ORLOFF
LOWENBACH
STIFELMAN &
SIEGEL P.A.

Interference Is Still Discouraged: New York’s Audit Interference Rule Remains an Important Factor in Relationships Between Business Owners and Their Accountants

By David Gorvitz

The old saying popularized by President Kennedy that “victory has 100 fathers and defeat is an orphan”[1] finds good application in the business nightmare scenario in which management suddenly uncovers major shortfalls or losses, precipitated or previously concealed by fraud, theft, or other misconduct of rogue employees or vendors. When such losses are large enough to impact the company's balance sheet or income statement, necessitating a charge, or worse yet, a restatement of prior financial results, they can trigger major repercussions for the business at the hands of its lenders and investors. But by the time the malfeasance is uncovered, the perpetrators are often no longer there to take responsibility, and even if they are apprehended, the money rarely is. The business owners, rightly aggrieved, often look to the company’s accountants, questioning how they could have failed to timely uncover the losses when it was their job to put together or verify the company financial statements. The accountants retort that they are not guarantors of the veracity of the financial statements, and even if they were negligent in the conduct of their audit procedures, it was management’s job to prevent the loss. How is this finger-pointing match adjudicated?

In cases where multiple parties are alleged to be at fault for the same loss, nearly every state recognizes some form of the comparative negligence principle, whereby the financial responsibility for the loss is allocated in some relation to parties’ relative fault.[2] Often, however, there are limitations on this concept in the professional liability context.[3] In actions against accounting professionals, perhaps the best known limitation on comparative negligence is New York’s audit interference rule, which has been adopted in several other states. Under the rule, a client's negligence can only be used as a defense by the accountant if it directly interfered with the accountant’s ability to carry out the engagement competently.

New York’s audit interference rule was first formulated in the decision of the Supreme Court, Appellate Division – First Department, one of the state’s intermediate appellate courts, in National Surety Corp. v. Lybrand.[4] In that case, brought by a brokerage house whose funds had been pilfered by an employee, the defendant auditors who had failed to discover the theft

claimed that the plaintiff was contributorily negligent in allowing it to happen in the first place. The appellate court sided against the auditors. "Accountants," it noted, "are commonly employed for the very purpose of detecting defalcations" which the audit recipient's "negligence has made possible." Thus, the fact that the audited entities may "have conducted their own business negligently," leading to financial wrongdoing taking place on their watch, does not mean that auditors could escape or mitigate "the consequences of their negligence" in failing to detect it. It is "only when" the audited entity has directly "contributed to the accountant's failure to perform his contract and to report the truth" that it can be charged with contributory negligence.[5]

Although it has never been adopted by New York's highest court, over time, the interference rule, as formulated in National Surety, has become settled law in New York for limiting comparative negligence in accounting malpractice cases.[6] Notably, the rule not only narrows accountants' comparative negligence defense but limits their use of the client's alleged negligence to defeat an element of the malpractice claim. Thus, if the business owner's negligence cannot be shown to have "substantially impeded defendant[] [accountants'] ability to complete the review that they had been hired to perform," that client's negligence also cannot be set up as the "sole proximate cause" of the loss to cut off the accountants' liability.[7]

Despite its name, the audit interference rule applies not only to auditors. Accounting professionals performing review and compilation engagements are impacted as well. The duties of accountants on non-audit engagements with respect to fraud materially impacting a client's finances are narrower than those of auditors.[8] Still, as a court held last year in 1650 Broadway Assocs., Inc. v. Sturm, even accountants retained to perform only compilation services and tax preparation, "must perform all [such] services in accordance with the standard of a reasonable accountant under similar circumstances, which includes reporting fraud that is or should be apparent" — in that case massive loans made by the corporation's treasurer to himself.[9] This responsibility, the court held, is not diminished by plaintiff's own negligence in failing to discover or prevent the fraud, unless it is "established that such negligence impeded defendant's [performance of its] duties to reveal to plaintiffs what it knew."[10]

While several jurisdictions besides New York have expressly adopted the audit interference rule,[11] it remains a minority position in the United States.[12] Indeed, by the middle of the last decade, one commentator was noting "a clear trend" in national case law "rejecting the rule."[13] One key factor cited as limiting the rule's popularity is the migration of nearly all U.S. jurisdictions from a regime of contributory negligence (where even a small quantum of negligence on the part of plaintiff precludes any recovery) to one of comparative fault (where liability is apportioned based on relative percentages of fault and even a partially negligent plaintiff can recover). Commentators have posited that the National Surety court had adopted the interference rule specifically to "avoid th[e] harsh result" of contributory negligence barring all recovery, a "rationale [that] is simply not present in a comparative-[fault] jurisdiction."[14] It has been noted that "Texas abandoned the audit-interference rule after it enacted a comparative negligence statute."[15] One federal case even questioned the survival of the rule in New York

itself, citing that state's adoption of the comparative-fault system, causing a commentator to theorize that the rule could be discarded everywhere.[16]

Those who foretold the doctrine's doom are likely to be disappointed. The doctrine has persisted and, if anything, made a modest comeback over the past 10 years. In New York, courts have reaffirmed it, most recently last year in Sturm,[17] even though the state has long had a comparative-fault regime.[18] A federal court in Alabama has also held that the rule would be recognized in that state. [19] And in New Jersey, courts have for the first time expressly extended to accountants their long-established "policy-based preclusion" against certain professionals' use of comparative fault to reduce their liability. Thus, in a slightly narrower conception of the New York rule, accountants "may not diminish their liability under [New Jersey's] Comparative Negligence Act … when the alleged negligence of the client relates to the task for which the professional was hired," unless the "client impedes the professional in his or her performance" of its work or otherwise "contribute[s] to or affect[s] the professional's failure to perform."[20]

The accountants' professional liability defense bar has complained that the audit interference rule was founded on a "popular misconception" of an auditor's role as broader than it actually is.[21] Indeed, to state that "accountants … are commonly employed for the very purpose of detecting defalcations" at client companies that had been missed by management may both oversimplify and overstate their remit.[22] While auditors may examine a client's internal controls in place to prevent fraud and theft, it is the business owners and their management who design and implement these controls. Furthermore, it is the owners and management who, in most cases, hire the employee or vendor who winds up committing the theft or fraud in the first place.

On the other hand, accounting professionals engaged to compile or pass upon financial statements bring their specialized knowledge to the task. Thus, auditors who must opine on whether financial statements fairly present a client company's financial position and results in accordance with the generally accepted accounting principles (GAAP) have expertise in the GAAP, significant experience in financial statement review, and skill in conducting the verification and substantiation procedures specially designed to confirm the existence of assets, cash flows, and profits listed in the financial statements[23] — all abilities that a business owner may lack.

As noted, an accountant's responsibility is cabined by the nature of the engagement. Even when the engagement is an audit, the professional will not be held liable for all instances of failing to detect financial malfeasance. Rather, liability will attach only if the auditor misses the underlying problem by negligently failing to follow the applicable professional standards **and** the problem results in a material financial misstatement that proximately causes damages.[24] Furthermore "the recognized and accepted professional standards for accountants and auditors [are] generally measured by GAAP and GAAS," the generally accepted auditing standards, "promulgated by the American Institute of Certified Public Accountants," accountancy's lead trade organization.[25] Proving that the accountant did not meet the professional standards generally requires the testimony of an expert accountant,[26] and accountants are afforded a wide latitude in using judgment to apply the standards; only an **unreasonable** breach can be grounds

for a finding of negligence.[27] And only the business owner who retained the accountant, or someone in "near privity" with the professional, can pursue that professional for losses caused by negligent failure to detect financial wrongdoing.[28]

The audit interference rule seems to embody a policy judgment that, within narrow confines — in areas of their special competency, applying standards set by their profession —accountants can be held wholly responsible to their clients for losses caused by negligent performance of their particular engagements in putting out or validating false financial statements, even when the clients may have also been remiss in failing to detect the problem. Courts adopting the doctrine appear to have concluded, in the words of an influential commentator cited in a number of cases, that it is not "unreasonable" for a client to "conduct[] his affairs on the assumption that [the accountant] is doing his job properly." [29] In other words, in this reading, a business owner is not unreasonable if, as part of an effort to ensure the correctness of the business's financial statements, he or she relies on the accountant to fill in some gaps within the accountant's area of expertise.

The important caveat to this notion, insisted upon by the courts as part of the interference rule is that, to be afforded its protection, the clients must leave the accountant completely free and unimpeded to do the job. It does not take much "interference" to lose the benefit of the rule. For example, the National Surety court explained that the business owners had been properly charged with contributory negligence in the prior leading case, Craig v. Anyon,[30] because they had "negligently represented to the accountants" that "the embezzler" was "a person to be trusted."[31] Thus, owners need to be completely transparent and honest with the accountants they engage to take advantage of the audit interference rule.

The New York courts' maintenance of the audit interference rule as an exception to comparative negligence is of a piece with their decision not to allow the common-law in pari delicto defense to accountant malpractice to be swallowed up by the comparative fault regime.[32] In protecting accountants from even partial liability where the client is chargeable with **complicity** in the underlying wrongdoing, New York courts see this defense as serving important public policy purposes of deterring fraud and crime.[33] Similarly, courts may see offering innocent, cooperative business owners complete protection from losses caused by their accountants negligently permitting the issuance of erroneous financial statements as promoting both greater accountant professional competence and business owner transparency.

The persistence of the audit interference rule in New York and its analogs in key jurisdictions, including New Jersey, Pennsylvania, and Illinois, means that it must continue to be taken into account by both business owners and accountants before and in the course of engagements. For accountants, it serves as yet another good reason to pay close attention to the contents of their engagement letters, including jurisdictional issues. For their part, business owners should be aware that giving their accountants as much transparency and as little resistance as possible when they do their jobs has significant benefits. For both sides, consulting competent counsel at both the engagement stage and early in any dispute is highly advisable.

1 President's News Conference of April 21, 1961 (139), Public Papers of the Presidents: John F. Kennedy, 1961.

2 10 Fletcher Cyc. Corp. § 4891.50, Negligence—Defenses.

3 1 Comparative Negligence Manual (3d ed) § 1:12, Application to other professional negligence actions.

4 9 N.Y.S.2d 554 (N.Y. App. Div. 1st Dep’t 1939).

5 Id. at 563.

6 See Shapiro v. Glekel, 380 F. Supp. 1053, 1058 (S.D.N.Y. 1974); Hall & Co., Inc. v. Steiner and Mondore, 543 N.Y.S.2d 190, 192 (N.Y. App. Div. 3d Dep’t 1989); Dan L. Goldwasser, M. Thomas Arnold, and John H. Eickemeyer, Accountants' Liability, (New York: Practicing Law Institute, 2012), at §4:3.2 n.343 (citing National Surety as the “leading case” for the doctrine).

7 Collins v. Esserman & Pelter, 681 N.Y.S.2d 399, 402 (N.Y. App. Div. 3d Dep’t 1998); see also JAG Orthopedics, P.C. v. AJC Advisory Corp., Index No. 511414/14, 18 N.Y.S.3d 579, 2015 WL 4509548, *4 (Sup. Ct. Kings Co. July 21, 2015) (holding that “plaintiff’s own negligence in monitoring” its embezzling office manager was “not show[n] to be the sole proximate cause of the loss since such negligence does not appear to have impeded the [defendant accountants’] performance of their duties in reviewing plaintiff’s tax materials”).

8 “Professional Insights: What is the difference between a compilation, review, and audit?,” AICPA & CIMA, Sep. 30, 2023, available at https://www.aicpa-cima.com/professional-insights/video/what-is-the-difference-among-a-compilation-review-and-audit (last visited Feb. 23, 2025).

9 210 N.Y.S.3d 19, 22 (N.Y. App. Div. 1st Dep’t 2024).

10 Id. at 23.; see also JAG Orthopedics, 2015 WL 4509548, at *3 (quoting 1136 Tenants' Corp. v. Rothenberg & Co., 319 N.Y.S.2d 1007 (N.Y. App. Div. 1st Dept 1971), aff’d o.b. 30 N.Y.2d 585 (N.Y. 1972)) (holding that non-auditing accountants are “not free to consider [any] suspicious circumstances” that they happen to encounter as part of their work “as being of no significance and prepare [their] financial reports as if same did not exist”).

11 See Jewelcor v. Corr, 542 A.2d 72 (Pa. Super. Ct. 1988); Board of Trustees of Community College Dist. No. 508, County of Cook v. Coopers & Lybrand, 803 N.E.2d 460, 468 (Ill. 2003); see also Stroud v. Arthur Andersen, 37 P.3d 783 (Okla. 2001); Fullmer v. Wohlfeiler & Beck, 905 F.2d 1394 (10th Cir. 1990) (applying Utah law); Lincoln Grain, Inc. v. Coopers & Lybrand, 345 N.W.2d 300 (Neb. 1984).

12 James H. Bicks, et al., "Defending Audit-Malpractice Cases: The Audit-Interference Rule," 8 (No. 1) ABA Professional Liability Litigation 1, 2-3 (March 26, 2012), available at

https://www.wiggin.com/wp-content/uploads/2019/09/22345_defending-audit-malpractice-cases_the-audit-interference-rule-l-aba-l-bicks-hoff-l-wint-2012.pdf (last visited Feb. 23, 2025).

13 Bryan Hunt, "Declining Vitality of the Audit Interference Rule," 2014 (No. 2) For The Defense 14, 16 available at https://www.hunt-lawgroup.com/siteFiles/News/Declining%20Vitality%20of%20the%20Audit%20Interference%20Rule.pdf (last visited Feb. 23, 2025).

14 Bicks at 2.

15 Id.

16 Hunt at 20 (citing Bank Brussels Lambert v. Chase Manhattan Bank, N.A., No. 93-Cv.-5298 (LMM), 1996 WL 728356, *1 (S.D.N.Y. Dec 18, 1996)).

17 Sturm, 210 N.Y.S.3d at 22; see also Town of Kinderhook v. Vona, 25 N.Y.S.3d 715, 717 (N.Y. App. Div. 3d Dep't 2016); JAG Orthopedics, 2015 WL 4509548, at *3.

18 L.1975, c. 69, § 1, eff. Sept. 1, 1975.

19 Colonial BancGroup Inc. v. PriceWaterhouseCoopers LLP, No. 11-Cv.-746 (BJR), 2017 WL 4171403, *6 (M.D. Ala. Sept. 12, 2017).

20 Kabakibi v. Sarva, No. A-2795-17T2, 2019 WL 5448676, *5 (App. Div. Oct. 24, 2019) (quoting Aden v. Fortsh, 169 N.J. 64, 77-78 (2001)).

21 Bicks at 3.

22 Id. (quoting National Surety, 9 N.Y.S.2d at 563).

23 See FN8.

24 See Cumis Ins. Soc'y Inc. v. Tooke, 739 N.Y.S.2d 489, 493 (N.Y. App. Div. 3d Dep't 2002).

25 Id.

26 Berg v. Eisner LLP, 941 N.Y.S.2d 616, 617 (N.Y. App. Div. 1st Dep't 2012).

27 Mishkin v. Peat, Marwick, Mitchell & Co., 744 F. Supp. 531, 538 (S.D.N.Y. 1990).

28 See e.g. DaPuzzo v. Reznick Fedder & Silverman, 303, 788 N.Y.S.2d 69, 71 (N.Y. App. Div. 1st Dep't 2005) (outside directors of audited company who were not party to audit engagement and never communicated with auditor cannot sue auditor for negligence).

29 Carl S. Hawkins, "Professional Negligence Liability of Public Accountants," 12 Vand. L.Rev. 797, 811 (1959) (cited in Aden, 169 N.J. at 77; Lincoln Grain, 345 N.W.2d at 307; Shapiro, 380 F. Supp. at 1058).

30 208 N.Y.S. 259 (N.Y. App. Div. 1st Dep’t 1925), aff'd o.b., 152 N.E. 431 (N.Y. 1926).

31 9 N.Y.S.2d at 563.

32 Kirschner v. KPMG LLP, 938 N.E.2d 941, 959 (N.Y. 2010).

33 Id. at 958.