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# Legal Developments: Auditors' Legal Liability

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## Auditors' Legal Liability

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The current concern in professional journals and the multitude of recent cases involving auditors' legal liability to third parties would lead one to believe that the whole problem is a rather new one. However, if one takes a purely historical case law approach, one can see a definite chronological trend toward increasing liability since 1919. More surprisingly, the legal principles that are followed today were formulated in the landmark *Ultramares* case[1] in 1931. Very little (in legal terms) has been changed. Only the number of cases has increased, possibly due to increased investor sophistication and/or an improved communication system. An examination of a few of the older cases and their relationship to some current cases will demonstrate present applicability.

The first case (in the United States) involving auditors' legal liability was decided on the basis of the legal concept of privity of contract. This *case* was the *Landell* case[2] in which the auditors were not held liable to an investor who relied upon the audited statement without the knowledge of the auditors. Since the investor did not have a contractual relationship with the auditors, the auditors were not held liable for their negligence. The court stated that the auditors were liable for carelessness or negligence only to their client.

The *Glanzer* case[3] widened the application of the privity of contract concept. Public weighers, rather than auditors, were the defendants. Bech was selling some beans to Glanzer. Bech asked the defendants, the Shepard Brothers, to weigh the beans and to give a copy of their certified weight to the buyer (Glanzer). The Shepard Brothers did so and were paid by the seller (Bech). When Glanzer attempted to sell the beans, he discovered the weight was incorrect. He sued the public weighers (Shepard Brothers) who claimed they were not liable because they did not have a contractual relationship with Glanzer. Not so, held the court. Since the weighers knew the buyer would rely upon their certification of weight, there existed a relationship so close as to approach privity and the weighers had assumed a "duty to weigh carefully for the benefit of all whose conduct was to be governed."[4] Several cases were decided later on the closeness of the parties rather than on privity of contract.

The *MacPherson* case[5] was notable in that the court held that the defendant was liable to unknown third parties where possible injury to "life and limb" was present, irrespective of contract. The manufacturer of an automobile was found guilty and liable when a defective wheel collapsed and injured an individual who had purchased the automobile from a dealer. The implications of this decision were analyzed in the landmark *Ultramares* case where the court refused to extend the same liability for negligence to "the circulation of a thought or a release of the explosive power resident in words." However, fraud does render an auditor liable and gross negligence can be an inference of fraud. The judge in *Ultramares* examined all aspects of liability and established the major legal principles followed today. These principles were a culmination and clarification of old principles plus the establishment of new ones. Briefly, they are as follows:

1. Privity of contract is not absolutely necessary in establishing liability for mere negligence. Where the relationship is so close as to approach privity, accountants are liable to persons who are legally "third parties." Such a relationship exists when the auditor has knowledge that a third party will rely and/or act upon the statements. Such a relationship also exists when an accountant audits a company for the expressed use by a third party.

2. When *mere* negligence is present, persons having no privity of contract (or its equivalent as described in No. 1 above) do not have recourse against the auditors. However, the auditors are liable to their employer (the audited company) for mere negligence.

3. Although negligence and fraud are not the same, *gross negligence* can be an *inference of fraud.* A pretense of knowledge where there is no such knowledge is fraud. The presence of an "intent to conceal" is also fraud.

4. Where fraud or an inference of fraud is present, accountants are liable both to persons having privity and to all third parties who rely upon their grossly negligent (fraudulent) statements.

5. *Reliance* by third parties is necessary to establish liability, even in cases of fraud.

The early cases following *Ultramares* illustrated how workable the distinction between mere and gross negligence (fraud) was. For example, in the *Beardsley v. Ernst* case,[6] the auditors specifically stated in their opinion that they had not examined the records of foreign constituent companies but had relied upon statements certified by a firm of chartered accountants. When the foreign companies later went defunct, the plaintiffs sued on the grounds that the auditors had "pretended knowledge where there was no such knowledge." The court held that the auditors were not liable as they had clearly disclosed their reliance upon information from abroad and there was "no pretense of knowledge as to the information received which would make defendants liable."

*The State Street Trust* case[7] was decided against the auditors under the same *Ultramares* principles. The auditors had sent ten copies of a "clean opinion" to the client with the knowledge that they would be used to obtain credit. After a lapse of thirty days, the auditors sent the client one copy of the statements with additional explanations which indicated that the auditors knew that certain reserves were inadequate. The amounts involved were material and the court held that the auditors were both grossly negligent and had an intent to conceal by not disclosing what they knew to the readers of the first set of statements.

In more current cases, the same principles have been applied. Much has been written about the *Yale Express* case[8] in which the court's decision against the auditors was based on the fact that the auditors knew that their statements were misleading (as a result of a subsequent management study) but failed to disclose it to the persons who were relying upon the statements. The court held that their actions indicated an "intent to conceal" and, therefore, fraud.

The *Bar Chris* case[9] involved many areas of dispute but the court held that there were several material misstatements which the auditors either knew or should have known. The court held that the auditors' opinion on such misleading statements constituted a "pretense of knowledge" and "negligence so gross as to infer fraud." Two interesting factors were decided in this case: the judge attempted to define what constituted materiality and the court held that auditors should not be held to a standard higher than that of their profession.

In the *Continental Vending* case[10] the court held that the auditors should have known that the president of the company was "looting the company for his own private dealings" and that the receivable and payable from the president's affiliated company should not have been netted. The first holding constituted an "intent to conceal" and the latter constituted "negligence so gross as to infer fraud." The distinguishing factor of this case was the imposition of criminal penalties. In other types of cases fraud had always resulted in criminal charges, so it is not too surprising that such penalties were imposed upon auditors.

Two recent cases deserve comment for their extension of case law principles. The first, the *1136 Tenants' Corporation* case, was decided against the accountants although no audit was involved. The accountants had done only the writeup work, but the court found that several glaring misstatements and omissions (missing invoices, irregular entries, etc.) constituted negligence so gross as to infer fraud. The court held that, since these obvious misstatements were not disclosed, the accountants were liable even though they had not conducted an audit. It is possible that this decision will set a very unfavorable precedent for future cases involving accountants.

The second, the *Rhode Island Trust* case,[11] was decided on the *Ultramares* principles even though the auditors had issued a disclaimer with their opinion. The court held that in spite of their disclaimer the auditors had implied in the notes to the financial statements that certain nonexistent leasehold improvements did exist. This decision points out the importance of careful and precise wording in audit reports.

It will be interesting to follow the trend of auditors' legal liability in the future, but, for the present, it appears that *Ultramares* is still the major precedent and that the principles laid down in that case are still the major guidelines in auditors' legal liability.

### Footnotes

1 *Ultramares Corp. v. Touche*, 229 App. Div. 581, 243 N.Y. Supp. 179 (1st Dept. 1930), reviewed, 255 N.Y. 170, 174 N.E. 441 (1931).

2 *Landell v. Lybrand, et. al.*, 107A783; 264Pa.406, 107 Atl. 783 (1919).

3 194 App. Div. 793, 186 N.Y. Supp. 88 (1922).

4 *op. cit.*, p. 794.

5 *MacPherson v. Buick Motor Co.*, 145 N.Y.S. 462; 160 App. Div. 55 (1914).

6 47 Ohio App. 241, 191 N.E. 808 (1934).

7 *State Street Trust Co. v. Ernst*, 278 N.Y. 104, 15 N.E. 2d416 (1938).

8 *Stephen Fischer, et. al. v. Michael Kletz, et. al.*, 266F. Supp. 180 (1967).

9 *Escott v. Bar Chris Construction Corporation*, 283 F. Supp. 643 (SDNY, 1968).

10 *U.S. v. Carl J. Simon, et. al.*, 425 F 2d 796 (1969). Cert. Den. 90 S Ct. 1235 (March 30, 1970).

11 David B. Isbell & D. R. Carmichael, "Disclaimers and Liability – The Rhode Island Trust Case," *The Journal of Accountancy*, April 1973, p. 37.