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Accountants and the Securities Act

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By Spencer Gordon

The securities act of 1933 has already been the subject of wide discussion. Its provisions have been analyzed and its historical and philosophical basis expounded on many occasions. It has elicited vigorous criticism and equally vigorous defense.

But the articles that I have seen contain little mention of the duties and liabilities of accountants. We read at length of the effect of the act upon the financial interests and upon the public, but the difficulties imposed upon accountants are of too technical and special a nature to warrant extended mention in articles dealing generally with the statute. In this address I shall direct myself particularly to the problems of accountants, the origin and extent of their responsibility, the defenses available to them in case of suit and the extent of their liability. I shall thus hope to avoid a repetition of much that has been ably said by others and to deal more thoroughly with the parts of the statute which have particular relation to the accounting profession.

When Responsibility Attaches

The statute provides for the registration of securities with the federal trade commission by the filing of "registration statements" in regard to such securities.

No suit can be brought under the statute against an accountant as such unless he—

". . . has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, . . ." (Section 11 (a) (4).)

See also section 7 in regard to filing the written consent of the accountant so named.

Extent of Responsibility

Section 11 (a) (4) provides for suits against an accountant only—

". . . with respect to the statement in such registration statement, report or valuation which purports to have been prepared or certified by him;"

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The officers and directors of the issuing corporation who sign the registration statement and the directors upon whom liability is imposed by the act may be sued with respect to any part of the registration statement. The accountant, however, may be sued only with respect to the statement in such registration statement, report or valuation which purports to have been prepared or certified by him. He is not responsible for any other part of the registration statement.

Basis of Suit

Section 11 (a) provides for suit—

"In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, . . ."

Section 8 provides that the effective date of a registration statement shall be the twentieth day after the filing thereof, with certain exceptions and with further provisions relating to amendments, inaccurate statements, etc. It is apparent that any attempt at literal enforcement of the provisions of section 11 (a) would create an impossible situation, in that, while provision may be made to insure the truth or untruth of statements when they are made or up to the time that a document containing such statements leaves the control of the maker, it is manifestly impossible for anyone except a prophet to make accurate statements of what facts will be twenty days later. This has resulted in the promulgation of article 15 of the commission's regulations, which provides that the statement—

"shall be dated and shall state that such accountant . . . does believe at the time of the date of such certificate that the statements therein are true . . .

"If anything comes to the attention of such accountant or other expert, or he obtains knowledge of any facts before the effective date of registration which would make any of the material items therein untrue or indicate that there was an omission to state a material fact required to be stated or necessary to make the statements therein not misleading, he shall bring such immediately to the attention of the commission."

Volumes might be written as to what is "a material fact" within the meaning of section 11 (a). The American Law In-

stitute has recently issued its *Restatement of the Law of Contracts.* In chapter 15 on fraud and misrepresentation this statement is made:

"Where a misrepresentation would be likely to affect the conduct of a reasonable man with reference to a transaction with another person, the misrepresentation is material . . ."

Relying on this definition I may venture to say that a "material fact" within the meaning of this section 11 (a) is a fact the untrue statement or omission of which would be likely to affect the conduct of a reasonable man with reference to the acquisition, holding or disposal of the security in question.

The term "registration statement" is defined in section 2 (8) as including—

". . . any amendment thereto and any report, document, or memorandum accompanying such statement or incorporated therein by reference."

Thus any certificate, report and/or valuation accompanying the registration statement would be held a part thereof and might be the basis of a suit.

Who May Sue—Limitation—Waiver

Under section 11 (a)—

". . . any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may . . . sue—."

By section 2 (2) the word "person" is defined as including an individual, a corporation, a partnership, an association, a joint-stock company, a trust, any unincorporated organization or a government or political subdivision thereof. Suit may be brought under section 11 (a) not only by such a person acquiring the security at the time of the original offering to the public but by any such person who may acquire the security at any time thereafter—

"unless it is proved that at the time of such acquisition he knew of such untruth or omission."

In order to maintain such a suit the person acquiring the security does not have to show that he was misled by the incorrect statement or omission, nor does he have to show that he relied on or even that he ever read the registration statement or any part of

it. Unless he actually knows of the untruth or omission, he may purchase the security blindly, and if he later discovers a material misstatement or omission in the registration statement he can take advantage of this as the basis for his suit. The statute places the burden on the defendant to prove that the plaintiff knew of the untruth or omission at the time he purchased the security. The plaintiff does not have to negative this as part of his affirmative case. If, however, the defendant does prove such knowledge on the part of the plaintiff, it is a complete defense to the suit allowed by the act.

The only limitation on such a suit is contained in section 13 providing that—

"No action shall be maintained to enforce any liability created under section 11 . . . unless brought within two years after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence . . . In no event . . . more than ten years after the security was bona fide offered to the public."

Section 14 provides that—

"Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this title or of the rules and regulations of the commission shall be void."

This probably invalidates only a condition, stipulation or provision which has been agreed to by the person acquiring the security in connection with such acquisition. It would hardly be held to mean that a competent person who had once acquired a security could not later, with full knowledge of the facts, give a release of liability or agree to any other condition, stipulation or provision.

Defenses

By section 11 (b) certain defenses are allowed, in addition to proof that the plaintiff at the time of the acquisition of the security knew of the untruth or omission:

". . . that before the effective date of the part of the registration statement . . . (A) he had . . . ceased . . . to act in every . . . relationship in which he was described in the registration statement as acting or agreeing to act, and (B) he had advised the commission and the issuer in writing that he had taken such action and that he would not be responsible for such part of the registration statement." (Section 11 (b) (1).)

While this provision seems to relate primarily to resignations by directors, etc., its language is broad enough to cover the case of the accountant. If an accountant gains any knowledge which makes him wish to repudiate the matter attributed to him before the effective date of the registration statement, he can do so and can escape liability by advising the commission and the issuer in writing that he has ceased to act in the relationship of accountant and that he will not be responsible for the part of the registration certificate attributed to him:

". . . that if such part of the registration statement became effective without his knowledge, upon becoming aware of such fact he forthwith acted and advised the commission, in accordance with paragraph (1), and, in addition, gave reasonable public notice that such part of the registration statement had become effective without his knowledge;" (Section 11 (b) (2).)

In the case of the accountant it probably would be unusual for the part of the registration statement attributed to him to become effective without his knowledge, in view of the fact that his written consent is required to be filed under section 7. But such a situation might arise, for example, where the accountant's consent had been forged or had been filed in violation of an agreement to hold it pending further examination of some phase of the registration statement. In such case he may escape liability in the manner indicated:

". . . as regards any part of the registration statement purporting to be made upon his authority as an expert or purporting to be a copy of or extract from a report or valuation of himself as an expert, (i) he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or (ii) such part of the registration statement did not fairly represent his statement as an expert or was not a fair copy of or extract from his report or valuation as an expert;" (Section 11 (b) (3) (B).)

This provision deals with the situation which will usually be presented in a suit against an accountant and the defense which will usually be made. Whether or not such a defense will succeed will depend, not upon whether the accountant himself believed that he made a reasonable examination, but upon whether the court or the jury under directions from the court determines

that the examination was in fact reasonable in the light of all the evidence in the case. The accountant can testify as an expert as to what he believes is a reasonable investigation and what the practice of accountants is in that regard, and he can produce other accountants to give substantiating testimony, but all that will be admissible only as evidence of what in fact is a reasonable investigation. The same is true of the question of whether the accountant "had reasonable ground to believe and did believe." Those are questions of fact. What the accountants may testify is admissible in evidence, but it is not conclusive.

Thus although the accountant involved may testify that he made what was in his opinion a reasonable investigation and that in his opinion he had reasonable ground to believe, and in fact did believe, that the statements were correct, nevertheless the court or jury, whichever has the duty of determining the facts in a particular case, may find from all the evidence that the accountant has not sustained the burden of proof upon any one or all of these points and that he has not established that he made reasonable investigation, that he had reasonable ground to believe and/or that he did in fact believe.

The defense that the part of the registration statement which is involved in the suit did not fairly represent the accountant's statement as an expert or was not a fair copy of or an extract from his report or valuation as an expert is self-explanatory. Whether this defense has been established will also be a question of fact. Expert testimony will be desirable in many cases, but will not be conclusive:

". . . as regards any part of the registration statement purporting to be made on the authority of an expert (other than himself) or purporting to be a copy of or extract from a report or valuation of an expert (other than himself), he had reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, and that such part of the registration statement fairly represented the statement of the expert or was a fair copy of or extract from the report or valuation of the expert;" (Section 11 (b) (3) (C).)

The application of this subsection to the accountant appears to be as follows: Under section 11 (a) (4) he can be sued only with respect to matter which purports to have been prepared or certi-

fied by him. But in a balance-sheet or profit-and-loss statement certified by an accountant there may be items as to which he indicates that he in turn has relied upon another expert. As to such items, section 11 (b) (3) (C) is a defense if the accountant had reasonable ground to believe and in fact did believe that they were true, etc., and that they fairly represented the statement of the expert, etc.

". . . as regards any part of the registration statement purporting to be a statement made by an official person or purporting to be a copy of or extract from a public official document, he had reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true, and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, and that such part of the registration statement fairly represented the statement made by the official person or was a fair copy of or extract from the public official document." (Section 11 (b) (3) (D).)

Although this subsection would ordinarily be applicable to others than accountants, it is possible that the accountant's certificate may in part purport to be a statement made by an official person or a copy of or extract from a public official document. In such case the accountant will not be held for errors of fact in the statement or document if he had reasonable ground to believe and did believe that the statements were true, etc., and that the official statement or document was fairly represented in the registration statement.

As to each of these defenses the accountant is required to "sustain the burden of proof" (Section 11 (b)). In a trial the burden of proof is ordinarily upon the plaintiff. In all suits brought under section 11 the plaintiff must therefore sustain the burden of proof that there has been, in the part of the registration statement attributed to the accountant, an untrue statement of a material fact or the omission to state a material fact required to be stated in the registration statement or necessary to make the statements therein not misleading, and the plaintiff must also sustain the burden of proof that he has acquired such security, and that the accountant has with his consent been named as having prepared or certified the statement which is the subject of the suit. If the plaintiff establishes these facts, the burden of proof is imposed on the defendant to establish the defenses allowed under section 11 (b). The term "burden of proof" has been discussed in in-

numerable cases. Perhaps as good a definition as can be found is contained in the old New Hampshire case of *Lisbon* v. *Lyman*, 49 N. H. 553, 563, where Chief Justice Doe said:

"The burden of proof (in this case on the subject of emancipation) was on the plaintiff; and this burden was not sustained, unless the plaintiff proved it by a preponderance of all the evidence introduced on the subject. But it was not necessary for the plaintiff to produce anything more than the slightest preponderance . . . Before any evidence was introduced, the scales in which the jury were to weigh the evidence were exactly balanced; if they remained so after all the evidence was introduced, emancipation was not proved; if they tipped ever so little, in favor of the plaintiff, emancipation was proved."

Standard of Reasonableness

Section 11 (c) provides:

"In determining, for the purpose of paragraph (3) of subsection (b) of this section, what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a person occupying a fiduciary relationship."

Broadly speaking, a person occupying a fiduciary relationship is in the position of a trustee, and the duties of trustees have often been the subject of judicial expression. In tentative draft No. 2 of the American Law Institute's restatement of the law of trusts, section 169, the following appears:

"The trustee is under a duty to the beneficiary in administering the trust to exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property; and if the trustee has greater skill than that of a man of ordinary prudence, he is under a duty to exercise such skill as he has.

"Comments:

"a. The standard of care and skill required of a trustee is the external standard of a man of ordinary prudence in dealing with his own property. A trustee is liable for a loss resulting from his failure to use the care and skill of a man of ordinary prudence, although he may have exercised all the care and skill of which he was capable.

* * * * *

"b. Whether the trustee is prudent in the doing of an act depends upon the circumstances as they reasonably appear to him at the time when he does the act and not at some subsequent time when his conduct is called in question."

In the conference report on the securities act of 1933, H. R. report No. 152, 73rd congress, 1st session, appears the following:

"The standard by which reasonable care was exemplified was expressed in terms of the fiduciary relationship. A fiduciary under the law is bound to exercise diligence of a type commensurate with the confidence, both as to integrity and competence, that is placed in him. This does not, of course, necessitate that he shall individually perform every duty imposed upon him. Delegation to others of the performance of acts which it is unreasonable to require that the fiduciary shall personally perform is permissible. Especially is this true where the character of the acts involves professional skill or facilities not possessed by the fiduciary himself. In such cases reliance by the fiduciary, if his reliance is reasonable in the light of all the circumstances, is a full discharge of his responsibilities."

Section 11 (c) is, however, a very difficult section to construe in its relation to the accountant, because we have had no previous experience of an accountant as such acting in a fiduciary relationship.

"The performance of the duties of a trustee requires the exercise of a high degree of fidelity, vigilance and ability. Especially is this true when the trustee is a company organized for the purpose of caring for trust estates, which holds itself out as possessing a special skill in the performance of the duties of a trustee, and which makes a charge for its services which adequately compensates it for a high degree of fidelity and ability in the administration of a trust estate."—*Estate of Allis*, 191 Wis. 23.

As the accountant holds himself out as possessing a special skill in the performance of his duties, and as he performs these duties for compensation, if he is to be held to the standard of persons occupying a fiduciary relationship he must exercise a high degree of fidelity, vigilance and ability. Until the section in question has been construed by the courts, I can only say that it seems to increase the measure of precaution that the accountant must exercise to fulfill his duty of reasonable care. He should approach his work as though he were auditing a transaction involving the funds of a widow or minor child for whom he is the guardian or trustee.

Extent of Liability

Section 11 further provides:

"(e) The suit authorized under subsection (a) may be either (1) to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon,

upon the tender of such security, (2) or for damages if the person suing no longer owns the security."

The first branch of this subsection contemplates a suit brought by a person still holding the security. Upon tender of the security to the person sued, he may recover the consideration paid, with interest from date of payment, less the amount of any dividends or other income received from the security. There is no requirement that the plaintiff be one who acquired the stock at the original offering. Any subsequent purchaser still holding the security may sue under the section.

The liability thus imposed upon the accountant may be largely unrelated to and greatly in excess of any damage caused by the accountant's error. For example, in a $1,000,000 stock issue, the accountant may have made an untrue statement of a material fact by omitting to mention liabilities of $100,000, which in the average case would presumably have affected the value of the securities, when issued, to the extent of ten per cent. By reason of ensuing business conditions the stock which sold for $1,000,000, and in the average case should have sold for $900,000, had the accountant been correct in his statement, may fall on the stock exchange to a total value of $100,000, the stock which was issued at 100 then selling at 10. In this situation the holders of the stock may tender it to the accountant and require him to pay the consideration that they have given for it with the adjustments heretofore mentioned, so that if all the original purchasers still have their stock the accountant will have to pay approximately $1,000,000 and will receive stock worth only $100,000, a net penalty to the accountant of $900,000, although his error only affected the stock to the extent of $100,000.

The second branch of the subsection allowing "damages if the person suing no longer owns the security" apparently does not impose as clear a liability as the recovery of consideration expressly provided in section 11 (e) (1). In order to be consistent with that section, we should expect a provision somewhat as follows:

"or (2) to recover damages, equal to the consideration paid for such security with interest thereon, less the amount received for the security and any income received thereon, if the person suing no longer owns the security."

This would have placed the person who no longer owns the security in the same position as to ability to recover damages as

the person who still holds the security. But the act does not so provide, and, if this ambiguity is not obviated by subsequent legislation, it may be held, in a suit by a person who no longer owns the security, that only real damages can be recovered—that is, damages which are the natural result of the untrue statement or of the omission and can be traced to the error of the accountant. In the absence of clear language imposing such a liability, the courts should be slow to give "damages" which are caused by subsequent economic and market conditions and are not caused by the act of the person sued.

It is interesting to note, however, that Felix Frankfurter, a distinguished lawyer who is reputed to be one of the authors of the act, in an article in *Fortune* for August, 1933, seems to consider that the damages will include the full loss to the investor whether caused by the accountant's error or by subsequent events. His article states in part:

"When circumstances permit suit, the investor, on tender of the security, may recover the consideration he paid, or damages if he has parted with the security. Since the remedy is in the nature of a rescission, it avoids the inquiry, practically impossible, as to the extent of the damages due to the misrepresentation and the extent due to other causes. To force the injured party to disentangle these items of damage would impose upon him an unfair burden in litigation. Where a material misrepresentation has been made, it is not for those who have been guilty of bad faith or incompetence or recklessness to put the buyer to proof that his bargain was not bad for still other causes."

Section 11 contains a further provision:

"(g) In no case shall the amount recoverable under this section exceed the price at which the security was offered to the public."

The effect of this provision in a suit under section 11 (e) (1) is reasonably clear. Such a suit is to recover the consideration paid for the security with interest thereon, less the amount of any income received therefrom, upon the tender of such security. Under section 11 (g) if the consideration paid, with the adjustments provided, is greater than the price at which the security was offered to the public, the amount recoverable under section 11 (e) (1) is reduced to such price.

But when we attempt to determine the effect of section 11 (g) on suits for damages under section 11 (e) (2) if the person suing no longer owns the security, a difficult question is presented. If

the courts hold that the damages recoverable are only such damages as are the natural result of the untrue statement or of the omission, there would appear to be no reason for the application of section 11 (g) in a section 11 (e) (2) case, as such damages could hardly exceed the price at which the security was offered to the public. But if the courts hold that the remedy of damages given by section 11 (e) (2) should be construed in such a way that the person who has parted with the security has a remedy equivalent to the remedy of recovery of consideration expressly given by section 11 (e) (1) to the person who still holds the security, then section 11 (g) may affect such a suit for damages in either of two ways, depending on whether the courts attempt to give a construction which will make the section consistent or whether they follow the literal words of section 11 (g).

1. In order to make the remedies provided by section 11 (e) (1) and 11 (e) (2) entirely consistent, section 11 (g) should be construed to mean that in a suit for damages the measure of recovery shall be based not upon the consideration actually paid for the security but upon the price at which the security was offered to the public if that was less than the consideration paid. Such a construction would make section 11 (e) (1) and (2) and section 11 (g) consistent with the express provisions of section 11 (e) (1) and with the clear application of section 11 (g) to section 11 (e) (1).

2. If, however, section 11 (g) is construed literally, the only provision we find is that the amount recoverable shall not exceed "the price at which the security was offered to the public," and under a literal construction there is apparently no limit to the possible liability. For example, a security might be offered to the public at 100, subsequently purchased by the plaintiff at 200 and sold again at 100. The 100 lost by that particular plaintiff would not exceed the price at which the security was offered to the public. In the case of a fluctuating security with an active market there may be an infinite number of such purchasers who have sustained such losses, in each case up to but not beyond the price at which the security was originally offered to the public. As the same share of stock may be sold again and again as the quotations go up and down, the total of these losses may be more than the total amount at which the issue was originally sold to the public and may in fact be infinite in amount. Although this construction must be recognized as a possibility, I think that it is improbable that the courts will so hold, because it involves the

reading of language into section 11 (e) (2) to make it harmonize with section 11 (e) (1), but the refusal to continue the harmonizing process by reading anything into section 11 (g).

Other Remedies Reserved

By section 16 it is provided:

"The rights and remedies provided by this title shall be in addition to any and all other rights and remedies that may exist at law or in equity."

In *Ultramares Corporation* v. *Touche et al.*, 255 N. Y. 170, it was held that an accountant was liable for negligence only to one with whom he was in privity of contract, but that his liability for fraud ran to any person injured by such fraud, and there might be negligence so gross as to be evidence of fraud. Not involved in this case, but well established at common law, are the principles that the injury must be caused by a reliance on the act of the accountant, and that the damages recoverable must be the natural consequence of the accountant's negligence or fraud.

Under the securities act of 1933, in regard to the parts of the registration statement attributed to the accountant, with his consent, the accountant's liability is greatly broadened:

1. As to the persons who may recover in cases other than those of fraud: They need have no contractual relationship with the accountant.

2. As to the injury: This may be caused in part by events other than the negligence or fraud of the accountant.

3. As to the amount of the damage recoverable: This has been increased by section 11 (e) (1) and perhaps by section 11 (e) (2).

And "all other rights and remedies that may exist at law or in equity" remain.

Conclusion

In the provisions of the securities act of 1933 and in the authorities that I have given in support of the views expressed in this address, there has been much use of the word "reasonable," "reasonable investigation," "reasonable ground to believe," "circumstances as they reasonably appear," "the conduct of a reasonable man." Perhaps one may think that I should have discussed these expressions and should have explained their meaning, but it seemed to me that it would be more appropriate to do this in one place and at the conclusion of my address.

The best definition that I have ever seen of the reasonable man is contained in a volume entitled *Misleading Cases in the Common Law* by A. P. Herbert. I quote from the judgment of Lord Justice Morrow in *Fardell* v. *Potts*, at page 12:

"The common law of England has been laboriously built about a mythical figure—the figure of 'the reasonable man.' . . . He is an ideal, a standard, the embodiment of all those qualities which we demand of the good citizen. . . .

". . . It is impossible to travel anywhere or to travel for long in that confusing forest of learned judgments which constitutes the common law of England without encountering the reasonable man. . . . There has never been a problem, however difficult, which his majesty's judges have not in the end been able to resolve by asking themselves the simple question, 'Was this or was it not the conduct of a reasonable man?' and leaving that question to be answered by the jury.

". . . The reasonable man is always thinking of others; prudence is his guide, . . . He is one who invariably looks where he is going and is careful to examine the immediate foreground before he executes a leap or a bound; who neither star-gazes nor is lost in meditation when approaching trapdoors or the margin of a dock; . . . who never mounts a moving omnibus and does not alight from any car while the train is in motion; who investigates exhaustively the bona fides of every mendicant before distributing alms and will inform himself of the history and habits of a dog before administering a caress; who believes no gossip, nor repeats it, without firm basis for believing it to be true; who never drives his ball till those in front of him have definitely vacated the putting-green which is his own objective; who never from one year's end to another makes an excessive demand upon his wife, his neighbors, his servants, his ox or his ass; who in the way of business looks only for that narrow margin of profit which twelve men such as himself would reckon to be 'fair,' and contemplates his fellow-merchants, their agents, and their goods with that degree of suspicion and distrust which the law deems admirable; who never swears, gambles or loses his temper; who uses nothing except in moderation and even while he flogs his child is meditating only on the golden mean.

"Devoid, in short, of any human weakness, with not one single saving vice, sans prejudice, procrastination, ill-nature, avarice and absence of mind, as careful for his own safety as he is for that of others, this excellent but odious character stands like a monument in our courts of justice, vainly appealing to his fellow-citizens to order their lives after his own example."

I leave you with this definition and with the juries which will be duly empaneled to try any suits arising under the securities act of 1933.