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# Licenses--Accountants' Liability--Duty to Disclose [*Fisher v. Kletz*, 266 F. Supp. 180 (S.D.N.Y. 1967)]

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that has been adopted by California and Colorado.<sup>31</sup> This procedure differs from *Raskin* only in that it provides separate juries and sometimes separate judges for the determination of the issues of guilt and insanity. The jury that determines the insanity issue in the second trial is free from evidence which was presented on the issue of guilt and may without prejudice determine the defendant's mental responsibility. The split trial procedure has been recognized by several writers as the best possible solution to the problem which lies in the conflict between compulsory mental examinations and the right of an accused to have a fair trial.<sup>32</sup> On the other hand, the major criticism of the split trial method is that it is too costly and time consuming.<sup>33</sup> While the validity of this criticism is unquestionable, it may well be that the split trial procedure is the only one which meets the demands of the Constitution.

JOEL MAKEE

LICENSES — ACCOUNTANTS' LIABILITY —  
DUTY TO DISCLOSE

*Fischer v. Kletz*, 266 F. Supp. 180 (S.D.N.Y. 1967).

The common law duty of accountants has been defined in *Ultra-mares Corp. v. Touche*<sup>1</sup> as a duty flowing to those persons who rely on the representations made by accountants. Liability of accountants has been restricted to those cases in which the accountant is deemed to have been "grossly negligent." Recently, however, a federal district court in *Fischer v. Kletz*<sup>2</sup> suggested that under both the common law and the federal securities statutes accountants' duties should be more strictly construed and their liability more liberally interpreted.

The plaintiffs in *Fischer v. Kletz* were present and former owners of shares or debentures of the Yale Express System, Inc.

<sup>31</sup> CAL. PEN. CODE § 1026 (West 1956); COLO. REV. STAT. ANN. § 39-8-3 (1963).

<sup>32</sup> Comment, *supra* note 1, at 681-83; Note, *supra* note 1, at 102-04. The merit of the split trial procedure is also recognized by the medical profession. Bowman, *Psychiatry and Criminal Responsibility*, 57 J. MB. MEDICAL ASS'N 5 (1966).

<sup>33</sup> Note, *supra* note 1, at 103; Comment, *supra* note 1, at 681; Note, *Pre-Trial Mental Examination and Commitment*, 51 GEO. L.J. 143, 155-56 (1962). See generally Louissell & Hazard, *Insanity as a Defense: The Bifurcated Trial*, 49 CALIF. L. REV. 805 (1961).

They brought a class action against the public accounting firm of Peat, Marwick, Mitchell & Co. (PMM), alleging that Yale's 1963 year-end financial statements prepared and certified by PMM as independent public accountants<sup>3</sup> were materially misleading because they overstated Yale's net worth and failed to indicate a substantial operating loss. Despite PMM's subsequent discovery of the errors while serving as a dependent public accountant doing special accounting studies for Yale in early 1964, PMM did not reveal the inaccuracies of the annual report until May of 1965. Moreover, during the ensuing period PMM had acquiesced when Yale issued misleading interim reports. Plaintiffs claimed, as a result of PMM's silence, to have suffered as pecuniary damages the reduction in the value of Yale securities and brought their claim relying on: (1) common law deceit, alleging that the accounting firm knew that its audit and certificate would be relied upon by the public, and that PMM therefore had a continuing duty to alert the public of the material omissions; (2) section 18(a) of the Securities Exchange Act of 1934<sup>4</sup> (Exchange Act) on the theory that the defendants caused a false statement or report to be filed with the Securities Exchange Commission (SEC); (3) section 10(b)<sup>5</sup> and rule 10b-5<sup>6</sup> promulgated under the Exchange Act for the defendant's materially misleading statement and failure to correct the statement in the sale of a security; and (4) rule 10b-5 for defendant's act of aiding and abetting Yale in the fraudulent sale of securities.<sup>7</sup>

Typically the plaintiff alleging fraud has had to show that the

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<sup>1</sup> 255 N.Y. 170, 174 N.E. 441 (1931). Judge Cardozo held that an accountant's "gross negligence" could result in technical or constructive fraud. If fraud is present a right of action is open to anyone who suffered injury because he relied upon the accountant's report. Judge Cardozo, however, refused to hold the defendants liable on the theory of negligent misrepresentation.

<sup>2</sup> 266 F. Supp. 180 (S.D.N.Y. 1967).

<sup>3</sup> An *independent* public accountant owes his primary duty to the public. A *dependent* public accountant, on the other hand, owes his primary duty to his client in their business relationship. During the preparation of Yale's annual report, PMM was an independent public accountant. Following certification of the report PMM became a dependent accountant employed by Yale to undertake special studies. The resulting issue became whether PMM had a continuing obligation to the public, superior to the duty it owed to its client, to report subsequently discovered information concerning the accuracy of the annual report it had certified. *Id.* at 182-84.

<sup>4</sup> 15 U.S.C. § 78(r) (1964).

<sup>5</sup> 15 U.S.C. § 78(j) (1964).

<sup>6</sup> 17 C.F.R. § 240.10b-5 (1967).

<sup>7</sup> In other litigation dealing with the same controversy, PMM had been unsuccessful in moving to dismiss or in the alternative, for a stay of proceedings. 249 F. Supp. 539 (S.D.N.Y. 1966). Defendants likewise were unsuccessful in their objection to plaintiffs' class action. 41 F.R.D. 377 (S.D.N.Y. 1966).

defendant has made a false representation of a material fact, with knowledge of its falsity and with intent to deceive, and with action taken thereon and damage resulting therefrom.<sup>8</sup> But here the alleged breach of duty confronting the court was a *nondisclosure* rather than an *affirmative misrepresentation*. The court relied on the theory that statements made in commercial settings are actionable if one fails to disclose to another a fact which he knows may induce the other to act or refrain from acting.<sup>9</sup> Arguing by analogy to *Loewer v. Harris*,<sup>10</sup> the court concluded that the form of the representation, whether it is affirmative or a tacit nondisclosure, is not crucial; rather, the significant factor is its impact upon the person it induces to act.<sup>11</sup>

Another problem facing the court was the defendant's allegation that gain by defendant, which was absent here, is a necessary element in an action based on nondisclosure. The court indicated that prior cases involving affirmative misrepresentations did not require proof of gain but allowed the action of deceit regardless of the defendant's interest in the transaction.<sup>12</sup> The court suggested that the requirement of intent in a deceit action<sup>13</sup> may be satisfied by imputing intent: (1) when the defendant says nothing while knowing that his representation will be relied upon by others; or (2) if through an objective analysis, the defendant falls below an imposed duty to disclose.<sup>14</sup> The effect of either is to shift to the defendant the burden of disproving intention. The court, in denying the defendant's motion to dismiss the common law action, has in effect suggested that PMM could be found liable for negligent

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<sup>8</sup> Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?*, 57 Nw. U.L. REV. 627 (1963).

<sup>9</sup> 266 F. Supp. at 185; see *Miller v. Bargain City, U.S.A., Inc.*, 229 F. Supp. 33 (E.D. Pa. 1964); RESTATEMENT OF TORTS §§ 551(1)-(2) (1938).

<sup>10</sup> 57 F. 368 (2d Cir. 1893), in which the defendant failed to disclose a change in business conditions and the plaintiff relied on the defendant's original representations to his detriment.

<sup>11</sup> 266 F. Supp. at 185-86.

<sup>12</sup> *James-Dickinson Farm Mortgage Co. v. Harry*, 273 U.S. 119 (1927) (intentional inducement to act); *Goldsmith v. Koopman*, 140 F. 616 (S.D.N.Y. 1905) (intentional nondisclosure); *Endsley v. Johns*, 120 Ill. 469, 12 N.E. 247 (1887) (defendant's fraudulent misrepresentation of a check); *Pasley v. Freeman*, 100 Eng. Rep. 450 (K.B. 1789).

<sup>13</sup> The requirement of proof of intent as an essential element of a deceit action was established in *Derry v. Peck*, 14 App. Cas. 337 (1889) and many courts still consider it a requisite to maintaining the fraud action. See, e.g., *Weber v. C.M.P. Corp.*, 242 F. Supp. 321 (S.D.N.Y. 1965). But see, e.g., *Hedley Byrne & Co. v. Heller & Partners, Ltd.*, [1963] 3 W.L.R. 101 (suggesting that the intent requirement of *Derry v. Peck* should no longer be held to control).

<sup>14</sup> 266 F. Supp. at 188-89.

misrepresentation or deceit with the element of intent being presumed.<sup>15</sup>

The plaintiffs also sought recovery under section 18(a) of the Exchange Act,<sup>16</sup> which imposes liability upon *any* person who knowingly makes a false or misleading statement or report filed pursuant to *any* rule or regulation of the Exchange Act.<sup>17</sup> Moreover, the section does not limit liability to any particular type of statement or report and extends the civil remedy to any person injured by a false report.<sup>18</sup> Plaintiffs contended that the filing of Yale's annual report with the SEC containing PMM's false certification was the equivalent of the filing of a false statement within the language of the statute. The court in denying PMM's motion to dismiss concluded that the question of whether PMM was liable under the section would depend upon defendant's knowledge prior to the filing of the annual report that the statements it had certified were false.<sup>19</sup>

Plaintiffs further argued that they were entitled to relief under section 10b and rule 10b-5 of the Exchange Act.<sup>20</sup> Rule 10b-5 extends liability to any person, who directly or indirectly: (a) employs a scheme to defraud; (b) makes a misleading statement or material omission which he fails to correct; or (c) engages in a fraudulent practice in connection with the purchase or sale of any security.<sup>21</sup> The district court found that a civil remedy exists under rule 10b-5

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<sup>15</sup> In a recent case dealing with an action based on negligent misrepresentation, *Texas Tunneling Co. v. City of Chattanooga*, 204 F. Supp. 821 (E.D. Tenn. 1962), *rev'd*, 329 F.2d 402 (6th Cir. 1964), the appellate court noted that although the case would have to be reversed because of a controlling Tennessee decision, *Howell v. Betts*, 211 Tenn. 134, 362 S.W.2d 924 (1962) which did not extend liability for negligent misrepresentation, given the proper facts, such an action could be maintained. *Cf. Biankja v. Irving*, 49 Cal. 2d 647, 320 P.2d 16 (1958).

<sup>16</sup> 15 U.S.C. § 78(r) (1964).

<sup>17</sup> *Id.*

<sup>18</sup> *See Hoover v. Allen*, 241 F. Supp. 213 (S.D.N.Y. 1965); *Miller v. Bargain City, U.S.A., Inc.*, 229 F. Supp. 33 (E.D. Pa. 1964).

<sup>19</sup> 266 F. Supp. at 189. Although the opinion of the court did not indicate the fact, it should be noted that section 18(a) requires that the moving party must have purchased in reliance on the statement and that the statement must have caused the damage for which relief is sought. The suggestion has been made that while the misleading statement is likely to have an effect on the market price of the security, it is extremely unfair to place the burden of proof on the plaintiff, and that the reliance requirement can be established without requiring that the plaintiff have read the document complained of because of the generally recognized fact that the information filed with the Securities Exchange is more likely to reach the plaintiff by indirect means. 3 L. LOSS, *SECURITIES REGULATION* 1753 (2d ed. 1961).

<sup>20</sup> 15 U.S.C. § 78(j) (1964); 17 C.F.R. § 240.10b-5 (1967).

<sup>21</sup> 17 C.F.R. § 240.10b-5 (1967).

for defrauded investors.<sup>22</sup> However, taking the plaintiffs' allegations as true, the court faced the problem of finding a theory by which the defendant could be brought within the remedial provisions of rule 10b-5.

Prior to *Fischer v. Kletz*, parties under rule 10b-5 had successfully maintained actions against four classes of defendants. The first three classes consisted of insiders, broker-dealers, and corporations; common to these was the potential of economic gain resulting from fraudulent practices. The fourth category related to those who aided and abetted the first three.<sup>23</sup> The problem confronting the *Fischer* court was finding a theory on which liability could be extended to an accounting firm that stood to receive no economic advantage through its silence.<sup>24</sup>

The court argued that *H. L. Green Co. v. Childree*<sup>25</sup> and *Pettit v. American Stock Exchange*<sup>26</sup> both supported the finding that one who achieves no economic advantage, or remains inactive when he has a duty to disclose, may be found liable under the section. But, as the district court pointed out in both *H. L. Green Co.* and *Pettit*, liability was predicated upon allegations of aiding and abetting, a class wholly within a traditional rule 10b-5 action. The plaintiffs in *Fischer v. Kletz* had made no aiding or abetting allegation in regard to the annual report liability,<sup>27</sup> and the court did not present a compelling reason for subjecting PMM to liability under rule 10b-5. In fact, the court simply concluded that the defendant's motion to dismiss should be denied on the theory that the case

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<sup>22</sup> 266 F. Supp. at 190; see, e.g., *Miller v. Bargain City, U.S.A., Inc.*, 229 F. Supp. 33 (E.D. Pa. 1964). *Contra*, *Jordan Bldg. Corp. v. Doyle, O'Connor & Co.*, [1966-1967 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,996, at 96,382 (N.D. Ill. June 28, 1967) (denial of plaintiff's action on the theory that purchasers are not entitled to a remedy under rule 10b-5).

<sup>23</sup> 266 F. Supp. at 190.

<sup>24</sup> The court could have rationalized its denial of PMM's motion on the theory that the fee received by the accountant to perform the audit satisfied the economic gain requirement.

<sup>25</sup> 185 F. Supp. 95 (S.D.N.Y. 1960).

<sup>26</sup> 217 F. Supp. 21 (S.D.N.Y. 1963).

<sup>27</sup> Plaintiffs alleged that PMM had aided and abetted Yale in the issuance of *fraudulent interim reports* violating section 10(b) and rule 10b-5. The court denied the defendant's motion to dismiss and indicated that the action might be successful if the plaintiffs could show at trial that the defendants had given substantial assistance or encouragement to Yale's course of conduct. The court seemed to have no difficulty in placing PMM in the aiding and abetting class of rule 10b-5 defendants. 266 F. Supp. at 189-94.

"raises novel and difficult issues"<sup>28</sup> important enough to require further factual and legal development.

The *Fischer* court could have based its decision on either of two theories. First, if the purpose of the Exchange Act is to insure the widest possible distribution of information about corporate affairs for investor protection,<sup>29</sup> it would be inconsistent with this purpose to deny a remedy simply because the remedy has not been given before. Second, the opinion of Chairman Cary in *Cady, Roberts & Co.*<sup>30</sup> suggests that PMM could be included in the class of 10b-5 defendants. The Chairman stated that the duty to disclose arose "first, [from] the existence of a relationship giving access, directly or indirectly to information intended to be available only for a corporate purpose and second, the inherent unfairness involved where a party takes advantage of such information knowing that it is unavailable to those with whom he is dealing."<sup>31</sup> To effectuate the purposes of the Exchange Act, the Chairman's statement must be liberally interpreted as imposing a duty to disclose upon *any* individual having access to corporate information that should be divulged to the investing public, rather than restricting the application of rule 10b-5 to corporate insiders.

It is also arguable that since accountants hold themselves out as members of a skilled profession to be relied upon by the public, they should be responsible for their failure to maintain the highest professional standards.<sup>32</sup> Accountants have recognized that the opinions they express in financial statements may be relied upon by third persons.<sup>33</sup> Moreover, their ethical code requires disclosure of misleading statements or material omissions in the reports they certify.<sup>34</sup> Breach of this duty to disclose should require the imposition of liability as suggested by *Fischer v. Kletz*. However, accountants can argue that the duty to disclose does not apply to subsequently

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<sup>28</sup> *Id.* at 194.

<sup>29</sup> *The Prospects for Rule X-10-5: An Emerging Remedy for Defrauded Investors*, 59 YALE L.J. 1120 (1950).

<sup>30</sup> 40 S.E.C. 907 (1961).

<sup>31</sup> *Id.* at 912.

<sup>32</sup> See *Smith v. London Assurance Corp.*, 109 App. Div. 882, 96 N.Y.S. 820 (Sup. Ct. 1905).

<sup>33</sup> J. CAREY & W. DOHERTY, *ETHICAL STANDARDS OF THE ACCOUNTING PROFESSION* (1966). "Investors, credit grantors, prospective purchasers of businesses, regulatory agencies of government, and others may rely on a CPA's opinion that financial statements fairly reflect the financial position and results of operations of the enterprise which he has audited." *Id.* at 19.

<sup>34</sup> AICPA CODE OF PROFESSIONAL ETHICS art. 2, § 2.02.

discovered information,<sup>35</sup> and even if it did, they would not be permitted to reveal such information if they had entered into a confidential dependent relationship such as PMM did when undertaking the special studies for Yale.<sup>36</sup> Moreover, the effect of such a rule, as suggested by *Fischer*, would be too burdensome. For example, it could make the accountants insurers for the investing public;<sup>37</sup> it could expose them to being joined as party defendants in actions against corporations for whom they have prepared financial statements; it could encourage corporations to change independent public accountants yearly to protect themselves from accountants' disclosures; it could contribute to inaccurate financial reporting because the accountant would not be familiar with the corporation's business and accounting techniques; and finally, confusion and injustice could result in the absence of a clear delineation of what was to be subsequently disclosed, how it should be disclosed, and how long the duty to disclose should last.<sup>38</sup>

However, to refuse to extend the civil liability of accountants just because problems will be created is no answer. This is especially so in light of the broad provisions of the federal securities acts which were designed to establish at least a minimum standard for investor protection<sup>39</sup> as well as the evolving trend of the common law toward extending liability to those who hold themselves out to public reliance.<sup>40</sup> The considerations that should be determinative as to whether the accountants shall be held liable are the extent to which their failure to disclose erroneous information in a financial report affected the public, the foreseeability of harm that would result if the disclosure were not made, and the policy of preventing

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<sup>35</sup> *But see* 1 CPA HANDBOOK ch. 6, at 40 (R. Kane ed. 1952) (an accountant has the duty to disclose subsequently acquired information where he knows the report he has certified will be used in a registration statement).

<sup>36</sup> AICPA CODE OF PROFESSIONAL ETHICS art. 1, § 1.03. The question is thus raised as to whom the public accountant owes the primary duty, to the investors, or to the employer. *Fischer* suggests it is owed to the public. *See Touche, Niven, Bailey & Smart*, 37 S.E.C. 629 (1957).

<sup>37</sup> *Ultramares Corp. v. Touche*, 255 N.Y. 170, 174 N.E. 441 (1931). Judge Cardozo suggested that "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 indeterminate amount for an indeterminate time to an indeterminate class." *Id.* at 179, 174 N.E. at 444.

<sup>38</sup> 266 F. Supp. at 188-89.

<sup>39</sup> *See* *Fleischer, Federal Corporation Law: An Assessment*, 78 HARV. L. REV. 1146 (1965).

<sup>40</sup> *See* cases cited note 15 *supra*; W. PROSSER, TORTS § 102 (3d ed. 1964).