Analysis and Perspective

LIABILITY WITHOUT END? CONSULTANTS, CONTRACTS, AND THE LIMITS OF ENVIRONMENTAL RESPONSIBILITY

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As use of consultants to identify or mitigate environmental concerns expands exponentially under pressure from new environmental regulations and toxic exposures, their potential liabilities expand as well.

This article addresses the nature and scope of consultant liability under the common law and pertinent environmental statutes. It focuses first on liability under contract and tort theory for acts or omissions in conducting environmental audits. It particularly examines the possibility of common law duties beyond the scope of the contract, whether to persons who might foreseeably rely on the consultant's performance, or to the public in general. It also discusses auditors' duties to warn the public of environmental dangers or otherwise disclose audit findings to regulatory agencies, including implications of the government's recent case against the law firm of Kaye Scholer. Since few cases to date involve environmental audits, this article takes into account cases involving "audits" by financial or other professionals that have largely defined the law on these issues. Finally, it suggests ways auditors can protect themselves from liability arising through the contract and otherwise.[2]

Why Audit?

The complex technical and legal content of modern environmental laws makes compliance assurance difficult even for large, well-staffed companies, let alone smaller ones. Multimillion-dollar fines or penalties which often follow even technical violations—let alone jail terms, or the strict, joint and several liability for cleanups under the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) now averaging over $25 million per site, exclusive of natural resource damages—provide powerful incentives to assure such compliance.[3] Moreover, even large companies may need independent assessments to get a fresh perspective, convince plant managers to change their behavior, or prevent self-serving interpretations that perpetuate noncompliance, while smaller firms may lack the staff and funds to assure their own compliance. Due to the ensuing need for technical expertise and comfort (including comfort that directors are exercising due diligence), the use of consultants to conduct various environmental audits or train company personnel to conduct internal audits has expanded apace over the last five years.

Audits may consist of "snapshot" compliance assessments, comprehensive risk evaluations, or pre-acquisition site reviews to identify specific superfund law or similar liabilities.[4] For example, an environmental site assessment prior to the purchase or sale of commercial or residential property can allow the buyer or seller to determine whether the property is contaminated and the extent of contamination and potential liabilities, as well as to clean up the property to acceptable levels without costly government supervision.[5] If done sufficiently in advance of closing, such audits can also be "deal makers" instead of "deal breakers," allowing sellers and buyers to negotiate deductibles, shared cleanup costs, or other options in purchase agreements. Site assessments are also critical to establish baselines limiting future liability for contamination, and to invoke possible "secured creditor" or "innocent purchaser" defenses against liability.[6]

Environmental audits may also assess internal company procedures designed to produce compliance with local, state and federal environmental laws—assessments that can yield important clues to possible site contamination as well.[7] Although compliance audits still raise fears that information on civil or criminal violations will conveniently be packaged for prosecutors, even smaller companies will have to conduct them in light of the expanded personal liability of officers and directors with control over polluting activities.[8] Bills introduced in the last Congress would require that audits be performed and subject companies to civil as well as criminal liability for failure to perform them.[9] Under recent Department of Justice guidelines, enforcement discretion not to refer environmental cases for criminal prosecution will most likely be exercised where companies have good audit programs and promptly fix (as well as report) what they find.[10]

Finally, the new Clean Air Act, like other environmental statutes, makes felonies of any "knowing" failure to keep records or make required reports, including certified reports of current compliance status.[11] It also extends personal civil and criminal liability for such violations to senior corporate managers and other "responsible corporate officers."[12] Moreover, it creates a presumption that violations are continuing and per day, unless the defendant establishes otherwise.[13] Since audits of procedures are the only way to ensure proper recordkeeping and reporting, as well as to ensure systematic documentation of when exceedances cease, periodic audits are virtually required.

Given that consultants will increasingly perform audits, under what circumstances will they be liable for the performance of these functions, and to whom? Are they required to encourage the client to disclose violations discovered in the course of an audit? Are they required to disclose information their clients won't disclose? When, if ever, must they warn regulatory agencies of possible hazards to the public welfare discovered by an audit? At what point will they be found to have participated in a violation by failing to make such disclosures? Do recent actions by the Office of Thrift Supervision (OTS) holding lawyers and accountants personally responsible for S&L losses have bearing on these issues? These questions are not academic; they may involve millions of dollars in damages, even where the auditor's actions are only a small part of the cause of loss.

Standards Of Performance Owed To Auditor's Client

The consultant's immediate duty is to the employer with whom it has entered into a specific written agreement. Performance of the specific promises agreed to is central to the contractor's duties.[14] The contract may provide for the

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assessment of a particular site or a broader scope of work, such as an audit of compliance with permits and statutes.

Aside from the specifics of the written agreement, the consultant, like all those who contract to perform, implicitly agrees to perform in a manner consistent with the standards of the profession.[15] The claim that such performance has not been rendered can be called one in "negligence," for violating a legal duty of care owed the client; in "malpractice," for the more specific violation of professional standards; or for breach of contract.[16] In any case, where the client claims to have suffered a loss because of the professional's performance, professional standards will play a role in the outcome of that claim.

The weight given professional standards varies by jurisdiction. Some jurisdictions regard noncompliance with the accounting profession's Generally Accepted Audit Standards as determinative of whether negligence or malpractice has occurred, regardless of other proof by the accountant that he did nothing wrong.[17] Others specifically deny this determinative role to the standards.[18] Still others require that professional standards be admitted as evidence of the duty of care required of a professional, without their being determinative one way or the other.[19]

The accounting profession offers a sobering example of the role professional standards may play in liability suits. In the wake of recent financial losses at major institutions, the American Institute of Certified Public Accountants (AICPA) has been described as overreacting to the possibility that Congress might regulate the profession by setting "unrealistically high guidelines" which have proved useful to plaintiffs' attorneys. AICPA sees itself reasonably addressing requirements of its profession and practitioners.[20]

The American Society for Testing and Materials among other organizations, has recently promulgated standards for the conduct of Phase I as well as other types of audits.[21] This is a reasonable step to take in reaction to concerns over divergent audit quality and the prominent role of audits in satisfying the "due diligence" aspects of the "innocent landowner" defense under CERCLA.

But the accountants' situation offers two lessons. First, professionals responsibly setting minima they see as necessary for competent performance, are likely establishing standards to be used as evidence, if not absolute proof, in future cases. Indeed, their aim of certainty may foment greater business uncertainty.[22]

Second, whether those standards become controlling may depend as much on politics as on legal doctrine. The savings and loan chaos of the 1980s spotlighted the accounting profession and made it a target for recovery of huge losses, essentially, a backup insurer. Similarly, cost recovery "insurance" against CERCLA-type liability remains a major theme in the legal, banking, insurance and industrial communities. Whether audit standards formalized in partial response become a dominant legal issue in this area may depend on parties' perceived need for another deep pocket and whether auditors (or those hiring them) successfully obtain a "safe harbor" like that recently extended by EPA to secured creditors.

Auditor Liability To Third Parties

The environmental auditor's duties inherently implicate parties outside the immediate contractual relationship. Contamination, or the failure to detect it, may affect entire populations. Improperly operated nuclear generating, water treatment or hazardous waste facilities have the power to transform traditional notions of "damage." Moreover, regulatory agencies may also have direct interest in the contents of an audit. Under what circumstances will these "implications" become actual liabilities to third parties where the auditor is alleged to have misserved his client? Those liabilities also seem to be expanding, though the legal standards for liability are far from clear.[23]

Third-Party Beneficiary—Contract Law

A person for whose benefit a valid contract is made, although not a party to the agreement, may maintain an action under the contract against the promisor if the benefit of the contract is not realized. Where the contract does not specifically assert an intention to benefit a third party, circumstances surrounding the contract will be examined.[24]

A recent California case illustrates how an auditor's contract may be analyzed. Beta Associates, which had contracted with the buyer of property to perform a pre-acquisition audit, erroneously reported there was no ground water contamination. Following detection of the contamination, the buyer sued the seller, who in turn sued Beta, claiming that the seller was a third party beneficiary of the audit contract. The court rejected that claim, noting that the buyer had not discussed with the consultant an intention that anyone else would benefit from the contract, nor that the seller would review or rely on it. Moreover the seller had not been shown a copy of the contract.[25]

A *transactional* audit may affect the rights of a party to purchase an asset, the interest of a lender financing the transaction, or the value of the transaction to principals or other parties. A *compliance* audit may, among other things, affect the facility's ability to operate, as well as its liability for violations or for exposing workers or neighbors to harm. Under these circumstances the auditor's contract with its client may become the source of broader liability. The auditor may avoid naming other parties as beneficiaries, and may expressly provide that such benefits are precluded by its contract. But as indicated below, that will not be the end of the matter.

Negligence

Even where the contract itself is found not to benefit a third party, the auditor may be liable for negligence if, in performing his job, he came to owe that third party an *independent* duty of care. In *Caldwell v. Bechtel*[26], Bechtel had contracted with the Washington Metropolitan Area Transit Authority (WMATA) to provide "safety engineering services" to other contractors working for the Authority. A heavy equipment operator who worked for another contractor developed silicosis after prolonged exposure to silica on the job, and claimed that Bechtel violated duties owed him arising out of its "safety engineering services" contract with the Authority.

The court specifically declined to base its holding on benefits running directly to the plaintiff under the Bechtel-Authority contract, although it noted that such rights probably did exist.[27] Instead it held that Bechtel had "placed itself in the position of assuming a duty" to the plaintiff. The court cited Bechtel's superior skills and position, the contract between Bechtel and WMATA, and Bechtel's resultant ability to foresee the harm that might reasonably be expected to befall the plaintiff. Therefore the terms of the contract, which Bechtel argued ran solely to its own employer, could not limit parties to whom a duty was owed.

How Far Does The Duty Extend?

Despite its refusal to rely on the contract terms, *Bechtel* suggests that the plaintiff there was a "foreseeable" beneficiary because he worked at a site Bechtel supervised and was one of those whom Bechtel had promised to protect. *Bechtel*

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draws the line at the implication that a consulting relationship can create an independent duty to a *member of the general public*.[28] But that line can be crossed where the public is in fact a "foreseeable" beneficiary, or where the consultant stands in the shoes of an employer who owes the public a more general duty.

For example, the common law recognizes a duty not to cause physical harm to a third person through negligence in the performance of services to another. One who renders services to another which "he should recognize as necessary for the protection of a third person or his things" may be liable to the third person for physical harm resulting from negligent performance of his duties, if the injured party can show that (1) the negligence increased the risk of the physical harm that resulted; (2) the duty negligently performed was owed by the consultant's employer to the injured party; *or* (3) either the employer or the injured party relied upon the performance.[29] Under these principles, an insurance company whose agent regularly inspects a client's construction site or an inspector hired by a telephone company to check the soundness of line poles or the adequacy of street lighting may be directly liable to employees or the public injured as a result of its "negligent inspection."[30]

These principles should concern anyone who audits for power or water companies, other large utilities, or private corporations whose scale of operations may implicate the general public. As the case law indicates, the consultant's liability to a member of the public could well depend on whether the entity hiring him had a duty to that member or class of members.

Such principles and general "foreseeability" intersect with special force in the area of accountant liability. The liability of accountants and financial auditors to third parties has special relevance to environmental auditors, both because financial audits often serve as the model for environmental audits and because the duties assumed may well be analogous.

Parties who were not involved in the original agreement for accounting services, such as purchasers of stocks or bonds or investors in a closely-held company, frequently rely upon those analyses. The accountant can thereby assume a duty to an enormous sector of the population.

Three distinct general approaches govern the third party liability of accountants. *First*, the "New York" rule imposes liability only if the negligent accountant knew the purpose for which its financial reports were to be used; knew the injured person intended to rely on the report to further that purpose; *and* manifests through conduct both a link to the injured person and "the accountant's understanding of that party or parties' reliance."[31] "Manifest, linking" conduct refers, *e.g.*, to the accountant's transactions or communications with the injured party.

New York has explicitly extended this test to the third party liability of architects and engineers. Where an engineering firm subcontracted with an architect hired to evaluate a school district's buildings, and the engineers erroneously reported structural weaknesses that caused the district to incur unnecessary expenses, the district's claim against the engineers was upheld. The engineers asserted non-liability because they had no contract with the district. The court held that "recovery may be had for pecuniary loss arising from negligent misrepresentations where there is actual privity of contract between the parties *or a relationship so close as to approach that of privity*." The court found "near privity" under the standards above: The engineers were clearly aware of the purpose for which the work was being done; they knew the district would rely on the reports; and their conduct, including direct contact with the district and the contractors' communications with them, linked the engineers to the district and manifested their awareness of the district's reliance. The court also held that the defendants allegedly rendered their reports with the "objective of thereby shaping *this plaintiff's* conduct, and thus they owed a duty of diligence . . . not only to [the architect who hired them] but also to the school district who relied."[32]

Second, the broader "New Jersey" rule predicates liability on whether the user of the report was theoretically "foreseeable." The report need not have been intended to serve, and the accountant need not have known of, the particular injured person. Rather, liability ensues where the auditor's statement fails to limit those parties to whom the company may disseminate the information, and where any party who could have been "reasonably foresee[n] as [a] recipient[] of the [financial] statement"[33] relies on the information and suffers a loss.

Finally, in *Bily v. Arthur Young*[34] the California Supreme Court recently adopted a third approach requiring the plaintiff to show the accountant knew of the existence of a specific transaction or a well-defined type of transaction which the report was intended to influence.[35] The court rejected the "New Jersey" rule, which had been the rule in California.[36]

Bily denied a $4.3 million claim by investors that an improperly prepared audit caused them to invest in a new computer company. In so doing, the court restricted recovery to those parties whom the "supplier of the information" intended to influence. The court did not adopt the New York requirement that the auditor have "manifested awareness" of the other party. Nor did it require that the auditor know of the specific transaction or the parties involved. Rather, it focused on "situations in which the supplier *undertakes* to supply information to a third party who he or she *knows is likely to rely on it* in a transaction that *has sufficiently specific economic parameters*."[37] The California court looked to the "supplier engagement and the supplier's communications with the third party." The absence of such communications led it to dismiss both third party beneficiary and negligence claims.

Perhaps more important than its result is *Bily*'s rationale that liability for massive damage awards is disproportionate to the auditor's role in the transaction, which the client controls both as to the information on which the auditor must rely, and report distribution and contents.

Moreover, *Bily* noted, sophisticated parties such as lenders or strategic investors who rely on the audit should be skillful enough to avoid damage, or may not actually rely on the report. The court specifically rejected the New Jersey rationale that a financial report is the equivalent of a consumer product, put on the market with power to injure innocent third parties.

But this analysis also suggests that an impact on the general public—on persons without such sophistication—might cause the court to look at the environmental auditor's duty less favorably. It also suggests that because environmental auditors (rather than their clients) prepare their reports and have access to more than paper information, different standards may apply.[38]

Auditor Duty To Warn Or Disclose

The discussion above assumes that a professional has failed to meet standards, causing injury to its client or to a third party. But even where the consultant performs without error, other duties and liabilities may arise. Must an auditor who discovers a serious violation disclose it to governmental

agencies? If so, when? Does an auditor who uncovers a condition that could endanger an entire community owe that community a warning? Does the potential scope of environmental damage create or expand a duty to warn?

The conventional, generally correct wisdom is that an environmental auditor's duties are completely discharged when he reports his findings to his client. For example, both CERCLA and the Clean Air Act Amendments contain reporting requirements. Under CERCLA, a person in charge of a facility must report hazardous releases, or face criminal and civil liability.[39] The Clean Air Act imposes civil liability on the "owner or operator of a major stationary source" for violations of various provisions of the Act, and criminal liability on "[a]ny person" for knowing violations.[40] Such violations include failure to report numerous conditions or substantive violations. But because these duties apply to the owner or person in charge of the facility, no direct requirement to report or to disclose is imposed on the consultant who may acquire knowledge of a violation.[41]

However, conventional wisdom is not the end of the matter. What if the auditor knows his client will not report or take steps to fix a serious condition? What if imminent danger is involved? In such circumstances, the common law may intersect with statutory provisions to impose reporting duties on a consultant. Such situations are among the most sensitive and dangerous for auditors, since they pit client loyalty and client confidentiality against potentially overriding obligations to the public. They may also leave the auditor liable for damages for breaching confidentiality obligations to his client.

Under the common law, one generally owes no duty to act or to warn those with whom he has no "special relationship." [42] However "special relationships" can create such a duty in two distinct ways. *First*, an auditor may have a duty to warn one with whom he has a direct "special relationship." *Second*, he may have a duty to warn a third party if he has a professional relationship with a client whom he knows, through that professional role, poses a danger to that third person.[43]

The lead case of *Tarasoff v. Board of Regents*,[44] in which a patient told his psychotherapist he intended to (and did) kill a named victim, shows how a professional relationship can create a duty to warn. The court found that the special relationship between the psychotherapist and the patient gave rise to the psychotherapist's *duty to warn the victim*—despite his lack of any special relationship with her, and despite the doctor-patient privilege. The central factor creating liability was the professional's knowledge that his client posed a danger to the public. Thus the auditor who reports findings to a client whom he reasonably expects to take the appropriate remedial steps, will have discharged his duty under the common law.

But an auditor's professional relationship with a client could trigger far-reaching liability if the auditor knows his client's actions, *e.g.*, deliberately ignoring a serious environmental condition, create foreseeable harm. For example, the *Bechtel* court cited *Tarasoff* in holding, among other things, that Bechtel's "special relationship" with its employer, WMATA, imposed a duty to warn the equipment operator who later contracted silicosis.[45] This observation underscores the tenuous distinction between contractual and tort liability, where a duty is allegedly owed to a particular third party.

However, in both *Tarasoff* and *Bechtel* the potential victim (or narrow class of potential victims) was immediately identifiable. These cases do not resolve how far, and to whom, the duty to warn extends when that is not so.

Some cases suggest that identification of a specific victim is not required for a duty to warn, and that a professional might in fact owe a duty to warn the public in general. In a subsequent case relying on *Tarasoff*, a Veterans Affairs mental patient killed several people in a nightclub after leaving treatment without authorization. The court refused to make "identifiability of the victim a precondition" of the agency's duty to warn, relying solely on the fact that VA doctors had "reasonably foresee[n] that ... other persons [would be endangered]." [46] Conversely, since *Tarasoff* the California Supreme Court has refused to find a county liable where a released inmate's threat had been general ("I will kill a child"), distinguishing situations in which a "specifically known and designated individuals" had been threatened.[47] The court also cited the difficulty and likely ineffectiveness of "generalized warnings . . . frequently repeated," which the county would have had to make. Indeed, it suggested that the county's failure to warn did not itself cause the injury, since no warning would have sufficed.[48]

An auditor might be faced with a client who continues to operate under dangerous and threatening conditions of which the auditor has notified him. If the client's continuing operation causes an injury, some jurisdictions might hold the consultant liable for failure to report what he learned through his professional relationship. Given a severe environmental threat, *e.g.*, contamination of a public water supply or a leaking nuclear power plant, the auditor may well have difficulty arguing that an effective and focused warning to the appropriate group could not have been devised. That is particularly true where all that need be done is inform the proper environmental agency, to which a report in effect represents a warning to the public.

A duty to warn is usually recognized when a victim has suffered a physical injury. It seems self-evident that the psychiatrist who remains silent while his dangerous patient does no harm will not be liable. But environmental reporting requirements seem to envision an intermediate type of harm, perhaps best exemplified by the concept of "imminent hazard" in the Resource Conservation and Recovery Act Amendments to the Solid Waste Disposal Act.[49] An "imminent and substantial endangerment to health and the environment" created by waste handling practices gives the government or citizens' groups the authority to seek an injunction compelling costly cleanup measures by any person who contributed to the "endangerment," whether or not exposure or harm have occurred. Combined with required reports of threatened releases by facility owners, such provisions appear to contemplate that the public must be continuously protected from such exposures. In effect, such provisions define exposure or the threat of exposure as an "imminent hazard" to the public. They suggest that an auditor's silence in these circumstances might support a damages claim by someone *merely exposed* to an emission or a release. At least where the exposure is to substances causing a latent, slowly developing disease, such "liability by silence" is not purely hypothetical.[50]

Kaye Scholer—The Outer Limits Of Liability

The most recent and spectacular cause for concern about auditor liability to third parties is the now famous case of Kaye Scholer, Fierman, Hays & Handler, the law firm which faced liability exceeding $275 million for its representation of Lincoln Bank. The firm finally settled by paying $41 million to the Office of Thrift Supervision, which also barred several Kaye Scholer attorneys from practicing before it.

Kaye Scholer was accused of failing to disclose accurately the dire financial condition of Lincoln Bank, as well as of directly misrepresenting to regulators Lincoln's eligibility to take part in investment transactions prohibited by federal banking law.[51] The charges imply a general requirement that

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a consultant or other professional either disclose damaging information about its client to regulatory agencies, or at least not actively conceal such information, to avoid facing enormous liability.

The matter has generated unprecedented publicity within and beyond the legal community.[52] Apart from assertions that the case destroys attorney-client privilege, concern centers on two major areas: the firm's alleged direct liability for failure to report or accurately represent to OTS the bank's practices and poor financial condition, when it undertook that duty directly; and the firm's apparent third party liability in the underlying OTS-Lincoln matter, although it was not a party there. Applied to professional-client relations in general, the case seems to remove any qualifications on a professional's duty to warn the government when he has reason to suspect a client's wrongdoing. Indeed, OTS's "Statement of Charges" is replete with descriptions of Lincoln transactions which Kaye Scholer allegedly ignored or mischaracterized, and with detailed descriptions of Kaye Scholer's allegedly violative internal decisions as it went about representing its client.

But the case's reputation is broader than its reach. In fact, pertinent banking legislation itself imposed direct liability on Kaye Scholer, taking the case out of the common law realm.

The relevant statute authorizes a cease-and-desist order requiring an insured depository institution or any "institution-affiliated party" to "take affirmative action to correct any conditions resulting from any violation or practice with respect to which such order is issued."[53] The order can require "such depository institution or *such party*" to

> (A) [m]ake *restitution* or provide reimbursement, indemnification or *guaranty against loss*, if
>
> (i) Such depository institution or such party was unjustly enriched in connection with such violation or practice; *or*
>
> (ii) The violation or practice involved the reckless *disregard for the law* or any *applicable regulations* or prior order of the appropriate Federal banking agency.[54]

Under 12 U.S.C. 1818(c), "temporary cease and desist orders" may be imposed against "any institution-affiliated party" under basically the same terms as above. Under this section the OTS ordered the freeze of assets which forced Kaye Scholer to settle.

Moreover, under 12 U.S.C. 1813(u) an "[i]nstitution-affiliated party" is:

> (4)(a) Any *independent contractor* (including any *attorney, appraiser* or *accountant*) who knowingly or recklessly participates in
>
> (A) *Any* violation of *any law* or regulation;
>
> (B) *Any breach of fiduciary* duty; or
>
> (C) *Any unsafe* or *unsound practice* which caused or is likely to cause, more than a minimal financial loss to, or a significant adverse affect on, the insured depository institution (emphases added).

Thus an *attorney* who commits certain acts is an "institution-affiliated party" subject to the *statutory* sanctions that include the potentially lethal asset freeze Kaye Scholer faced. And *any* "institution-affiliated party" is subject to an order requiring it to make restitution if *"the violation or practice involved a reckless disregard for the law or any applicable regulations,"* or if a "fiduciary duty" to the client was breached.

The point is less the substance of these statutes than their power to transform the professional's relationship with a client. Because Kaye Scholer acted as Lincoln's agent, and interposed itself between Lincoln and the Federal Home Loan Bank Board, Kaye Scholer's misrepresentations to the FHLB in that capacity became the basis for one of the charges.[55] But Kaye Scholer was also accused of violating its fiduciary duties to Lincoln and engaging in unethical and improper professional conduct by, among other things, continuing to represent both Lincoln and its parent, whose interests were conflicting.[56] Under the statute, at least in theory, such a *violation of a duty to a client* makes one a liable "affiliated party" up to the amount of the institution's loss.

Kaye Scholer had begun to represent Lincoln before enactment of these provisions. But from the moment of their enactment, it became subject to sweeping bank statutes that hold consultants to financial institutions directly liable for losses incurred from the way those consultants go about their job. These statutes are a function of legislative, administrative, and popular determinations that financial institutions deserve extraordinary legal protection—even from their own agents. This is not to say that Kaye Scholer's only sin was to represent parties potentially in conflict. It is to say that sin opened the door to much broader liability under the very special laws which applied.

No environmental statute or regulation researched for this article specifically holds a consultant or attorney directly liable for its conduct in relation to the public or public regulatory agencies, much less to its client. But policies and public perception can shape legal duties.[57] As a result of Kaye Scholer and subsequent OTS cases, there now exists a general perception that consultants and other bank professionals should be policemen for the public good as well as competent advisers to their clients—and that they deserve what they get if something goes wrong.[58] If the public were to demand similar "extraordinary protection" from environmental professionals whose actions might indirectly affect the air it breathes or the water it drinks, the statutory framework that nearly killed Kaye Scholer might seem gentle by comparison.

Conclusions

Environmental auditors may face liability on several fronts. Direct liability to the client, whether in tort or contract, will generally turn on the auditor's exercise of reasonable care in the performance of its expected duties—a standard which requires neither perfect results viewed in hindsight, nor performance better than another qualified auditor would give. Indirect liability may arise to third parties, either because they are viewed by a court as particular beneficiaries of the contract, or because the auditor, its client, or the third party acted in such a way as to create a "nearly contractual" relationship for the benefit of that party. Finally, liability to the public in general or to government agencies may arise, when courts impose legal duties based on special relationships, or when such duties are expressly imposed by statute or regulation.

Against both direct and indirect liability, the contract of employment represents the auditor's first line of defense. Among other things, auditors should consider structuring (and bargaining for) engagement contracts which:

- Set forth the scope of the undertaking as clearly and narrowly as possible, so as to assume responsibility for satisfactorily performing *only* defined tasks—and *only* for related difficulties or problems;
- Establish the standards governing liability under the contract, limiting the duty owed to that reasonably and customarily expected of such a professional, and minimizing the chance that consensus or industry (*e.g.*, ASTM) standards will become *per se* determinants of liability; and
- Include in confidentiality agreements provisions expressly excusing the auditor from liability in damages to its client,

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in the event it is required by law to disclose information about its clients.

With respect to third party claims based on the contract, the auditor should consider engagement terms which:

▸ Limit disclosure of the document solely to the party for whom it was prepared;

▸ Make clear which if any factual information was provided by the client, and is not the result of the auditor's own investigation;

▸ Presume that all information not specifically identified as generated by the auditor, was provided or derived from data provided by the client;

▸ Exclude third parties from the benefits of the contract, by making clear that the engagement is solely for the benefit of the client;

▸ Include indemnification or "hold harmless" clauses which can limit the auditor's liability or shift it to others;

▸ Provide that the substantive law of a jurisdiction favorable to third-party defendants governs disputes under or relating to the contract;[59] and

▸ Specify that the relationship between the auditor and the client is not a "special" one.

These suggested steps are not guarantees. Differences in bargaining power, including the auditor's desire for work in a fiercely competitive environment, may preclude raising, much less pressing for, many of them. Moreover, even if the client accepts a laundry list of protective clauses, courts may hold unenforceable or seriously limit indemnification/hold harmless agreements.[60]

The parties' behavior may also undercut such provisions. For example, though the contract excludes third party beneficiaries, a court may find, as in *Bechtel*, that the auditor assumed a third party duty by virtue of his overall responsibilities. The client who maintains regular contact with a third party concerning the status or contents of the audit may create a perception that the auditor owed that party an independent duty.

Therefore, apart from contract terms, conduct is also important. How the auditor performs its tasks, and how clients are expected to respond to those activities and use the auditor's products, can alter or override the contract. Auditors should accordingly consider:

▸ Avoiding behavior that would place them in the shoes of utility of other clients with potential liability to a wide range of service beneficiaries. For example, auditors should beware of assuming responsibility for tasks which the client regularly and routinely performs for the benefit of a large number of its customers;

▸ Avoiding conduct which manifests an intent to benefit third parties, such as regular contact or direct communication with those to whom the client may show the audit report; and

▸ Addressing conduct in a protocol or other attachment to the contract. Such protocols could, for example, state that the client does not intend to and will not show the audit report to third parties (such as prospective purchasers) who might rely on it to their detriment, or that the auditor relies exclusively on the client to communicate with third parties, and only then on a need-to-know basis, not comprising routine business activities. They may also specify that only client-generated summaries of the audit are to be communicated to lenders or other third parties, or require draft reports to be destroyed.

These suggestions are not exhaustive. They do not, for example, address how audit findings should be drafted to minimize consultant *and* client liability. But they are sufficient to indicate that while environmental auditors will not usually be liable to their clients merely because they make a mistake or miss a non-obvious hazard, current practices, professional standards, legislation or regulation, developments in analogous audit fields, and the parties' conduct may all expand what direct duties are owed. Moreover, indirect liability to third parties or the public may arise, whether or not the audit report was deficient.

How successfully auditors and clients hiring them deal with these issues may well turn on their ability to keep up with developments in this fast-changing field. For the ability of clients to recoup losses related to improper audits or protect themselves against forced disclosure of audit findings to government agencies is inversely related to steps auditors may seek to take to protect themselves. The one is a mirror image of the other.

Endnotes

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[2] For a related article with a different emphasis, see Lisa A. Jensen, "The Risk in Defining Risk: Potential Liability of Environmental Consultants and Engineers," 23 ER 1954 (BNA) (Dec. 4, 1992).

[3] For example, provisions for criminal liability under the 1990 Clean Air Act Amendments punish repeated "knowing or negligent endangerment" with up to a $2 million dollar per day fine for corporations and 15-year jail terms for individuals. *See generally*, Elliot, et al., "The Clean Air Act: New Enforcement and Liability Provisions," 42 *J. Air Waste Management Assoc.* 1414 (1992).

[4] *See, e.g.*, Arthur D. Little, Inc., *Environmental Auditing: An Overview* (n.d.; circa 1984), 2-3. In addition to those in text, benefits of audits include: determination that plant programs are in compliance with governmental and corporate policies; identification of environmental hazards; confirmation that knowable environmental hazards have been identified and are being controlled and managed; assessment of capability to meet future requirements; verification that appropriate operating procedures are in place and are being followed; establishment of management's interest in corporate-wide adherence to environmental standards and policies; or communication of new environmental requirements, corporate policies, procedures and standards. *Id. See also* Freeman and Cunningham, "The Environmental Audit: Management Tool or Government Weapon?," 23 *Chemical Waste Litigation Reporter* 3 (1992).

[5] A.D. Little, *supra*.

[6] *See* Comprehensive Environmental, Response, Compensation and Liability Act ("CERCLA"), 42 U.S.C. Section 9601 *et seq.*, at Section 9601(35)(B) (Innocent Landowners), Section 9601(20)(A) (Secured Creditors) as well as the recent EPA final rule clarifying the latter, at 40 C.F.R. Sections 300.100 and 300.1105. This rule remains subject to pending litigation. On the Innocent Landowner defense, see, *e.g.*, M. Levin and K. Smith, "Is 'Innocence' Bliss," 42 *J. Air Waste Management Assoc.* 610 (1990).

[7] *See, e.g.*, Malcolm Weiss, "Issues of Confidentiality and Disclosure in Environmental Auditing," U.S. EPA (April, 1984).

[8] For example, federal courts have held liable stockholders or officers in closely held corporations for environmental response costs, where they actively participated in the management of the facility from which the release of hazardous substances occurred, or had the authority to influence waste disposal practices. *See New York v. Shore Realty Co.*, 759 F2d 1032 [22 ERC 1625] (CA 2, 1985); *U.S. v. Northeastern Pharm. & Chem. Co.*, 810 F2d 726 [25 ERC 1385] (CA 8, 1986), *cert. den.* 484 US 848 [26 ERC 1856] (1987).

[9] For example, the major proposal in the 102d Congress to reauthorize the Clean Water Act (S. 1081) (Baucus) would have required that applicable parties hire outside auditors to check compliance with all environmental laws and that the report be given to EPA, where it would become public information. This provision has thus far been

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deleted from the bill's latest version (103d Cong. 1st Sess., S. 1114). Under a proposed amendment ("Financial Fraud Detection and Disclosure Act") to the Securities and Exchange Act of 1934, an accountant who discovers an illegal act while auditing a company issuing securities must inform the firm's management or directors, and, in the event they do not report the illegality, must resign from the audit and report the event to the Securities and Exchange Commission. (H.R. 574) (Dingell).

[10] United States Department of Justice, *Guidelines for Criminal Enforcement* (July 1991).

[11] Section 113(c)(2) *as amended*, 42 U.S.C. 7413(c)(2); *see also, e.g.*, Section 503(b), 42 U.S.C. 7661(b).

[12] Section 113(c)(6), 42 U.S.C. 7413(c)(6); Section 113(h), 42 U.S.C. 7413(h).

[13] *See* Section 113(c)(6), 42 U.S.C. 7413(c)(6); Sections 113 (h), 113(a)(1); 42 U.S.C. 7413(h), 7413(a)(1).

[14] A consultant may be involved in assessing compliance, or in actual remediation of the site. This article focuses on the auditing aspect of the consultant's duties, as opposed to the kinds of engineering operation that, done poorly, could make the consultant as much a direct contributor to contamination as a site operator.

[15] *See* W. Keeton, D. Dobbs, R. Keeton and D. Owen, *Prosser and Keaton on the Law of Torts* ("Prosser") (5th Ed. 1984), Section 92.

[16] The difference between these theories may involve distinctions in the period allowed for bringing the claim, in the type of proof allowed at trial, or the type and amount of damages allowed. *See, e.g., Sears Roebuck & Co. v. Enco*, 43 NY2d 389, 396 (NY CtApp, 1977), holding that a claim of architectural malpractice may be based on either failure to comply with the standard of care required by the contract, or failure to comply with the contract itself.

[17] In *Greenstein, et. al. v. Burgess Marketing*, 744 SW2d 170, 185 (Texas CtApp, 1987), the court held failure to comply with GAAS constituted negligence, and quoted *Securities and Ex. Comm. v. Young*, 590 F2d, 785, 788 (CA 9, 1979), holding that "an accountant usually discharges the duty owed to his client by complying with recognized industry standards, such as the [GAAS], when performing an audit."

[18] The court in *Maduff Mortgage Corp. v. Deloitte, Haskins & Sells*, 779 P2d 1083, 1086 (Ore CtApp, 1987) viewed GAAS as "only evidentiary" and admissible as evidence, but not determinative of whether negligence occurred.

[19] *See Nelson v. Com*, 368 SE2d 245-246 (Va SupCt, 1988), requiring expert testimony on the standard of care required of architects. Earlier this year the U.S. Supreme Court ruled that American Institute of Certified Public Accountants (AICPA) standards defining management responsibility do not define what constitutes "management" in the context of a Racketeer Influenced and Corrupt Organizations (RICO) charge. *Reves v. Ernst & Young*, ____ US ____, 113 SCt 1163, 1173 (1993).

[20] A recent Connecticut suit is reported as directly implicating AIPCA and its standards. Reportedly plaintiffs claiming against Arthur Andersen sued the AIPCA on the theory that if Andersen had not violated professional standards, then the standards themselves had not been set high enough by the professional association. *See* Gail D. Cox, "Unlimited Liability," *National Law Journal*, December 21, 1992 at 22.

[21] *See* American Society for Testing and Materials, *Standard Practice for Environmental Site Assessments: Phase I Environmental Site Assessment Process*, E-1527 (May 1993) and *Standard Practice for Environmental Site Assessments: Transaction Screen Process*, E-1528-93 (May 1993), in *Annual Book of ASTM Standards* (1993).

[22] Comments on the ASTM standards recognize they might be used as legally required minima in damage suits. *See* "Some Consultants Concerned Standards Could Lower Quality of Site Assessments," 2 *Due Diligence Guide* (BNA) 11 (February 1993).

[23] Duties to third parties may also create conflicts with the duty of confidentiality owed to a client. For one discussion of confidentiality issues in the context of environmental audits, *see*, S. Mullaney and M. Levin, "Discovery and Disclosure: How to Protect Your Environmental Audit Report," A&WMA Paper 93-FA-167.04 (1993).

[24] *See* 17A Am. Jur. 2d "Contracts" Section 442 (1991).

[25] "Seller Not Third-Party Beneficiary of Assessment Commissioned by Buyer," *Real Estate/Environmental Liability News* (Nov. 9, 1992). The case was also decided on a third party liability theory under *Bily v. Arthur Young*, discussed below.

[26] 631 F2d 989 (CA DC, 1980).

[27] *Id.* at 997, 999.

[28] *Cf.* 631 F2d at 998, *citing with approval Cutlip v. Lucky Stores, Inc.*, 325 A2d 432 (Md CtApp, 1974), which distinguishes an independent duty owed to the public in general from the independent duty owed to a particular employee, and ascribing any duty owed the public to specific contractual terms.

[29] *Restatement of Torts (Second)* (1965) Section 324 A, "Liability to Third Person for Negligent Performance of Undertaking." *Bechtel* does not cite this principle, although it seems to explain the consultant's liability at least as well as the grounds mentioned.

[30] *See, Phillips v. Liberty Mutual Ins.*, 813 F2d 1173 (CA 11, 1987); *David v. Broadway Maintenance Corp.*, 451 FSupp 877, 881 (DC EPa, 1978); *Restatement, supra*, Section 324A, comment d, illus. 2, at 144.

[31] *Credit Alliance v. Andersen & Co.*, 65 NY2d 536, 553 (NY CtApp, 1985).

[32] *Ossining School v. Anderson*, 73 NY2d 417, 425-426 (NY CtApp, 1989). In *Prudential Ins. v. Dewey, Ballantine*, 80 NY2d 377, 381-382 (NY CtApp, 1992) New York recently extended liability under this test to attorneys. The law firm, Dewey, wrote an opinion letter asserting the validity of Prudential Insurance's mortgage on property owned by Dewey's client, U.S. Lines. The underlying mortgage had been erroneously written in an amount one-one thousandth of the correct amount, and Prudential suffered a corresponding loss when it foreclosed. Under the New York test Dewey had a duty to Prudential because it (1) knew the use to which the document would be put—its client had instructed it to do so pursuant to the client's restructuring agreement with Prudential; (2) Prudential did rely on the letter; and (3) by addressing the letter to the Prudential and delivering it there, Dewey had engaged in conduct evincing its awareness of that reliance. However, although Dewey did owe a duty to Prudential, the letter, by its terms, was found not to breach that duty. *See* note 38, *infra*.

[33] *Rosenblum v. Adler*, 461 A2d 138, 153 (NJ SupCt, 1983). According to the court in *Bily v. Arthur Young*, 834 P2d 745, 755-756 (Calif SupCt, 1992), Alabama, Arkansas, Idaho, Nebraska, Illinois, Kansas, Pennsylvania and Utah follow the New York rule; Wisconsin and Mississippi follow that of New Jersey.

[34] 834 P2d 745 (Calif SupCt, 1992).

[35] *Bily* indicates that seventeen jurisdictions base third party accountant liability on whether the financial auditor intended to influence a transaction. 834 P2d at 756-757.

[36] 834 P2d at 757, 766-767, discussing *International Mortgage v. Butler*, 177 CalApp3d 806, an intermediate level case.

[37] 834 P2d at 769 (emphasis added), citing *Restatement of Torts (Second)* Section 552.

[38] The attorneys in *Prudential Ins. Co. v. Dewey, Ballantine, supra*, although they had a duty to the mortgagee which relied on their opinion letter (and suffered a multimillion dollar loss), were found not to have violated that duty—*i.e.*, not to have caused the loss. The opinion letter specified that the lawyers had relied on reports and documents which they had not independently verified; assessed only the legal validity of the mortgages at issue, not their dollar amounts; and was further qualified as subject to bankruptcy and state law. Finally, the plaintiffs, under their agreement with the law firm's client, had accepted the letter as written, containing only "general assurances." 80 NY2d at 386-387.

[39] 42 U.S.C. Section 9603(a).

[40] 42 U.S.C. Sections 7413(b), (c). Section 7413(b) also imposes liability on persons "other than" the owner or operator of a major stationary source. However this apparently means the owner or operator of something other than a "major" source, rather than a person other than an owner or operator. *See* n. 41 below.

[41] *U.S. v. Carr*, 880 F2d 1550 [30 ERC 1128] (CA 2, 1987).

Some state statutes do impose such direct reporting obligations. *See, e.g.*, regulations promulgated under the Petroleum Bulk Storage Act (PBSA), New York Environmental Conservation Law (ECL) Section 17-1000 *et seq.* at 6 New York Code of Rules and Regulations (NYCRR), Part 613.8 (requiring reporting to the Department of Environmental Conservation (DEC) within two hours by "any person with knowledge of a spill, leak or discharge of petroleum"). New

York's Hazardous Substances Bulk Storage Act (HSBSA), (ECL) Section 40-0111(3) requires notification of the DEC by a "person [who is] in a contractual relationship" with the owner of a "hazardous substance," or with an owner's employee or agent, and "who inspects, tests or repairs any portion of [a] facility which was or is used for the storage of hazardous substances," of any "release of a reportable quantity [as set forth in regulations] of a hazardous substance into the environment." Such report must be made "promptly" and "as soon as [the person] has knowledge."

New York asserts that it pursues consultants who fail to report, but it is not clear whether such "pursuit" entails prosecution rather than a civil penalty or notice, or whether it has ever involved a general auditor rather than, *e.g.*, a licensed tank inspector. Conversation with DEC Department of Environmental Enforcement, 2/9/93. Like the principles discussed below, these statutes could give rise to tort liability where, *e.g.*, a plaintiff alleges harm from a release due to the consultant's failure to report it to DEC, which is charged with protecting the public by taking prompt corrective measures.

[42] This general principle has been ascribed to the focus of the "older common law" on standards for restraining "active misconduct working positive injury," and on the difficulty of setting forth "standards of unselfish service to fellow men" that are closer to moral than legal principles. Prosser, *supra*, Section 65 at 373, 376.

"Special relationships" recognize historically recurring situations that require action for the benefit of strangers with whom one already has a direct relationship. Common law "special relationships" were traditionally limited to those between a common carrier and its passenger; an innkeeper and its guests; a possessor of land who holds it open to the public which accordingly enters; an employer and employees; and a party who is required by law to take or voluntarily takes custody of another so that the other is deprived of "normal opportunities for protection." *Restatement of Torts, (Second)*, Section 314(a) (1965). A shopkeeper's duty to warn customers of dangerous premises, and an employer's duty to warn employees, have also been established. See Prosser Section 65.

[43] *Restatement of Torts (Second)*, Section 315.

[44] 551 P2d 334 (Calif SupCt, 1976).

[45] 631 F2d at 1000-1001.

[46] *Lipari v. Sears, Roebuck & Co.*, 497 FSupp 185 (DC Neb, 1980).

[47] *Thompson v. County of Alameda*, 614 P2d 728, 736 (Calif SupCt, 1980).

[48] The Eleventh Circuit recently certified to the Supreme Court of Alabama the question whether, under Alabama law, a parent corporation had a general duty to the public to control its subsidiary so as to prevent the sale of inherently dangerous asbestos products. *In re: Birmingham Asbestos Litigation*, (CA 11, No. 91-7602).

Personal injury plaintiffs asserted that the relationship between the parent and the subsidiary was a "special" one under *Restatement of Torts (Second)* Section 315(a), and that this relationship, together with the parent's knowledge of potential harm from the subsidiary's actions and its power to control the subsidiary, gave rise to the duty. The Alabama Supreme Court rejected the argument as unsupported by precedent and inconsistent with well-established principles for piercing the corporate veil. *In re: Birmingham Asbestos Litigation* (Ala SupCt, No. 1911667-CER, October Term, 1992-1993). However, that the issue was raised and certified indicates the viability of this theory of third party liability and the breadth of the relationships which might be found "special."

[49] RCRA Section 7003, 42 U.S.C. Section 6973 ("Imminent Hazard"). For the startling scope of "imminent hazard" *see, e.g., Reserve Mining Co. v. EPA*, 514 F2d 492 [7 ERC 1618] (CA 8, 1975) ("'endangering' includes potential as well as actual harm"); *Ethyl Corp. v. EPA*, 541 F2d 1, 13 [8 ERC 1785] (CA DC, 1976), *cert. den.* 426 US 941 [8 ERC 2200] (1976) ("'endanger means something less than actual harm'"); *U.S. v. Hardage*, 1 *Chem. & Radiation Waste Litig. Rep.* 689 (DC WOkla, 1980), ("[imminent] hazard does not depend on the proximity of the final effect but may be proved by the setting in motion of a chain of events which could cause serious injury.").

[50] *See, e.g., Ward v. Desachem*, 771 F2d 663 (CA 2, 1985), discussing the applicable date at which the statute of limitations begins to run in a case of toxic exposure (time injury was discovered, *not* time of exposure to the toxic substance), but presuming throughout that exposure to dangerous substances which causes an injury will give rise to a claim brought within the appropriate time-frame. *See also*, New York Civil Practice Laws and Rules (CPLR) Section 214-c [2], (McKinney's 1990 and 1992 Supp.), adopting a date-of-discovery over a date-of-exposure accrual for "personal injury . . . caused by the latent effects of exposure to any substance or combination of substances."

[51] OTS, Memorandum of Points and Authorities in Support of Petition For and Order to Show Cause and For Summary Enforcement of Administrative Subpoenas, MISC. No. 92-101, U.S. District Court for the District of Columbia ("Memorandum"), Notice of Charge, First Claim, paragraphs 10-14, *et seq.*

[52] For example, a *Washington Post* op-ed piece treated the case as a logical extension of common-law third-party liability claims against accountants and other professionals, expressing fears of pervasive and potentially limitless third party liability. The fact that "accounting firms and law firms are better able to bear financial losses than is the victim of a transaction gone awry," it asserted, stands behind the behavior of the government in *Kaye Scholer*, and portends severe danger to any party who undertakes representation where losses may occur. Philip I. Lacovara, "Follow the Money," *Washington Post*, July 21, 1992, A-19. *See also*, Rita H. Jensen, "Firm, OTS Settled at High Cost," *National Law Journal*, March 23, 1992, 1, 31; "Agency Tries to Rein in S&L Lawyers," *Id.*, July 27, 1992, 1, 38, (implying the case has wide implications for the attorney client-privilege and practice of law in general); Stephanie B. Goldberg et al., "Kaye Scholer: The Tremors Continue" [Special Section] *ABA Journal* (July, 1992).

[53] 12 U.S.C. 1818(b)(6)(A)(i) and (ii).

[54] *Id.* (emphasis added).

[55] "Memorandum," Third Claim, at 19.

[56] *Id.*, Fourth Claim.

[57] Don J. Benedictis, "The Big Freeze," *ABA Bar Journal, supra* at 57-58, describes the 1989 addition of "new section 1813(u)(4)" above as a "subtle" change in the previous wording of the statute, and as a direct result of "the mood in Congress" in the wake of the 1980's savings and loan crisis. This section made Kaye Scholer's liability possible.

[58] Some limits on liability may be discerned in the U.S. Supreme Court's recent ruling in *Reves v. Ernst & Young, supra*, n. 18, that preparation of audit reports for a client does not constitute "operation or management" of an enterprise giving rise to civil liability for fraud under RICO. 113 SCt at 1173-1174.

[59] Under the *Restatement (Second) Conflict of Laws*, the jurisdiction must have some relevant connection to the parties. See sections 187, 188, 205(d).

[60] For a useful discussion of limitations on hold harmless and indemnification agreements, see Jensen, *supra*, at 1958.

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