1975).

143. *See id.* at 129 & n.1. Cooperman incorporated on his attorney's advice to obtain the benefits of limited liability. Cooperman testified he did not operate the business any differently than when it was a sole proprietorship.

144. *See id.* at 129.

145. *See id.* Cooperman was denied benefits because he was the president of a viable corporation and, therefore, not unemployed.

corporate entity, held that the entity may be disregarded to prevent fraud, protect third parties or prevent a grave injustice.¹⁴⁶ Ultimately, the court held that the "alter-ego" doctrine applies in cases where the rights of the shareholders are at issue.¹⁴⁷

To recover under this "alter-ego" theory, a shareholder must establish that the "individuality and separateness of the corporation and the individual have ended and that it would be unjust to persist in the recognition of a separate entity."¹⁴⁸ In *Cooperman*, the court held that if the corporation was allowed to remain a separate entity, a "grave injustice" would be done to Cooperman.¹⁴⁹ The court, therefore, allowed Cooperman to disregard the corporate entity so he could obtain unemployment benefits.

While some argue that *Cooperman* is limited in scope because the case deals with unemployment benefits,¹⁵⁰ another recent California case applied the "reverse" pierce doctrine to a contract case.¹⁵¹ In *Lebastchi v. Superior Court*, the plaintiff sued defendant corporation and defendant shareholder for a breach of contract.¹⁵² Defendant shareholder requested a change of venue arguing that venue was proper in the county where he resided and not in the county where the contract was executed and to be performed.¹⁵³ The court held that, for purposes of venue, "[an] alter-ego allegation places the individual in the same position as the corporation,[i.e.,] as a party to the contract."¹⁵⁴ The court stated the alter-ego doctrine arises when plaintiff claims defendant is "using the corporate form unjustly and in derogation of plaintiff's interest."¹⁵⁵ The proper issue is whether in any particular case equity is best accomplished by disregarding the corporate entity.¹⁵⁶ As applied to the Smith case, Accountants are attempting to use the corporate form unjustly by claiming lack of privity, in derogation of the Smiths' interests. By disregarding the corporate entity of Re-Comp, and holding the Smiths in the same position as the corporation, the Smiths become parties to the con-

146. *See id.* at 131.

147. *See id.* (emphasis added).

148. *See id.* at 131.

149. *Id.*

150. *Id.* at 132-33. It appears that *Cooperman* may be distinguishable from other cases because it involved unemployment benefits and, therefore, other public policy issues come into play. Because *Cooperman* involved an unemployed cameraman-director, the court considered the fact that unemployment was due to the "erratic" nature of the motion picture industry and not to Cooperman's lack of diligence in obtaining employment. The court also considered that Cooperman received no compensation as president and had no managerial responsibilities. *Id.*

151. *Lebastchi v. Superior Court of San Diego County*, 39 Cal. Rptr. 2d 787 (Cal. Ct. App. 1995).

152. *Id.* at 789.

153. *See id.*

154. *Id.* at 788.

155. *Id.* at 790.

156. *See id.* at 790 (citing 9 WITKIN SUMMARY OF CALIFORNIA LAW, *Corporations* § 12 (9th ed. 1989)).

tract and therefore have privity of contract with Accountants. As a result, the Smiths can now maintain a cause of action against Accountants.

In California, cases like *Cooperman*¹⁵⁷ and *Lebastchi*¹⁵⁸ indicate the court's willingness to disregard the corporate entity when continued recognition of the corporate fiction will result in a "grave injustice" and to "protect the interests of the shareholders." This equitable doctrine should be available to shareholders of closely held corporations in jurisdictions requiring strict privity in an action for independent auditor liability. One major drawback of the "reverse pierce" is that it is an equitable doctrine available at the court's discretion. As such, it provides plaintiffs with less than predictable results. However, there is some comfort in that California is a jurisdiction that recognizes application of the doctrine.

V. CONCLUSION

Based on the facts as presented in this article, it is clear that existing California law does not provide the Smiths with an adequate remedy. *Bily* has essentially eliminated any recovery for professional malpractice for shareholders in small closely held corporations. This result is unjust since justice is never served if the court cannot even consider the facts of a particular case, especially the special concerns of, in this instance, the small closely held corporation. Finally, vesting the entire possibility of success with the equitable remedy of "reverse" piercing of the corporate veil is speculative at best. Without a substantive change in the law, the Smiths are without a remedy for their \$5 million loss caused solely by independent auditor negligence.

*Lori J. Lechner**

157. See *Cooperman v. California Unemployment Ins. Appeals Bd.*, 122 Cal. Rptr. 127, 127 (Cal. Ct. App. 1975).

158. See *Lebastchi*, 39 Cal. Rptr. 2d at 787.

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