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The Expanding Scope of Accountants' Liability to Third Parties

Arthur J. Marinelli, Jr.

In increasing numbers, accountants are finding themselves defending against claims brought by investors and creditors who have suffered financial loss in transactions in which they relied on financial reports and statements prepared by the accountants. The author surveys the recent developments in case law and federal legislation which have been at the core of this expanding liability. After examining and analyzing the impact of common law, federal securities legislation, and federal criminal statutes, the author concludes that the expanded liability and potential litigation should cause the accounting profession to upgrade the care and objectivity employed in the preparation of financial statements.

I. INTRODUCTION

THE PRINCIPAL FUNCTION of the independent public accountant is the examination of his client's financial statements and the certification of reports diagnosing the fiscal health of that business. The statements are then widely disseminated and relied on by investors and creditors in determining the advisability of placing their financial trust in the business. Millions of credit and investment dollars are advanced annually in reliance on accountants' diagnoses.¹ Therefore, while accounting is not a perfect science, the statements are expected to be free of severe distortions.

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In recent years, there has been an increasing number of claims brought against accountants by creditors and investors alleging loss due to the auditors' failure to perform their analyses properly.² There is little doubt that accounting firms are now thought of as a source of salvage when credit losses occur or investments go sour.³

The proper limits of an accountant's liability to third parties has

¹ Meek, *Liability of the Accountant to Parties Other Than His Employer for Negligent Misrepresentation*, 1942 WIS. L. REV. 371.

² See Heinemann, *Accountant Role Undergoing Test*, N.Y. Times, March 27, 1966, § 3, at 1, col. 3.

³ Wall Street J., Nov. 15, 1966, at 13, col. 2.

been a subject of controversy under both the common law and federal securities legislation.⁴ This article will examine that controversy, inquiring into the accountant's legal duties in his relationship with his client, the liability which may result from misfeasance in performing those duties, and the limits to which that liability will be extended to third parties affected by the accountant-client relationship.

II. LIABILITY OF THE PUBLIC ACCOUNTANT TO HIS CLIENT

The duty owed by an accountant to his client depends upon the agreement he has made with the client. Audit engagements are usually informally contracted, and evidenced by "an engagement memo" in the accountant's working papers. The agreement usually sets out in detail the limits of the undertaking, especially where some of the work required in the customary audit is to be eliminated.⁵ Implicit in every contract for employment is the duty to perform the contracted services with the skill to be expected of a reasonably prudent man possessing the accountant's training and knowledge.⁶ This contractual standard is an adoption of the standard of care imposed by courts in negligence suits,⁷ and is the standard applied in negligence cases involving lawyers, doctors, and other professional men.⁸ As in these other professions, the services rendered by accountants are considered highly skilled and, in theory at least, are governed by personally enforced professional standards of performance and codes of ethics. The legal standard then imposed reflects the judicially-ascribed opinion that while those who hire professionals are not justified in expecting infallibility, they do have the right to expect reasonable care and the ordinary skill and competence of the members of that profession.⁹

⁴ See generally Securities Act of 1933, 15 U.S.C. §§ 77a-bbbb (1964); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78hh-1 (1964).

⁵ Litigation can arise because of disagreements as to the specific services contemplated by the parties to the contract. See, e.g., *Maryland Casualty Co. v. Cook*, 35 F. Supp. 160 (E.D. Mich. 1940); *National Surety Corp. v. Sybrand*, 256 App. Div. 226, 9 N.Y.S.2d 554 (1939); *O'Neill v. Atlas Auto Financing Corp.*, 139 Pa. Super. 346, 11 A.2d 782 (1939).

⁶ Note, *The Accountant's Liability for What and to Whom*, 36 IOWA L. REV. 319, 320 (1951).

⁷ See, e.g., *Baveroff v. Indemnity Insurance Co.*, 203 F. Supp. 49 (W.D. Ga. 1962), *aff'd* 309 F.2d 959 (5th Cir. 1962).

⁸ *Atkins v. Crosland*, 406 S.W.2d 263 (Tex. Civ. App. 1966).

⁹ *Lindner v. Barlow, Davis and Wood*, 210 Cal. App. 2d 660, 665, 27 Cal. Rptr. 101, 104 (1st App. Dist. 1962).

Liability to the client will arise whenever the conduct of the accountant falls below the standards of his profession, and may be based on breach of contract,¹⁰ fraud or negligence. The accountant's work in a particular case will be judged against auditing standards and procedures which have been developed by the accounting profession itself speaking through the American Institute of Certified Public Accountants. Auditing procedures relate to the acts to be performed by the accountant in the audit, while standards deal with measures of the quality of the performance of those acts and the objective to be attained by the use of the procedures undertaken.¹¹ Thus, the failure to follow certain procedures may result in negligence in the audit in one set of circumstances but will not result in negligence under a different set of circumstances. Because of the highly technical nature of the literature involved, expert accounting testimony will usually be necessary to establish whether accounting standards and principles have been followed.¹² If the task which should have been performed is obvious even to a layman, however, liability can be established without expert testimony.¹³ The only acceptable defense will be a showing that due care was exercised in the audit, and that the procedures were reasonable in light of the current professional practices. An important piece of evidence, crucial to the defense, will be the accountant's detailed, comprehensive and carefully prepared working papers.¹⁴

The greatest number of litigated claims between accountants and clients arise from the accountant's failure to discover defalca-

¹⁰ See text accompanying note 6 *supra*. All actions by clients against accountants involve both negligence and breach of contract. In an appropriate case, damages will be limited to the amount paid in compensation to the accountant rather than the more extensive recovery allowed under a negligence theory. See Board of County Comm'rs of Allen County v. Baker, 152 Kan. 164, 102 P.2d 1006 (1940) (full recovery of consideration paid to accountants when performance insufficient for the purposes contemplated under the contract); Craig v. Anyon, 212 App. Div. 55, 208 N.Y.S. 259, *aff'd without op.* 242 N.Y. 569, 152 N.E. 431 (1925) (recovery limited to consideration paid because negligence of accountants not sole proximate cause of the losses); East Grand Forks v. Steele, 121 Minn. 296, 141 N.W. 181 (1913) (recovery limited to consideration paid because special circumstances which would give accountants reason to know of the losses were not shown).

¹¹ See COMM. ON AUDITING PROCEDURE, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, AUDITING STANDARDS AND PROCEDURES, No. 33, at 15 (1963).

¹² See Kurland, *Accountant's Legal Liability: Ultramares to BarChris*, 25 BUS. LAWYER 155, 157 (1969).

¹³ *Id.*

¹⁴ Coakley, *Accountants Legal Liability*, 126 J. ACCOUNTANCY, No. 1, July, 1968, at 58, 59.

tions on the part of the client's employees.¹⁵ The ordinary examination, directed to an expression of an opinion on financial statements, is, of course, not aimed primarily at discovering these crimes. Yet, the independent auditor will be responsible for undetected fraud where the non-detection clearly results from his failure to comply with generally accepted auditing standards.¹⁶

While neither as clear nor as certain as the duty owed to a client, liability to third parties can arise. Because of the greater uncertainty, and greater potential recoveries, liability to third parties is a potentially more disruptive factor in the accountant's business. The balance of this article is devoted to a close analysis of the law surrounding this third-party liability.

III. AUDITOR'S LIABILITY TO THIRD PARTIES

Traditionally, accountants have been almost totally insulated from "non-client" claims by the "rule of privity," which permits sustaining a claim for contractual negligence only when the plaintiff was in privity of contract with the defendant. The common law allowed this obstacle to be surmounted only where there was proof of actionable fraud.¹⁷ Gradually, the courts found themselves softening the harshness of this rule in specific cases by the factual finding that the negligence was "gross negligence" or "recklessness" sufficient to support an action in the nature of fraud.¹⁸ Because of this judicial device, however, the laws of fraud and negligent misrepresentation have become inextricably entangled.¹⁹

Concern over the accountant's traditional relative immunity from third-party claims has resulted in consideration being given to expanding the class to whom the accountant owes a duty of care, or to redefining the concept of fraud to encompass acts heretofore considered harmful but not actionable. This expansion and redefinition

¹⁵ See, e.g., *Maryland Casualty Co. v. Cook*, 35 F. Supp. 160 (E.D. Mich. 1940); *Dantzer Lumber & Export Co. v. Columbia Cas. Co.*, 115 Fla. 541, 156 So. 116 (1934); Levitin, *Accountants' Scope of Liability for Defective Financial Reports*, 15 HASTINGS L.J. 436, 438 (1964).

¹⁶ *Board of County Comm'rs of Allen County v. Baker*, 152 Kan. 164, 102 P.2d 1006 (1940); see also Annot., 54 A.L.R.2d 324, 338 (1957).

¹⁷ Note, *Accountants' Liabilities for False and Misleading Financial Statements*, 67 COLUM. L. REV. 1437, 1438 (1967).

¹⁸ See, e.g., *State Street Trust Co. v. Ernst*, 278 N.Y. 104, 15 N.E.2d 416 (1938). This case is discussed in greater detail in the text accompanying note 55 *infra*.

¹⁹ See, e.g., Katsoris, *Accountants' Third Party Liability: How Far Do We Go?*, 36 FORDHAM L. REV. 191, 193 (1967).

have been proceeding under both the common law²⁰ and federal securities regulations.²¹

A. *Common Law Liability for Negligence*

The landmark case of *Ultramares Corp. v. Touche*²² still stands as the predominant authority in the area of accountants' liability to third parties. In *Ultramares*, public accountants were employed by the Stern Company to perform the yearly audit of the company's books and to prepare a certified balance sheet. The accountants knew that Stern's operation demanded large amounts of credit and that Stern would circulate the certified balance sheet to bankers and suppliers, but did not know the identity or number of persons who would use the balance sheet. The accountants overvalued the company's assets and the overvaluation was incorporated in the balance sheet upon which the plaintiff, a creditor of the company, relied in extending credit to Stern. After Stern had failed, the plaintiffs sought recovery from the accountants for the losses sustained and alleged that the accountants' misrepresentations were both negligent and fraudulent.

Writing for a unanimous court, Judge Cardozo had no difficulty finding negligence on the part of the accountants. He was concerned, however, with the adverse effects of holding accountants accountable to unforeseen third parties. Accordingly, the decision followed the rule of privity and held that an accountant is liable for negligence only to the party with whom he has made a contract for services, or to a party whom the accountant knew, at the time when the statements were prepared, would rely on them.

The holding in *Ultramares*, relying once more on the shield of privity, seems inconsistent with other opinions by Judge Cardozo in which he appeared to disfavor the entire notion of privity. Prior to *Ultramares*, the general rule of privity had been weakened in tort law by the doctrine of "dangerous instrumentalities." The privity element was not required when the alleged negligence involved articles which were inherently dangerous and likely to put human life in imminent danger.²³ Judge Cardozo himself was a central figure in the expansion of the doctrine, once holding that the manufacturer would be liable for articles "reasonably certain" to

²⁰ See text accompanying notes 22-66 *infra*.

²¹ See text accompanying notes 67-123 *infra*.

²² 255 N.Y. 170, 174 N.E. 441 (1931).

²³ *Thomas v. Winchester*, 6 N.Y. 397, 409 (1852).

imperial life and limb when negligently made, *if* that manufacturer knew that the article would be used by someone other than the immediate purchaser.²⁴ In *Glanzer v. Shepard*,²⁵ Cardozo carried this assault on the citadel of privity out of the personal injury field and into the arena of economic and business loss. The defendants in *Glanzer* were certified public weighers who had negligently weighed and certified a shipment of beans. It was later shown that the shipment weighed much less than the defendants had certified, and thus was worth much less than the plaintiffs had paid. Although the defendants had been contracted and paid by the seller, the court held them liable to the plaintiff-buyer because it was for that buyer's ultimate use that the certification was made.²⁶

At first glance, it would seem that *Glanzer* could have been applied by analogy in the later *Ultramares* situation. The primary elements were remarkably similar: *A* contracts *B* to make a measurement (assessment) of *A*'s product (business) and to certify that measurement as accurate. *C* then relies on that measurement in extending money for *A*'s product (business). The *Ultramares* court distinguished *Glanzer*, however, on the grounds that the service rendered by the defendant in *Glanzer* was primarily for the benefit of a third person who was, in effect if not in name, a party to the contract, and was only incidentally rendered for the benefit of the formal promisee. *Ultramares* differed in that the service was rendered primarily for the benefit of the Stern Company, the formal promisee, and only incidentally or collaterally for the use of those who might later see the statements. Cardozo observed that foresight of the possibility of later reliance does not necessarily create liability for negligence, even though such foresight may be material in terms of liability for fraud.²⁷ But this distinction can be criticized as artificial. The client is going to be financially benefited by being able to more readily obtain credit, but likewise many creditors and shareholders not only use but require a report and certificate of the books and financial records by an independent accountant.²⁸ Real benefit accrues to creditors and shareholders from an independent accountant's certificates and services. Under a pure tort theory, the harm to the plaintiffs in both *Glanzer*

²⁴ *MacPherson v. Buick Motor Co.*, 217 N.Y. 382, 389, 111 N.E. 1050, 1053 (1916).

²⁵ 233 N.Y. 236, 135 N.E. 275 (1922).

²⁶ 233 N.Y. at 238-39, 135 N.E. at 275.

²⁷ 255 N.Y. at 182-83, 174 N.E. at 446.

²⁸ Solomon, *Ultramares Revisited: A Modern Study of Accountants' Liability to the Public*, 18 DEPAUL L. REV. 56, 73-74 (1968).

and *Ultramares* seems to fall within the foreseeability or "risk reasonably to be perceived" rule of tort liability for negligence.²⁹ Harm in both *Ultramares* and *Glanzer* was foreseeable even though, in *Ultramares*, the actual persons likely to rely on the defendants' certified balance sheet were unknown, while the reliance in *Glanzer* was limited to one party who was known by the defendant. The court's refusal to extend liability to third parties in *Ultramares* can, with a fair degree of certainty, be attributed to an apparent policy determination that all imposed or assumed risks should be calculable. As Judge Cardozo stated: "If liability for negligence exists [between accountants and unknown third parties], a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class."³⁰ But one can ask whether the indeterminate nature of this sort of risk in this profession is any more fearsome than the speculative nature of the risks facing any profession. The use of liability insurance among public accounting firms and the ability of the profession to pass the costs of such insurance on to its customers, who in turn can pass on the cost to the entire consuming public, seems to cast doubt on the necessity of the *Ultramares* decision.

The most unfortunate aspect of the *Ultramares* case is its subsequent treatment. Almost without exception courts have applied the *Ultramares* decision in a mechanical fashion,³¹ implying that *Ultramares* allows no room for imposing on accountants a duty of care running to third parties in cases involving negligent misrepresentation. One example of the mechanical application of the rule can be found in the English case of *Candler v. Crane, Christmas & Co.*³² In *Candler* the accountants prepared a balance sheet for their client and were told to exhibit it to a prospective investor when completed. The accountants personally put the balance sheet before the investor who then invested in the company in reliance on facts contained in the balance sheet. The accountants had negligently failed to check certain assets which, if properly reviewed, would have revealed a state of fiscal ill-health. The company later became insolvent, and the investor brought an action for negligence against the accountants to recover his original in-

²⁹ Note, *Potential Liability of Accountants to Third Parties for Negligence*, 41 ST. JOHN'S L. REV. 558, 592 (1967).

³⁰ 255 N.Y. at 179, 174 N.E. at 444.

³¹ See Levitin, *supra* note 15, at 447.

³² [1951] 2 K.B. 164 (C.A.).

vestment. The court, in a two to one decision, held for the defendants citing *Ultramares* for the proposition that accountants are not liable to third parties for their negligent misrepresentations. In a critique of the decision, Professor Seavey has pointed out that the analogy to *Ultramares* was poorly drawn, and that *Glanzer* should have been the authority used.³³ In *Candler*, as in *Glanzer*, the plaintiff was actually foreseen and the class of plaintiffs was limited.

Lord Denning, in a critical dissenting opinion in *Candler*, had concluded that an accountant's duty should extend to cases "where the accountant prepares his accounts and makes his report for the guidance of the very person in the very transaction in question."³⁴ His view was subsequently adopted by The House of Lords in *Hedley Byrne & Co. v. Heller & Partners*.³⁵ In that decision, *Candler* was deemed to be "a typical case of agreeing to assume a liability: [the defendant accountants] knew why the plaintiff wanted to see the accounts and why their employers . . . wanted them to be shown to him, and agreed to show them to him without even a suggestion that he should not rely on them."³⁶

Although *Hedley Byrne* dealt specifically with a banker's report to a third party on the financial responsibility of one of its customers, the language of the House of Lords was expressly intended to apply to any person possessed of a special skill who was trusted by a third party to utilize that skill, when he knew, or ought to have known, that reliance was being placed on him.³⁷ This is an important, but limited, modification of the liability of accountants for professional negligence. The rule enunciated in *Hedley Byrne* would impose on accountants a duty of care owed to persons other than those with whom the accountant is in a contractual or fiduciary relationship. He may be liable for neglect of that duty if, but only if, he knows or ought to know that a financial report, account or statement prepared by him has been prepared for a specific purpose or transaction, will be shown to a particular person or class

³³ Seavey, *Candler v. Crane, Christmas and Co. — Negligent Misrepresentation by Accountants*, 67 LAW Q. REV. 466 (1951).

³⁴ [1951] 2 K.B. 164, 183 (C.A.).

³⁵ [1964] A.C. 465 (1963).

³⁶ *Id.* at 487 (Lord Reid).

³⁷ While all the Lords agreed on this point in theory, they held that the defendant was not liable in this particular case. No duty of care arose because the defendants expressly disclaimed responsibility for the reliability of the facts they reported.

of persons, and may be relied on by that person or class of persons in that particular connection.³⁸

The subsequent interpretation of the *Ultramares* case has been questioned not only in England in *Candler* and *Hedley Byrne*, but has come under attack in this country as well. In *Rusch Factors, Inc. v. Levin*,³⁹ a corporation sought financing from a commercial banking and factoring corporation. The bank requested certified financial statements which were then prepared by the defendant-accountant. The corporation was insolvent when the accountant negligently prepared his statement, but the bank relied on the certified statement to the contrary. The loan was not paid and the bank sued the accountant. In holding that "an accountant should be liable in negligence for careless financial misrepresentations relied upon by actually foreseen and limited classes of persons,"⁴⁰ the court emphasized the qualitative difference between liability to an undefined, unlimited class envisioned in *Ultramares*, and liability to a plaintiff who was a single party whose reliance was, in fact, foreseen. In this respect the plaintiff in *Rusch Factors* was found to be similar to the plaintiff in *Glanzer*.⁴¹ The court further questioned the decision in *Ultramares*:

³⁸ *Accountants' Liability to Third Parties — The Hedley Byrne Decision*, 120 J. ACCOUNTANCY, Oct., 1965, at 66-67.

³⁹ 284 F. Supp. 85 (D.C.R.I. 1968).

⁴⁰ *Id.* at 93.

⁴¹ *Id.* at 90, 91. The court did not have to overrule *Ultramares* since it found that the facts fit *Glanzer* rather than *Ultramares*. The *Rusch Factors* holding has been adopted by the Supreme Court of Iowa in *Ryan v. Kanne*, ___ Iowa ___, 170 N.W.2d 395 (1969). Additional factors of interest in this case include the court's rejection of the defense that the accountant's report was uncertified, and the court's method of computing damages.

Lack of certification was rejected as a defense because liability was based on the accountant's failure to perform the procedures that they had agreed to do and claimed to have done. Further, the imposition of liability was not affected by the existence of a disclaimer of reliability. The *Hedley Byrne* case, on the other hand, presents a factual situation wherein disclaimer was a successful defense.

The *Rusch* court found the correct measure of damages to be the same as that applied where the parties are in privity, or the amount necessary to place the corporation in the position it would have been in had the account been correctly stated. For example, the accountant's negligence produced errors of \$33,069.22. The court subtracted \$5,000 as the margin of error beyond which the accountants had not warranted correctness and added \$1,380 as the reasonable cost of producing a corrected report, to produce a sum of \$30,069.22. See 170 N.W.2d at 407. Thus the damages were the same as if the parties had contracted for the services.

Most recently, in *Stephens Indus., Inc. v. Haskins & Sells*, 438 F.2d 357 (10th Cir. 1971), the court refused to accept the inroads made by *Rusch Factors* and *Ryan*, noting that the forum state (Colorado) had not yet adopted the developing trend. The decision can be distinguished from *Rusch Factors* and *Ryan*, however, because of the finding that the accountants had exercised due care.

The wisdom of the decision in *Ultramares* has been doubted . . . and this court shares the doubt. Why should an innocent reliant party be forced to carry the weighty burden of an accountant's professional malpractice? Isn't the risk of loss more easily distributed and fairly spread by imposing it on the accounting profession, which can pass the cost of insuring against the risk onto its customers, who can in turn pass the cost onto the entire consuming public? Finally, wouldn't a rule of foreseeability elevate the cautionary techniques of the accounting profession? For these reasons it appears to this court that the decision in *Ultramares* constitutes an unwarranted inroad upon the principle that "[t]he risk reasonably to be perceived defines the duty to be obeyed."⁴²

As further support for its decision the court in *Rusch Factors* also cited the proposed section on negligent misrepresentation in the *Restatement (Second) of Torts* which would extend the accountant's liability to "the person or one of the persons for whose benefit and guidance he intends to supply the information, or knows that the recipient intends to supply it."⁴³ The same tentative draft included the following hypothetical illustration of the above-stated rule of law:

A is negotiating with a bank for a credit of \$50,000. The bank requires an audit by certified public accountants. A employs B & Company, a firm of accountants, to make the audit, telling them he is going to negotiate a bank loan. A does not get his loan from the first bank but does negotiate a loan with another bank, which relies upon B & Company's certified statements. The audit carelessly overstates the financial resources of A, and in consequence the second bank suffers pecuniary loss. B & Company is subject to liability to the second bank.⁴⁴

The holding in *Rusch Factors* that an accountant should be liable in negligence for careless misrepresentation relied upon by *actually foreseen and limited classes of persons* suggests a trend away from mechanical application of the *Ultramares* decision. The test created by the court in *Rusch Factors* appears to be sound. It avoids the unlimited and unforeseen liability that Cardozo feared would result from finding liability on the facts presented in *Ultramares*, and represents a return to the basic "foreseeability" rule created in *Palsgraf*.⁴⁵

⁴² 284 F. Supp. at 90, 91, *citing* *Palsgraf v. Long Island R.R.*, 248 N.Y. 339, 344, 162 N.E. 99, 100 (1928).

⁴³ RESTATEMENT (SECOND) OF TORTS § 552 (Tent. Draft No. 12, 1966).

⁴⁴ RESTATEMENT (SECOND) OF TORTS, Comments and Explanatory Notes, § 552, at 13-16, 23-25 (Tent. Draft No. 12, 1966).

⁴⁵ See text accompanying note 42 *supra*.

B. *Liability for Deceit*

An action in deceit has traditionally been available to any party who has justifiably relied on the intentional misrepresentation of a material fact.⁴⁶ In accountant's liability cases, the greatest concern is caused by the requirement of *scienter*, or guilty intent. Intent can be established not only by proof of actual knowledge of the falsity of the representation, but also by proving lack of knowledge of its truth or reckless disregard for the truth.⁴⁷ Negligence is not a substitute for intent, but it may nevertheless be evidence that the defendant's assertion was not made with an honest belief in the truth of the statement.⁴⁸

*Ultramares v. Touche*⁴⁹ clearly presents the distinctions between intentional and negligent misrepresentation. In that case, the failure of the defendants to verify \$706,000 of accounts receivable, an entry which later proved to be fictitious, was held to create a jury question on allegations of fraud. Cardozo observed that the defendants' act of certifying the financial statements as being true to the best of their knowledge when, as a jury might find, they had no knowledge of the facts, could support a finding that they had acted without a sincere and honest belief in the truth of the statements.⁵⁰ If the jury did find that the facts supported the allegations of fraud, the accountant would be liable to those persons whom he reasonably should have foreseen would be injured by his misrepresentations.⁵¹ As discussed previously, the scope of liability for negligence is significantly more limited. The difference here is grounded on the policy that liability for the intentional wrongdoer should be greater than for the negligent wrongdoer.⁵² The rule is also intended to deter future misconduct.⁵³

This facet of the *Ultramares* holding was later applied in the

⁴⁶ See generally W. PROSSER, TORTS § 102, at 713-19 (3d ed. 1964).

⁴⁷ In the leading case on deceit the House of Lords declared that for a deceit action to lie there must be proof that a "false representation has been made (1) knowingly, or (2) without belief in its truth, or (3) recklessly careless of whether it be true or false." *Derry v. Peek*, 14 App. Cas. 337, 374 (1889).

⁴⁸ *Id.* at 375-76.

⁴⁹ 255 N.Y. 170, 174 N.E. 441 (1931).

⁵⁰ *Id.* at 192-93, 174 N.E. at 449-50.

⁵¹ Seavey, *Caveat Emptor as of 1960*, 38 TEXAS L. REV. 439, 440 n.6 (1960).

⁵² Keeton, *The Ambit of a Fraudulent Representor's Liability*, 17 TEXAS L. REV. 1, 4 (1938); Seavey, *supra* note 51, at 440-41.

⁵³ Comment, *Accountants' Liabilities to Third Parties Under Common Law and Federal Securities Law*, 9 B.C. IND. & COM. L. REV. 137, 143 (1967).

case of *State Street Trust Co. v. Ernst*.⁵⁴ In that situation, the defendant accountants released to their client a certified balance sheet which listed accounts receivable valued at 2,000,000 dollars without disclosing that over 768,000 dollars of these accounts were stagnant and probably would never be collected. The balance sheet was used to obtain credit from the plaintiff, and the accountants had been made aware that the balance sheet was to be used for that purpose. Thirty days after the plaintiff received the balance sheet, and after the loan had been made, the accountants sent to their client an explanatory letter containing comments and explanations of the balance sheet which had not appeared on the distributed report. The corporation failed and the creditors sued the accountants, alleging fraud. The trial court set aside a verdict for the plaintiffs and directed a verdict for the defendants. The New York Court of Appeals reversed, elaborating on the relationship between negligence and fraud, reiterating principles laid down in *Ultramares*, and holding that accountants may be liable to third parties in deceit even where deliberate or active fraud is lacking. The court suggested that statements certified as true when there is no actual knowledge as to that truth, reckless misstatements, or professional opinions based on obviously flimsy grounds should be sufficient bases for liability:

A refusal to see the obvious, a failure to investigate the doubtful, if sufficiently gross, may furnish evidence leading to an inference of fraud so as to impose liability for losses suffered by those who rely In other words, heedlessness and reckless disregard of consequence may take the place of deliberate intention.⁵⁵

Thus, the *State Street* case underscores the fact that there is no clear line between fraud and gross negligence.⁵⁶ In sum, there is a possibility of recovering from an accountant for deceit where there is a showing of intentional or reckless misrepresentation in a balance sheet upon which the creditor or investor has justifiably relied to his detriment.

C. *The Duty to Disclose After-Acquired Facts*

The possibility of a duty of care arising subsequent to the certification of a financial statement has been raised in the case of *Fischer v. Kletz*.⁵⁷ In denying the accounting firm's motion to dis-

⁵⁴ 278 N.Y. 104, 15 N.E.2d 416 (1938).

⁵⁵ 278 N.Y. at 112, 15 N.E.2d at 418-19.

⁵⁶ See text accompanying notes 17-19 *supra*.

⁵⁷ 266 F. Supp. 180 (S.D.N.Y. 1967).

miss, a United States district court implied that the accountants who failed to disclose after-acquired information might be found liable, in deceit, to investors who had relied on the previously certified financial statements.

Fischer began as a class action for damages brought by current and former stockholders and bondholders of the Yale Express System, Inc. against the public accounting firm of Peat-Marwick-Mitchell & Co. (PMM). PMM had been employed by Yale to prepare and certify the corporation's 1963 financial statements.⁵⁸ The annual report and PMM's certification were issued to Yale stockholders on April 9, 1964, and approximately three months later a report containing certified financial statements was filed with the Securities and Exchange Commission (SEC). Subsequent to filing those statements PMM was commissioned to conduct special studies of Yale's past and current income and expenses. While conducting the special studies, PMM discovered that the certified 1963 annual report had contained figures that were substantially false and misleading. It was not until May 5, 1965, that PMM communicated its discoveries to the SEC and the stock exchanges on which Yale stock was registered although PMM had notified Yale's management of their findings prior to November, 1964. The plaintiffs claimed that as a result of PMM's silence they suffered pecuniary damages and based their claim on both common law deceit and various violations of the Securities Exchange Act of 1934.⁵⁹

The alleged breach of duty confronting the court in the deceit action was a *nondisclosure* rather than an *affirmative misrepresentation*. While nondisclosure has in the past been the basis of deceit actions, liability in those cases was predicated on the existence of a fiduciary relationship,⁶⁰ or the fact that the persons involved were parties to a business transaction.⁶¹ The *Fischer* court

⁵⁸ Since Yale securities were registered on a national securities exchange it was required to have its annual report certified by an independent public accountant and filed with the Securities and Exchange Commission. See Securities Exchange Act § 13(a), 15 U.S.C. § 78m(a) (1964).

⁵⁹ 15 U.S.C. § 78(r) (1964). See text accompanying notes 102, 109 *infra* for a discussion of the claims under the Securities Act.

⁶⁰ See *Foreman v. Henry*, 87 Okla. 272, 210 P. 1026 (1922); *DeSwarte v. First National Bank*, 188 Wis. 455, 206 N.W. 887 (1926).

⁶¹ RESTATEMENT OF TORTS § 551(2)(b) (1938). "One party to a business transaction is under a duty to exercise reasonable care to disclose to the other, before the transaction is consummated . . . any subsequently acquired information which he recognizes as making untrue or misleading a previous representation which when made was true or believed to be so." See, e.g., *Loewer v. Harris*, 57 F. 368 (2d Cir. 1893), (seller of business held liable for nondisclosure of a change of business conditions for failing to disclose a downturn of business after having previously reported an upward trend).

found that the effect of the certification was similar to a representation made in a business transaction in that it supplied information which was justifiably relied on for decisional purposes.⁶² The court further concluded that the significant factor was the impact made by the representation upon the person who relied on it.⁶³

Of further consideration in *Fischer* was the question whether gain by the defendant is a necessary element in an action based on nondisclosure. The Court relied on the case of *Goldsmith v. Koopman*⁶⁴ for the proposition that proof of such gain is unnecessary in actions based on nondisclosure. In *Goldsmith*, the court had underscored the fact that in actions for nondisclosure the complainants are hurt, and that this, rather than defendants' gain, is the gravamen of the action.⁶⁵

The *Fischer* court thus effectively broadened the scope of the common law action of deceit to include after-acquired information which discloses the falsity of a party's certification of a financial statement. If the accountants knew at the time they made their certification that the balance sheet contained substantial errors, the accountants would be liable for their false representations.⁶⁶ It does not follow that a different concept of liability should be applied merely because the knowledge of the falsity is acquired at a later time.

It is undeniable that the imposition of liability for nondisclosure of post-certification errors will increase costs to the accounting profession and have some disruptive effect on the securities markets, but these costs are clearly outweighed by the disruptions of the securities markets which can occur if the accountant does not publicize his later findings of error in certified financial statements.

D. *The Federal Securities Laws*

Events leading up to and following the stock market crash of 1929 made it clear that federal regulation of securities practices was necessary to protect the investing public.⁶⁷ Congress chose to protect the public by requiring full disclosure of relevant information in the issue of securities rather than passing on the quality of

⁶² 266 F. Supp. at 186.

⁶³ 266 F. Supp. at 185-86.

⁶⁴ 140 F. 616 (S.D.N.Y. 1905).

⁶⁵ *Id.* at 621.

⁶⁶ See *State Trust Co. v. Ernst*, 278 N.Y. 104, 15 N.E.2d 416 (1938).

⁶⁷ Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, at 29-30 (1959).

the security.⁶⁸ The main thrust of the federal legislation was expressed by its sponsors as being to "place the owners of securities on a parity, so far as possible, with the management of corporations, and to place the buyer on the same plane so far as available information is concerned, with the seller."⁶⁹

The independent public accountant has been given a central responsibility in the application of these statutes. When investigating the financial condition of corporations, the investing public looks to annual reports, prospectuses, and registration statements and relies especially upon the statements of accountants, because of their independence and expertise. Certification by an accountant, as required under the statutes, serves as a check on management's accounting. If based on an extensive and expert review of financial statements and underlying records and procedures, certification provides adequate assurances that these statements fairly present the affairs of the company.⁷⁰

To ensure a high standard of performance by accountants under the federal securities statutes, the scope of civil liability to third parties has been substantially expanded. As James Landis, one of the drafters of the Securities Act of 1933, stated: "We were particularly anxious through the imposition of adequate civil liabilities to assure the performance by corporate directors and officers of their fiduciary obligations and to impress upon *accountants* the necessity for independence and a thorough professional approach."⁷¹

The following portion of this article will consider the accountant's exposure to civil liability under both the Securities Act of 1933⁷² and the Securities Exchange Act of 1934⁷³ through an analysis of the civil liabilities sections of the acts and judicial authority interpreting those sections.

1. *The Securities Act of 1933*.— Key provisions of the 1933 Act, directed at achieving full disclosure in securities registration statements and prospectuses, require that various financial facts be included in the statements. Balance sheets and profit and loss statements "in such detail and such form as the Commission shall pre-

⁶⁸ See generally 1 L. LOSS, *SECURITIES REGULATION* 121-28 (2d ed. 1961); Knauss, *A Reappraisal of the Role of Disclosure*, 62 MICH. L. REV. 607 (1964).

⁶⁹ 77 CONG. REC. 2918 (1933) (remarks of Congressman Rayburn related specifically to what was to become the Securities Act of 1933).

⁷⁰ See Barr and Koch, *Accounting and the S.E.C.*, 28 GEO. WASH. L. REV. 176 at 186-87 (1959).

⁷¹ Landis, *supra* note 67, at 35 (emphasis added).

⁷² 15 U.S.C. §§ 77a-77bbbb (1964).

⁷³ 15 U.S.C. §§ 78a-78hh-1 (1964).

scribe"⁷⁴ are required, and these financial statements must be certified by an independent public or certified accountant.⁷⁵

Section 11 of the Securities Act imposes civil liability for misrepresentations or omissions of material facts in the registration statement.⁷⁶ A prerequisite to liability under this section is that the omission or misstatement be material. Whether a particular fact is material will depend on the facts and parties involved in each case — what is important to the seasoned speculator will not be material to the small investor. As to the average investor, most courts adopt a standard similar to that in *Escott v. BarChris Construction Corporation*,⁷⁷ where Judge McLean said:

The average prudent investor is not concerned with minor inaccuracies or with errors as to matters which are of no interest to him. The facts which tend to deter him from purchasing a security are facts which have an important bearing upon the nature or condition of the issuing corporation or its business.⁷⁸

Section 11 expands accountants' third-party liability significantly beyond that of common law. Privity is not a necessary element under section 11, and the misrepresentation need not be addressed to nor intended to influence the investor. Moreover, there is no requirement of *scienter*, and consequently no proof of fraud or deceit

⁷⁴ Schedule A §§ 25-26, 15 U.S.C. § 77aa (25)-(26) (1964).

⁷⁵ *Id.*

⁷⁶ 15 U.S.C. § 77k(a) (1964). Subsection (a) provides that whenever a registration statement becomes effective and contains an untrue statement of a material fact, or omits a material fact which is required to be stated, or which is necessary to keep the statement from being misleading, any person acquiring the security:

may, either at law or in equity, in any court of competent jurisdiction sue —
(1) every person who signed the registration statement;

. . .

(4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him. . . . (emphasis added).

⁷⁷ 283 F. Supp. 643 (S.D.N.Y. 1968).

⁷⁸ *Id.* at 681. But see Address by Louis Loss, American Bar Association Section of Corporation, Banking and Business Law, Sept. 27, 1968, ("The BarChris Case: Prospectus Liability") reprinted in 24 BUS. LAWYER 527, at 532-33 (1969), in which Professor Loss indicated that the cases under sections 11 and 10b-5 which have proceeded to final judgment for the plaintiff have not really posed questions of materiality but rather have been cases which have been extraordinary. What has evolved under the case law has been something closer to a "special circumstance" doctrine. See S.E.C. v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) cert. denied, 394 U.S. 976 (1968) (large ore strike); Speed v. Transamerica Corp., 235 F.2d 369 (3d Cir. 1956) (corporation quadrupled its tobacco inventory).

is necessary for a section 11 claim.⁷⁹ Proof of reliance is eliminated under the section except in one narrow instance.⁸⁰ Thus, the legal rules and requirements that made finding accountants liable to third parties so difficult under the common law have been largely eliminated.

There are, however, three defenses built into the statute.⁸¹ The accountant will not be held liable if he can prove that: (1) he had ceased to act as accountant before the effective date of the registration on which liability is asserted, and that he had informed the Securities Exchange Commission of that fact; or (2) part of the registration statement became effective without his knowledge, and that he had informed the Commission and given reasonable public notice of that fact; or (3) he had, after reasonable investigation, reasonable grounds to believe, and did in fact believe, that at the time the statement became effective the statements it contained were true, complete as to all material facts, and not misleading.⁸² The Act defines what constitutes reasonable investigation and reasonable grounds for belief as "the standard of reasonableness . . . required of a prudent man in the management of his own property."⁸³

Although section 11 provides the foundation for extremely broad third-party liability, it has fostered relatively few suits involving accountants. In *Shonts v. Hirliman*,⁸⁴ an early case brought against an accountant under section 11, the purchasers of registered securities were denied recovery from the accountants and directors of the corporation. The complaint in *Shonts* alleged that financial statements prepared by the defendant accountant made no mention of a material fact — namely, the existence of a rental agreement. The rental agreement was, however, entered into subsequent to the time of certification and filing of the registration statement, but prior to the date on which the registration statement became effective.

⁷⁹ See *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951).

⁸⁰ The exception is set forth at 15 U.S.C. § 77k(a) (1964), as follows:

If such person acquired the security after the issuer has made generally available to its security holders an earning statement covering a period of at least twelve months beginning after the effective date of registration statement, then the right of recovery under this subsection shall be conditioned on proof that such person acquired the security relying upon such untrue statement in the registration statement or relying upon the registration statement and not knowing of such omission but such reliance may be established without proof of the reading of the registration statement by such person. *Id.*

⁸¹ See 15 U.S.C. § 77k(b) (1)-(3) (1964).

⁸² This last, "due diligence," defense is the most significant. See *Id.*

⁸³ See 15 U.S.C. § 77k(c) (1964).

⁸⁴ 28 F. Supp. 478 (S.D. Cal. 1939).

The court held that there could be no recovery against the accountants because there was no omission or misrepresentation of a material fact at the time that the registration statement was certified. The court interpreted section 11 as not covering the situation in which the accountant did not know of a subsequent undertaking by his client.⁸⁵

Shonts represents an extremely early interpretation of section 11. The court's holding that section 11 responsibility for accountants is terminated with the date of certification of the statement plainly contradicts the words of the statute itself. The language of section 11 gives the accountant a defense only if he believed, after reasonable investigation, that the statements were true at the time that the registration statement became *effective*.⁸⁶

The erroneous interpretation given by the *Shonts* court has subsequently been corrected in *Escott v. BarChris Construction Corp.*,⁸⁷ the first definitive decision imposing liability on accountants under section 11. The BarChris Corporation was in the business of constructing bowling alleys for purchasers who merely made small down payments prior to construction and, when the building was finished, paid the balance of the contract price in long term notes. The notes were then discounted by BarChris. BarChris' business grew dramatically and its capital structure became increasingly complex. In 1961, the corporation sold debentures to the public and the financial statements for the registration statements were certified by BarChris' regular auditors. A year later BarChris became insolvent and an action was brought by purchasers of the debentures against the directors, officers, underwriters, and auditors.

Accountants for BarChris sought to avoid liability by pleading due diligence in the preparation of the financial statements, a defense available under section 11.⁸⁸ Under the *Shonts* rationale the defense would probably have been successful. But the *BarChris* court upheld liability under section 11 and directed its inquiry to the question of whether a reasonable investigation had been under-

⁸⁵ Specifically the court declared:

The rental arrangement was not called to their [the accountants'] attention. There was no entry on the books at their disposal, from which, by further inquiry, they might have discovered that there was such an undertaking. Absent these, they cannot be charged with a misrepresentation which was made later — long after their certification. *Id.* at 483.

⁸⁶ See 15 U.S.C. § 77k(b)(3)(B)(i) (1964).

⁸⁷ 283 F. Supp. 643 (S.D.N.Y. 1968).

⁸⁸ See note 82 *supra* & accompanying text.

taken by the accountants prior to the effective date of the registration statement.

In order to determine whether a reasonable investigation had been made, the court considered not only the adequacy of the 1960 audit, upon which the registration statement was based, but also the statutorily required "S-1" review of that audit, which must be made prior to the time the registration statement becomes effective.⁸⁹ The court paid particular attention to the fact that the effective date of a registration statement cannot predate this re-evaluation and updating of the client's financial position. The S-1 review took on much significance in *BarChris* because many important changes had occurred in the corporation's financial position between the date of the audit and the effective date of registration. The S-1 review had failed to reveal those changes.⁹⁰

The accountant's "due-diligence" defense was rejected because the court felt that the S-1 review did not meet the recognized standards of the accounting profession.⁹¹ More specifically, the court found that the accountant in charge of the review had not followed the complete procedure outlined in his firm's written program for such a review, did not spend enough time "on a task of this magnitude, [and most] important of all, . . . was too easily satisfied with glib answers to his inquiries."⁹²

Although the *BarChris* court purported to adopt the standards of the accounting profession itself as the gauge of a "reasonable investigation" under section 11, the court did little to resolve the problem of determining when the S-1 review is adequate. One still does not know what answers by company officials are to be classified as "glib," nor does one know what shall constitute a "danger signal" appearing in the financial reports that is sufficient to require further investigation. One commentator has examined the facts in *BarChris* and concluded that "it is difficult to see wherein the auditors failed to make a 'reasonable investigation' in the course of the S-1 re-

⁸⁹ The accountant carries out an S-1 review as part of his obligation under § 11. The section makes the accountant responsible for his opinion upon the audited financial statements as of the effective date of the registration statement. The effective date will not occur until sometime after the accountant has completed his audit and issued his opinion. He must satisfy himself that the audited financial statements still present the financial position and results of operations as of the end of the audited period at the effective date of the registration statement.

⁹⁰ See 283 F. Supp. at 702. Several errors were also made in the 1960 audit itself. Their significance is discussed by the court at 698-701.

⁹¹ *Id.* at 703. See also COMM. ON AUDITING PROCEDURE, *supra* note 8, at 76.

⁹² 283 F. Supp. at 703.

view"⁹³ and that even if the accountant had learned all that the court indicated a diligent S-1 review would have exposed, it would not have made a significant difference in those statements which the court found to be materially in error.⁹⁴ If this interpretation of the facts in *BarChris* is correct, then the court did not hold the accountant only to the standard recognized in the accounting profession but, in fact, fashioned a higher standard of its own.

BarChris is significant in that it is the first case to impose liability on accountants under section 11. As such, it breathes life into a previously little-used statutory provision. The case emphasizes the importance of the S-1 review and suggests that the standards for the S-1 review need to be re-examined by the accounting profession.

2. *The Securities Exchange Act of 1934*.— Under the Exchange Act, accountants' liability for misleading statements is founded upon the express liability of section 18,⁹⁵ and the liability implied under sections 10(b)⁹⁶ and the SEC rule 10b-5.⁹⁷ The Exchange Act requires the filing of various reports as well as registration applications with the SEC by companies whose securities are listed upon national exchanges and most issues traded in the over-the-counter market.⁹⁸ Generally, the financial statements must be certified by independent public or certified accountants.⁹⁹

(a) Express Liability.— Section 18 of the 1934 Act¹⁰⁰ expressly

⁹³ Address by A. A. Sommer, Jr., American Bar Association Section of Corporation, Banking and Business Law, Sept. 27, 1968, ("The BarChris Case: Prospectus Liability"), reprinted in 24 BUS. LAWYER 593 at 602-03 (1969).

⁹⁴ *Id.* at 605.

⁹⁵ 15 U.S.C. § 78r (1964).

⁹⁶ 15 U.S.C. § 78j(b) (1964).

⁹⁷ 17 C.F.R. § 240.10b-5 (1967).

⁹⁸ See Phillips & Shipman, *An Analysis of the Securities Acts Amendments of 1964*, 1964 DUKE L.J. 706.

⁹⁹ See Lee & Hall, *Accounting Aspects Securities Acts Amendments of 1964*, 20 BUS. LAW 325 (1965).

¹⁰⁰ Section 18 reads in pertinent part:

(a) Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this chapter or any rule or regulation thereunder . . . which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading. A person seeking to enforce such liability may sue at law or in equity in any court of competent jurisdiction. In any such suit the court may, in its discretion, require an undertaking for the payment of the costs of such

creates liability for those persons who make false or misleading statements on any document filed with a national securities exchange. Like section 11 of the 1933 Act, it requires that the misstatement be material. Unlike section 11, however, section 18 allows a defense of good faith where a defendant had no knowledge that the statement was false or misleading.

Section 18 requires *scienter*, causation and reliance, none of which are required when dealing with registration statements under section 11 of the 1933 Act. Section 18 seems to have added very little to the prospects of successful recovery by investors for false or misleading statements against accountants beyond common law deceit actions and section 11 actions. As Professor Loss has pointed out:

Except for avoiding any question that the person making the false statement or causing it to be made can be sued by the buyer or seller notwithstanding the absence of privity between them, it is hard to see what advantage § 18 gives the investor that he does not have in common law deceit.¹⁰¹

Regardless of the utility of section 18 in protecting investors, judicial authority has made it clear that accountants are indeed subject to its express liability. In *Fischer v. Kletz*,¹⁰² a plaintiff alleged that accountants charged with preparation of a report required by the SEC knew, in advance of filing, that certified statements were false. The district court declared that these facts, if established, would support the imposition of liability upon accountants under section 18.¹⁰³

(b) Implied Liability.—Of prime significance to the accountant is the judicial recognition of implied civil liability under section 10(b)¹⁰⁴ of the 1934 Act and SEC rule 10b-5,¹⁰⁵ which represent the

suit, and assess reasonable costs, including reasonable attorneys' fees, against either party litigant. 15 U.S.C. § 78r (1964).

¹⁰¹ 3 L. LOSS, SECURITIES REGULATION 1752 (1961).

¹⁰² 266 F. Supp. 180 (S.D.N.Y. 1967).

¹⁰³ *Id.* at 189.

¹⁰⁴ 15 U.S.C. § 78j(b) (1964):

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange — . . .

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations appropriate in the public interest or for the protection of investors.

¹⁰⁵ 17 C.F.R. § 240.10b-5 (1967):

It shall be unlawful for any person, directly or indirectly, by the use of any

antifraud backbone of the Act. Although neither section 10(b) nor rule 10b-5 expressly provides for civil liability, the courts have consistently inferred a civil remedy.¹⁰⁶

Implied civil liability for accountants under rule 10b-5 was first recognized in *H.L. Green Company v. Childree*,¹⁰⁷ where it was alleged that the defendant auditors had knowingly prepared false financial statements with the intent to induce the plaintiff to enter into a merger with their client. Since section 10(b) and rule 10b-5 are concerned with fraud in connection with the *purchase or sale* of securities, it is at once difficult to see how the accountants who prepared the statements, as opposed to the seller who used the statements, could be named as defendants. The court, however, found that an accountant could indeed be liable to an investor under section 10(b) and rule 10b-5 even though his activities were confined to the preparation of the false and misleading statements. Implicit in the *Childree* decision is the determination that the accountant's activities were undertaken *in connection with the purchase or sale* of securities.

Childree thus raises the significant problem of defining the "in connection with" concept of section 10(b) and rule 10b-5. The phrase has been broadly construed to apply to any practices that are likely to mislead investors to their detriment,¹⁰⁸ and courts are now considering the requirement satisfied if the misled plaintiff is reasonably within the "scope of influence" of the person making the statements on which the plaintiff relied.¹⁰⁹ The best known judicial ex-

means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

¹⁰⁶ See *Brennan v. Midwestern United Life Ins. Co.*, 259 F. Supp. 673 (N.D. Ind. 1966); *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946).

¹⁰⁷ 185 F. Supp. 95 (S.D.N.Y. 1960).

¹⁰⁸ *Heit v. Weitzen*, 402 F.2d 909 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1969).

¹⁰⁹ RESTATEMENT (SECOND) OF TORTS § 531 (Tent. Draft No. 12, 1966) reads as follows:

GENERAL RULE

One who makes a fraudulent misrepresentation is subject to liability for pecuniary loss

(a) to the persons or class of persons whom he intends or has reason to expect to act or refrain from action in reliance upon the misrepresentation; and

(b) for pecuniary loss suffered by them through their reliance in the

position of the scope of influence test is that of Judge Waterman in *S.E.C. v. Texas Gulf Sulphur*.¹¹⁰ He declared: "Rule 10b-5 is violated whenever assertions are made . . . in a manner reasonably calculated to influence the investing public."¹¹¹

Other decisions have applied the scope of influence interpretation of section 10(b) and rule 10b-5 with respect to accountants' liability. For example, in *Fischer v. Kletz*,¹¹² the court was faced with a complaint alleging that the defendant-accountants had recommended the use of misleading figures in a financial statement which they had neither prepared nor certified. The court held that it could be possible to find that the plaintiff had been within the "scope of influence" of the accountants' actions, and refused to dismiss the complaint.

Some indication of the limits of the "scope of influence" test were set forth in *Wessel v. Buhler*.¹¹³ Certain financial statements had been prepared by the defendant-accountant for administrative corporate purposes, but were never publicly disseminated or seen by an investor until after the litigation was commenced. The first of these statements was prepared to accompany an application for a surety bond, the second was a balance sheet that accompanied an application for a small business administration loan, and the third was an audited balance sheet used by the corporation itself. Each statement showed deficiencies in the corporate records and indicated that the company was in serious trouble. Subsequently, the corporation issued a misleading prospectus containing some of the figures which the defendant-accountant had prepared for the earlier statements. The district court imposed liability upon the accountant on the basis of those figures.¹¹⁴

But the Ninth Circuit Court of Appeals refused to hold the accountant liable for the misleading prospectus. Applying the "scope of influence" test, the court was unable to find any connection between the stock transaction and the accountant's preparation of the earlier financial reports sufficient to satisfy the test and impose liability under section 10(b) and rule 10b-5.

type of transaction in which he intends or has reason to expect their conduct to be influenced.

¹¹⁰ 401 F.2d 833 (2d Cir. 1968), *cert. denied sub. nom.*, *Kline v. S.E.C.*, 394 U.S. 976 (1969).

¹¹¹ 401 F.2d at 862. *See generally* 401 F.2d at 858-62.

¹¹² 266 F. Supp. 180 (S.D.N.Y. 1967).

¹¹³ 437 F.2d 279 (9th Cir. 1971).

¹¹⁴ *Id.* at 281.

Fischer and *Wessel* can also be contrasted by their dispositions of the allegations that the accountants should be liable under section 10(b) and rule 10b-5 for "aiding and abetting" schemes to defraud investors.¹¹⁵ The question utmost in the mind of the *Fischer* court was whether the accountants, in recommending the use of the inaccurate figures, had given *substantial* assistance or encouragement to the corporate officials. Although he doubted that this could be proven, Judge Tyler refused to dismiss the complaint without giving the plaintiffs further opportunity to develop the facts. In *Wessel*, the facts developed at trial did not show *any* affirmative evidence that the accountant had *substantially encouraged* those who prepared the misleading prospectuses. The court, therefore, affirmed the trial court's directed verdict for the accountant.

Neither the *Wessel* nor the *Fischer* courts would declare that accountants could be held liable under rule 10b-5 solely for failing to publicly disclose that misleading figures were being used. The *Fischer* court concluded that an alleged "aiding or abetting" based on non-disclosure of after-acquired knowledge of error with respect to prior false statements would be difficult to prove.¹¹⁶ There is, however, some authority for imposing a duty on accountants to speak out under appropriate circumstances. In *Brennan v. Midwestern United Life Insurance Company*,¹¹⁷ a case not involving accountants, the court refused to dismiss a complaint alleging that the defendant's silence and inaction was sufficient encouragement to constitute an "aiding and abetting" of a violation of the statute. The court explained that "to rest the definition of aiding and abetting solely on abstract and mechanical distinctions between active and passive assistance . . . would be to defeat and hamper the intelligent and responsible development of the law . . ."¹¹⁸ Under the *Brennan* approach it may be possible for an accountant to sub-

¹¹⁵ For purposes of defining "aiding and abetting" under section 10(b) and rule 10b-5 the courts have adopted the standard set forth in the *Restatement of Torts*:

For harm resulting to a third person from the tortious conduct of another, a person is liable if he

. . .

(b) knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself. RESTATEMENT OF TORTS § 976 (1938).

¹¹⁶ Compare 266 F. Supp. at 196 with 437 F.2d at 283.

¹¹⁷ 259 F. Supp. 673 at 682 (1966). In the decision on the merits, Judge Eschbach based his finding for plaintiff on affirmative acts but repeated his belief that such acts might not always be necessary. 286 F. Supp. 702 at 727 (N.D. Ind. 1968), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

¹¹⁸ *Id.* at 682.

stantially encourage violations of section 10(b) and rule 10b-5 by keeping silent, and thereby incur liability.

There are other factors to be considered before it can be concluded that imposition of such a duty is desirable. Professor Bromberg has expressed the fear that bystanders could be found liable as easily as violators, because the standards for aiding and abetting are too vague.¹¹⁹ He suggests that a higher level of knowledge or benefit should be required before a failure to speak out can be considered aiding and abetting. These additional requirements, however, may be little help to the accounting profession. Although the benefit contemplated by Professor Bromberg is something more than the benefit of receiving a fee for professional services,¹²⁰ a strong argument can be made for imputing a high level of knowledge to accountants because of their close association with a client's financial records. No court has as yet adopted the *Brennan* theory regarding silence and, in fact, the *Fischer* and *Wessel* courts specifically refused to do so. But it remains impossible to say that under no set of facts could an accountant give "substantial encouragement or assistance" to violators of the securities laws by failing to disclose the potential fraud.

The reliance that the public justifiably places in the affirmative representations of independent public accountants has led to other burdens being imposed on them under section 10(b) and rule 10b-5. Because of this special reliance, the court in *Drake v. Thor Power Company*¹²¹ declared that it was not necessary that the misrepresentation be intentional in order for an accountant to be held responsible where there is reliance because the effect on the investor is the same regardless of intent. This also obviates the need for the defrauded party to prove that the accountant benefitted from the misrepresentation.¹²² Privity also is not required.¹²³

Thus it is apparent that accountants can be liable for any misleading statement that can be reasonably construed as being "in connection with" the purchase or sale of securities. They also may be liable if any of their activities can be construed as encouraging the

¹¹⁹ A. BROMBERG, SECURITIES LAWS: FRAUD — S.E.C. RULE 10B-5 § 8.5, at 533 (1969).

¹²⁰ *Id.* § 8.5 at 584.

¹²¹ 282 F. Supp. at 94 (N.D. Ill. 1967).

¹²² *See* 282 F. Supp. at 105.

¹²³ *See* BROMBERG, note 121 *supra*, at 583. Professor Bromberg states that the standard articulated in *Drake* is the most relaxed yet under rule 10b-5 and that it may apply only to independent certifying accountants.

use of misleading statements in a transaction. Accountants should be aware that potential civil liability under section 10(b) and rule 10b-5 has made them responsible to the purchaser rather than their client. In this way, the goal of full and fair disclosure in securities transactions can be attained.

E. *Threat of Criminal Action*

Recent case authority has added a new dimension to accountants' liability to clients and third parties. In *United States v. Simon*¹²⁴ the court of appeals affirmed the imposition of criminal penalties upon accountants who failed to disclose information regarding the likelihood of an affiliate's outstanding debt being repaid, knowledge of which they had learned in the course of preparing a routine annual audit. The accountants were aware of the fact that collateral used to secure the particular debt was in fact inadequate¹²⁵ and that the debt itself had been improperly indicated on the financial statements. The accountants certified the statements and soon thereafter the company failed. The Government charged the accountants with the violation of federal statutes which prohibit the filing of false financial reports with the United States,¹²⁶ mail fraud,¹²⁷ and filing false reports with the Securities and Exchange Commission.¹²⁸

At the trial there was conflicting testimony by expert witnesses as to whether applicable professional standards required disclosure in this situation. The eight defense experts¹²⁹ all agreed that neither generally accepted accounting principles nor auditing standards required disclosure of the nature of the collateral or the increase in the receivables. On the other hand, the Government's two experts presented conflicting testimony.¹³⁰ All of the expert witnesses agreed that there is no official declaration by either the Accounting Institute or the SEC which recognizes a specific obligation either to require disclosure or to inquire into affiliates. The court determined that the issues of whether the financial statements fairly presented

¹²⁴ 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 400 U.S. 827 (1970).

¹²⁵ The bulk of the collateral, approximately 80 percent, was the company's own stock and convertible debentures.

¹²⁶ 18 U.S.C. § 1001 (1964).

¹²⁷ 18 U.S.C. § 1341 (1964).

¹²⁸ 15 U.S.C. § 78ff (1964).

¹²⁹ Defendant's eight expert witnesses were six accounting practitioners, a professor of accounting, and a former Chief Accountant of the SEC.

¹³⁰ The government's two expert witnesses were the Chief Accountant of the SEC and an SEC staff accountant.

the financial position of the company, and whether the defendants acted in good faith should be determined by the jury. The jury subsequently convicted the defendants on all counts.¹³¹ In affirming the conviction, the United States Court of Appeals for the Second Circuit held that the jury was not bound to accept expert testimony that an honest judgment had been made by the defendants, and that the finding of the jury was reasonable.¹³²

Simon underscores the need for the accounting profession to establish more uniform standards with a narrowed range of choices so that a more objective basis for evaluating an auditor's professional performance can be established.¹³³ The case also shows the need for the accounting profession to educate the public on the function performed by an auditor and the responsibility assumed by the certifying auditor. Criminal prosecutions will probably continue to play a minor role compared to civil, administrative, and professional actions in ensuring that accountants live up to the standards and principles laid down by the profession and the courts.

CONCLUSION

The significant number of law suits instituted by investors against accountants has resulted in plaintiffs' recovering against accountants in heretofore untested situations. Accountants will likely be able to resist their clients' attempts to influence the content of financial statements once they point to examples in which accountants have been held liable to investors. The financial statements which the independent public accountant audits and certifies are relied upon by creditors and investors as representing fully and fairly the financial condition of his client. Thus, the accountant shares the responsibility as a party with superior knowledge, to prevent fraud and make disclosure of facts which he learns are erroneous. The accounting profession can either take the preferred path of greater self-regulation or expect an increasing number of civil and criminal cases imposing ever broader liability on the profession.

¹³¹ No jail sentences were imposed but the defendants were fined up to \$7,000.

¹³² See 425 F.2d at 806.

¹³³ For the same conclusion see, Note, *Federal Criminal and Administrative Controls for Auditors: The Need for a Consistent Standard*, 1969 WASH. U.L.Q. 187. See also Note, *Accountants — Auditors — Compliance with General Accounting Principles Not a Complete Defense to Criminal Fraud*, 23 VAND. L. REV. 809 (1970).