Rethinking The Principles Of Duty And Privity For Contractual Liability In The 21st Century

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The legal theory that required privity of contract for recovery in a negligence action derives from an English case decided over 150 years ago: the seminal case of *Winterbottom v. Wright*. The question is whether the holding (some would argue dictum) of *Winterbottom* should still be the law today.

The current economy and investor scandals demonstrate why this issue is particularly important today. Currently, accountants, stock professionals, brokers and advisers, lawyers, and consultants are immune from liability for their negligent conduct to third parties with whom there was an absence of privity, even if the harm suffered by the third parties was foreseeable, and the third parties were easily identifiable. This article will argue that the privity requirement should be abandoned as outdated, and based upon a misinterpretation of the leading American case discussing privity, *Ultramares Corp. v. Touche*.

The concept of duty is fundamental to negligence law. Simply put, “there is no negligence unless there is in a particular case a legal duty of care, and this duty must be which is owed to the plaintiff himself and not merely to others.”

There have been cases innumerable analyzing when a defendant owes a duty to a particular plaintiff, as opposed to the world at large. This issue is narrowed slightly when analyzing when a contracting party owes a duty to a third-party.
At Common Law, privity was required for there to be a duty of one to another.\textsuperscript{iv} *Winterbottom* and its progeny instituted the privity requirement, but almost immediately exceptions to the privity requirement arose. This requirement was essentially eliminated in negligence cases resulting in bodily injury or death.\textsuperscript{v} While many courts retain the privity requirement for claims of purely economic damage, there is simply no reason to adhere to the concept of privity in the 21\textsuperscript{st} Century.

The concept of “duty” is constantly changing. “Constantly the bounds of duty are enlarged by knowledge of a prospective use.”\textsuperscript{vi} The concept of foreseeability has been universally adopted in determining whether one owes a duty to another, and the extent of the duty, in negligence cases involving bodily injury or death. Adopting the foreseeable party standard, modified for “public” services, to economic injuries to third persons makes sense in creating a fair and just negligence standard.

At common law, there was no general duty owed by one to another. The duty only arose from another source, i.e. a contract. The law of torts and negligence did not begin to develop until the late 18\textsuperscript{th} century and early 19\textsuperscript{th} century.\textsuperscript{vii} Negligence law developed slowly in the 19\textsuperscript{th} century, with the concept of duty remaining linked to some external requirement, contract, stature, etc. This began to change in the early 20\textsuperscript{th} century, with the New York Court of Appeals, and in particular one of its members Benjamin Cardozo, leading the way.
In the first half of the 20th Century, five significant cases dealing with a party’s duty, on lack of duty, to another arose from the New York Court of Appeals, all five written by Judge (later Justice) Cardozo: MacPherson v. Buick Motor Co.\textsuperscript{viii}; Glanzer v. Shepard\textsuperscript{x}; Moch v. Rensselaer\textsuperscript{x}, Palsgraf v. Long Island RR\textsuperscript{xii}; and Ultramares Corp. v. Touche\textsuperscript{xii}. These cases provide the foundation for negligence cases in the United States, and are still followed to varying degrees today. The principles expounded by these cases, duty, proximate cause, etc., are still applicable today. The only distinction is the application of those principles.

The main thrust of all the cases is that, without a duty owed by one to the injured party, there is no cause of action for negligence.\textsuperscript{xiii} Fundamentally, the determination of whether defendant owes plaintiff a duty is question of law, to be decided by the court.\textsuperscript{xiv} Thus, in determining whether a defendant is liable for particular injuries, the court holds great weight in determining what actions of a defendant are, or could be, negligent. Other issues involving negligence actions, i.e., breach of a duty, proximate causation and damages, are generally questions of fact to be decided by a jury. The concept of duty is a way for the judiciary to control the expansion of liability.

**Duty In General**

The key issue in determining a duty is foreseeability. Perhaps the most famous line defining a duty was provided by Chief Judge Cardozo of the New York Court of Appeals: “The risk reasonably to be perceived defines the duty to
obey, and risk imports relations; it is risk to another or to others within the range of apprehension.”

In order for a defendant to owe plaintiff a duty, the plaintiff must show “the act as to him had possibilities of danger so many and apparent as to entitle him to be protected against the doing of it though the harm was unintended.”

Judge Cardozo articulated a fundamental principle of negligence law: without a duty, there is no wrong. Without a wrong, there is no necessity to determine whether the conduct proximately caused injury. In Palsgraf, Cardozo was firmly rooting the concept of duty to foreseeability. A defendant owes a duty to the foreseeable plaintiff, not the unforeseeable plaintiff. This has been the foundation of American negligence law for nearly 100 years.

The necessity for a clearly defined principle of duty is necessary to permit entities to know what conduct is expected. This is particularly true of contracting parties. Contracting parties must be able to take into account potential exposure when setting a price for the service, obtaining insurance, or deciding whether to take a job. The duties imposed on the contracting party, and thus the party’s potential exposure, must be known before the contracting party accepts the job and begins work.
MacPherson

Cardozo began his reinterpretation of negligence principles in *Macpherson v. Buick Motor Company*. *Macpherson* analyzed whether contractual privity was necessary in order to hold a manufacturer of a defective product liable to a person that was not the purchaser, but it was reasonably foreseeable that plaintiff was a potential user of the product. *Macpherson* involved a defective wheel on a Buick that was sold to a dealer, and the dealer sold it to a non-party. Plaintiff was riding in the vehicle when the wheel broke and caused an injury. Thus, plaintiff had no direct relationship to Buick. The court, by Judge Cardozo, held nonetheless that plaintiff could maintain an action against Buick.

In *Macpherson*, Cardozo began developing the foreseeability principle later emphasized in *Palsgraf*. Cardozo stated: “Because the danger is to be foreseen, there is a duty to avoid the injury.” Cardozo noted that earlier decisions holding in favor of the manufacturer, i.e. no privity - no liability, relied upon the distinction that the conduct, though negligent, was not likely to result in injury to anyone except the purchaser. “The principle of the distinction is for the present purposes the important thing.” Put another way, prior cases held there was no liability to third parties because such injury was not foreseeable.

In *MacPherson*, Cardozo emphasized that he was not changing established principles, only their application.
In the application of its principle, there may at times have been uncertainty resulting in an error. There has never in this State been doubt or disavowal of the principle itself.”

The court analyzed decisions of earlier cases, including *Thomas v. Winchester*, 6 N.Y. 397, which permitted a claim by an end user against the manufacturer of a poison that was falsely labeled. *Thomas* limited its abandonment of the privity requirement because of the inherent danger of injury in mislabeling the poison. *Macpherson* thus recognized that the creator of an item might be liable to a foreseeable end user.

Whenever one person supplies goods, or machinery, or the like, the purpose of their being used by another person under such circumstances that every one of ordinary sense would, if he thought, recognized at once that unless he used ordinary care and skill with regard to the condition of the thing supplied or the mode of supplying it, there will be danger of injury to the person or property of him for whose use the thing is supplied, and who is to use it, a duty arises to use ordinary care and skill as to the condition or manner of supplying such thing.”

Cardozo recognized that a supplier of an instrumentality, where it is foreseeable that it may cause injury, must use ordinary care and skill as to the condition or manner of supplying the instrumentality. This is the basis of modern product liability law. In *Macpherson* the instrumentality created a hazard to life and limb. However, there is no reason in the 21st Century why these principles cannot be applied to the negligent creation of items that cause purely economic damage.
Indeed, 90 years ago, Cardozo recognized that limitation of these principles to poison was not appropriate. Cardozo noted that, whatever the limitation in the original decision may have been, the holding in *Thomas* "has no longer that restricted meaning." Cardozo recognized that the application of the principles regarding negligence could change over time.

Cardozo expanded the application of the principles to apply to any item where it was reasonably foreseeable that life or limb would be in peril when the thing is negligently made.

If to the element of danger there is added knowledge that the thing will be used by persons other than the purchaser, and used without new tests, then, irrespective of conduct, the manufacturer of this thing of danger is under a duty to make it carefully.

Cardozo continued by noting that there must be knowledge that, in the usual course of events, the danger will be shared by others than the buyer. Such knowledge may be inferred by the nature of the transaction. This principle will be explored in depth later in this article by analyzing the application of negligence principles to service providers that negligently prepare documents to be used by third parties that cause economic injury. As noted by Cardozo, there is simply no reason why application of these principles cannot change over time.

Precedents drawn from the days of travel by stage coach do not fit the conditions of travel today. The principle that the danger must be imminent does not change, but the things subject to the principle do change. They are whatever the needs of life in a developing civilization requires them to be."
The application of negligence principles to contractual cases causing purely economic damage was explored by Cardozo in two later cases, *Glanzer* and *Ultramares*. The question is: Do principles and precedents drawn from the days of one-on-one services, where buyers purchased services directly from companies without the use of middle-men, i.e. brokers, accountants, etc., fit into the conditions of today, where services are specialized, and sellers may often provide services to third parties, paid by a buyer. *Glanzer* supports the application of the foreseeability principle to economic damage caused by a negligently prepared report prepared by a third party, while the accepted interpretation of *Ultramares* limits the application. However, a close review of both decisions demonstrates that the limited application of *Ultramares* should be the exception, not the rule.

**Palsgraf**

The facts of *Palsgraf* are well known by any first year law student, and need not be repeated in depth here. An unidentified man was attempting to board a Long Island Railroad train as the train leaving a station. An employee of the railroad, standing on the platform, pushed the man onto the train. The man was carrying a package wrapped in a newspaper, which fell to the tracks. The package contained fireworks, which exploded. At the other end of the platform were several scales that fell over as a result of the explosion. One of the scales hit Mrs. Palsgraf, causing injury. Mrs. Palsgraf sued the Long Island Railroad for
negligence. The question was whether the railroad owed a duty to Mrs. Palsgraf in its conduct towards the unidentified man. The Court of Appeals, in a 4-3 decision, held that the railroad did not owe such a duty.

Judge Cardozo began by noting that negligence is the absence of due care, according to the circumstances. The negligence has to be specific to the party injured. Thus, if no hazard was apparent to a person of ordinary diligence, an act, with reference to the plaintiff, does not become a tort because it happened to result in an injury. The duty must be to the individual complaining, not to the world at large.

“Negligence, like risk, is thus a term of relation. Negligence in the abstract, apart from things related, is surely not a tort, if indeed it is understandable at all. Negligence is not a tort unless it results in the commission of a wrong, and the commission of a wrong imports the violation of a right.

Thus, Judge Cardozo set out the principle that a party is only liable if they commit a wrong against an individual entitled to protection. There is no logical reason why this principle should be limited to personal injury. A duty should be owed to all foreseeable parties who are injured by negligent conduct, even if the injury is purely economic.

**Moch**

In *Moch v. Rensselaer Water Company*, decided four months prior to *Palsgraf*, the Court took a cautious approach to the potential liability of a private
water company. The defendant had a contract with the City of Rensselear to supply water for, among other purposes, service at fire hydrants. Water would be furnished to private takers at reasonable rates. While the contract was in force, a fire occurred, and spread to plaintiff’s warehouse. The complaint alleged that the defendant neglected to supply water with sufficient pressure to combat the fire.

The question was whether the defendant owed plaintiff a duty from which liability could arise. The Court, by Cardozo, said no.

Cardozo was clearly concerned about the consequences of unlimited liability being imposed on a public utility company. “We are satisfied that liability would be unduly and indeed indefinitely extended by this enlargement of the zone of duty.” In Moch, the original building that was connected to defendants water supply was not owned by the plaintiff, but the plaintiff was the owner of the building to which the fire spread. In addition, the water company did not directly cause any damage. Although not stated in the opinion, this may be considered a proximate cause case, in which the court was making a policy determination as to the extent of liability of a negligent actor. This analysis would place this opinion in line with Cardozo’s other cases.

In addition, this case falls squarely in today’s application of the duty of public entities, such as police and fire departments. Governmental departments have no general duty to the public at large. A water company, a quasi-public entity, should, arguably, have the same protections, and thus would only owe a
duty for damages caused by its failing to perform its contractual obligations if it owed a person or entity a special duty. Cardozo may have been thinking about the potential unlimited exposure to the public at large unless some limitation was applied.

Glanzer

Glanzer, decided in 1922, six years before Palsgraf, applied negligence principles to contract cases to determine whether a contractor was liable to third person for negligently performing its duties. Glanzer involved the potential liability of a public weigher, hired by the seller, who incorrectly provided a certificate of weight to plaintiff buyer. Significant in the court’s decision was the direct contact between the public weigher and the plaintiff. Indeed, the defendants communicated directly with the plaintiff to ascertain whether the shipment was in order. Also of consequence was the fact that the report the weigher was to issue was the very reason for the contract between the seller and weigher. “The plaintiffs’ use of the certificates was not an indirect or collateral consequence of the action of the weighers. It was a consequence which, to the weighers’ knowledge, was the end and aim of the transaction.”

Thus, the idea of foreseeability, later articulated in Palsgraf, was apparently on Judge Cardozo’s mind in Glanzer. While Glanzer did not deal with bodily injury, but negligent breach of contract, the court clearly noted that it was foreseeable that a mistake in the weighing would directly injure the plaintiff.
Judge Cardozo hinted at the foreseeability standard that was to come: “Constantly the bounds of duty are enlarged by knowledge of a prospective use.”

**Ultramares**

*Ultramares* involved an accounting firm that prepared an audit. Unknown to defendants, the firm that hired the accounting firm used the audit to obtain loan guarantees. The audit was negligently prepared. Plaintiff, a company that was harmed because of the negligent audit, sued the accounting firm. The Court of Appeals held that plaintiff did not have a cause of action sounding in negligence.

The Court in *Ultramares* was clearly concerned about foreseeability. The Court was concerned that permitting recovery by an unknown plaintiff would expand the duty of accountants to a class of people both unforeseeable in number and existence. The Court noted the fundamental question:

We have brought to the question of duty, its origin and measure....To creditors and investors to whom the employer exhibited the certificate, defendants owed a like duty to make it without fraud, since there was notice in the circumstances of its making that the employer did not intend to keep it to himself. A different question develops when we ask whether they owed a duty to these to make it without negligence. If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an *undetermined amount for an indeterminate time to an indeterminate class*. The hazards of a business conducted on these terms are so extreme as to enkindle
doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences.xxxvii

The Court examined its recent decision in Glanzer. The Court noted that in Glanzer, there was something more than a report prepared for a specific buyer.

Here was something more than a rendition of a service in the expectation that the one that ordered the certificate would use it thereafter in the operations of his business as occasion may require. Here was a case where the transmission of the certificate to another was not merely one possibility among many, but the “end and aim of a transaction,” as certain and immediate and deliberately willed as if a husband would to order a gown to be delivered to his wife, or a telegraph company, contracting with the sender of a message, were to telegraph it wrongly to the damage of the person expecting to receive it.xxxviii

The Court then concluded that a duty did not arise to unidentified and indeterminate (unforeseeable) third parties for the audit where the defendant did not know that the contracting party would use it in the manner so used.

The Glanzer and Ultramares cases can be reconciled by the concept of foreseeability. If the class of potential plaintiffs is foreseeable and definable, the contracting party should owe a duty to third parties. In determining when a contracting party owes a duty to a third-party, absent privity, courts have held that the contracting party owes a duty to the third-party when the relationship approaches privity.xxxix However, the Courts analyzing this “functional equivalently of privity” test have often held that such conditions do not exist.xl
Application Of The Ultramares Doctrine

One question to ask is whether Ultramares would have been decided differently if the accountant defendants knew the purpose for which the audit was being prepared. If the accountants knew that the audit would be used by the client to secure financing, knew that the report would be shown to various entities to secure the financing, and that those entities would rely on the audit, it would then have been foreseeable that an identified class of persons could be harmed if the audit was negligently prepared. Thus the end and aim of the transaction, preparation of the audit, was to secure funding. Under these facts, the court may well have held that the damaged lenders could seek recovery from the accountants.

Put another way, Ultramares simply stands for the proposition that, when a contractor (accountant, broker, lawyer, real estate agent, etc.) is hired to prepare a general report without specific knowledge of what the report will be used for, the contractor that negligently performs its hired task has no duty to unidentified third parties. Cardozo’s reliance upon privity may have been nothing more than the “term of the times.” At the time Ultramares was decided, privity was king. Indeed, Ultramares was not a limitation of liability to third parties, but an expansion. The court implied that strict privity was no longer required for the contractor to face liability to third parties, if there was a “bond ... so close as to approach that of privity...” The characteristics of that bond were left unstated.
But Cardozo was working within the “citadel of privity”\textsuperscript{xlii} and was thus constrained by the times to act cautiously. Cardozo did not change the principles of law, merely their application.\textsuperscript{xliii}

The accepted Ultramares rational, that privity is necessary for liability to third parties, has been described as the “majority” rule, and is not without criticism.\textsuperscript{xliv} However, much of this criticism is based on the traditional interpretation requiring privity for liability to third parties. If Ultramares is interpreted as a foreseeability case, much of the criticism would become moot.

**Contractual Liability To Third Parties**

There are three primary theories used to resolve the question of whether a contracting party is liable to third parties. The first is the traditionally accepted analysis of Ultramares requiring privity, although this approach has generally been modified to permit liability if there is the functional equivalent to privity.\textsuperscript{xlv}

The second theory is the reasonably foreseeable theory, wherein all parties who are reasonably foreseeable recipients of the product can recover, if they rely on the product.\textsuperscript{xlvi} The last theory was promulgated in the Restatement (Second) of Torts, section 522(1)-(2). This theory is an intermediate approach; permitting recovery to the person of class of persons who the contracting party knew or should have known would rely upon the information contained in the report.

Although it is sometimes difficult to discern the differences between the [three] approaches, appropriate lines can be drawn between the respective Ultramares Corp., Credit Alliance Corp,
and Restatement approaches and the nonrestrictive foreseeability approach. For example, although the Restatement’s approach extends liability to a larger potential class of third parties than do the *Ultramares Corp.* and *Credit Alliance Corp.* approaches, it does not extend liability beyond an identified third party, a known third party, or third parties who enter into some type of transaction as originally contemplated. In other words, under the *Ultramares Corp.* and *Credit Alliance Corp.* approaches, “the precise identity of the informational consumer [must] be foreseen by the auditor,” but under the Restatement approach, the precise “informational consumer” need not be known; rather the Restatement approach “contemplates identification of a narrow group, not necessarily the specific membership within that group.” Moreover, unlike the foreseeability approach, the Restatement approach does not extend to “every reasonably foreseeable consumer of the financial information.”

Analyzing the five opinions by Cardozo together, I would argue that today, Cardozo would adopt the Restatement approach. Indeed, the Restatement approach combines Cordozo’s two most important principles: foreseeability and protection from unlimited liability. *Glanzer* and *Macpherson* demonstrate Cordozo’s willingness to abandon, or at least significantly modify, the privity requirement and permit recovery by foreseeable injured parties. *Palsgraf, Moch* and *Ultramares* demonstrate Cardozo’s concern about unlimited liability arising from a specific contract or conduct. The Restatement approach combines these principles. Privity is not required, but liability is limited to the class of parties that is specifically foreseeable.

Simply put, there should be one standard of duty in tort cases: foreseeability, limited to the class of entities that a contracting party knew of
should have known may be injured by the contracting parties negligent action or inaction. This should be true whether the injuries are bodily injury, property damage, or purely economic.

**Conclusion**

Judges are often insulated to the practical realities engaged in the real world. Courts are often behind the times in adjusting to changing circumstances. In addition, courts often stick with opinions and decisions that were cutting edge when made long after the opinions have outlived their usefulness.

The reality of business in the 21st Century, with email and instant messages, faxes, voice mail, etc., require courts to adapt to the changing conditions. When dealing with the concept of duty, and of the adhering to the privity concept, courts are still locked into the 19th Century. However, courts can look to opinions that are nearly 100 years old for support in applying the foreseeable concept when dealing with the duty owed by contracting parties. Businesses must adapt to changing circumstances to survive, and courts must keep up with changing circumstances in order to ensure that business, and the courts, run smoothly.

Taking the five opinions authored by Judge Cardozo nearly 100 years ago we can form a reasonable principle that can be applied to all negligence cases. If a party knows, or should know, that another party will rely upon the first party’s performance, the first party may be liable to all such foreseeable parties for
negligent performance, action or inaction. The exposure will be based on the known risk. For example, an accountant that performs an audit that the accountant is told will only be used internally will not owe a duty to any other party. If the accountant knows or should know that the audit will be used to secure financing, the accountant would owe a duty to the banks and lenders to whom the audit is provided for the financing. If the accountant knows or should know that the audit will be used for an IPO, the accountant would owe a duty to all potential investors. While this may lead to a virtually unlimited exposure, the accountant would be aware of this exposure and could take precautions: increase the fee charged for the audit; obtain extra professional liability insurance; reject the job; or be very, very careful in performing the audit.

The one caveat is that when the contracting party performs the equivalent of a governmental function, i.e. delivering services to the public at large, the contracting party would not owe a duty to the public at large, absent a special relationship. For example, a water company would be liable for damages caused directly from its negligent action or inaction (a water main break), but would not be liable for a failure to supply water to the general public. See, *Moch*, where Cardozo was concerned with unlimited liability, and the accompanying affect on public services. xlviii

The supply of water and electricity to the general public is analogous to the supply of services provided by the government, i.e. police, fire, education.
While a police or fire department may owe a duty to those to whom they have a “special relationship,” there is no duty owed to the general public.  This corresponds with the holding in *Moch*. As noted by Justice Garibaldi, dissenting in *Weinberg*, whether a private water company owes a duty to the general public “will have a significant impact on the delivery of water to a large segment of the public and on the rates it will pay for this essential commodity.”

Thus we have the rule: A contracting party owes a duty to all entities it knows or should know will rely upon the services provided, except in the case of a contracting party providing the equivalent of governmental functions to the general public. This principle should be applied whether the damages are personal injury, property damage or pure economic loss. This is a simple standard of care that can be applied to any negligence case.

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i 10 Mees & W 109 (1842).
ii 255 N.Y. 170 (1938).
iii Salmond, Torts (6 Ed.) 24.
vii *Seavey, Reliance Upon Gratuitous Promises*, 64 Harv. L. Rev. 913, 194 (1951).
viii 217 N.Y. 382 (1916).
ix 233 N.Y. 236 (1922).
x 247 N.Y. 160 (1928).
xi 248 N.Y.399 (1928).
xii 255 N.Y. 170 (1938).
xiii See, *Palsgraf* at 341.
xv *Palsgraf* st 344 (1928).
xvi *Id.* at 345.
Of course, some acts give rise to liability to anyone that may be injured, such as strict product liability, etc. However, for the purposes of this paper, we are limiting our discussion to acts of negligence.

Cardozo stated that the benefit derived from a public entity “must be primary and immediate in such a sense and to such a degree as to bespeak the assumption of a duty to make reparation directly to the individual members of the public if the benefit is lost. The field of obligation would expand beyond reasonable limits if less than this were to be demanded as a condition of liability.”

The court held that an action in fraud may sound, however.

See, MacPherson at 391 (The principle does not change, but the things subject to the principle do change.).

Credit Alliance Corp. v. Arthur Anderson & Co., 65 N.Y.2d 435 (1985), permitting recovery where the relationship is “sufficiently approaching privity.”

See also, Weinberg v. Dinger, 106 N.J. 469 (1987) where the New Jersey Supreme Court held that a water company was not immune from suit for its negligence in failing to provide sufficient water pressure. Justice Garibaldi wrote a vigorous dissent, where he wrote of his concern about the continued viability of water suppliers and the water rates to many of the state’s residents.