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ULTRAMARES REVISITED: A MODERN STUDY OF ACCOUNTANTS' LIABILITY TO THE PUBLIC

KENNETH IRA SOLOMON*

THE LAST few years have witnessed an increasing quantity of lawsuits brought by third parties against accountants many of which have involved claims for damages in the millions of dollars.¹ A recent editorial in the leading professional periodical pointed out that widespread publicity is given to suits against large firms of accountants for "astronomical" amounts but small accounting firms are also being subjected to claims for amounts which, while much less in absolute terms, would financially ruin the CPA-partners if the litigation by the third parties were successful.² The editorial further went on to surmise that the cause of the sudden spurt in such claims seems to be the fact that banks and other financial institutions are increasingly hoping that accounting firms can be made a source of salvage when loans go bad or credit losses occur.³

This bit of conjecture might well be supported when the following account from the *Wall Street Journal* is considered:

Four banks, including Bank of America, San Francisco, and Chase Manhattan Bank, New York, are suing Peat, Marwick, Mitchell & Co., a nationwide certified public accounting concern for a total of \$6,113,230 in damages.

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¹ The recent increase in suits directed against accounting firms is well diagramed by Heinemann, *Accountant Role Undergoing Test*, N.Y. Times, March 27, 1966; Sec. 3, at 1, col. 3.

² Editorial, *The Specter of Auditors' Liability*, 120 J. Accy. (No. 3, September 1965) 33.

³ *Id.*

The suits, filed in Marin County Superior Court near San Francisco, charge that the accounting firm issued statements that were "misleading" in some respects about the finances for 1958 through 1960 of Otis, McAllister & Co., a large San Francisco-based coffee importer declared bankrupt in 1963. Bank of America is suing for \$3,550,885 and Chase Manhattan for \$1,132,990. In addition, Wells Fargo Bank & Trust Co., San Francisco, claims \$699,355, and Henry Schroder Banking Corp., New York, seeks \$730,000. Several individual partners of the accounting company [firm] also were named defendants.

The plaintiffs charge that in the years at issue Otis-McAllister hadn't always repaid a bank with proceeds from selling a specific lot of coffee the bank had financed, but did so from proceeds of collateral pledged to another lender. The banks contend that Peat, Marwick was aware of this situation or should have known about it, and that its financial reports on the company failed to point up the matter. A spokesman at Peat, Marwick's New York headquarters said the company [firm] denied "absolute liability" in the case. He said the banks "had reason to know what was going on, but they didn't do anything about it." At one point, according to the accounting official, the banks offered to settle the disputed liability for about \$1.3 million. But, he said, Peat, Marwick's insurers decided against this approach "and chose to have the matter litigated on its merits."⁴

Excerpts from the complaint which was filed in the *Bank of America* case⁵ along with analytical comments thereon appear in *Appendix B* of this study.⁶ This suit and the publicity it has spawned further serve to illustrate that the number of accountant lawsuits, and the level of damages being sought by third parties, are mounting steadily toward unbelievable enormity.⁷ It is generally agreed upon by jurists and legal commentators that the law of accountants' liability to third parties, although giving the surface impression of well-settled doctrine, is still far from being crystal clear even at this late and crucial date. Our first step, then must be the consideration of what seem to be the traditional concepts of the independent accountants' legal responsibilities to third parties.

The standard of care applicable to the determination of whether an independent accountant has exercised due care in his conduct of an

⁴ *Accounting Firm Sued by 4 Banks for a Total of \$6,113,230 Damages*, The Wall Street Journal, May 15, 1965.

⁵ *Bank of America v. Peat, Marwick, Mitchell & Co.*, No. 42748 (Superior Court of Marin County, California, 1968).

⁶ Continuous correspondence between this writer and Eldon C. Parr, Counsel for the Bank of America, has revealed that the case was only recently settled. Unfortunately, the terms of the settlement did not permit him to disclose the details of the settlement. Letter from Eldon C. Parr, Counsel, Bank of America, Legal Dept., San Francisco, California, April 8, 1968. There can be little doubt about the felt need for secrecy on the part of the defendant-CPA firm, because of the great threat of generating future litigation by those hungry for dollars in settlement of nuisance claims.

⁷ See also The Wall Street Journal, Nov. 15, 1966, at 1, col. 6.

audit examination is similar to the standard applied to doctors, lawyers and other professional experts, in that their conduct is not measured in terms of the customary "reasonable man" test of negligence but rather in terms of a "reasonable CPA" test.⁸ Why this favored treatment? Primarily, the fact that the services rendered by these groups are considered to be highly skilled;⁹ there exist internal codes of ethics and standards of performance established through self-organization;¹⁰ and the public's relative ignorance of the technical ramifications involved in the performance of the complex services rendered by these groups¹¹ create the need for a specialized standard of care to be utilized by judge and jury in evaluating the conduct of independent accountants,¹² doctors,¹³ engineers¹⁴ and lawyers.¹⁵ A direct offshoot of the special negligence standard or "professional measuring stick" is the problem of expert testimony and the related ethical effects brought about by attempts at professional policing of such testimony.¹⁶ The ethical overtones as well as the apparent lack

⁸ *Dantzler Lumber & Export Co. v. Columbia Casualty Co.*, 115 Fla. 541, 156 So. 116 (1934); *Gammel v. Ernst & Ernst*, 245 Minn. 249, 72 N.W.2d 364, 54 A.L.R.2d 316 (1955); *Rassieur v. Charles*, 354 Mo. 117, 188 S.W.2d 817 (1945). See generally Curran, *Professional Negligence—Some General Comments*, 12 VAND. L. REV. 535, 538-540 (1959); RESTATEMENT OF TORTS § 290F, comment e and § 299C, comment b.

⁹ RESTATEMENT OF TORTS, *supra* note 8.

¹⁰ The tendency to self-regulate and establish codes of ethical conduct and uniform standards of performance while determinative of "professional" status and hence reliability for internal policing of the ranks may likewise serve as a device for dangerous disregard of the public's interest. Some balance is obviously optimally desirable. See *Morris, Custom and Negligence*, 42 COLUM. L. REV. 1147, 1163-1167 (1942).

¹¹ See James and Sigerson, *Particularizing Standards of Conduct in Negligence Trials*, 5 VAND. L. REV. 697, 710 (1952). Concern has been exhibited over leaving such technical matters to the jury at all. See Note, *Accountant's Liability*, 13 ST. JOHN'S L. REV. 310, 323, 326 (1939).

¹² See *Gammel v. Ernst*, *supra* note 8; *Smith v. London Assur. Corp.*, 109 App. Div. 882 96 N.Y.S. 820 (1905); Note, *The Accountant's Liability—For What and to Whom*, 36 IOWA L. REV. 319 (1951).

¹³ See REGAN, DOCTOR AND PATIENT LAW 17, 29-30 (3d ed. 1956). See also McCoid, *The Care Required of Medical Practitioners*, 12 VAND. L. REV. 549, 558-575 (1959), and cases cited in note 55 therein.

¹⁴ See *Cowles v. Minneapolis*, 128 Minn. 452, 151 N.W. 184 (1915); Bell, *Professional Negligence of Architects and Engineers*, 12 VAND. L. REV. 711 (1959).

¹⁵ See Note, *The Bases of the Attorney's Liability to His Client for Malpractice*, 37 VA. L. REV. 429 (1951).

¹⁶ See Curran, *supra* note 8, at 545, where it is suggested that the widespread reluctance to testify for plaintiffs in medical malpractice suits may represent a "conspiracy of silence."

of "professionalism" exhibited by recent CPA editorials and official pronouncements urging fellow certified public accountants not to testify "against" their colleagues will be considered later in this study.¹⁷

Traditionally, absent special statutory provisions, there has been no CPA liability for mere negligent conduct to third parties who were not in some contractual relationship—privity of contract—with the accountant at fault,¹⁸ with the possible exception of those instances where the accountant knew in advance that the specific third party was the one for whose *primary benefit* the statements audited by the independent accountant were intended.¹⁹ Third parties not in privity have, however, been allowed recovery where the independent accountant has participated in an intentional fraud or has been so reckless as to justify a finding of gross negligence (a concept not as yet adequately defined by the courts) sufficient to satisfy by inference the requisite intent necessary to constitute fraud. The special statutory provisions alluded to above are enacted as an integral part of the federal securities regulations of the 1950's, which not only permit a suit by a non-client lacking privity of contract on the basis of a false statement or omission in the financial statements, but also shift the burden of proof onto the defendant-accountant who must establish his freedom from negligence or fraud along with the fact that such negligence or fraud was not the proximate cause of the damages sustained by the plaintiff.²⁰ However, banks and similar credit lenders apparently cannot *as yet* take advantage of these provisions and bring an action thereunder,²¹ and the applicability of this federal

¹⁷ See notes 130 through 135 *infra* and the accompanying text. For the moment, let it merely be noted that, as well recognized by Spacek (*infra* note 131), testimony is not given "against" anyone but is proffered by a professional man as an expert witness *on the basis of facts* and it is *only upon these facts* which he offers his expert testimony.

¹⁸ Early efforts of legal commentators concentrated on establishing the accountant's *contract* with his employer as the basis for *any* duty to *any* party for negligent performance of his audit examination and resulting misstatements. See Rouse, *Legal Liability of the Public Accountant*, 23 KY. L.J. 3 (1934).

¹⁹ Early focus on the *contract* resulted in a correlated brigade of arguments against contributory negligence as a defense to such a non-tort action. See Comment, *The Legal Responsibility of Public Accountants*, 35 YALE L. J. 76 (1925); Rouse, *supra* note 18.

²⁰ These federal regulations are embodied in and have been promulgated under the Securities Act of 1933, 48 Stat. 74, and the Securities Exchange Act of 1934, 48 Stat. 881.

²¹ The Securities Acts apparently do not provide a remedy to such credit grantors. See Meek, *Liability of the Accountant to Parties Other Than His Employer for Negligent Misrepresentation*, 1942 WIS. L. REV. 371, 383-388. However, with the recent broad inter-

legislative remedy is likewise still apparently limited to special circumstances involving registration statements filed with the Securities and Exchange Commission as an incident to the offering of listed securities. Thus, much of the potential third party causes of action fall outside the sphere of coverage presently envisioned by the federal courts in their interpretation of these statutes.

Recent litigation under Section 10(b) of the Securities Exchange Act of 1934²² has nevertheless witnessed a massive expansion of the scope of CPA liability thereunder. In *Green v. Childree*,²³ a federal court held for the first time that certified public accountants whose activities were confined to the preparation of false and misleading financial statements and representations were not immunized from civil suit brought by investors under Rule 10b-5²⁴ as a "participant" in a sale of securities where the investor's purchase was induced by such statements. With this holding as a foundation, the United States District Court for the Southern District of New York, in *Fischer v. Kletz*,²⁵ in denying the defendant CPA firm—Peat, Marwick, Mitchell & Co.'s²⁶ motion to dismiss claims based on Section 10(b) and Rule 10b-5, implied that:

- (1) The element of a "gain" to the defendant, found so crucial in prior Section 10(b) civil actions,²⁷ was not necessary in cases

pretations of a "security" sanctioned by the courts, this exclusion of credit grantors from the penumbra of Securities Act protections may be questionable today. See Coffey, *The Economic Realities of a 'Security': Is There A More Meaningful Formula?* 18 WEST. RES. L. REV. 367 (1967).

²² 15 U.S.C. § 78j(b) (1963).

²³ *Green v. Childree*, 185 F. Supp. 95 (S.D.N.Y. 1960).

²⁴ 17 C.F.R. 240.10b-5 (1968) provides: "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, (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 the 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."

²⁵ *Fischer v. Kletz*, 266 F. Supp. 180 (S.D.N.Y. 1967).

²⁶ Peat, Marwick, Mitchell & Co. were the auditors for Yale Express System, Inc. For an interesting and penetrating analysis of the economic and financial background of the Yale Express fiasco which eventually resulted in *Fischer v. Kletz* litigation, see Whalen, *The Big Skid at Yale Express*, FORTUNE, November 1965, at 144.

²⁷ See, e.g., *Cochran v. Channing Corporation*, 211 F. Supp. 239 (S.D.N.Y. 1962); *SEC v. Texas Gulf Sulphur Co.*, 258 F. Supp. 262 (S.D.N.Y. 1966).

involving nondisclosure in a report *required to be filed with the SEC* where the "unique" liability of accountants for nondisclosure is at issue;²⁸ and

- (2) Even though the relationship between the accountants and the plaintiff-debenture-holders and shareholders is an important circumstance, the lack of "privity," as that term has traditionally been defined in the law, does not necessitate the dismissal of a Section 10(b) action.²⁹

It is instructive to note the thinking of the court on the issues of "intent" and "privity" for the purpose of comprehending its refusal to dismiss the plaintiffs' *common law* tort cause of action founded on the nondisclosure of after-acquired information as well as for some "educated" speculation upon the future course of a "federal common law" of accountants' liability to third parties. On the former point, the district judge had this to say:

The imposition of the duty creates an objective standard against which to measure a defendant's actions and leaves no room for an analysis of the subjective considerations inherent in the area of intent. Thus, to base liability in part upon subjective standards of intent of the nondisclosing defendant would blur and weaken the objective basis of impact of nondisclosure upon the plaintiff. In the alternative, if this rationale be deemed unacceptable, it can be persuasively urged that in a nondisclosure case, *intent can be sensibly imputed* to a defendant who, knowing that plaintiff will rely upon his original representations, sits by silently when they turn out to be false. (Emphasis added)³⁰

The district judge responded to the defendant firm's privity argument with an excerpt from the opinion of Judge Lord in the recent case of *Miller v. Bargain City, U.S.A., Inc.*³¹ "In my judgment, it would be an unwarranted constriction of the broad protection contemplated by the federal scheme of securities legislation to engraft upon that scheme a requirement that is neither a part of the statute nor a part of the governing common law tort principles."³²

²⁸ *Fischer v. Kletz*, *supra* note 25, at 191; the court cites Fleischer, 'Federal Corporation Law': An Assessment, 78 HARV. L. REV. 1146, 1156 (1965).

²⁹ *Fischer v. Kletz*, *supra* note 25, at 192-93; See also Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?*, 57 NW. U. L. REV. 627 (1963); 19 CASE WEST. RES. L. REV. 387, 394 (1968), wherein it is concluded that *Fischer* "suggests a significant extension of accountants' liability under both the common law and the federal securities regulations."

³⁰ *Fischer v. Kletz*, *supra* note 25, at 188.

³¹ *Miller v. Bargain City, U. S. A., Inc.*, 229 F. Supp. 33, 37 (E.D. Pa. 1964).

³² *Fischer v. Kletz*, *supra* note 25, at 193.

One might quite legitimately consider this summary dismissal of the ancient prerequisite to negligence liability—"privity"—an analytical shame. Perhaps, this is one of the sacrifices associated with the "nationalization" of an entire body of legal liability principles under the guise of a predominant federal interest.³³

Before we can intelligently consider the possible and probable changes in the common law of accountants' liability to third parties which we may expect to observe or encounter in the very near future in light of these federal securities cases, emerging tort law concepts and current socio-economic conditions, a new look at the traditional concepts of the CPA's liability to third parties is essential. This re-examination will proceed, at first, primarily through a "revisitation" to the *Ultramares* decision, which still stands as the keystone for the entire area of accountants' legal liability to third parties.

The earliest decision directly concerned with a certified public accountant's liability to a third party not in privity in the United States was *Landell v. Lybrand*,³⁴ decided in 1919. The defendant-CPAs audited the books and accounts of the Employers' Indemnity Company for the year 1911. The plaintiff, having been shown the defendant's report by someone touting that company's stock, averred that he had been induced to buy eleven shares of the capital stock of the company, at the price of \$200 per share, on the strength of Lybrand's report as to its client's assets and liabilities at the close of the business year 1911. A further contention was that the report was false and untrue and that the stock purchased on the strength of the report was value-

³³ Kessler, *Court Decision Prods Prospectus Preparers to Check Facts Better*, *The Wall Street Journal*, May 14, 1968, at 1, col. 6, commented upon the opinion of Federal District Judge Edward C. McLean in his March 29 decision in *Escott v. Bar-Chris Construction Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968), where it was held that underwriters, lawyers, auditors and directors all were blameworthy for false financial information contained in a prospectus. Kessler comments upon this landmark decision as follows: "The decision is likely to mean that everyone connected with a registration will be much more meticulous than in the past. . . . In theory, it means that nearly everyone involved must check every material fact himself by plodding through company records." Kessler also points out that: "He (Judge McLean) also ruled that the accountants in the *Bar-Chris* case were liable for the portions of the prospectus they had worked on because they had failed to show due diligence. He ruled that they had never ascertained whether there had been important changes in the company's financial situation in the months after their audit but before the registration. There had been an important change, the judge said." This type of loose decision may well represent the vogue of the near future—underwriters and corporate lawyers, as well as accountants, beware!

³⁴ *Landell v. Lybrand*, 264 Pa. 406, 107 A. 783 (1919).

less. Based upon these allegations, the plaintiff-stockholder's cause of action was framed in terms of "trespass for negligence." The defendant CPA firm demurred on the ground that the stockholder's statement of his claim failed to disclose a meritorious cause of action. Hence, the court, procedurally taking as true the averments by the stockholder, was for the first time confronted with a "pure" question of legal theory: Is a CPA liable for *negligence* to a *stockholder* who *relied* on the accountant's false and untrue financial report? The Pennsylvania Supreme Court weakly responded, holding Lybrand not liable because "the plaintiff was a stranger to the defendants and their report, and, as no duty rested upon them to him, they cannot be guilty of any negligence of which he can complain."³⁵ Unfortunately, the court did not enter into any discussion concerning the peculiar nature of the services performed by accountants or whether it is reasonable to foresee that stockholders or potential investors might rely on their certified financial reports. Rather, all that the Pennsylvania court did was to utter the above statement concerning absence of duty and cite a quite inapplicable case,³⁶ wherein the same court had decided that a job applicant could not recover damages for injuries suffered when visiting his potential employer's premises as a result of faulty construction and repair of those premises by a building contractor because the job applicant was a "mere licensee,"³⁷ and, hence, was owed no duty of care. A commentator at the time criticized *Landell* stating that both "its justice and expediency are questionable."³⁸

Judicial pronouncements such as *Landell v. Lybrand* have gone a long way toward clouding the law of accountants' liability as have

³⁵ *Id.* at 408.

³⁶ *Schiffer v. Sauer Co.*, 238 Pa. 550, 85 A. 479 (1913).

³⁷ *Id.* at 554. See also James, *Tort Liability of Occupiers of Land: Duties Owed to Licensees and Invitees*, 63 *YALE L. J.* 605 (1954).

³⁸ 29 *YALE L. J.* 234 (1919), wherein it is concluded: "[A]n attorney cannot reasonably be expected to foresee [sic] that strangers will probably act on his advice, for experience shows otherwise. And this reasoning seems to apply also to cases of physicians, because a doctor prescribes for a particular patient and does not intend, nor is it reasonably probable, that third parties will rely and act upon his advice to this particular patient. But neither of these classes of cases conflicts with the proposition that public accountants should be held liable to third parties for negligence, when it is reasonably foreseeable that third parties may act upon their audits. And if the courts will not impose this duty to [sic] the public, then it is submitted that this is a case for legislative enactment."

the blind reliances, by legal commentators³⁹ and jurists in subsequent cases, on the *Landell* holding without thoroughly considering the limited thought process and underlying precedential basis used by the Pennsylvania court in that early case.

This brings us to the famous case of *Ultramares v. Touche*.⁴⁰ In *Ultramares*, Judge Cardozo attempted to summarize, clarify, and expound for continuing future guidance the law of accountants' liability. Due to the recent flood of litigation⁴¹ involving third party efforts to recoup financial losses from certifying independent accountants, modern developments in the nature, scope and uniform character of the audit services rendered by the organized practice of public accounting,⁴² the apparent poor public image of the CPA—public misinformation about what he does and the responsibility he assumes, and public attitude favoring expansion of CPA legal liability, and emerging legal concepts in other areas of tort law and in the rapidly expanding field of federal securities regulation, Judge Cardozo's *Ultramares* opinion needs to be reviewed and critically analyzed once again at this crucial time, even though this task has been undertaken many times.⁴³ It must be noted, however, that most such efforts were put forth in the late thirties and early forties by innumerable scholars, not a small number of whom were overly-enamored with Cardozian logic⁴⁴ and might have been a bit biased in their analyses.

Ultramares was a *tort* action initiated against Touche, Niven & Co., a national firm of certified public accountants, for damages suffered through the misrepresentations made by the accountants in connection with their examination of, and report on, the financial records of Fred Stern & Co. as of December 31, 1923. The plaintiff presented its case

³⁹ See, e.g., MacMillan, *Sources and Extent of Liability of a Public Accountant*, 15 CHI-KENT REV. 1 (1936). Although quite dull and written in a summary fashion, it presents a survey of cases prior to and including *Ultramares*.

⁴⁰ *Ultramares Corporation v. Touche*, 255 N.Y. 170, 174 N.E. 441 (1931).

⁴¹ See, e.g., *supra* notes 2, 4; Heinemann, *supra* note 1; *The Wall Street Journal*, Nov. 15, 1966, at 1, col. 6; *supra* note 5.

⁴² See Broad, *The Progress of Auditing*, 101 J. ACCY. (No. 5, Nov. 1955) 38-43.

⁴³ Examples of these analyses are Seavey, *Mr. Justice Cardozo and the Law of Torts*, 48 YALE L. J. 390, at 412-422 (1939); Harper and McNeely, *A Synthesis of the Law of Misrepresentation*, 22 MINN. L. REV. 939 (1938); Rouse, *supra* note 18; Keeton, *The Ambit of a Fraudulent Representor's Responsibility*, 17 TEXAS L. REV. 1 (1938); Mac Millan, *supra* note 39; Meek, *supra* note 21.

⁴⁴ See, e.g., Seavey, *supra* note 43; Harper and McNeely, *supra* note 43.

on the basis of two theories, the first cause of action in its complaint founded on misrepresentations that were merely negligent and the second keyed to misrepresentations alleged to have been fraudulent. Judge Cardozo wrote for a unanimous New York Court of Appeals and permitted recovery on the theory of actionable fraud but denied any right of recovery based on the theory of negligence, *in the absence of privity*, stating that to allow such recovery would so expand the field of liability for negligent speech as to "make it merely, if not quite, coterminous with that of liability for fraud."⁴⁵ In Cardozo's words, "If liability for negligence exists [to third parties], a thoughtless slip or blunder, the failure to detect a theft or forging beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class."⁴⁶

It is extremely interesting to compare the words of Judge Cardozo quoted above from *Ultramares* with his thoughts as expressed in his 1916 decision in *MacPherson v. Buick Motor Co.*,⁴⁷ which involved a claim, *also in tort*, by the purchaser of a defectively manufactured automobile who was injured as a result of its conditions against the manufacturer of the automobile. In such cases, traditionally the purchaser's sole cause of action was on his contract of purchase against the retail dealer from whom he had bought the automobile, and, due to the absence of privity of contract, no cause of action for negligence would lie against the manufacturer. The "grand-daddy" English case requiring such privity was *Winterbottom v. Wright*⁴⁸ which involved a suit by the driver of a mail coach against the supplier of the coach who had made the coach available pursuant to a contract with the postmaster. The driver, an employee of that postmaster, was injured when the coach broke down due to a latent and negligent defect. Recovery was denied because the driver and the supplier were not "in privity." Notice what Lord Abinger had to say in his opinion in *Winterbottom v. Wright*:

There is no privity of contract between these parties; and if the plaintiff can sue, every passenger, or even any person passing along the road, who was injured

⁴⁵ *Supra* note 40, at 185, 174 N.E. at 446-47.

⁴⁶ *Supra* note 40, at 179, 174 N.E. at 444.

⁴⁷ *MacPherson v. Buick Motor Co.*, 217 N.Y. 382, 111 N.E. 1050 (1916).

⁴⁸ *Winterbottom v. Wright*, 10 M. & W. 109 (Exch. 1842).

by the upsetting of the coach, might bring a similar action. Unless we confine the operation of such contracts as this to the parties who entered into them, the most absurd and outrageous consequences, to which I can see no limit, would ensue.⁴⁹

Do these words of Lord Abinger not sound similar to those of Judge Cardozo in *Ultramares*?

In *MacPherson*, Judge Cardozo rejected the rationale of *Winterbottom v. Wright* and allowed the purchaser of the defective automobile to recover, concluding:

The contractor who builds a scaffold invites the owner's workmen to use it. The manufacturer who sells the automobile to the retail dealer invites the dealer's customers to use it. The invitation is addressed in the one case to determinate persons and in the other to an indeterminate class, but in each case it is equally plain, and in each case its consequences must be the same (liability for negligence, regardless of the lack of privity). There is nothing anomalous in a rule which imposes upon A, who has contracted with B, a duty to C and D and others according as he knows that the subject-matter of the contract is intended for their use.⁵⁰

In the writer's opinion, these words do not jibe with Judge Cardozo's own words in *Ultramares* where he expressed the fear of exposing accountants to a liability to an *indeterminate class*.⁵¹ In other words, Judge Cardozo held that the *identity* of future automobile purchasers need not be foreseeable to Buick before Buick can be held liable for its own *negligent* conduct, even though the beneficiaries of this duty of care are ultimate consumers—"an indeterminate class who, in the nature of things, will eventually use or come in contact with the products in question." Likewise, it logically follows that Judge Cordozo in *Ultramares* should have held that the *identity* of future users of the financial statements and reports prepared by accountants need not be foreseeable to those accountants as a precondition to the imposition of liability for their own negligent conduct. He might have said in *Ultramares*:

After all, since the accountant knows that his report and certified financial statements are normally included as part and parcel of his client's annual report to stockholders, creditors, potential investors and financial analysts, this *class* of ultimate readers of his report and statements is certainly foreseeable to him even though the *identity* of the specific members of this class is not known to him. Hence, these users of financial statements are beneficiaries of a duty of care

⁴⁹ *Id.* at 114.

⁵⁰ *Mac Pherson*, *supra* note 46, at 393.

⁵¹ *See supra* note 40, at 179, 174 N.E. at 444.

owed to them by the accountant; and, if he should be negligent, he must, in fairness and right, compensate those who have been injured by his wrongful act or conduct.⁵²

What factors, then, forced Judge Cardozo to make the apparent turnabout in *Ultramares*? Our answer may rest in a more detailed analysis of the *Ultramares* decision. Touche, Niven had been employed by Fred Stern & Co. at the end of each of the three years preceding 1923 to render a similar service in the certification and preparation of a balance sheet exhibiting the financial condition of the company. Stern's operations demanded extensive credit and the company had borrowed huge sums of money from banks and other lenders, and this information was well known to Touche, Niven. The CPA firm was also aware of the fact that in the usual course of business its client would circulate the certified balance sheet among banks, other credit lenders, stockholders, customers or suppliers "according to the needs of the occasion, as the basis of financial dealings."⁵³ Consequently, when the balance sheet was prepared, the defendant firm of certified public accountants provided its client with thirty-two copies certified with serial numbers as counterpart originals.⁵⁴ *Ultramares Corporation* was a factor in New York and was approached by Stern & Co. with a request for loans of funds sufficient to finance its sales of rubber in March, 1924, and, as a precondition to its receipt of any loans, Stern was required to present the factor with a certified balance sheet. Conforming to *Ultramares*' request, Stern transferred to the factor one of the certificates signed by Touche, Niven attesting to the correctness of the balance sheet and the solvent equity position in excess of \$1 million disclosed therein as of December 31, 1923.⁵⁵ In

⁵² Such a forthright statement would have abandoned privity just as the California Supreme Court repudiated that doctrine in the case of a notary improperly acting as an attorney who was held liable to the intended beneficiary of a will drafted by the notary, but defectively executed due to his negligence. *Biakanja v. Irving*, 49 Cal. 2d 647, 320 P.2d 16 (1958). See Wade, *The Attorney's Liability for Negligence*, 12 VAND. L. REV. 755, 759 (1959).

⁵³ *Supra* note 40, at 173, 174 N.E. at 442.

⁵⁴ Surely the number of copies of the certified balance sheets supplied by Touche must not be ignored in resolving the quagmire of "primary benefit." Carefully examine and compare the language of the district court in *Fischer v. Kletz*, *supra* note 25, highlighted in the text, *supra* note 30.

⁵⁵ The balance sheet showed assets of \$2,550,671.88, liabilities of \$1,479,956.62, and a resulting stockholders' equity position of \$1,070,715.26. *Supra* note 40, at 174, 175, 174 N.E. at 442.

reality, Stern & Co. was insolvent and the books had been falsified by the management of Stern so as to set forth accounts receivable and certain other assets which turned out to be fictitious.

On the faith of the certificate, Ultramares made its initial loan to Stern which was followed by many others.⁵⁶ In light of the insolvent financial position of Stern & Co., it is no surprise that the loans went bad and that the rubber company was declared a bankrupt on January 2, 1925. At this point Ultramares understandably sought to salvage some measures of recovery for its imprudent extension of credit by instituting the suit against Touche, Niven for damages suffered in reliance on the latter's audit examination which was allegedly performed in a negligent and/or fraudulent manner. Judge Cardozo found (and there can be little doubt that he was correct in this respect) that the performance of the audit by Touche, Niven and its employees was clearly negligent.⁵⁷ For example, in the areas of accounts receivable and inventory, even a modicum of reasonable caution and diligence would have revealed substantial falsifications of invoices, inflations of inventory, nondisclosure of pledged accounts and other irregularities that existed. This certainly *was not* one of those instances where, as boldly and critically asserted in a recent *Journal of Accountancy* editorial, "a jury, in light of hindsight, inferred that if financial statements turn out to be wrong, the auditor should have found the errors."⁵⁸

Professor Green⁵⁹ long ago viewed *Ultramares* as a desirable judicial pronouncement because it gives the judge and jury more of an equalized power as a result of the psychological effects upon the jury of a fraud formula which is more sobering than a negligence formula requiring less moral culpability.⁶⁰ This may be a practical expedient from the standpoint of the administration of the judicial process at the trial level, but when viewed in light of its effect upon the rights of

⁵⁶ The reliance issue was, strangely enough, not controverted. Judge Cardozo merely stated, *supra* note 40, at 175, 174 N.E. at 443: "On the faith of that certificate the plaintiff made a loan which was followed by many others." (Emphasis added) In the case of a public investor, however, this issue may be the subject of great controversy. Examine the authorities cited, *supra* note 29.

⁵⁷ *Supra* note 40, at 179, 174 N.E. at 444.

⁵⁸ *Supra* note 2, at 33.

⁵⁹ Note, *The Judicial Process—Ultramares Corp. v. Touche*, 26 ILL. L. REV. 49 (1931).

⁶⁰ *Id.* at 55.

specific parties litigant, the thrust of such a concept is jurisprudentially brazen and repulsive. A contemporary of Professor Green has criticized his attitude as expressed above,⁶¹ noting that the alternative in *Ultramares* was not the abandonment of the fraud theory, but rather, that it should not preclude the negligence theory.⁶²

The real problem facing Judge Cardozo was whether the negligent conduct, even though it clearly existed, was a wrong *to the particular plaintiff*: Did the accounting firm owe to Ultramares Corporation a duty of care not to be negligent? Judge Cardozo first set forth the long-established rule that "the defendants owed to the creditors and investors, to whom their client exhibited the certificate, a duty to make their certificate and audit *without fraud*,"⁶³ because "there was notice in the circumstances of its making that the client (employer) did not intend to keep it to himself."⁶⁴

After discussing the many avenues down which the assault upon "the citadel of privity" had proceeded up until 1931, many of those great inroads having been established by Cardozo himself,⁶⁵ he stated that the service rendered by Touche, Niven was *primarily for the benefit of the Stern Company*,⁶⁶ "a convenient instrumentality for use in the development of the business,"⁶⁷ and only *incidentally* or *collaterally* for the use of those third parties who might later have the certified report presented to them by officials of Stern.⁶⁸ "Foresight of these possibilities," he opined, "may charge with liability for fraud but the conclusion does not follow that it will charge with liability for negligence."⁶⁹

⁶¹ Shampaine, *Liability of Accountants to Third Parties for Negligence and Deceit*, 17 ST. LOUIS L. REV. 248 (1932).

⁶² *Id.* at 256.

⁶³ *Supra* note 40, at 179, 174 N.E. at 444.

⁶⁴ See Bohlen, *Misrepresentation as Deceit, Negligence, or Warranty*, 42 HARV. L. REV. 733 (1929).

⁶⁵ *E.g.*, MacPherson v. Buick Motor Co., *supra* note 47; *Glanzer v. Shepard*, 233 N.Y. 236, 135 N.E. 275 (1922); *International Products Co. v. Erie R.R.*, 244 N.Y. 331, 155 N.E. 662 (1927); *Doyle v. Chatham & Phoenix Nat. Bank*, 253 N.Y. 369, 171 N.E. 574 (1930). See Prosser, *Assault on the Citadel*, 69 YALE L.J. 1099 (1960).

⁶⁶ *Supra* note 40, at 183, 174 N.E. at 446.

⁶⁷ *Id.*

⁶⁸ *Id.* Reexamine Bohlen, *supra* note 64.

⁶⁹ *Supra* note 40, at 183, 174 N.E. at 446.

Judge Cardozo next suggested that if the assault on privity be broadened so that accountants' liability for negligence be recognized, such an extension "is a question of policy and, if made, would so expand the field of negligent speech as to make it nearly, if not quite, coterminous with liability for fraud."⁷⁰ This critical assertion is, in this observer's opinion, based on a serious false premise on the part of Judge Cardozo. He seems to have confused mere negligence with negligence "so gross as to warrant an inference of fraud" and equated one with the other *in this area of accountants' liability*. Perhaps, what led Judge Cardozo to believe that extending liability for negligence to accountants would equate this legal responsibility with liability for fraud was a lack of basic understanding about the nature of an audit examination, generally accepted internal standards of audit performance, and uniform auditing procedures. It must be emphasized, in fairness to Judge Cardozo, that at the time of his *Ultramares* decision, uniform professional audit standards and recognized internal auditing procedures and detailed practices were not as well developed as they presently are.⁷¹ Nevertheless, it certainly appears that there are some errors made by accountants which would be actionable only on the theory of fraud, and others on the theory of mere negligence, and a third group which might overlap both areas of potential liability. For example, where the accountant is in collusion with management and intentionally misrepresents the financial condition of the enterprise under review for the purpose of misleading the third party(ies), such conduct definitely seems actionable as fraud. Additionally, a "dichotomy of errors" may be established taking cognizance of the nature of an audit examination and the underlying professional standards⁷² prevalent in the performance of such audits, which define, both in a general manner and with specific utility, the scope of (1) *mere* negligence and (2) negligence so *gross* as to warrant an inference

⁷⁰ *Supra* note 40, at 185, 174 N.E. at 447. *But cf.* the passage from *Shampaine*, *supra* notes 61, 62, demonstrating that such equalization was not the analytical consequence of recognizing liability for negligence.

⁷¹ See Broad, *supra* note 42, at 38-43; Solomon, *A List of Audit Techniques*, 26 ILL. CPA (Summer 1964) 38. The present state of refined audit standards and procedures is due in large part to the McKesson & Robbins fiasco of the 1930's and its sad aftermath resulting from the failure to discover almost \$20 million of phony current assets. See *In the Matter of McKesson & Robbins*, SEC Acctg. Series, Release No. 19 (1940).

⁷² See AICPA, Committee on Auditing Procedure, *GENERALLY ACCEPTED AUDITING STANDARDS—THEIR SIGNIFICANCE AND SCOPE* (1954); AICPA, Committee on Auditing Procedure, *STATEMENTS ON AUDITING PROCEDURE* No. 33 (1963).

of fraud. As an illustration of how this "natural" dichotomy would operate, it is submitted that gross negligence could effectively encompass the failure to comply with, and total disregard for, the self-promulgated generally accepted audit standards,⁷³ required audit procedures,⁷⁴ or the specific mandates of the rules of ethical conduct⁷⁵ formulated by the American Institute of CPAs, while mere negligence could be restricted to those instances where there has been some bona fide attempt at compliance with professional standards, generally accepted procedures and rules of ethics but *carelessness in their application* has resulted in a misrepresentation in the financial statements and a consequential falsification in the audit report.⁷⁶ The writer does not envision, nor desire, wholesale subjugation of independent accountants to unlimited liability for every mistake that happens to get printed in a financial statement. Rather, it is hoped that an honest recognition of liability for negligence along with judicial reliance on *self-promulgated standards and rules of audit practice* and the maintenance of *strict standards of proof* to establish a basis for recovery will, in the long run, act to improve the quality of CPA performance and *reduce* the quantity of litigation directed against the accounting profession in this country.

In essence, Judge Cardozo's fear of coterminating liability for fraud with liability for "negligent speech" on the part of accountants was neither correct nor justified. Many cases have recognized the distinction between the reckless misrepresentation essential to an action for fraud and the negligent misrepresentation that may be actionable apart from any allegation of fraud, in areas of tort law other than accountants' liability.⁷⁷

The historical basis for the imposition of liability for the use of speech in a reckless manner, absent a fraudulent intent on the part of the speaker, seems to have been quite well formulated by Jeremiah Smith in 1900.⁷⁸ He observed:

⁷³ *Id.*

⁷⁴ STATEMENTS ON AUDITING PROCEDURE NO. 33, *supra* note 72. See also SEC Actg. Series, Release No. 21 at 38 (1956); and Solomon, *supra* note 71, at 38-39.

⁷⁵ AICPA, BY LAWS—CODE OF PROFESSIONAL ETHICS 28-33 (1964). See also CAREY, PROFESSIONAL ETHICS OF CPAs (1956).

⁷⁶ See Meek, *supra* note 21; Note, The Accountant's Liability, *supra* note 12; and Champagne, *supra* note 61, at 256.

⁷⁷ Bloomquist v. Farson, 222 N.Y. 375, 118 N.E. 855 (1918); Seneca Wire & Mfg. Co. v. A. B. Leach & Co., 247 N.Y. 1, 159 N.E. 700 (1928).

⁷⁸ Smith, Liability for Negligent Language, 14 HARV. L. REV. 184 (1900).

An action for misstatement should be allowed when these requisites are present:— 1. Defendant volunteered a statement to the plaintiff. . . . 2. The statement was not true in fact. 3. Defendant, though believing the statement, had no reasonable grounds for such belief 4. Defendant made the statement with the intention that plaintiff should act upon it. 5. The subject-matter of the statement was such that one who acted in reliance upon it would be likely to incur substantial pecuniary loss in case the statement proved incorrect 6. Plaintiff acted in reliance upon the statement and such action and reliance on his part was reasonable 7. Plaintiff was damaged by so acting.⁷⁹

One must quite clumsily exert his manipulative powers in order to fit the negligent certified public accountant misstatement outside this framework.⁸⁰ Likewise, the awkward nature of the *Ultramares* differentiation between fraud, negligence and negligence so gross as to create an inference of fraud, along with the inappropriateness of forcing interested parties to grapple with this unnecessary and illogical intermingling of fraud with negligence, are aptly illustrated by the simplified legal theory of liability for negligent speech outlined by Jeremiah Smith⁸¹ and the correlated difficulties of struggling to fit the *Ultramares* trichotomy within its bounds.

In addition, the possibility, quite conceivable to this observer, definitely exists that since Judge Cardozo had in *Ultramares* an "open and shut" case of gross negligence (*i.e.*, failure to trace to supporting invoices in any manner whatsoever and accounts receivable in excess of \$700,000 not entered on the books) and *scienter* (*i.e.*, the accountants made a statement as true to their knowledge when they had no such knowledge on the subject), he was much freer in his defense of the citadel of privity in the area of accountants' liability for negligence than he otherwise would have been had there not existed the means for permitting recovery on the alternate theory of fraud.⁸² This goes a long way toward explaining Judge Cardozo's apparent inconsistent turnabout in *Ultramares* with his earlier expressions, especially in *MacPherson v. Buick*, that:

- (1) "The manufacturer who sells the automobile to the retail dealer invites the dealer's customers to use it" and even though the

⁷⁹ *Id.* at 195-96.

⁸⁰ See also *Davis v. Nuzum*, 72 Wis. 439, 40 N.W. 497 (1888); *Griswold v. Gebbie*, 126 Pa. 353, 17 A. 673 (1889).

⁸¹ See text, *supra* note 79.

⁸² *Ultramares*, *supra* note 40, at 190, 191-92; see SIGAUD, ACCOUNTANTS' LEGAL RESPONSIBILITY COURSE MANUAL AND DISCUSSION GUIDE at 116-17 (1956).

customers are an *indeterminate class* the manufacturer is plainly liable for negligence, regardless of the lack of privity;⁸³ and

- (2) "There is nothing anomalous in a rule which imposes upon A, who has contracted with B, a duty to C and D and others according as he knows" *or does not know* "that the subject-matter of the contract is intended for their use."⁸⁴

Two final "Cardozian platitudes" set forth in *Ultramares* loom large, remain uncontroverted, and appear to not be completely correct when examined more closely—Cardozo held that:

- (1) "The service rendered [by Touche, Niven & Co.] was primarily for the benefit of the Stern Company a convenient instrumentality for use in the development of the business, and only incidentally or collaterally for the use of those to whom Stern might exhibit it thereafter."⁸⁵
- (2) "[P]ublic accountants are public only in the sense that their services are offered to any one who chooses to employ them," not "in the sense that the services are rendered in the pursuit of an independent calling, characterized public, giving rise to the duty to speak with care [to the public] . . . This is far from saying that those who do not employ them are in the same position as those who do."⁸⁶

Let us first consider Judge Cardozo's assertion to the effect that the certified public accountant's services are rendered *primarily* for the *benefit* of his client. Of course, the client is going to be financially benefited thereby since he can more readily obtain credit and encourage potential investors to part with their funds. *But* if we consider the term benefit as intended to mean *use* (as that term should be interpreted when considered in light of its employment by Cardozo himself), creditors, stockholders, potential investors and suppliers in

⁸³ *MacPherson v. Buick Motor Co.*, *supra* note 47, at 393, 111 N.E. at 1054.

⁸⁴ *Id.* The English courts had apparently taken the same step earlier and repudiated *Winterbottom v. Wright*, *supra* note 48. See *White v. Steadman*, 3 K.B. 340, 348 [1913].

⁸⁵ *Supra* note 40, at 183, 174 N.E. at 446.

⁸⁶ *Supra* note 40, at 188, 174 N.E. at 448, wherein Cardozo pointed to lawyers who opine as to the validity of publicly issued municipal bonds, and title companies insuring titles to parcels of land to be sold, as potential additional victims, if liability to the public were to be sanctioned as against the independent accountants.

our modern credit-oriented economy not only *use*, but many require and create the very need for, the independent CPA's report and certificate concerning the results of his audit examination of the client's books and financial records, balance sheet, income position, and other accounting, financial and related schedules, exhibits or comments. In fact, to say that the primary utility derived from the independent accountant's report and statements rests with third parties, such as suppliers, credit lenders, potential and present investors, and financial analysts is certainly no great overstatement.⁸⁷ Obviously, the CPA is aware of this use of his certificates and reports by "the public" and takes this factor into consideration in *billing* the client for the services rendered in conjunction with his audit examination.⁸⁸ As direct evidence in support of this assertion is the fact that Touche, Niven & Co. (even in its 1923 audit of the records of Fred Stern & Co.) supplied Stern's management with *thirty-two* copies of their certified report.⁸⁹ Judge Cardozo was, therefore, amiss in contending that the services rendered by the accountants were only *incidentally* for the use of those third parties to whom its client's management might subsequently exhibit the certified statement and report.⁹⁰ A commentator of *Ultramares* has viewed "privity" as a determinant of the "real parties in interest."⁹¹ One wonders whether such a legitimate reading of the privity limitation in light of the CPA's cognizance of third party use does not itself compel the recognition of CPA liability for negligence to investors and credit grantors as "the real parties in interest."⁹²

Regarding Judge Cardozo's statement that public accountants are *public* only in the sense that their services are offered to any member

⁸⁷ Judge Cardozo is not totally blameworthy. The poor public image and understanding of the CPA and his attest function have contributed greatly to the confusion (judicial and public) about the "primary benefit" of his certification and audit report. See Heinemann, *supra* note 1. These problems are further intertwined with and compounded by the failure of accountants to develop uniform principles and postulates. See Lerner and Solomon, *Accounting and Law Intertwined: A Case Study of the Need for Uniform Accounting Principles*, 56 *GEORGETOWN L.J.* 670 (1968).

⁸⁸ No small part of the blame for poor public understanding of the CPA's role as an auditor and his related financial responsibility to the public rests on the shoulders of the accounting community itself. See Broad, *supra* note 42, at 38-43.

⁸⁹ See *supra* note 54.

⁹⁰ See Broad, *supra* note 42; Hanson, *Responsibilities of Independent Public Accountants*, 22 *BUS. LWYR.* 975 (1967).

⁹¹ Note, *Scope of Liability of a Negligent Report*, 8 *TEMP. L. Q.* 404, 410 (1934).

⁹² See *Watson v. Jones*, 41 *Fla.* 241, 254, 25 *So.* 678, 688 (1899).

of the general public, the editors of the *Accountant's Handbook* state that the two most important features of the public accountant's work are "the expert nature of the assignments which he undertakes and the *independence* with which he carries them out."⁹³ They offer in discussion of the second essential element the following excerpt from a leading authority on CPA independence:

Clearly there would be no great store by the certified public accountant's opinion or certificate if the users of published reports were not confident of his independence of judgment as well as his technical competence The basic difference between privately employed accountants and professional practitioners is in their responsibilities, moral or legal, to the corporation or the public, and in the extent to which their relationship may tend to influence their judgment. In the last analysis, therefore, it is his independence which is the certified public accountant's economic excuse for existence.⁹⁴

Unless the truth of these observations has dissipated to falsity since 1946 when they were originally expressed (and it is much more likely that they are even more correct in light of the modern development of our United States credit-oriented economy⁹⁵ and growth of the organized practice of public accounting since World War II),⁹⁶ public accountants are predominantly *public* in the sense that their services are rendered in the pursuit of an independent calling. It appears that Judge Cardozo in *Ultramares* severely erred in prima facie dismissing the question of whether any corresponding duty arises to speak with care on the part of these *public* servants pursuing an *independent* calling and thereby safeguarding the public's interest, in that he did not consider the true cornerstone of the accounting profession, its "economic excuse for existence,"⁹⁷ *independence*. In effect, Judge Cardozo gave the public accountants more of a special favor than even they, themselves, claim to deserve by his misconstruction of the term "public."⁹⁸

The post-*Ultramares* accountants' liability decisions in the United States and England have not really departed from the basic precepts

⁹³ WIXON AND KELL, ACCOUNTANTS' HANDBOOK (4th ed. 1962).

⁹⁴ CAREY, *supra* note 75.

⁹⁵ See Heinemann, *supra* note 1; The Wall Street Journal, Nov. 15, 1966, at 1, col. 6.

⁹⁶ Broad, *supra* note 42; and Hanson, *supra* note 90.

⁹⁷ *Supra* note 94.

⁹⁸ *Supra* note 93.

laid down so definitively by Judge Cardozo in *Ultramares*.⁹⁹ Because of this and so as not to detract from our complete study of the keystone *Ultramares* formulations, a brief analytical summary of these later cases appears as *Appendix A* at the conclusion of this study.

A playful analytical exercise seems most appropriate at this time to even further illustrate the doctrinal "strain" in *Ultramares* as a monumental tort law pronouncement. This "five-finger" exercise will first entail the allocation of one case to each "finger."

- (1) The *MacPherson v. Buick* type of case where the consumer, injured as a result of a defectively manufactured product, seeks to recover damages for resulting injuries from the manufacturer.
- (2) Landlord liability situations where L leases a "tumbledown" building to be used by the lessee at once as a place of public entertainment, L being aware that the premises are to be thrown open to the general public.
- (3) The case in which a mother, standing across the street from her young child, observes the child being struck and killed by an automobile operated in a negligent manner by D driver and suffers severe emotional injury and mental anguish, seeking to recover compensation for *her* injuries from the driver.
- (4) The *Moch Co.*¹⁰⁰ "waterworks" type of case where a private taker of water from the municipality suffers fire damage to his property as a result of the water company's failure to furnish adequate water and pressure to extinguish the fire pursuant to its contract *with the city*.
- (5) The *Ultramares*-type situation with a slight variation where the CPA audits the books and records of C Company and renders an opinion on its financial statements knowing that his published opinion and certificate will be exhibited along with the financial statements to credit lenders and stockholders as part and parcel of C Company's annual report. The CPA has been careless in his examination although acting in a good faith effort at compliance with accepted standards of field work and investigation, resulting in a substantial overstatement of

⁹⁹ See LEVY, ACCOUNTANTS' LEGAL RESPONSIBILITY 19-24, 131-46, 194 *et seq.* (1954).

¹⁰⁰ *Moch Co. v. Rensselaer Water Co.*, 247 N.Y. 160, 159 N.E. 896 (1928).

C Company's net income and a severely distorted balance sheet. A relying shareholder who otherwise would have sold his stock *but for* reliance on the CPA's opinion accompanying the favorable financial statements seeks to recoup his losses from the CPA when C Company is found soon afterward to be insolvent.

The playful exercise becomes one of determining whether all five "fingers" can properly be part of the same "hand," that hand being a unified theory of tort liability, even though the traditional results seem inconsistent.

As we have already seen, liability clearly exists in Case 1, and the absence of privity is immaterial since the automobile dealer is treated as a mere "conduit" or "funnel" passing the manufacturer's dangerous auto through to the ultimate consumer, which passage was plainly foreseeable to the manufacturer.¹⁰¹

In the Case 2 situations, the landlord has consistently been held liable to persons other than the lessee who have suffered injury as a result of the defective premises even though there is no "privity" between the members of the public and the landlord and even though there is another party on whom the risk of loss could have been passed off (the lessee).¹⁰² The theory supporting recovery from the landlord in such cases has been that injury to members of the public other than the lessee is to be forseen by the landlord and, in turn, this foreseeability of risk "imposes a duty of care" on the landlord.¹⁰³

The scale of liability then moves traditionally to nonrecovery in Cases 3, 4 and 5. In Case 3, the mother standing on the sidewalk has consistently been denied recovery for her emotional injuries.¹⁰⁴ How-

¹⁰¹ *Supra* note 50.

¹⁰² See *Junkermann v. Tilyou R. Co.*, 213 N.Y. 404, 108 N.E. 190 (1915), and cases cited therein. It is interesting to note that in Cardozo's assault upon privity in *MacPherson*, the landlord's duty in these "tumbledown" leasing situations was instrumental in providing precedential authority for developing the theory of auto manufacturer's liability.

¹⁰³ See 2 RESTATEMENT OF TORTS § 167, (1966); Eldredge, *Landlord's Tort Liability for Disrepair*, 84 U. PA. L. REV. 467 (1936), a general discussion of landlord responsibility predicated upon foreseeability as well as certain other bases, including "nuisance", not material here.

¹⁰⁴ See *Mitchell v. Rochester Ry. Co.*, 151 N.Y. 107, 45 N.E. 354 (1896); *Waube v. Washington*, 216 Wis. 603, 258 N.W. 497 (1935), which denied recovery on the basis of lack of "proximate cause," utilizing the limitation logic of *Palsgraf v. Long Island R. Co.*, 248 N.Y. 339, 162 N.E. 99 (1928) (which incidentally was also formulated by Judge Cardozo); See also HARPER AND JAMES, 2 TORTS 1035 (1956).

ever, if she were placed "in danger" (*i.e.*, walking across the street *with* the child) yet escaped physical injury herself, recovery would normally be allowed the mother for her emotional anguish and mental harm.¹⁰⁵ One might seriously question the logic of this distinction, yet a handy "rule of thumb" *is* provided. Perhaps the distinction is an outgrowth of the "common law conservatism" that there must be some *limit* to the harms for which the legal system will force the negligent actor to pay. Suppose the mother is at home and does not see the accident, but a neighbor rushes in and tells her of the tragedy? If it is thought that recovery should not be allowed the mother under such circumstances, it would create a severe strain on theory to permit recovery where the mother fortuitously happened to see the accident with her own eyes while standing across the street.¹⁰⁶ Even more hazardous from a logical standpoint, is the extension of liability a rational incident where the "remoteness" is minimized just because the mother accompanied her child across the intersection and was herself in danger of being hit? What is revealed by the above sequence, nevertheless, is the common law reaction that there must be some *limit* on potential liability for tortious conduct. Of additional significance, in this writer's opinion, is the fact that emotional injuries of friends and relatives of the victim is the type of variable which cannot be insured against on any sensible rate scale or coverage plan by automobile drivers.¹⁰⁷ This factor tends even more toward maintaining some cut-off point, but, in turn, apparently upsets the theoretical scheme of uniform liability for conceptually similar tortious conduct.

The Case 4 "waterworks" situation has generally gone in favor of

¹⁰⁵ See *Hambrook v. Stokes Bros.*, 1 K.B. 141 (CA 1925). Examine the theory of recovery espoused by the Maryland court in *Bowman v. Williams*, 164 Md. 397, 165 A. 182 (1933).

¹⁰⁶ Goodhart, *Emotional Shock and the Unimaginative Taxicab Driver*, 69 L. Q. REV. 347, 352 (1963), notes the logical strain of a sliding scale of remoteness in terms of the length of time consumed by the taxicab in backing into the child crossing the street. The same difficulty arises when remoteness is measured in terms of the mother's distance from the place of impact. See generally Green, *Fright Cases*, 27 ILL. L. REV. 761 (1933); Magruder, *Mental and Emotional Disturbance in the Law of Torts*, 49 HARV. L. REV. 1033 (1936). It should be remembered that this same Professor Green found the result in *Ultramares* quite appealing for its effect upon the judge-jury function in the judicial process—consider his attitude in these "fright cases" alongside his *Ultramares* attitude.

¹⁰⁷ Compare this non-insurability with the contrasting situation presented by accountants' liability. But notice the effect upon insurance coverage and rates which has resulted from the recent rush to the courthouse.

the water utility companies primarily based on the "absence of privity" rationale, at times reinforced by the distasteful "nonfeasance-misfeasance" distinction.¹⁰⁸ Like the Case 3 common law gut reaction or "sensual desire" to set some practicable limit, the "privity" limitation in the waterworks cases really boils down to a *policy judgment* to the effect that it is advisable to protect water companies from the "indeterminate" liability which might arise from the destruction by fire of a large portion of the city or town due to lack of water pressure.¹⁰⁹ However, the likelihood that the water company can, and most likely *does*, pass this risk off to the city in the form of higher rates cannot be neglected and certainly cuts the other way—toward imposition of liability. Also, of great significance is the glaring fact that the leading waterworks cases were decided at a time¹¹⁰ when the "nonfeasance" and "absence of privity" limitations were sufficient in correlated areas of tort law to prevent recovery ipso facto.

The variation of the *Ultramares* problem, Case 5, is much like each of the other four situations in certain respects. It appears to the writer that the factual and circumstantial position of the CPA is most similar to that of the landlord in Case 2. As is true of the landlord and the defective leased premises, the CPA has advance knowledge that his statements and report will be relied upon by certain segments of the public and their harm from reliance should the CPA be careless in his audit examination is certainly foreseeable to him. The exact *identities* of the members of the public who will enter the "tumbledown" building are no more known to the landlord than are the specific *identities* of the users of the CPA's statements and report. Even so, while the landlord has long been held liable to the injured public, the negligent CPA is protected by the *Ultramares* shield. The fact that in the landlord case we have an additional party in the person of the lessee in possession whom the common law could have alternatively chosen as our sole subject for liability cuts even more against *Ultramares* as a limiting doctrine since, in the CPA negligence

¹⁰⁸ *Supra* note 100; *Reimann v. Monmouth Consol. Water Co.*, 9 N.J. 134, 87 A.2d 325 (1952). See Seavey, *Reliance Upon Gratuitous Promises or Other Conduct*, 64 HARV. L. REV. 913 at 920-921 (1951).

¹⁰⁹ Seavey, *supra* note 108. But what if our values, and hence our policy judgments, change? See the California model *Biakanja v. Irving*, and Wade's comment thereon, *supra* note 52.

¹¹⁰ Even the *Reimann* case, *supra* note 100, decided in 1952, preceded the new wave of "products liability" innovations.

situation, there is no other alternative subject upon whom the responsibility for the CPA's carelessness may be shifted.¹¹¹

The modified *Ultramares*-type case is also analogous to the automobile manufacturer situation (Case 1) since the dealer as a conduit or funnel through which the manufacturer gets his autos to the ultimate consumer closely resembles C Company, the CPA's client, which serves as the conduit for getting the CPA's reports and financial statements to those who need such periodic reports and for whose benefit the CPA's independent audit services are *primarily* rendered—credit granters, stockholders, and potential investors. Similarly, the city in Case 4 can be considered a conduit between the waterworks utility and the private parties who are intended to derive the *primary benefit* of the water services as residents of the city.¹¹²

Hence, it would appear that the "privity" requirement will, whether we like it or not, eventually fall in the CPA case and waterworks case as it has fallen in the manufacturer's and landlord's liability situations because this limiting doctrine represents an outmoded liability-limiting common law policy which may no longer be controlling due to the widespread prevalence of liability insurance and the ability to pass the risk of loss on to CPA clients or water utility customers through the fee or price mechanism.¹¹³ Such a result would provide a unified theory of common law tort liability through a probable future revision of the results in Cases 4 and 5 to conform with the recognition of liability in Cases 1 and 2, except for the apparent inconsistency with Case 3 where the plaintiff-mother seeking redress for the emotional injury suffered and is denied recovery. The denial of recovery there could be simply reconciled by classifying the "type" or "character" of the harm as *emotional*, but this attachment of labels as an easy way out must, in my opinion, be condemned and rejected as a distinction or device just as untenable as past efforts at characterization such as "negligent speech," "gross" v. "mere", and "non"-feasance. Such a "justification" would be wholly spurious. If "finger"

¹¹¹ The CPA's client, of course, would not be responsible for the CPA's negligence and would be an alternative risk-bearer only where the client itself participated in a collusive fraudulent scheme.

¹¹² We here utilize the term "primary benefit" as a measure of *use*, further reinforcing its similar meaning in the case of financial statements certified by the independent accountant.

¹¹³ See *supra* notes 107, 121. See also notes 140, 141, *infra*.

number 3 can properly be a part of the same "hand" as the other four cases, there must be a more substantial and meaningful distinction.

As in the CPA liability case, the danger connected with subjecting the automobile driver to liability for emotional injuries to friend and family of the accident victim seems to be the problem of limitless and unbearable monetary damages.¹¹⁴ However, as indicated previously, the risk of emotional injuries to friends and families of accident victims is not the type of variable which can be insured against on any sensible rate scale or coverage plan available to auto drivers individually or as a class. On the other hand, the risks of loss to the CPA can be insured against and are capable of actuarial measurement.¹¹⁵

The common law gut reaction to the effect that there must be *some limit* on potential liability for tortious conduct which was said to constitute the need for denying the mother recovery for her emotional injuries¹¹⁶ does not demand *complete* immunization of the CPA from liability for negligence. In fact, CPA negligence liability would not contravene this common law *limitation* policy because the nature of the CPA's services itself provides an inherent limitation. This arises out of the requirement that the investor or lender must show *reliance* on the CPA's statements and reports¹¹⁷—in effect, that he would not have invested or made the loan *but for* the favorable report of the CPA on C Company's financial condition. With this inherent limitation in hand, the CPA's liability for negligence would not contravene the policy of the common law as expressed in those cases denying recovery to the mother since the liability would not be "limitless" but rather, restricted to well-defined determinable classes—those third persons for whose benefit the CPA's services are primarily rendered *and* who relied thereon.

The above analytical exercise clearly reveals the "doctrinal strain" in *Ultramares* and suggests to the writer five possible courses of future models of CPA liability for negligent conduct.

- (1) *Retention of the Ultramares doctrine*: recovery for fraud and negligence so gross as to be tantamount to fraud, but no re-

¹¹⁴ *Supra* note 109.

¹¹⁵ *Supra* note 113.

¹¹⁶ HARPER AND JAMES, *supra* note 104, at 1035; Green, *supra* note 106.

¹¹⁷ Examine the discussion of the "reliance" issue presented in note 56, *supra*.

covery for "mere" negligence absent privity of contract.

- (2) *Ultramares absent the privity requirement*: privity stripped away as a prerequisite and recovery allowed for negligence, as well as for fraud, *but subject to strict requirements as to proof of both negligent conduct and third party reliance.*
- (3) *Expansion of federal securities act coverage*: solely statutory recovery under a uniform federal regulation as characterized by the apparent *Fischer v. Kletz* looseness of standards and easy liability," with or without the concomitant shifting of the burden of proof on to the CPA and with or without a "nationalized" common law recovery.
- (4) *Internal professional regulation as the sole deterrent*: no statutory or common law liability with the entire matter left to internal regulation within the accounting community itself.
- (5) *Strict liability*: absolute CPA liability for any errors appearing in published certified financial statements without the need for injured third parties to prove negligence—a combination of *res ipsa loquitur* and ultrahazardous activity, coupled with widespread existence of liability insurance and a superior risk-bearing ability.

Based upon the voluminous discussion and analyses set forth earlier in this study, it should be apparent that the retention of the *Ultramares* doctrine seems unjustifiable in light of currently emerging tort law concepts¹¹⁸ and the sophisticated nature and complexity of the independent accountant's audit services today.¹¹⁹ In line with the same factors, the cogency of a modified *Ultramares* absent the privity requirement coupled with the maintenance of strict standards of proof, as outlined above, should be realized.¹²⁰ This type of rule would coincide with the general trend in the "products liability" cases¹²¹ and

¹¹⁸ *Supra* notes 101-17.

¹¹⁹ Reexamine notes 71-77, 87-90, and 93-98, and the accompanying text.

¹²⁰ This dispensation of the privity limitation should proceed along lines similar to the model set forth by the California Supreme Court in its landmark anti-privity pronouncement, *Biakanja v. Irving*, *supra* note 52.

¹²¹ An excellent example of the recent trend toward strict liability is the opinion of the Illinois Supreme Court, not generally regarded as a free-wheeling overly libertarian judicial body, in *Suvada v. White Motor Co.*, 32 Ill. 2d 612, 210 N.E.2d 182 (1965). The court concluded that lack of privity was no defense to the manufacturer of a defective product (brake on a motor vehicle); that this result is demanded by public policy and the "justice" of imposing loss on the one creating the risk and reaping the profit. *See also*

would have the insured CPA paying for his mistakes to those who have been thereby injured, just as railroads, automobile manufacturers, and soda-pop bottlers are required by the legal system to compensate the victims of their errors of neglect.¹²² However, the writer must emphasize that concomitant with the destruction of the privity limitation, equity demands the careful maintenance of strict standards of proof¹²³ so that the independent accountant is not forced to become a blanket guarantor of every financial statement to which he appends his opinion.

The obvious escape hatch which comes to mind is the wholesale use of disclaimers of opinion by the accountants. It has been recognized that the widespread use of disclaimers of opinion as a device for avoiding liability would not produce a satisfactory solution, but would only further compound the troubles by its consequences on the credit standing of his clients and its ultimate destruction of the accountant's very purpose for existence.¹²⁴ This is to say nothing of the fact that repetitive use of disclaimers on a wholesale basis may be the quickest means for separating the CPA from his clients (*i.e.*, the client will find itself another accountant).¹²⁵ Alternatively, the independent public accountant's fees would become so unreasonably enormous that their cost would far outweigh their worth with a correlated deterioration of the accountant's attestation function.¹²⁶ Expansion of the Federal regulations promulgated under the sweep of the securities legislation of the 1930's would be inadvisable, if not impossible, at the present time in light of the inherent limitation

Postillon, *Products Liability: The Negligence Theory*, 53 ILL. B. J. 562 (1965); Noel, *Strict Liability of Manufacturers*, 50 A.B.A.J. 446 (1964); Metzger, *The Social Revolution in Products Liability*, 49 ILL. B. J. 710 (1961).

¹²² See Note, 36 IOWA L. REV. 319 (1951).

¹²³ Those concerned with a specific delineation of those legal pitfalls present in day-to-day audit practice should consult Graf and Brown, *Accountants' Legal Responsibility*, 4 ARTHUR YOUNG J. at 1-14 (Jan. 1957).

¹²⁴ Note, *Potential Liability of Accountants to Third Parties for Negligence*, 41 ST. JOHN'S L. REV. 588, 599 (1967):

"A possible undesirable result of use of disclaimers as a hedge against liability could arise where accountants, intimidated by the new standard of liability, use disclaimers even though confident of the accuracy of their audit. Such a practice would hamper the effectiveness of auditors, and could prove to be a needlessly adverse reflection of the credit standing of their client."

¹²⁵ The Wall Street Journal, Nov. 15, 1966, at 1, col. 6.

¹²⁶ See Hanson, *supra* note 90, at 975.

on such regulations insofar as the basis for their validity lies in the interstate securities transactions.¹²⁷ This seems to hinder recovery by third parties other than stockholders who have relied on the independent accountant's misrepresentations, specifically creditors, potential investors and financial analysts.¹²⁸ In addition, the correlated problems of *federalism* arising out of the snatching of a large chunk of common law tort liability from the state courts where the litigation has traditionally rested inevitably seems to creep up.¹²⁹

Suggested reliance on internal professional regulation as the sole deterrent to CPA negligence certainly is tempting from a deterrence standpoint, but clearly is lacking in the *compensatory* need of the tort law system to make the injured party whole again. There may even be grave doubts as to the effectiveness of internal discipline as a deterrent. Possible internal penalties available at the present time include termination or suspension of membership in the American Institute of Certified Public Accountants and/or the State Society of CPA's along with the temporary or permanent loss of the license to practice granted by the particular State. However, the utility of the membership termination or suspension sanctions are questionable when the weakness of their administration in the past is considered. In addition, the revocation of a license by the state normally would be unthinkable absent the most vile type of fraud and collusive behavior on the part of the accountant. Further evidence of the inadequacy of internal discipline as a deterrent is the prevalence of the attitude exemplified by a recent *Journal of Accountancy* editorial which urged member CPAs not to testify "against" colleagues,¹³⁰ viewed by many outside the ambit of the accounting profession¹³¹ and even by some within its own house,¹³² (and perhaps too vigorously) as being commensurate

¹²⁷ Cf. Coffey, *supra* note 21.

¹²⁸ But see *supra* note 21.

¹²⁹ This is especially true in light of the looseness and "easy liability" exemplified by *Fischer v. Kletz*, *supra* note 25.

¹³⁰ *Supra* note 2.

¹³¹ Recent attacks upon accountants in the press, especially The Wall Street Journal, have been prompted by such pronouncements. See also *supra* note 1.

¹³² Spacek, Letter to the Editor, 120 J. Accy. 2d (No. 5, November 1965), where-in the writer, a managing partner of Arthur Andersen & Co., suggests that "to urge the profession not to testify at all when it would be against another CPA member is to ignore the responsibilities that we owe to client and investors . . . The public will not expect high standards of performance if we improperly try to protect ourselves from a proper accountability and thus cover up our deficiencies."

with denying accountability for the work the CPA does.¹³³ Such an editorial pronouncement does have the clear effect of improperly attempting to protect CPAs from a proper measure of personal responsibility,¹³⁴ covering up their deficiencies, and ignoring the moral obligations owed to clients and investors.¹³⁵

A similar practice has long existed in the organized practice of medicine but with an interesting twist. The expert medical testimony "against" colleagues has been discouraged, but has also been used as a "whip" to weed out "undesirable" practitioners.¹³⁶ In effect, there has been a professional allocation of expert testimony on a discriminatory basis¹³⁷—testimony being discouraged against "good" doctors, encouraged against the "bad." However, one should seriously question and challenge the professional association's criteria for differentiating the "good" practitioner from the "bad." Because of these administrative dangers as well as the absence of compensation for the injured third party plaintiffs, internal professional regulation and discipline even as a deterrent to CPA negligence seems highly inappropriate. Nonetheless, such self-regulation can, and should if administered properly, be relied upon by the law with regard to the establishment of standards of care by which negligent conduct may be measured.

The final possibility, strict liability for all financial statement errors, would deem the independent accountant's certificate and statements an "ultrahazardous"¹³⁸ implement similar to an airplane or a wild beast. At first, this theoretical analogy may appear ridiculous but a similar rationale has recently developed concerning products liability litigation, which area it will be remembered was the initial

¹³³ "The accounting profession's apparent reluctance to accept legal responsibility to third parties must be looked upon as a detracting factor in the profession's struggle to gain full public recognition as a profession." SALMONSON, *AUDITING STANDARDS, THE LAW AND THIRD PARTIES* (Ph. D. Dissertation, Univ. of Mich., 1956) at 292-93.

¹³⁴ *Id.* See also Note, 36 IOWA L. REV. 319 (1951); Hawkins, *Professional Negligence Liability of Public Accountants*, 12 VAND. L. REV. 797, 822 (1959).

¹³⁵ Some have even been brazen enough to hint at incorporating with *limited liability* as a solution to the recent rash of lawsuits and publicity. See Zack, *The CPA and Corporate Practice*, 37 N.Y. CPA 185, 186 (1967).

¹³⁶ See Curran, *supra* note 8, at 538-40.

¹³⁷ See Regan, *supra* note 13; Curran, *supra* note 8, has diagramed a "conspiracy of silence."

¹³⁸ RESTATEMENT OF TORTS, § 520 (1935); see Note, *Absolute Liability for Dangerous Things*, 61 HARV. L. REV. 515 (1948).

cornerstone of the original assault on privity.¹³⁹ The prevalence of liability insurance among the large public accounting firms is unbelievably extensive.¹⁴⁰ In addition, the risk-bearing ability of most independent public accounting firms is clearly superior to that of the ordinary investors who might be injured by reliance on the CPA's certificate and statements.¹⁴¹ On the other hand, one should cast serious doubts upon the deterrence aspect of such absolute liability without proof of fault, as well as the sense of forcing independent accountants to guaranty their work from all defects. This could only lead to a total disclaimer of all responsibility in order for the CPA to survive economically which, in turn, would spell the demise of the attestation function and the accountant's economic excuse for existence.

Accountants' liability insurance rates are based on a common risk pool¹⁴² whereunder the rates of one firm are determined on a par with the rates of others of a similar class.¹⁴³ This system may not provide the optimum risk allocation, which is the subsumed major advantage of

¹³⁹ See generally James, *Products Liability*, 34 TEXAS L. REV. 44 (1955). Some recent expansions are *Biakanja v. Irving*, *supra* note 52, and *Dunn v. Ralston Purina Co.*, 38 Tenn. App. 229, 272 S.W.2d 479 (1954). Consider again, in this light, the repudiation of privity in *Suvada v. White Motor Co.*, *supra* note 121.

¹⁴⁰ As long ago as 1959, the *minimum* loss limit reported by national firms was \$5 million, *Insurance for Accounting Firms and Practitioner*, AICPA, ECONOMICS OF ACCOUNTING PRACTICE, (Bulletin 10, 1959). Scholars prominent in the field of tort law have suggested that the prevalence of insurance in certain risk areas creates an atmosphere in which the extension of liability is inevitable. Professor Ehrenzweig has gone even further in advocating that in certain cases (hazardous activities) there should be imposed upon a party the *duty* to carry liability insurance coverage and should this duty to insure be breached by failure to insure, liability would automatically result. See Ehrenzweig, *Assurance Obligees—A Comparative Study*, 15 LAW & CONTEMP. PROB. 445 (1950).

¹⁴¹ The significance of the superior risk-bearing ability of a *class* of potential defendants such as independent accountants lies in the fact that these abilities seem to be the cornerstone for the imposition of liability *without fault* upon members of the particular class. Professor Morris has suggested that such class liability absent fault "has drawn criticism," but "seldom evokes widespread outrage." MORRIS ON TORTS 248 (1953).

¹⁴² In addition, as with other types of liability insurance, the unit cost of limits in excess of the basic policy limit of liability decreases as the limit gradually increases. See *supra* note 140.

¹⁴³ Insurance, even on the basis of a common risk pool, is not a satisfactory solution to the problem of accountants' liability. In fact, it has been reported that, as a result of the recent flood of litigation, only six insurance companies will now handle accountants' liability policies for large amounts of coverage, and then only as a favor to the larger firms, whereas as late as 1966 some fifteen insurance companies freely wrote such policies. See Metz, *Accounting Profession, Vexed By Lawsuits, Weighs Responsibility to Shareholders*, N.Y. Times, Nov. 20, 1966, Sec. 3 at 1, col. 1.

strict liability based upon insurance and risk-bearing capacity because the more careful CPA firms are effectively bearing more than their share of the total loss due to the common risk pool while the more careless CPA firms are shifting part of their loss elsewhere among colleagues in an unfair manner.¹⁴⁴ Nevertheless, some may suggest that this risk allocation data are counteracted by viewing the audit as an ultrahazardous activity or undertaking containing an *inherent risk*.¹⁴⁵ Once this rationale is accepted, there is no great difficulty in concluding that there is no misallocation of risks because it is the common activity itself and not the degree of carelessness with which the activity is undertaken that causes the loss. In any event, the applicability of the absolute liability rationale to CPA audit services is certainly questionable, and the palatability of "strict CPA liability" does not lend much potential for implementation at the present time. Rather, its proponents should be satisfied with the destruction of the *Ultramares* privity citadel. One caveat to the accounting community: Stubborn clinging to the weak logic of *Ultramares* may result in the quite perverse effect of inducing a violent reaction from the legal system whereby the negligence route may be by-passed in favor of absolute liability without fault.

To summarize, the *Ultramares* doctrine will soon fall because of the following errors made by Judge Cardozo:

- (1) Failure to comprehend the nature of the audit function and the potential "built-in" trichotomy available to separate fraud, gross negligence and mere negligence. Liability for mere negligence would not be made "coterminous" with liability for fraud and the three areas of differentiated tainted conduct may be outlined as follows: (a) Collusion with management and deliberate misrepresentations (actionable as *fraud*); (b) Disregard for generally accepted auditing standards and/or audit procedures (actionable as *gross negligence* "tantamount to fraud"); and (c) Attempt at compliance with the standards of performance and accepted procedures but carelessness in this attempt (actionable as *mere negligence*).

¹⁴⁴ See *supra* note 143. It is therein additionally demonstrated that several companies have raised their rates by over 30% in order to accommodate *any* accountants' liability coverage whatsoever.

¹⁴⁵ See Ehrenzweig, *supra* note 140; MORRIS, *supra* note 141.

- (2) Assumption that the independent accountant's certificate and services are rendered "only incidentally" for the use of third parties and for the "primary benefit" of the accountant's client, even though it has been clearly demonstrated that the *real benefit* accrues to the credit granting, stockholder and financial analyst segments of the economy who, in fact, require and demand the CPA's reports and certificate.
- (3) Interpretation that the word "public" in the title "certified public accountant" means only that the CPA's services are "offered to any member of the general public," ignoring the crucial "economic excuse for the CPA's existence"—*independence*, and his function as a safeguard of the public interest serving as a "professional watchdog" and assuming the high degree of responsibility associated therewith.

These three factors, coupled with the widespread prevalence of large amounts of accountants' liability insurance coverage,¹⁴⁶ the CPA's superior risk-bearing capacity to that of the "average investor," and his risk-shifting potential through the fee mechanism,¹⁴⁷ further reinforced by the CPA's billing of fees to his clients which obviously includes some premium for the CPA's "independence,"¹⁴⁸ all demand that the absence of privity no longer be a bar to suits against certifying accountants by third party members of the public who suffer loss as a result of reliance on a report or statement proven to have been prepared negligently by the independent accountant. This unavoidability is the eventual thrust of the recent wave of litigation directed against accountants by investors and credit granters seeking to recoup some measure of salvage for sour investments. The following incisive comments have been recently offered concerning this mad rush to the courthouse and the projected consequences thereof:

Regardless of the reasons for the suits, and although most accountants expect them to fail, they have generated much concern in the accounting community. While there is no reason under classic negligence theory to allow accountants to escape liability to third persons or classes of persons whom they could reasonably have expected to rely upon their financial reports, the public policy issue once again arises. It is feared that the future of accounting firms, particularly small ones,

¹⁴⁶ *Supra* notes 140, 142.

¹⁴⁷ *See supra* notes 141, 145.

¹⁴⁸ Few would be bold enough to question the fact that the *independent* CPA is paid a large premium because of this feature alone. *See CAREY, supra* note 75.

might be jeopardized by exposure to such potentially astronomical liability It also seems safe to say that the possible liability of an accounting firm for its negligence, if a duty of care to third parties were imposed by law, would be much greater than the potential liability of a tortfeasor causing physical harm. Obviously, it is not socially desirable to have reputable accounting firms ruined financially because of one negligent audit.¹⁴⁹

It is clear that the CPA should not be made a guarantor of the absolute accuracy of the financial statements he certifies,¹⁵⁰ and, as a necessary and viable limitation upon such blanket liability to the public, stringent standards of proof of both negligent conduct and reliance must be carefully formulated and scrupulously safeguarded by the courts. This would serve the needed purpose of limitation without the logical strain connected with preservation of "privity," while relying upon the accountants' self-promulgated standards of audit practice as the proper measure of the prevailing standard of care. In the long run, such a structured system of responsibility would act to improve the quality of audit services and to *reduce* the mounting volume of litigation focused against the American accountants. It has been convincingly demonstrated that expansion of accountants' liability *for negligence* does not possess those inherent dangers feared by some, either monetarily or in terms of having to verify each and every journal entry,¹⁵¹ and that juries have been terribly fair to the accountants in the cases litigated thus far.¹⁵² Finally, the judicial "nationalization"

¹⁴⁹ Note, 41 ST. JOHN'S L. REV. 588, 597 (1967).

¹⁵⁰ Prospects for the future clearly indicate that the accounting community cannot close its eyes and hope that this problem will vanish. See Trueblood, *Legal Liability*, CPA, April, 1966, at 2, 3, wherein the AICPA President concludes: "As American business grows larger, the potential losses from business failure become greater for both creditors and investors. Financial distress and failure in business are increasingly accompanied by searches for scapegoats. Auditors become one of the searchers' targets."

¹⁵¹ Hawkins, *supra* note 134, at 822-23: "The cases suggest two considerations as governing the extent to which verification must be made in the investigative process. One is the presence or absence of suspicious circumstances. The other is the need for some reasonable sampling or testing technique, even in the absence of suspicious circumstances. Both considerations are consistent with the standards set by the accounting profession—that is, the accountant should first evaluate the system of internal control to ascertain to what extent it can be relied upon, and then obtain sufficient, competent, evidential matter upon which to formulate an adequate conclusion respecting the matter reported."

¹⁵² Hawkins, *supra* note 134, at 823-24, where the writer notes that juries "have shown their disposition to exonerate the accountant in cases where the accountant could offer some reasonable explanation for the mistake he made" and that the jury under the common law negligence formula will produce verdicts "that the accountant profession can live with."

of this body of common law liability principles under the penumbra of the Federal securities acts, as implied by the decision in *Fischer v. Kletz* and its overtones of "easy liability,"¹⁵³ is hopefully not to become the answer.

APPENDIX A

POST-ULTRAMARES DECISIONS

- 1937—In *O'Connor v. Ludlam*,¹⁵⁴ the United States Court of Appeals for the Second Circuit adhered to *Ultramares* in holding, "A mere mistake in the the balance sheet which is the result of negligence only is not ordinarily a basis for recovery by a third person."¹⁵⁵ The decision also attempted to crystallize the judicial thinking on the questions of falsity and intent, in the following manner. "On the question of falsity, the issue is whether a true or false impression is created. On the question of intent, fraud may be established by showing that a false representation has been made. An intent to deceive may be inferred from a lack of honest representation and if an audit is so superficial as to be only a pretended audit then the element of knowledge of falsity is present."¹⁵⁶
- 1938—In *State Street Trust Co. v. Ernst*,¹⁵⁷ the New York Court of Appeals, after Mr. Justice Cardozo's departure for the United States Supreme Court and apparently desirous of following the *Ultramares* precedent which he constructed, held that in the absence of a contractual relationship or its equivalent, accountants cannot be found legally responsible for ordinary negligence in preparing a certified balance sheet despite their awareness that the balance sheet will be utilized as an instrumentality for obtaining credit.¹⁵⁸ However, the real import of the *State Street Trust* case lies in the majority's clarification of the *Ultramares* doctrine concerning those

¹⁵³ See *supra* note 25.

¹⁵⁴ *O'Connor v. Ludlam*, 92 F.2d 50 (2d Cir. 1937), *cert. denied*, 302 U.S. 758.

¹⁵⁵ *Id.* at 53.

¹⁵⁶ *Id.* at 53-54. Compare this language as to intent with the thoughts on the same subject as recently expressed by the federal district court in *Fischer v. Kletz*, *supra* note 25. Keep in mind the possible creation of a "federal common law" based upon this much more liberal standard of proof and liability.

¹⁵⁷ *State Street Trust Co. v. Ernst & Ernst*, 278 N.Y. 104, 15 N.E.2d 416 (1938).

¹⁵⁸ *Id.* at 111, 15 N.E.2d at 423. Judge Finch, writing for the four man majority, further concluded:

"The foregoing presents abundant evidence from which a jury could find that defendants knew facts which vitally affected financial worth of Pelz-Greenstein (the client), and which defendants totally suppressed on the certified balance sheet but disclosed to Pelz-Greenstein alone . . . Where the record shows acts on the part of the accountants, as outlined above, we cannot say, as a matter of law, that plaintiff has failed to make out a case for the jury." *Id.* at 121.

instances where accountants may be liable to third parties even though deliberate or "active" fraud may be lacking. The court designated as sufficient bases of liability:

- (1) A representation certified as true to the knowledge of the accountant when there is no knowledge;
- (2) A reckless misstatement; or
- (3) An *opinion* based on grounds so flimsy as to lead to the conclusion that there is *no genuine belief in its truth*.¹⁵⁹

In other words, heedlessness or reckless disregard for the truth or the consequences may take the place of deliberate intention and serve as an actionable tort. It has been suggested that *State Street Trust* really represents a subtle but marked shift from the rationale espoused by Cardozo in *Ultramares* because a finding of fraud could now be based upon an error of judgment, which in effect was really negligence.¹⁶⁰ This view does not, however, appear justified, and *State Street Trust* is best viewed as merely explaining how gross negligence could operate so as to give rise to an inference of fraudulent intent.

1943—In *Fidelity & Deposit Co. of Maryland v. Atherton*,¹⁶¹ the New Mexico Supreme Court held that independent accountants who have notice incidental to the performance of their audit examination that the client intends to exhibit to creditors and investors the financial statements which they prepare and certify owe to these third party members of the public a duty not to assert knowledge where no knowledge exists. It must be noted that this pronouncement does not present any radical departure from the *Ultramares* doctrine since Cardozo clearly viewed such a representation of knowledge of truth where there was none as recklessness tantamount to fraudulent intent.

1951—In *Chandler v. Crane, Christmas & Co.*,¹⁶² an English case involving a suit by a third party who relied on the defendant-accountant's certified balance sheet in making an investment in the audited company, the independent accountant's employee admittedly was careless with the performance of the work entrusted to him and knew specifically that the plaintiff was relying on his certified financial statements. The majority of the court reiterated the established rule that false statements are not actionable in the absence of a contractual obligation, a fiduciary relationship, or fraud,¹⁶³ or, to put it more bluntly, that merely negligent misstatements

¹⁵⁹ *Id.* at 112.

¹⁶⁰ SALMONSON, *supra* note 133, at 131-37. See also the strong dissent of Judge Lehman in *State Street Trust Co. v. Ernst & Ernst*, *supra* note 157, at 125 and at 128 where he concluded: "The error of judgment does not indicate a wilful expression of a false opinion, or an expression of opinion based on grounds so flimsy that the jury might conclude that the opinion was not based on genuine belief. To permit recovery in a case where the evidence does not sustain such a conclusion is to wipe out the distinction which this court has always drawn and which it reiterated in the *Ultramares* case."

¹⁶¹ *Fidelity & Deposit Co. of Maryland v. Atherton*, 47 N.M. 443, 144 P.2d 157 (1943).

¹⁶² *Candler v. Crane, Christmas & Co.*, 1 All E.R. 426, 2 K.B. 164 (CA 1951).

¹⁶³ *Id.* at 437 (Asquith, L. J.) and 443 (Cohen, L. J.). Both Lord Justices clung to the restrictiveness of *Derry v. Peek*, 14 App. Cases 360 (1889).

are not actionable absent some relationship of contract or trust between the actor and the injured third party seeking recovery. A strong dissent by Lord Denning, however, no doubt foreshadowed things to come.¹⁶⁴ He argued that the rule regarding recovery for negligent misstatements be made coextensive with the theory permitting recovery by persons not in privity for physical injuries "resulting, for example, from the negligent manufacture of a product, if there is that proximity represented by knowledge of the actor that a *particular* third party intends to rely upon the statements made."¹⁶⁵ Lord Denning was careful to point out that he would confine the duty 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,"¹⁶⁶ and stated he "understood" that it would be "going too far"¹⁶⁷ to make an independent accountant liable to any person in the land who chooses to rely upon the accountants in matters of business.¹⁶⁸

1955—In *C.I.T. Financial Corp. v. Glover*,¹⁶⁹ CIT claimed to have relied on the results of an audit examination by the CPA firm of Barrow, Wade, Guthrie & Co. of a subsequently bankrupt trading corporation in originally making a substantial loan to that client and then refraining from calling in the loan. Chief Judge Clark of the Second Circuit, speaking for the court stated, that in the trial court, District Judge Ryan had properly charged the jury that in order to establish liability on the part of the defendant-accountants to the plaintiff for ordinary negligence in the preparation of a post-loan audit, "the jury had to find that these reports had been made for the *primary benefit* of the plaintiff lender."¹⁷⁰ The court held, however, that the charge to the jury in any event was immaterial and could not have affected the outcome of the litigation because the jury had found that the accountants' representations had not been *negligently* false or misleading. Some have read Judge Clark's opinion for the Second Circuit as standing for much more than it actually says.¹⁷¹ It seems a proper interpretation that the Second Circuit in *CIT* did no more than clarify *State Street Trust* and *O'Connor v. Ludlam* through resort to the *Ultra-mares* term, "primary benefit."

1963—*Hedley Byrne & Co., Ltd. v. Heller & Partners, Ltd.*,¹⁷² although involving the liability of a bank issuing a report on the credit-worthiness of a customer, is a controlling decisional pronouncement over the law of accountants' liability to third parties in England because of its reversal of

¹⁶⁴ *Id.* at 428-436.

¹⁶⁵ *Id.* at 434.

¹⁶⁶ *Id.* at 435.

¹⁶⁷ *Id.*

¹⁶⁸ See also Seavey, *Comments on Candler v. Crane*, 67 L. Q. REV. 466 (1951).

¹⁶⁹ *C. I. T. Financial Corp. v. Glover*, 224 F.2d 44 (2d Cir. 1955).

¹⁷⁰ *Id.* at 46.

¹⁷¹ See, e.g., Saul Levy's reading of the C.I.T. decision in *The C.I.T. Case*, 102 J. Accy. (No. 4, October 1955); *Where We Stand Today*, 26 N.Y. CPA (January, 1956).

¹⁷² *Hedley Byrne & Co., Ltd. v. Heller & Partners, Ltd.*, 2 All E.R. 575, 3 W. L. R. 101 (H. L. 1963).

the *Chandler* case¹⁷³ and the traditional English lumping together of all such similar situations under the blanket catch-basin of "negligent speech." Lord Reid, speaking for the House of Lords, concluded that: "If in the ordinary course of business or professional affairs, a person seeks information or advice from another, who is not under contractual or fiduciary obligation to give the information or advice, in circumstances in which a reasonable man so asked would know that he was being trusted, or that his skill or judgment was being relied on, then the person replying accepts a duty to exercise such care as the circumstances require in making his reply; and a failure to exercise that care will support an action for negligence if damage results."¹⁷⁴ Counsel for the Institute of Chartered Accountants in England¹⁷⁵ have interpreted *Hedley Byrne* as doing nothing more than adopting the rule enunciated in *Ultramares*¹⁷⁶ and also prevailing in South Africa.¹⁷⁷

APPENDIX B¹⁷⁸

Excerpts From Complaint Filed in *Bank of America National Trust & Savings Association v. Peat, Marwick, Mitchell & Co.*, Superior Court of Marin County, State of California, Dept. No. 1, Docket No. 42748

This complaint serves to illustrate the intermingling of fraud, gross negligence and ordinary negligence theories at the trial level as well as the confused state of the law in terms of what I choose to call a *de facto* negligence formula operating in full force under the guise of the *Ultramares* doctrine, Judge Cardozo's opinion in that landmark case to the contrary notwithstanding. For example, whereas the first cause of action in this complaint smacks of intentional misstatement keyed to *knowledge* of falsity the third cause of action likewise utilizes *knowledge* coupled with "suppression" of the truth as an additional distinct wrong for which the bank sought compensation. Further confusion stems from the fact that it was found necessary to include a fifth cause of action grounded on a "failure to provide accurate information" which apparently was deemed to be separate and distinct from both the first and third causes of action in terms of knowledge or knowledge plus suppression, respectively.

The second cause of action framed in terms of "no reasonable ground" for belief is, of course, an offshoot of the *Ultramares* legacy akin to reckless disregard for the truth sufficient to supplant intent by raising an inference of fraud. The

¹⁷³ *Candler v. Crane*, *supra* note 162.

¹⁷⁴ *Supra* note 172, at 584.

¹⁷⁵ *The Accountant* (England), August 7, 1965.

¹⁷⁶ Examine the treatment of *Hedley Byrne* as an "extension" of CPA liability in Great Britain in 120 J. Acc'y. 66 (No. 4, October 1965).

¹⁷⁷ *Herschel v. Mrupi*, 1954 S. A. 464.

¹⁷⁸ Comments on the recent settlement and undisclosed details thereof appear in note 6, *supra*.

fifth cause of action, again, may constitute duplicity in light of the reckless disregard theory espoused by the second cause of action, as apparently it likewise manifests with regard to the first or third causes of action.

The fourth cause of action seems confined in its entirety to carelessness or simple negligence, implicitly repudiating the *Ultramares* exclusion of such a remedy. It is, therefore, a shame analytically that the case was settled before trial for the treatment of this negligence cause of action in the California courts would no doubt have been instructive in light of past assaults on privity in that state.¹⁷⁹ The disposition of the California courts to destroy privity as a limitation upon tort liability may readily explain the pre-trial settlement of this case by the defendant-CPA firm which had earlier indicated for public consumption in the press a preference for having "the matter litigated on its merits."¹⁸⁰ Finally, the sixth cause of action was framed in terms of a statutory violation of a rule of professional conduct promulgated by the State's Board of Accountancy.

The following excerpts from the complaint may further aid in clarifying the above-discussed matters:

VI

BANK is informed and believes and on such information and belief alleges that PEAT was retained by OTIS prior to June, 1958, to conduct annual audits and to issue accountants' reports and financial statements concerning OTIS's financial condition and to perform other accounting services. In 1960 PEAT prepared Consolidated Financial Statements of OTIS and its subsidiaries as of June 30, 1960, and rendered its opinion with respect thereto on or about October 3, 1960 (hereinafter referred to as the "1960 Report"). By the 1960 Report and by prior Consolidated Financial Statements and opinions, PEAT represented, and intended to represent to the creditors of OTIS to whom OTIS might apply for credit, or for the continuance of credit, or to whom OTIS might supply the 1960 Report and said Consolidated Financial Statements and opinions, that PEAT had made careful examinations and audits of the accounts, books and records of OTIS, that in PEAT's opinion the 1960 Report and said prior Consolidated Financial Statements presented fairly the true consolidated financial condition of OTIS and its subsidiaries, and that the 1960 Report and each of said prior Consolidated Financial Statements were based upon such careful examination and audit.

VII

The 1960 Report contained the following representations, among others, which were willfully suggested and asserted as facts:

- A. PEAT's examination was made in accordance with generally accepted auditing standards.
- B. The 1960 Report, with related notes, presented fairly the financial position of OTIS and its subsidiaries as of June 30, 1960, and the results of OTIS's operation for the year then ended, in conformity with generally accepted accounting principles, applied on a basis consistent with that of the preceding fiscal year.

¹⁷⁹ See, e.g., *Biakanja v. Irving*, *supra* note 52.

¹⁸⁰ See the Wall Street Journal account in the text accompanying note 4, *supra*.

- C. Note 5 in explanation of the entries for 'Acceptances, loans and bills payable to banks' and 'Long-term debt' states:

Note 5—Assets Pledged

'Acceptances, loans and bills payable to banks, \$17,971,973 at June 30, 1960, principally relate to coffee import financing under collateral agreements with various banks. Acceptances of \$10,524,060 are collateralized by trust receipts on coffee and the proceeds therefrom. Demand loans and advances of \$4,007,064 arise from matured acceptances. Other bills, drafts and notes totalling \$3,440,849 are unsecured.

'The following assets are pledged as security for long-term debt (in addition to the pledging of capital stock of certain acquired subsidiaries):

	<i>Net book value</i>
Notes receivable	\$ 368,690
San Francisco real estate	403,246
Panama real estate	113,240
	<u>\$ 885,176</u>

- D. The 1960 Report represented the Current Assets for the year ended June 30, 1960, in part as follows:
- | | |
|----------------------------|--------------|
| Trade accounts receivable | \$ 7,167,350 |
| Notes receivable | 1,615,870 |
| Marketable securities | 618,858 |
| Property in course of sale | 2,004,620 |
| Total current assets | \$24,978,494 |
- E. The 1960 Report represented certain 'Real estate held for sale' as an asset with a value of \$1,676,215.
- F. The 1960 Report represented that the 'Total current liabilities' were \$22,082,974.
- G. The 1960 Report represented that the consolidated net loss for the year ended June 30, 1960, was \$828,328.

VIII

The 1960 Report failed to disclose that OTIS was out-of-trust in a substantial amount as of June 30, 1960. As used herein, the expression 'out-of-trust' means failure of a trustee to comply with its obligations as set forth in an applicable trust receipt. . . . Under the terms of such trust receipts, OTIS, as trustee, was required to hold certain documents and entrusted goods in trust for the benefit of BANK, as entrustor, for certain specified purposes subject to BANK's security interest. OTIS was to account by delivering the proceeds of any sale of entrusted goods in whatever form received to BANK immediately upon receipt thereof by OTIS, to be applied to OTIS's related debt to BANK, provided that if proceeds were in the form of notes, bills, receivables, acceptances, or in any form other than cash, they need not be applied until non-cash proceeds were converted to cash by payment. A failure by OTIS to make such delivery or application would make OTIS 'out-of-trust.'

IX

BANK is informed and believes, and on such information and belief alleges, the 1960 Report was prepared and more than one copy of the 1960 Report was

delivered to OTIS in the City and County of San Francisco on or about October 3, 1960. OTIS delivered one of such copies to BANK in San Francisco on December 5, 1960. OTIS, in accordance with its past practice and in accordance with the usage of such reports, furnished the copy of the 1960 Report to BANK in order to obtain credit for the conduct of its business, which practice and usage was known to PEAT at all times mentioned herein; PEAT also knew that BANK would rely on said statement in the extension of credit to OTIS.

X

In reliance upon the 1960 Report and prior Consolidated Financial Statements of OTIS prepared by PEAT and furnished to BANK by OTIS, BANK extended credit secured by trust receipts to OTIS between June 1, 1961, and November 9, 1961, in various amounts including credit in the amount of \$3,550,885.91.

XI

No part of said credit in the amount of \$3,550,885.91 has been repaid. A schedule of said indebtedness showing the credit extended in the form of bankers' acceptances with the date of maturity of each . . . and the balance owing to BANK relative to each such acceptance is attached hereto

XII

The 1960 Report of PEAT was incorrect, untrue, false, and misleading in the following respects, among others:

- A. As of June 30, 1960, OTIS was 'out-of-trust,' which fact, although known to PEAT, was not reported by PEAT.
- B. PEAT represented in its 1960 Report in Note 5, set forth in Paragraph VII hereof, that OTIS was complying with its obligations to secured creditors on bankers' acceptances and trust receipts for coffee, which was not true and which PEAT knew was not true.
- C. PEAT overstated the amount of the assets of OTIS listed under the following categories in the 1960 Report: 'Trade accounts receivable,' 'Notes receivable,' 'Marketable securities,' 'Property in course of sale,' 'Total current assets,' and 'Real estate held for sale.'
- D. PEAT understated the amount of liabilities of OTIS listed under the category 'Total current liabilities' in the 1960 Report.
- E. PEAT understated the amount of consolidated net loss of OTIS under the category 'Net income (loss)' in the 1960 Report for the year ended June 30, 1960.

XIII

All of the aforesaid representations of material facts by PEAT in the 1960 Report were intended by PEAT to induce creditors of OTIS, including BANK, to extend credit to OTIS from time to time in the future. The 1960 Report was prepared by PEAT as a firm of certified public accountants registered with the State of California and was unqualified, except as to certain subsidiaries.

XIV

PEAT in the 1960 Report suggested as facts those material representations contained and alleged in Paragraph VII hereinabove. Said material representations were not true and PEAT knew at the time they were made that they were not true.

XV

BANK extended credit and loaned the amounts of money to OTIS in the manner hereinbefore alleged in Paragraphs X and XI in the reasonable belief that such loans initially secured by trust receipts would continue to be secured by trust receipts until repaid with the proceeds of the sale of the property covered by the trust receipts. At the time said loans were made to OTIS, BANK did not know that OTIS was out-of-trust, or that PEAT overstated the amount of assets in the 1960 Report in the categories of 'Trade accounts receivable,' 'Notes receivable,' 'Marketable securities,' 'Property in course of sale,' 'Total current assets' and 'Real estate held for sale,' or that PEAT understated the amount of 'Total current liabilities' in the 1960 Report, or that PEAT understated the amount of consolidated net loss BANK would not have extended credit and loaned the amounts of money or any amounts of money to OTIS in the manner hereinbefore alleged in Paragraphs X and XI, or in any other manner, if it had known that OTIS was or had been out-of-trust, or that PEAT overstated the amount of assets in the 1960 Report . . . , or that PEAT understated the amount of 'Total current liabilities' . . . , or that PEAT understated the amount of consolidated net loss of OTIS

XVI

As a direct and proximate result of the extension of credit and making of loans to OTIS as hereinbefore alleged, BANK has been damaged in the amount of THREE MILLION FIVE HUNDRED FIFTY THOUSAND EIGHT HUNDRED EIGHTY-FIVE and 91/100 DOLLARS (\$3,550,885.91), the amount unpaid by OTIS on the credit and loans referred to in Paragraphs X and XI hereof, together with interest on the principal amount of each acceptance listed in Exhibit C hereof from the date of its maturity to the date of repayment to BANK.

SECOND CAUSE OF ACTION

For a Second Cause of Action against Defendants, and each of them, Plaintiff alleges:

I

Plaintiff re-alleges and incorporates herein by reference each and all of the allegations contained in Paragraphs I through XIII and XV through XVII of its First Cause of Action hereinabove set forth.

II

PEAT asserted as facts those material representations contained and alleged in Paragraph VII of BANK's First Cause of Action. Said representations were not true and at the time said representations were made PEAT had no reasonable ground for believing them to be true.

THIRD CAUSE OF ACTION

For a Third Cause of Action against Defendants, and each of them, Plaintiff alleges:

I

Plaintiff re-alleges and incorporates herein by reference each and all of the allegations contained in Paragraphs I through XIII and XV through XVII of its First Cause of Action hereinabove set forth.

II

PEAT failed to disclose and in fact suppressed material facts respecting which it is alleged in Paragraph XII of BANK's First Cause of Action herein that the 1960 Report was incorrect, untrue, false and misleading.

III

PEAT knew said undisclosed facts were material, knew BANK would not extend credit or lend further sums of money to OTIS if BANK were apprised of said facts, and PEAT knew further that BANK was unaware of said facts. Facts were communicated by PEAT in the 1960 Report and prior Consolidated Financial Statements of OTIS likely to mislead creditors of OTIS, including BANK, and BANK was misled for want of communication of the facts which were suppressed as alleged in Paragraph II of this Third Cause of Action.

FOURTH CAUSE OF ACTION

For a Fourth Cause of Action against Defendants, and each of them, Plaintiff alleges:

I

Plaintiff re-alleges and incorporates herein by reference each and all of the allegations contained in Paragraphs I through IX, XIII, and XV through XVII of its First Cause of Action hereinabove set forth.

II

In the preparation of the 1960 Report, and prior Consolidated Financial State-

ments of OTIS prepared by PEAT, PEAT negligently failed to exercise that degree of care or skill required by law in the following respects:

- A. It failed to act with that degree of care or skill commonly exercised by certified public accountants in the community of San Francisco, California.
- B. It failed to comply with Section 58 of Title 16 of the Administrative Code of the State of California, issued pursuant to Section 5018 of the Business and Professions Code.

III

PEAT was careless and negligent in its audit and its preparation and issue of the 1960 Report in failing accurately, fairly and clearly to report the financial condition of OTIS, as alleged in Paragraph XII of BANK's First Cause of Action.

IV

As a result of said negligence and carelessness, the 1960 Report was incorrect, untrue, false and misleading in material respects and failed to present fairly the financial position of OTIS and subsidiaries and the result of their operations for the period ending June 30, 1960, in conformity with generally accepted accounting principles applied on a basis consistent with that of preceding fiscal years, to-wit, in failing to report that OTIS was 'out-of-trust,' in overstating the amount of assets . . . , in understating the amount of liabilities . . . , and in understating the amount of the consolidated net loss . . . BANK extended credit and made loans, and suffered loss and damage as alleged in Paragraph XVI of BANK's First Cause of Action, as a direct and proximate result of PEAT's negligence and carelessness as aforesaid.

FIFTH CAUSE OF ACTION

For a Fifth Cause of Action against Defendants, and each of them, Plaintiff alleges:

I

Plaintiff re-alleges and incorporates herein by reference each and all of the allegations contained in Paragraphs I through XI, XIII, and XV through XVII of its First Cause of Action hereinabove set forth.

II

In the 1960 Report, and in prior Consolidated Financial Statements of OTIS prepared by PEAT, PEAT undertook to provide accurate information of facts concerning the financial status of OTIS, and to report what was disclosed by an investigation and review of the financial records of OTIS conducted in accordance with generally accepted accounting standards.

III

PEAT did not provide accurate information concerning the financial status of

OTIS and did not report fully material facts and information discovered in the course of its investigation and review of the financial records of OTIS.

IV

BANK extended credit and made loans, and suffered loss and damage as alleged in Paragraph XVI of BANK's First Cause of Action, as a direct and proximate result of PEAT's failure to provide accurate information and to fully report material facts and information discovered as hereinabove alleged in Paragraph II of this Fifth Cause of Action.

SIXTH CAUSE OF ACTION

For a Sixth Cause of Action against Defendants, and each of them, Plaintiff alleges:

I

Plaintiff re-alleges and incorporates herein by reference each and all of the allegations contained in Paragraphs I through XI, XIII, and XV through XVII of its First Cause of Action hereinabove set forth.

II

The California State Board of Accountancy has adopted rules of professional conduct to which PEAT is, and at all times mentioned herein was, subject. Rule 58 of Title 16 of the California Administrative Code was in effect and applicable to PEAT. The purpose of Rule 58 was, and is, to enable creditors, stockholders and others who receive financial statements to determine the extent to which such statements may be relied upon. Compliance with Rule 58 was mandatory upon PEAT, and PEAT's opinions which were included in the 1960 Report, and said prior consolidated statements, did not comply with Rule 58.

III

BANK extended credit and made loans, and suffered loss and damage as alleged in Paragraph XVI of BANK's First Cause of Action, as a direct and proximate result of PEAT's failure to comply with Rule 58 of Title 16 of the California Administrative Code.

WHEREFORE, BANK prays judgment against Defendants, and each of them, as follows:

1. Damages in the amount of THREE MILLION FIVE HUNDRED FIFTY THOUSAND EIGHT HUNDRED EIGHTY-FIVE and 91/100 DOLLARS (3,550,885.91), plus interest to date of payment;
2. BANK's costs of suit incurred herein; and
3. Such other relief as the Court may deem just and proper."