

# STUDENT COMMENT

## ACCOUNTANTS' LIABILITIES TO THIRD PARTIES UNDER COMMON LAW AND FEDERAL SECURITIES LAW

A recent decision in the United States District Court for the Southern District of New York raises unique and interesting issues with respect to the duties of accountants to persons other than their clients. In *Fischer v. Kletz*,<sup>1</sup> the defendant accountants, Peat, Marwick, Mitchell and Company (PMM),<sup>2</sup> honestly and carefully, but nevertheless falsely, represented the financial status of Yale Motor Transport Company (Yale)<sup>3</sup> on balance sheets which were known to be for the use of the investing and lending public. The balance sheets showed a substantial net income for the fiscal period in question, when in fact, there was a substantial loss. Upon a re-examination of Yale's status,<sup>4</sup> PMM discovered facts which indicated the error in the original audit. PMM informed Yale of the factual discovery and alerted Yale to the misrepresentative character of the balance sheet; neither PMM nor Yale took any further action. Subsequently, Yale went into bankruptcy. Those purchasers of Yale securities who had acquired their securities after PMM's discovery brought suit for damages against PMM under the Securities Act of 1933 and the Securities Exchange Act of 1934, and for common law deceit. PMM moved to dismiss, raising a major legal issue: whether accountants have a duty to the investing and lending public to disclose misrepresentations discovered after the distribution of their certified balance sheets. The court overruled PMM's motions to dismiss and determined that accountants *may* be obliged both at common law and under the securities legislation to disclose such misrepresentations. This comment will consider the issues raised by *Fischer v. Kletz* against the general background of accountants' obligations to persons other than their clients under both the common and statutory law.

### I. COMMON LAW

#### A. *The Foundations of Liability*

1. *Deceit—The Duty of Honesty.* An action in tort for deceit can be brought against a person who intentionally misrepresents a material fact to another who justifiably relies thereon and is thereby damaged.<sup>5</sup> A fact is

<sup>1</sup> 266 F. Supp. 180 (S.D.N.Y. 1967). For other published materials dealing with this controversy, see *Fischer v. Kletz*, 249 F. Supp. 539 (S.D.N.Y. 1966) (motion to stay pending resolution of factual questions by the ICC); 41 F.R.D. 377 (S.D.N.Y. 1966) (motion for determination of class in class actions); CCH Fed. Sec. L. Rep. ¶ 91,835 (S.D.N.Y. 1966) (motion for discovery); CCH Fed. Sec. L. Rep. ¶ 91,866 (S.D.N.Y. 1966) (motion to intervene in class action); Brief for SEC as Amicus Curiae, *Fischer v. Kletz*, CCH Fed. Sec. L. Rep. ¶ 91,844 (S.D.N.Y. 1966).

<sup>2</sup> See generally *Fortune*, July 1, 1966, at 88.

<sup>3</sup> See generally *Fortune*, November, 1965, at 144.

<sup>4</sup> 266 F. Supp. at 183.

<sup>5</sup> See generally W. Prosser, *Torts* § 102, at 713-19 (3d ed. 1964) [hereinafter cited as Prosser].

material if it would invite reliance by a reasonable man.<sup>6</sup> There seems to be little doubt that the accountant's balance sheet may encourage or discourage a prospective purchaser or seller. The facts stated therein are therefore material. It is also quite certain that the reliance of the ordinary creditor or investor on the balance sheet is justified. Indeed, a primary function of the balance sheet is to provide information to those who are concerned with the financial condition of the company audited. Neither will a serious problem of causation be presented with respect to the accountant's deceit, since, if the defendant had represented truly, the plaintiff investor or lender would not have been injured. The true facts would have come to his attention either directly or indirectly (as through a stockbroker), and he would not have invested or lent.

While the elements of materiality of the misrepresentation, justifiability of reliance, and causative connection between the harm done and the defendant's statement may concern courts in deceit cases, it is the element of intent, scienter, which most frequently invites discussion.<sup>7</sup> Scienter clearly exists when the speaker knows that his statement is false. When the speaker's frame of mind is less than one of intent to mislead, courts have enlarged scienter to include recklessness.<sup>8</sup> In *Ultramares Corp. v. Touche*,<sup>9</sup> for example, the defendant accountants were employed by the Stern Company to perform the yearly audit of the company's books. The defendants overvalued the company's assets, and the overvaluation was incorporated in the balance sheet upon which the plaintiffs, creditors of the company, subsequently relied in extending credit. When the company failed, the plaintiffs sought recovery of the loans made, alleging that the defendants' overvaluation was fraudulent, or at least negligent. The New York Court of Appeals, speaking through Judge Cardozo, held that the defendants owed relying parties a duty of honesty imposed by law. While the record did not reveal facts sufficient to support a finding of fraud, it did show that the defendants' conduct was sufficiently reckless to support an inference of fraud. In *State St. Trust Co. v. Ernst*,<sup>10</sup> the holding of *Ultramares* on the issue of recklessness was further extended. The defendant accountants released to their clients a balance sheet which listed accounts receivable as assets, when in fact it was doubtful whether 38 percent of those receivables would ever be collected. An explanatory covering letter was not sent to possible lenders or investors until thirty days after the balance sheet was sent. In the interim, the plaintiffs had extended credit to the client company. When the company failed, the plaintiff creditors sued, alleging fraud.

<sup>6</sup> Restatement of Torts § 538(2)(a) (1938).

<sup>7</sup> See generally Prosser § 102, at 715-16.

<sup>8</sup> For some time the common law failed to recognize a cause of action in deceit for negligent misrepresentation. If a defendant could show an honest belief on his part in the truth of the representation at the time of its making, then the complainant had no grounds for suit, even if the defendant had negligently misrepresented. Because this rule worked harsh results by denying to innocent relying parties recoveries against misrepresenting defendants who were at fault, the rule developed that scienter will be imputed to a speaker who makes a representation either with reckless disregard whether it be true or false, or conscious that he has no basis in fact to so represent.

<sup>9</sup> 255 N.Y. 170, 174 N.E. 441 (1931).

<sup>10</sup> 278 N.Y. 104, 15 N.E.2d 416 (1938).

The trial court set aside a verdict for plaintiffs and directed a verdict for defendants. The New York Court of Appeals reversed, saying:

A refusal to see the obvious, a failure to investigate the doubtful, if sufficiently gross, may furnish evidence leading to an inference of fraud so as to impose liability for losses suffered by those who rely on the balance sheet. In other words, heedlessness and reckless disregard of consequence may take the place of deliberate intention.<sup>11</sup>

In summary, then, to recover against an accountant for deceit, an injured creditor or investor must show an intentional or reckless misrepresentation in a balance sheet upon which he has justifiably relied.

2. *Negligent Misrepresentation—The Duty of Care.* The elements of negligent misrepresentation are a duty of care and its breach, resulting in harm to the plaintiff. The duty of care is created in the case of an accountant when he contractually undertakes to perform his services. What is "reasonable care under the circumstances" with respect to accountants is determined by a factual consideration of accounting practice and procedure.<sup>12</sup> The duty of care is breached by failure to meet minimal standards of accounting practice and procedure, resulting in a balance-sheet misrepresentation.<sup>13</sup> The causative connection between the harm done and the accountant's misrepresentation is determined by the application of the "but for" rule of causation, as in the action for deceit.<sup>14</sup> To whom the accountant is liable for breach of the duty of care will be considered in a later section.

3. *Strict Liability—The Duty of Correctness.* Strict liability for representations neither fraudulent nor careless, but nevertheless false, has been recognized by both law and equity.<sup>15</sup> When one party induces another to contract by means of an innocent misrepresentation, equity recognizes a right of rescission.<sup>16</sup> Moreover, a damage remedy has become available to a party induced to contract by an innocent misrepresentation of the other party.<sup>17</sup> In addition, in *Ford Motor Co. v. Lonon*,<sup>18</sup> a consumer-third party, who purchased a chattel from a retail dealer in reliance on the innocent but false representations of the chattel's manufacturer, was allowed as damages from the chattel's manufacturer the difference between the actual value of the chattel and its value if it were as represented. The plaintiff, having relied on Ford manuals and advertising, purchased a Ford tractor from a local dealer. When the tractor failed to operate as represented the plaintiff sought from Ford the pecuniary loss which allegedly resulted from Ford's false representation. The court relied heavily on two sections of the Restatement (Second) of

<sup>11</sup> Id. at 112, 15 N.E.2d at 418-19.

<sup>12</sup> See generally Committee on Auditing Procedure, Am. Inst. of Accountants, Generally Accepted Auditing Standards (1954); Hawkins, Professional Negligence Liability of Public Accountants, 12 Vand. L. Rev. 797, 802-09 (1959); Rouse, Legal Liability of the Public Accountant, 23 Ky. L.J. 1, 11-37 (1934).

<sup>13</sup> See Hawkins, *supra* note 12, at 804-09.

<sup>14</sup> See id. at 800; Rouse, *supra* note 12, at 37-39.

<sup>15</sup> Prosser § 102, at 724.

<sup>16</sup> Fields v. Hauptert, 213 Ore. 179, 181, 323 P.2d 332, 333 (1958).

<sup>17</sup> Stein v. Treger, 182 F.2d 696, 699 (D.C. Cir. 1950).

<sup>18</sup> 398 S.W.2d 240 (Tenn. 1966).

Torts—section 402B<sup>19</sup> and the proposed section 552D.<sup>20</sup> Both sections are closely related to the growth of strict liability in the products area, and both seek to fill gaps in the development of strict liability for products injurious to either person, property, or pocketbook. Section 402A of the Restatement<sup>21</sup> would impose such liability on the manufacturer if the product was defective and, therefore, dangerous when it left the manufacturer's control. The showing of a defect is essential to a section 402A recovery. Section 402B and proposed section 552D impose the same liability. A manufacturer is liable for harm resulting from a product even though he does not sell the product to the injured person, is careful in both manufacture and inspection, and does not release the product in a defective condition, as long as he makes representations about the product which induce its purchase and which turn out to be false.

No court has attempted to analogize strict liability for false representations in the products area to the area of service contracts. Dean Prosser has, however, hinted that strict liability for misrepresentation is an expanding area, and that there may be no significant reason to distinguish between misrepresentations related to contracts for the sale of goods and those related to contracts of service.<sup>22</sup> Thus, an accountant who performs his services with both honesty and utmost care could be held liable if he misrepresents the actual financial status of the corporation audited.

Several reasons militate against such a rule of liability. First, there is a fundamental difference between the sale of goods and the performance of

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<sup>19</sup> Restatement (Second) of Torts § 402B (1964) states:

One engaged in the business of selling chattels who, by advertising, labels, or otherwise, makes to the public a misrepresentation of a material fact concerning the character or quality of a chattel sold by him is subject to liability for physical harm to a consumer of the chattel caused by justifiable reliance upon the misrepresentation, even though

(a) it is not made fraudulently or negligently, and

(b) the consumer has not bought the chattel from or entered into any contractual relation with the seller.

<sup>20</sup> Restatement (Second) of Torts § 552D (Tent. Draft No. 17, 1966) states:

One engaged in the business of selling chattels who, by advertising, labels, or otherwise, makes to the public a misrepresentation of a material fact concerning the character or quality of a chattel sold by him is subject to liability for pecuniary loss caused to another by his purchase of the chattel in justifiable reliance upon the misrepresentation, even though it is not made fraudulently or negligently.

<sup>21</sup> Restatement (Second) of Torts § 402A (1964) states:

(1) One who sells any product in a defective condition unreasonably dangerous to the user or consumer or to his property is subject to liability for physical harm thereby caused to the ultimate user or consumer, or to his property, if

(a) the seller is engaged in the business of selling such a product, and

(b) it is expected to and does reach the user or consumer without substantial change in the condition in which it is sold.

(2) The rule stated in Subsection (1) applies although

(a) the seller has exercised all possible care in the preparation and sale of his product, and

(b) the user or consumer has not bought the product from or entered into any contractual relation with the seller.

<sup>22</sup> Prosser § 102, at 725-27.

services.<sup>23</sup> The end result sought from the manufacturer in the sale of goods transaction is a product which is sold to the consumer and which will do him no harm. That end result is most probably going to be reached as long as the manufacturer runs a quality operation. The manufacturer controls the environment of production and can reduce variables which might produce defects. In the service contract, the end result sought, the solution to a particular problem, is often beyond the control of the performing party. What is really bargained for is the practical experience and knowledge of the performing party, which, it is hoped, will produce the desired result. Often, however, that result is not produced, precisely because unknown or uncontrollable factors intervene and destroy the effectiveness of the servicer's performance. Certainly, no compelling argument can be made for rendering doctors strictly liable when they perform their services at a level of skilled competence but nevertheless fail to cure the patient. Any attempt to impose such a liability on an accountant is an attempt to impose a perfection of result impossible of achievement.

There are further reasons militating against a rule of strict liability. It should be noted that the accountant derives no direct benefit from his misrepresentation. In the products area, on the other hand, representations are made in propaganda selling devices which increase sales and thereby increase the manufacturer's profits. Recovery against he who has derived financial benefits as a direct result of his misrepresentations has a restitutional nature, completely lacking in cases of recovery against a party who innocently misrepresents but does not take any benefits from that misrepresentation. It is for this reason that "liability has been rather narrowly limited to defendants who have some pecuniary interest in making the representation, to the exclusion of others."<sup>24</sup> Furthermore, a rule of strict liability might work a fundamental injustice on accountants. If a client hid liabilities or inflated assets in such a way that even great care on the part of the accountant could not discover the fraud, the rule of strict liability would shackle the accountant with liability to creditors or investors injured by the fraud of another.<sup>25</sup> Finally, the historical development of misrepresentation has been restrictive. The barriers to third-party recovery for negligent misrepresentation are just now being broken. In view of this, any development of strict liability concepts in the area of accountants' representations seems improbable.<sup>26</sup>

<sup>23</sup> See Comment, *Contract Formation and the Law of Warranty: A Broader Use of the Code*, 8 B.C. Ind. & Com. L. Rev. 81, 87-89 (1966).

<sup>24</sup> Prosser, *Misrepresentation and Third Persons*, 19 Vand. L. Rev. 231, 237-38 (1966).

<sup>25</sup> See Hawkins, *supra* note 12, at 799-802.

<sup>26</sup> Much of the development of strict liability in the products area has been based on the economic theory of "enterprise liability." According to this theory, the risk of loss from defective products is placed upon the manufacturer rather than the individual consumer or user, since the manufacturer can insure against the risk and pass the cost of insurance off to his buyers, thus spreading the risk of loss over the entire group of buyers. The same type of economic reasoning is applicable to the service area. If strict liability is imposed on accountants, they will insure, passing the costs of premiums onto their customers, the businesses who use their services. In turn, the businesses will pass the costs onto the consumers of their products or services. Thus, the risk of loss from accountants' mistakes is spread over a broad group at a low cost per person. On the other hand, if accountants are relieved of strict liability, the risk of loss is cast upon the investing and lending public. While it is theoretically possible that every lender or creditor could insure against the risk of loss from a balance-sheet mistake, it is

B. *The Extent of Liability*

1. *The Extent of Liability for Deceit.*<sup>27</sup> Because deceit is an intentional tort, the legal fundamentalist, analogizing to torts such as battery, is inclined to apply the doctrine of transferred intent and to conclude that any person injured by the deceit in the manner intended by the speaker is entitled to recover, even if the representation was not directed at that person. In fact, the law at first severely limited the liability of an intentional misrepresenter. In *Peek v. Gurney*,<sup>28</sup> Lord Cairns stated:

Every man must be held responsible for the consequences of a false representation made by him to another, upon which a third person acts, and so acting is injured or damnified, *provided it appear that such false representation was made with the intent that it should be acted upon by such third person in the manner that occasions the injury or loss.*<sup>29</sup> (Emphasis added.)

Apparently, the House felt that any other rule would allow limitless liability, wholly disproportionate to the wrong. In the usual case of transferred intent, the complainant is almost invariably one person, whereas, from its nature, the intentional misrepresentation may continue far beyond its original intended ambit to a limitless group of prospective plaintiffs. Indeed, it is the limitless character of liability that is critical; for members of large but quantitatively defined groups can recover under the rule of *Peek v. Gurney* as long as the misrepresentation is intended to influence them.

The modern rule, precipitated by Judge Cardozo's decision on the issue of deceit in *Ultramares*,<sup>30</sup> has extended the ambit of an intentional misrepresenter's liability to those persons whom the speaker should reasonably have foreseen would be injured by his misrepresentation. While this rule increases the liability of the intentional misrepresenter, it clearly defines its limits and thus is not subject to the objection of limitless liability raised by the House in *Peek v. Gurney*. There are several justifications which support the modern

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practically improbable. Consequently, a single individual lender or creditor is apt to be subjected to an extensive loss. Furthermore, from a logical point of view, it is probably far more feasible to establish rates at which accountants could be covered than rates at which investors or lenders could be covered.

It should be noted that no court has considered the application of "enterprise liability" to the service area.

<sup>27</sup> See generally Levitin, *Accountants' Scope of Liability for Defective Financial Reports*, 15 *Hastings L.J.* 436, 450-60 (1964); Meek, *Liability of the Accountant to Parties Other Than His Employer for Negligent Misrepresentation*, 1942 *Wis. L. Rev.* 371-77; Prosser, *supra* note 24; Note, *The Accountant's Liability—For What and To Whom*, 36 *Iowa L. Rev.* 319, 321-22 (1951).

<sup>28</sup> L.R. 6 H.L. 377 (1873). The defendant promoters of a corporation issued a prospectus in order to induce the investing public to purchase the corporation's first allotment of ownership shares. The plaintiff, who received and read the prospectus which contained a material misrepresentation, did not purchase from the corporation but rather purchased a few months later in the market. When the corporation failed, the plaintiff brought suit. The House of Lords denied recovery, limiting the defendants' liability exclusively to recipients of the prospectus who purchased the original allotment, since they only were those whom the defendants intended to induce by the prospectus.

<sup>29</sup> *Id.* at 413.

<sup>30</sup> 255 N.Y. 170, 174 N.E. 441.

rule.<sup>31</sup> First, it would be anomalous for the liability of the intentional misrepresenter to be more limited than that of the negligent wrongdoer in personal injury and property damage cases. Since liability extends to foreseeability in those cases it should extend at least as far in intentional misrepresentation cases. Second, the choice between the intentionally tortious defendant and the innocent injured plaintiff is usually made in favor of the innocent party, unless some compelling policy factor dictates otherwise. Third, the modern rule may have some deterrent effect on future misconduct. It is submitted that the modern rule which extends liability to the limits of foreseeability is a better rule than the older, more limited, rule.

2. *The Extent of Liability for Negligent Misrepresentation.* Many legal writers have concluded that accountants, if negligent, should be liable to certain third persons injured as a result of their negligence.<sup>32</sup> Nevertheless, no appellate court decision, English or American, has ever held an accountant liable to a third person for negligent misrepresentation. To understand the present state and tendency of the law of extent of liability for negligent misrepresentation, in particular as it relates to accountants, it is necessary to consider briefly earlier law relating to legally imposed duties which may arise out of contractual relationships.

The earlier common law rule was that the only duties arising out of a contractual relation were contractual duties and a duty of careful performance owed by each party to the other; that is, all duties were bounded by privity of contract.<sup>33</sup> With the development of negligence theory, that rule was replaced by the general principle that a contractor owes a duty of care imposed by law to those persons who could foreseeably be injured should the contract not be performed with care.<sup>34</sup> Although many cases extended and refined this principle, it has received only slight acceptance in services cases where economic loss has followed from a negligent misrepresentation.<sup>35</sup>

In *Glanzer v. Shepard*,<sup>36</sup> however, the New York Court of Appeals extended this negligence principle into the area of economic loss caused by misrepresentation. In that case, the defendant, a professional weigher and certifier, contracted with a bean vendor to weigh a shipment of beans and to forward certificates to both the plaintiff vendee and the vendor of the shipment. The plaintiff paid his seller for the beans in accordance with their weight as represented by the defendant's certificate. When it turned out that the beans did not weigh as much as represented, and that therefore the buyer had acquired less than he paid for, he sought the difference in damages. Recovery was allowed on the ground that the defendant had negligently misrepresented,

<sup>31</sup> See generally P. Keeton, *The Ambit of a Fraudulent Representor's [sic] Responsibility*, 17 Texas L. Rev. 1 (1938).

<sup>32</sup> E.g., Hawkins, *supra* note 12, at 818-21; Levitin, *supra* note 27, at 449-50; Seavey, *Candler v. Crane, Christmas & Co., Negligent Misrepresentation by Accountants*, 67 L.Q. Rev. 466, 473-81 (1951).

<sup>33</sup> E.g., *Winterbottom v. Wright*, 10 M. & W. 109, 159 Eng. Rep. 402 (Ex. 1842).

<sup>34</sup> E.g., *MacPherson v. Buick Motor Co.*, 217 N.Y. 382, 111 N.E. 1050 (1916).

<sup>35</sup> E.g., *Jaillet v. Cashman*, 235 N.Y. 511, 139 N.E. 714 (1923), *aff'g per curiam* 202 App. Div. 805, 194 N.Y. Supp. 947 (1922), *aff'g mem.* 115 Misc. 383, 189 N.Y. Supp. 743 (1921).

<sup>36</sup> 233 N.Y. 236, 135 N.E. 275 (1922).

and that the plaintiff's reliance was the very aim and purpose of the certificate. Citing *MacPherson v. Buick Motor Co.*,<sup>37</sup> the court said:

In such circumstances, assumption of the task of weighing was the assumption of a duty to weigh carefully for the benefit of *all whose conduct was to be governed*. We do not need to state the duty in terms of contract or of privity. Growing out of a contract, it has none the less an origin not exclusively contractual. Given the contract and the relation, the duty is imposed by law. . . .

. . . Constantly the bounds of duty are enlarged by knowledge of a prospective use . . . .<sup>38</sup> (Emphasis added.)

*Glanzer* was received as a logical development of the risk theory of liability. Virtually all observers surmised that it stood for the proposition that one who negligently misrepresents a material fact will be liable to foreseeable third persons, who rely on the misrepresentations and are economically injured as a result.<sup>39</sup> This surmise was, however, modified by the subsequent *Ultramares* case,<sup>40</sup> where the New York Court of Appeals, the same court that had decided *Glanzer*, denied recovery on the ground that the potential limitlessness of recovery was a substantial policy reason militating against the imposition of liability, even though the class of persons injured was foreseeable. The court reasoned that if recovery were allowed, many professions would be inhibited and their respective existences endangered. *Glanzer* was distinguished on the basis that the certificate in that case had the plaintiff's reliance as its very aim and purpose, whereas in *Ultramares* the balance sheet was primarily for the benefit of the company audited, and only incidentally for the benefit of its creditors and investors. Moreover, in *Glanzer*, liability was limited in both amount and number of potential complainants.

The *Ultramares* decision has been criticized on several grounds. First, the social utility rationale put forward for the rule was considered weak and impractical. The court's statement that accounting and other related professions would be unable to sustain the huge burdens of liability was dismissed as

<sup>37</sup> 217 N.Y. 382, 111 N.E. 1050 (1916). In *MacPherson*, the New York Court of Appeals held the defendant car manufacturer, who negligently failed to inspect a defective wheel, liable in tort for personal injuries. The plaintiff had not purchased from the defendant but rather from the defendant's vendee, a retail seller of automobiles. The court reasoned that the risk of injury if the car were negligently made or inspected was foreseeable, or probable, as to the plaintiff, and not to the retailer-vendee. Because of the probability of injury to prospective users, the law imposes an affirmative duty of care on the defendant manufacturer as to members of that class. This duty is different in both origin and scope from the defendant's voluntarily assumed contractual duties and is in no way limited by privity of contract.

<sup>38</sup> 233 N.Y. at 239-40, 135 N.E. at 276.

<sup>39</sup> E.g., 21 Mich. L. Rev. 200, 203 (1922).

<sup>40</sup> In *Ultramares*, it will be recalled, the defendant accountants were employed by the Stern Co. to perform the yearly audit of that company's books. The defendants negligently overvalued the company's assets in the balance sheet upon which the plaintiffs, creditors of the company, subsequently relied. When the company failed, the plaintiffs sought recovery of the loans made to the company, alleging that the defendants' negligent misrepresentation of the company's financial status had induced them to make the loan.

factually erroneous.<sup>41</sup> It was argued that the professions could insure and pass the cost of premiums on to their clients.<sup>42</sup> Secondly, the attempt to distinguish *Glanzer* was rejected as semantic.<sup>43</sup> Realistically, a balance sheet is prepared at least as much for the creditors and investors of a business as it is for the business itself. The creditor-plaintiff was as much the foreseeable beneficiary of the defendants' certification of financial status in *Ultramares* as the buyer-plaintiff was the foreseeable beneficiary of the defendant's weight certification in *Glanzer*. Finally, the facts of the case did not support the court's application of its rule. The defendants prepared precisely 32 copies of the balance sheet to be given to Stern. The defendants knew that Stern would use these to obtain credit. The court might well have decided that the class of prospective plaintiffs was not limitless but clearly limited.<sup>44</sup>

The most unfortunate aspect of *Ultramares* was not, however, its rationale, rule, or result, but rather its subsequent treatment.<sup>45</sup> The misunderstanding of *Ultramares* by subsequent courts is nowhere more evident than in a 1951 English Court of Appeals case, *Candler v. Crane, Christmas & Co.*<sup>46</sup> There, the plaintiff responded to a one-man company's solicitation for capital and requested that he be supplied with a current balance sheet so that he might assess the company's worth before investing £2000. The defendant accountants prepared the balance sheet and personally put it before the plaintiff. The plaintiff immediately thereafter invested £2000 in the company. The accountants had negligently failed to check certain assets, and the company was in fact close to bankruptcy. When the company failed, the plaintiff sought to recover his original investment from the accountants. The Court of Appeals refused recovery, relying on *Derry v. Peek*<sup>47</sup> and *Le Lievre v. Gould*<sup>48</sup> for the proposition that an action in deceit for economic loss resulting from negligent misrepresentation does not lie when the complainant is not in privity with the misrepresenter. The court relied on *Ultramares* for the further proposition that even if a third person might recover for negligent misrepresentation, he might not so recover from an accountant, since the losses suffered would be economic and thus potentially limitless.<sup>49</sup> In a very strong dissent, Lord Denning made the following arguments: (1) the risk theory should be as applicable to cases of economic loss as to cases of property damage or personal injury; (2) the plaintiff's loss of his investment was a most probable event if the defendants should negligently misrepresent the company's value; (3) the plaintiff was not merely a foreseeable person to the defendants but rather he was actually foreseen, in that the balance sheet was prepared for the very

<sup>41</sup> See Meek, *supra* note 27, at 388-89.

<sup>42</sup> See Note, *supra* note 27, at 327-28.

<sup>43</sup> E.g., Levitin, *supra* note 27, at 445; Seavey, Mr. Justice Cardozo and the Law of Torts, 52 Harv. L. Rev. 372, 400 (1939).

<sup>44</sup> See Levitin, *supra* note 27, at 445.

<sup>45</sup> See, e.g., *Duro Sportswear, Inc. v. Cogen*, 131 N.Y.S.2d 20 (1954), *aff'd mem.*, 285 App. Div. 867, 137 N.Y.S.2d (1955) (*dictum*); *O'Connor v. Ludlam*, 92 F.2d 50, 53 (2d Cir. 1937).

<sup>46</sup> [1951] 2 K.B. 164 (C.A.).

<sup>47</sup> 14 App. Cas. 377 (1889).

<sup>48</sup> [1893] 1 Q.B. 491 (C.A.).

<sup>49</sup> [1951] 2 K.B. at 202-07.

aim and purpose of influencing his conduct. In an article discussing the case, Professor Seavey agreed with Lord Denning and argued that the mainspring of *Ultramares* was economic policy, and that this mainspring was absent in *Candler*. He pointed out that *Glanzer* should more appropriately have been used by the court, since the plaintiff in *Candler* was actually foreseen, intended to be influenced, and the potential class of plaintiffs was numerically limited, precisely as in *Glanzer*.<sup>50</sup>

It should be noted that although Lord Denning argued strenuously for the extension of the accountants' duty of care to persons not in privity of contract, he did not argue for a broad extension of liability:

Secondly, to whom do these professional people owe this duty? I will take accountants, but the same reasoning applies to the others. They owe the duty, of course, to their employer or client; and also I think to any third person to whom they themselves show the accounts, or to whom they know their employer is going to show the accounts, so as to induce him to invest money or take some other action on them. But I do not think the duty can be extended still further so as to include strangers of whom they have heard nothing and to whom their employer without their knowledge may choose to show their accounts. . . .

Thirdly, to what transactions does the duty of care extend? It extends, I think, only to those transactions for which the accountants knew their accounts were required.<sup>51</sup>

This position is very similar to that taken by the American Law Institute in the Restatement of Torts, section 552. That section states:

One who in the course of his business or profession supplies information for the guidance of others in their business transactions is subject to liability for harm caused to them by their reliance upon the information if

- (a) he fails to exercise that care and competence in obtaining and communicating the information which its recipient is justified in expecting, and
- (b) the harm is suffered
  - (i) by the person or one of the class of persons for whose guidance the information was supplied, and
  - (ii) because of his justifiable reliance upon it in a transaction in which it was intended to influence his conduct or in a transaction substantially identical therewith.

As applied to accountants, section 552 would, apparently, extend the duty of care only to those persons or classes and for those transactions for whom and for which the accountant actually knows he is preparing the balance sheet.

<sup>50</sup> Seavey, *supra* note 32.

<sup>51</sup> [1951] 2 K.B. at 180-82.

Although this section has not been applied to an accounting case, it has been used and approved in analogous areas. For example, in *Hawkins v. Oakland Title Ins. & Guar. Co.*,<sup>52</sup> the defendant title-searchers were held not liable in negligence to the plaintiff purchasers of certain property, even though the purchasers had relied on the title-search which contained a misrepresentation made through the defendants' carelessness. Since the defendants' title-search had been performed ten years before the purchase of the property by the plaintiffs and for the benefit of the plaintiffs' vendors, the then purchasers of the property, and not for the benefit of the plaintiffs, it was clear to the court that the Restatement rule did not allow recovery. Likewise, Lord Pearce in the 1963 House of Lords case, *Hedley Byrne & Co. v. Heller & Partners*,<sup>53</sup> utilized the Restatement rule to support his argument that bankers who negligently misrepresented a company's credit standing to a trade creditor, who had requested of the bankers that company's rating, should be liable in negligence since they knew the creditor would rely on the rating. On the other hand, at least one court has thought the Restatement to mean that a negligent misrepresenter is liable to all reasonably foreseeable persons who rely on his misrepresentation and are injured thereby. In *Texas Tunneling Co. v. Chattanooga*,<sup>54</sup> an engineering firm was held liable for the negligent misrepresentation of construction data relied upon by the plaintiff, a subcontractor hired by the city for which the data was prepared. The federal district court interpreted *Ultramares* as requiring the foreknowledge of one specific person's reliance before recovery could be extended to the limits of foreseeability. While this limitation of liability is not the holding of *Ultramares*, it is a reasonable elaboration if *Ultramares* is read alongside *Glanzer*.<sup>55</sup> The *Texas Tunneling* court next contrasted this limitation with Restatement section 552, which it read as extending liability to all foreseeable classes of persons. It is submitted, however, that the Restatement rule does not provide for liability to the full extent of foreseeability but only to those persons or classes of whom the representer in fact has knowledge, and whom he intends to influence. Comment (a), following section 552, suggests such a limitation:

As in the case of fraudulent misrepresentations the liability is confined to those who are intended to rely upon the information and who rely upon it in a type of transaction in which it is the maker's purpose to influence their conduct. This distinction does not come from the fact that the matter supplied is information rather than a tangible thing. It comes from the fact that it is supplied for guidance in a business transaction and not for guidance in a matter in which the safety of persons, lands, or chattels is involved.

<sup>52</sup> 165 Cal. App. 2d 116, 331 P.2d 742 (1958).

<sup>53</sup> [1964] A.C. 465, 539. See generally Stevens, *Hedley Byrne v. Heller: Judicial Creativity and Doctrinal Possibility*, 27 Modern L. Rev. 121 (1964).

<sup>54</sup> 204 F. Supp. 821 (E.D. Tenn. 1962), rev'd, 329 F.2d 402 (6th Cir. 1964).

<sup>55</sup> The holding of *Ultramares* was that an injured reliant party, even though foreseeable, could not recover against an accountant in negligence, since the economic burdens on accountants would be too great. It is true, however, that in *Ultramares* the injured parties were numerous, while in *Glanzer* the injured party was one company. It is this distinction between the two cases which justifies the *Texas Tunneling* court's reasoning.

The background of the Restatement rule is likewise suggestive of this limitation. Apparently, the case-law basis for the Restatement rule was *Glanzer and Ultramares*.<sup>56</sup> In *Glanzer*, the plaintiff was actually foreseen and recovery was granted, while in *Ultramares*, the plaintiff was foreseeable and recovery was refused. Unless, then, the Restatement is to be treated as a code and not as an exposition of present law,<sup>57</sup> it is clear that it extends liability only to those actually foreseen.<sup>58</sup>

Although the Restatement does not extend the duty of care to reasonably foreseeable potential plaintiffs, there is a great deal of disagreement as to whether the duty should be so extended. The most strenuous argument against the foreseeability extension is that society's interest in its professions requires that the risk of loss be thrown onto the foreseeable but actually unforeseen injured party. The classical hypothetical posed as a rhetorical question to support this argument is whether a cartographer who maps out an island area but who negligently fails to include one subsurface area of reef shall be liable in damages for all harm resulting when the *Queen Mary* sinks because her captain relied on the cartographer's map.<sup>59</sup> The thrust of this argument is that if cartographers were exposed to such risks, society would have no cartographers. Nor is the answer acceptable that cartographers can insure. Premiums would probably be prohibitive to protect against such a vast potential loss. Moreover, to say that cartographers can insure, and so there should be liability, is really to assume the very question asked, namely whether social interests dictate that the *Queen Mary* or the cartographer be burdened with protecting against the risk of loss. Perhaps the best response to the cartographer hypothetical is to take the pragmatically tenuous position that the cartographer should be liable to all those persons whom he should have foreseen would be injured as a result of his negligence. Since he performs a task which, if carried out negligently, will result in multiple loss of life, it may be the wiser course to impose such liability upon him in order to assure his utmost skill. Additionally, the cartographer hypothetical may be distinguishable from the accountant's case with respect to reliance. Because the expert mariner may have knowledge roughly equal to the cartographer's, his reliance may not be too great. Thus, the limited justifiability of reliance in the car-

<sup>56</sup> See Levitin, *supra* note 27, at 446 & n.42.

<sup>57</sup> A code states what a particular rule of law ought to be. A restatement states what it is. Thus, the formulation of a restatement rule of law will be based on case-law precedent. See H. M. Hart & A. M. Sachs, *The Legal Process* 757-61 (tent. ed. 1958).

<sup>58</sup> Rouse, *supra* note 12, at 68. Analysis of the Restatement section 552 does, however, allow the interpretation that the section extends the accountant's liability to the limits of foreseeability. That section states that liability extends to the "... class of persons for whose guidance the information was supplied." Insofar as the class of potential investors and lenders are as apt to be reading accountants' statements as are the accountants' clients, the accountants should foresee, as a practical matter, that the information is being supplied for the guidance of that class. Additionally, the fact that businesses are often required under the securities legislation to have audits made and to have the results certified and made available to the public suggests that accountants must always know that their certified statements are supplied for the guidance of the investing and lending public.

<sup>59</sup> This hypothetical was utilized by the majority in *Candler v. Crane, Christmas & Co.*, [1951] 2 K.B. at 194-95; it was distinguished in the dissenting opinion of Denning, L.J., *id.* at 183.

tographer situation may preclude recovery. On the other hand, the heavy reliance of the investing public on the certifications of accountants, and the extreme vulnerability of that public if the accountant is negligent, both seem to favor burdening the accountant with losses resulting from his negligence. Moreover, unlike the cartographer, the accountant is capable, practically speaking, of protecting against the risk of loss. He will not be driven out of business; he can pass the cost of insurance off to his clients without raising his fees too much.

Several other arguments favor extended liability for the accountant. First, there appears to be no sound reason for treating economic losses resulting from negligent misrepresentation any differently than personal injury or property damage resulting from negligence. In general, all foreseeable losses due to negligence should be compensated, unless some strong policy reason requires otherwise. Second, there is a very strong background in the common law that the party at fault compensate for the results of his fault. Third, there is no reason why accountants should be treated differently than any other profession. Generally, the extent of professional liability for negligence is measured by foreseeability. Simply because the effect of an accountant's negligence is only economic loss, he should not be entitled to a favored position. Finally, one effect of extending liability to foreseeable third persons may be to elevate the cautionary techniques of the accounting profession and thus to prevent future fraud and negligence. While no existing case sets forth a rule of law extending liability to the limits of foreseeability, it is submitted that there is a modern tendency, initiated in the law reviews and treated by some few courts, toward expanding the liability of negligent misrepresenters. Exactly how far this expansion will go and whether it will be applied to accountants remains to be seen.

The following conclusions may fairly be drawn with respect to the present state and tendency of the law of negligent misrepresentation in relation to an accountant's liabilities to third persons. First, that privity of contract may, but should not be a defense for an accountant when the plaintiff is injured by the accountant's negligent misrepresentation of the financial status of his client. Second, that the Restatement section 552 applies to accountants, so that when an accountant knows that a limited class of persons will rely on the balance sheet of his client, and if he should negligently misrepresent causing economic loss to some member of that class, the accountant is liable to that person. Finally, that there are strong theoretical grounds, not yet embodied in the cases but proposed in the law reviews, for extending an accountant's liability for negligent misrepresentation to all foreseeable persons who rely on the misrepresentation and are injured thereby.

### C. *Fischer v. Kletz: The Duty to Disclose After-Acquired Facts*

In *Fischer v. Kletz*, it will be recalled, the defendant accountants did not, upon subsequent discovery, disclose to the investing and lending public their misrepresentation of their client's assets in an already circulated balance sheet. One issue raised for the district court was whether an accountant is obliged under the common law to disclose to potential reliant parties facts existing at the time of the accountant's audit of the company but undiscovered

until some time after the accountant's issuance of his certified statement. The court decided that accountants are so obliged.

The court noted that there is no directly relevant case law determinative of the issue presented, and therefore borrowed from several related areas of the law. Analogies were first drawn from duty of disclosure cases which arose in the context of sales of goods. Citing Prosser,<sup>60</sup> and relying additionally on the related Restatement of Torts, section 551(2)(b),<sup>61</sup> the court stated that, "one who has made a statement, and subsequently acquires new information which makes it untrue or misleading, must disclose such information to any one whom he knows to be still acting on the basis of the original statement."<sup>62</sup> While this rule is literally applicable to the *Kletz* case, it should be noted that it derived from and is intended to apply only to nondisclosures in the case of a sale of goods. The importance of the rule, however, lies in its rationale that harm is very probably going to occur unless the party with the knowledge speaks. In this regard, another case which dealt with the imposition of the duty to warn is relevant. In *Ward v. Morehead City Sea Food Co.*,<sup>63</sup> the defendant supplier of fish was held liable in negligence to the estate of a purchaser of fish who died as a result of poison in the fish sold by the defendant to his retailer, who in turn sold to the purchaser. The court held *inter alia* that the defendant's knowledge of the poison, acquired after the fish had been transferred to the purchaser, his knowledge of the probability of harm from the poison, and the fact that he was the original seller, imposed a duty to warn by means reasonable under the circumstances. Since the defendant's attempt to warn by way of letters to retailers was held unreasonable, the duty to warn was breached, and the plaintiff was held liable. Analogizing to the *Kletz* case, it can be argued that the defendant accountant's knowledge of the misrepresentation, his consequent realization of the probability of financial harm, and the fact that he originally performed the service impose a duty to disclose. A significant additional factor present in *Ward* was that the original conduct of the defendant was negligent, so that in effect the duty imposed was a duty to correct a previous legally recognizable error. In *Kletz*, however, the original

<sup>60</sup> Prosser § 101, at 711.

<sup>61</sup> Restatement of Torts § 551 (1938) states:

(1) One who fails to disclose to another a thing which he knows may justifiably induce the other to act or refrain from acting in a business transaction is subject to the same liability to the other as though he had represented the nonexistence of the matter which he has failed to disclose, if, but only if, he is under a duty to the other to exercise reasonable care to disclose the matter in question.

(2) One party to a business transaction is under a duty to exercise reasonable care to disclose to the other before the transaction is consummated. . . .

(b) any subsequently acquired information which he recognizes as making untrue or misleading a previous representation which when made was true or believed to be so. . . .

<sup>62</sup> 266 F. Supp. at 185. This statement was derived from an English case, *With v. O'Flanagan*, [1936] 1 Ch. 575 (A.C.). In that case, the plaintiff purchasers sought rescission of a contract for the sale of a medical practice on the theory that the defendant seller did not disclose the fact that between the date of the original negotiations and the date of the actual execution of the sale the income rate of the practice had substantially decreased. The court granted the relief sought.

<sup>63</sup> 171 N.C. 33, 87 S.E. 958 (1916).

conduct was not negligent, and thus it can be argued that no duty to correct should be imposed.

The area of sales or purchases of stock by corporate insiders may likewise be looked to in the search for a legal basis for the imposition of a duty to disclose. Under the common law, two different rules govern the duty of a corporate insider to disclose. Under the first rule, no duty of disclosure exists unless there is a fiduciary relation between the person in possession of the information and the other party to the transaction. Thus, for example, in *Goodwin v. Agassiz*,<sup>64</sup> the defendant directors of a mining corporation who purchased the plaintiff's stock in the corporation without informing him of a possible copper strike were held not liable in an action of deceit for accounting, rescission, and lost profits. The court held that in the absence of a fiduciary relation between director and stockholder, no duty to disclose could be imposed. Under the second rule, the presence of certain special circumstances imposes upon the party in possession of the information the obligation to divulge. Special circumstances usually include knowledge of some impending transaction which will substantially increase or decrease the value of the stock. Thus, for example, in *Strong v. Repide*,<sup>65</sup> the defendant director of a sugar company, who, through a straw man, sought out the plaintiff and purchased her stock in the company without informing her of an impending purchase of the company by the U.S. Government, was held accountable for lost profits.

It might well be argued that both the fiduciary requirement of the first rule, and the special circumstances doctrine of the second, would lead to the imposition of a duty of disclosure on the accounting profession. While it is functionally impossible to classify the relationship between accountant and investing public as fiduciary, nevertheless, the heavy reliance of the public on accountants' statements suggests that the accounting profession does occupy a position of trust vis-à-vis investors and lenders. Such a position of trust demands good faith, and therefore requires full disclosure of pertinent information, where it is clear that not to so disclose will be harmful to the investing and lending public. Furthermore, the accountant's knowledge of a mistake in the balance sheet, coupled with his awareness of potential transactions involving his client's stock, might be considered "special circumstances" warranting the imposition of a duty to disclose.

The court in *Kletz* next dealt with a distinction relating to the plaintiffs' theory of common law liability. The plaintiffs made the argument, based on cases arising out of sales transactions, that the maker of a representation is obliged to disclose information which renders his original representation erroneous, regardless of whether that information had been present at the time of the representation or whether it arose from a subsequent change of circumstances. The court suggested the possibility that although there is a duty to disclose subsequently acquired information arising from some external change in circumstances, there is no authority that a duty of disclosure is operative when the representer later acquires information which existed but was not known at the time of the representation. The court was not troubled, however, by the lack of authority on this narrow proposition. From the reliant party's

<sup>64</sup> 283 Mass. 358, 186 N.E. 659 (1933).

<sup>65</sup> 213 U.S. 419 (1909).

viewpoint, the court reasoned, there was really no distinction between the two situations, since in both the balance sheet would be misleading.<sup>66</sup> The court might well have added that since the duty to disclose changes occurring after the information had been circulated is the broader duty, and since there is precedent for such a duty, *a fortiori* there is a duty to disclose facts existing but undiscovered at the time of the audit.<sup>67</sup>

The court also gave considerable attention to the defendants' argument that pecuniary gain must accrue to the misrepresenter in order for him to be liable. Relying heavily, although not exclusively, on cases in which persons making affirmative misrepresentations (as opposed to nondisclosures) have been held liable, even though taking no personal gain from their misrepresentations, the court eliminated pecuniary gain to the defendant as a necessary element of the plaintiffs' action.<sup>68</sup> If a person takes upon himself either contractually or voluntarily the function of making official representations, then, at the very least, he should be held to a level of reasonable care, as well as one of honesty. If the defendants' argument were accepted, and pecuniary gain had to be shown, the misrepresentation remedy would be limited solely to sales cases or cases of actual collusion.

The defendants further argued that intent to deceive was a necessary element of the plaintiffs' cause of action. The court rejected this argument as setting up an unreasonably subjective standard which would present grave difficulties of proof.<sup>69</sup> This seems to be a cogent observation in so far as the failure to act allows no inference as to intent. Thus, while proof of intent may be difficult in ordinary affirmative wrong-doing cases, it is almost insuperable in cases of nonfeasance. If the court had required a showing of intent to deceive in nondisclosure cases, it would have put a major obstacle in the way of the injured party.

The defendants contended finally that the imposition of a duty to disclose after-acquired information would be unfairly burdensome to the accounting profession.<sup>70</sup> The accountant performs his services on the basis of a predicted cost, and the additional burden of circulating further information to the investing and lending public would turn profits into losses. Moreover, the potential expansion of the duty to disclose would be frightening. Is the obligation satisfied by the publication of facts discoverable by routine re-check, or must the accountant carry out a detailed post-certification inspection? Is the duty limited to facts existing but undiscovered at the time of the original audit, or might it include facts which come into existence after the issuance of the balance sheet? The defendants did not assert that the after-acquired facts

<sup>66</sup> 266 F. Supp. at 185.

<sup>67</sup> The duty to disclose changes in circumstances after the information has been relied upon in a sales contract is very different from such a duty in the accounting context. It should be noted that the court in no way committed itself to the imposition on accountants of a duty to disclose changes in circumstances subsequent to the circulation of the certified balance sheet.

<sup>68</sup> 266 F. Supp. at 187-88.

<sup>69</sup> *Id.* at 188.

<sup>70</sup> *Id.* at 188-89. See Fortune, July 1, 1966, at 88, 130. But see Wilcox, Accountant's Responsibility for Disclosure of Events after Balance-Sheet Date, 89 J. Account. 286 (1950).

should not be disclosed. The thrust of their argument is that the obligation, and therefore the cost, of such disclosure should be carried by the company audited, and that the accountants' only obligations are to perform their contracts honestly and carefully and to disclose to the company whatever knowledge is discovered after certification and issuance.

While this argument of the defendants has a certain pragmatic lure, the court rejected it, and properly so. Certainly, the additional cost could be estimated and built into service charges. Indeed, one wonders just how much of an economic burden it would be to circulate the after-acquired information. Might not notifying the SEC, the major exchanges, the financial and investment journals, or the newspapers satisfy the requirement? Moreover, the potential expansion of the duty could be controlled by careful judicial reasoning. Simply because a rule might be expanded in future cases is not reason for refraining from imposing it in a present case which analytically demands it.

#### D. Conclusions

It is clear that the common law liabilities of accountants to persons other than their clients are limited. Since strict liability has not been recognized with respect to accountants' performance of their services, lack of either honesty or care must be present for an injured reliant party to recover. Additionally, even if fraud or negligence is present, the scope of liability is often limited. With respect to fraud, older cases limit recovery to those persons whom the defendant in fact intended to influence, or at least knew would be influenced. More recent cases extend the range of recovery to persons whom the misrepresenter knew or should have known would rely. With respect to negligence, recovery has for some time been limited to those persons whom the defendant knew would rely on his statements. Only recently have there been indications that persons whom the defendant should reasonably have foreseen might recover. In light of these limits, the *Kletz* decision is creative and innovative. Certainly, however, cases can be found or distinctions made which would bring about an opposite result in *Kletz*, and it would be no surprise for another court to reach a result differing from *Kletz*. Additionally, it should be noted that *Kletz* does not consider the possible limits of the liability it fashions. As in other areas of misrepresentation resulting in economic loss to a large group of persons, courts may well pull back from extensions of liability and circumscribe the injured parties' remedies. It is against this background of common law limitations that related federal legislation must be considered.

## II. THE FEDERAL SECURITIES LEGISLATION

Until 1933, any remedy a third party might have against an accountant for misrepresentation rested in the common law tort action for deceit.<sup>71</sup> In

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<sup>71</sup> Prior to 1933, the only legislation directed solely at securities regulation were the "Blue Sky" laws of the various states. In this comment only the federal scheme of regulation embodied in the Securities Act of 1933, 15 U.S.C. §§ 77a-77bbbb (1964), and the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78hh-1 (1964), will be considered. For a general discussion of civil liability under the "Blue Sky" laws, see L. Loss & E. Cowett, *Blue Sky Laws* 129-80 (1958).

1933, Congress passed the Securities Act,<sup>72</sup> which established a comprehensive scheme for regulating securities transactions. In 1934, the Securities Act was amended,<sup>73</sup> and Congress passed the Securities Exchange Act.<sup>74</sup> It is clear that Congress intended, in passing this legislation, to provide the public with more protection and better remedies than were available at common law. It is unclear, however, to what extent Congress expanded upon the common law. It will be the purpose of the following sections of this comment to determine the answers to two questions: (1) What is the scope of the duties imposed on accountants under the securities legislation? (2) To whom do these duties extend? These questions may be answered only by examining the legislative purpose of the legislation and the liabilities sections of the two acts, as interpreted by the courts.

### A. Legislative Intent

The necessity for federal legislation that would protect the investing public from fraudulent and irresponsible securities transactions<sup>75</sup> arose from the speculative and unorthodox financing of the 1920's and the resultant stock-market crash of 1929.<sup>76</sup> There were, essentially, two methods by which such protection could be afforded: (1) legislation which would set up a governmental agency to make public judgment as to the quality of the security proposed to be issued;<sup>77</sup> or (2) legislation which concentrated on demanding full disclosure of relevant information in the issue of securities.<sup>78</sup> Congress chose the latter course.<sup>79</sup>

In his message to Congress on March 29, 1933, President Roosevelt stated:

There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.<sup>80</sup>

The stated purpose of the Securities Act of 1933 was to "provide full and fair

<sup>72</sup> 48 Stat. 74 (1933).

<sup>73</sup> 48 Stat. 905 (1934).

<sup>74</sup> 48 Stat. 881 (1934).

<sup>75</sup> The deceptive and manipulative practices of the pre-crash period led to a Senate investigation which "indicted a system as a whole that had failed miserably in imposing those essential fiduciary standards that should govern persons whose function it was to handle other people's money. Investment bankers, brokers and dealers, corporate directors, accountants, all found themselves objects of criticism." Landis, *The Legislative History of the Securities Act of 1933*, 28 Geo. Wash. L. Rev. 29, 30 (1959).

<sup>76</sup> *Id.* For a general discussion of the economic and social factors leading up to the stock-market crash of 1929, see J. Galbraith, *The Great Crash, 1929* (1955); F. L. Allen, *Only Yesterday* (1931).

<sup>77</sup> Landis, *supra* note 75, at 30.

<sup>78</sup> See, e.g., *Companies Act, 1929*, 19 & 20 Geo. 5, c. 23.

<sup>79</sup> It has been suggested that Congress was influenced and favorably impressed by the English experience. See 1 L. Loss, *Securities Regulation* 128 (2d ed. 1961) [hereinafter cited as Loss].

<sup>80</sup> H.R. Rep. No. 85, 73d Cong., 1st Sess. 2 (1933).

disclosure of the character of securities sold. . . ."<sup>81</sup> The statute recognized that there were certain classes of persons who, because of their expertise or position, had intimate knowledge of the securities being offered. It imposed upon these persons a duty to disclose material information to the investing public, and a requirement that what is disclosed be an honest representation of the facts.<sup>82</sup> The act sought to enforce these duties through a scheme of civil and criminal liabilities.

The Securities Exchange Act of 1934 was intended to correct practices not covered by the previous act.<sup>83</sup> A basic mechanical difference should be noted. The 1933 act has detailed provisions outlining the disclosure requirements and liabilities for failing to meet these requirements. The 1934 act, however, is framed in comparatively broad terms, "deliberately left to be amplified by the S.E.C. and the courts . . . ."<sup>84</sup> This leaves greater discretion to the Securities Exchange Commission to promulgate rules to effectuate the broad legislative purpose.

It is manifest that accountants fall within the class of persons on whom the legislative scheme intended to impose the duty to disclose. Section 6 of the 1933 act requires that the registration statement filed with the commission be signed, *inter alia*, by the "principal accounting officer." Section 11 explicitly imposes liability on accountants in certain circumstances. As James Landis, one of the drafters of the Securities Act of 1933, stated:

We were particularly anxious through the imposition of adequate civil liabilities to assure the performance by corporate directors and officers of their fiduciary obligations and to impress upon *accountants* the necessity for independence and a thorough professional approach.<sup>85</sup> (Emphasis added.)

That the acts expressly impose civil liability on accountants in certain circumstances manifests a recognition of the role accountants play in securities transactions. The financial condition of the corporation, in its registration statements, prospectus, and annual reports, plays a vital role in the determination by the investing public of whether to buy or sell securities. The fact that accountants are inherently involved in the formulation of these statements necessitates that they be included in any regulation that seeks to provide full and fair disclosure. Moreover, the public puts great weight and reliance on the statements of accountants because of their expertise and independent position.

It is evident that Congress intended to impose upon accountants a duty of disclosure. When this duty is imposed, and to whom it extends, can only be

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<sup>81</sup> Securities Act of 1933, preamble, 48 Stat. 881.

<sup>82</sup> See Landis, *supra* note 75, at 35.

<sup>83</sup> Basically, the practices sought to be regulated by the 1934 act that were not regulated in the 1933 act were market manipulations. The 1933 act was concerned mainly with the conduct between individuals as individuals. The 1934 act was concerned with the conduct of individuals in relation to the market. See Note, Civil Liability Under Section 10B and Rule 10B-5: A Suggestion For Replacing the Doctrine of Privity, 74 Yale L.J. 658-59 (1965).

<sup>84</sup> *Trussel v. United Underwriters Ltd.*, [1961-1964 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 91,373, at 94,567 (D. Colo. 1964).

<sup>85</sup> See Landis, *supra* note 75, at 35.

determined through an analysis of the judicial construction of the civil liabilities sections of the acts. For clarity, the legislation will be examined in the following order: (1) the sections in which civil liability is express; (2) the sections in which the courts have implied civil liability.

### B. *Express Liabilities*

1. *Section 11 of the Securities Act.*<sup>80</sup> Section 11 of the Securities Act of 1933 imposes civil liability only for misrepresentations or omissions of ma-

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<sup>80</sup> Section 11 reads, in pertinent part:

(a) 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, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue—

(1) every person who signed the registration statement;

. . . . .

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

. . . . .

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

(b) Notwithstanding the provisions of subsection (a) of this section no person, other than the issuer, shall be liable as provided therein who shall sustain the burden of proof—

(1) that before the effective date of the part of the registration statement with respect to which his liability is asserted (A) he had resigned from or had taken such steps as are permitted by law to resign from, or ceased or refused to act in, every office, capacity, or 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; or

(2) 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) of this subsection, and, in addition, gave reasonable public notice that such part of the registration statement had become effective without his knowledge; or

(3) that (A) as regards any part of the registration statement not purporting to be made on the authority of an expert, and not purporting to be a copy of or extract from a report or valuation of an expert, and not purporting to be made on the authority of a public official document or statement, 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

terial facts in the registration statement filed with the commission.<sup>87</sup> Accountants are expressly included in the two classes of possible defendants: (1) the issuer;<sup>88</sup> and (2) those persons who are significantly and publicly connected with the registration statement.<sup>89</sup> While the liability of the issuer is absolute,<sup>90</sup> the liability of the accountant is more limited. The accountant will be liable only for intentional or negligent misrepresentations or omissions.<sup>91</sup> Liability will extend, however, as in the case of the issuer, to all persons who purchase the security.<sup>92</sup>

The elimination, under section 11, of any requirement of scienter, privity or reliance represents a radical departure from the common law tort of deceit. This disturbed members of the financing industry and the section was

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fact required to be stated therein or necessary to make the statements therein not misleading; and (B) 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; and (C) 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 no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement of the expert or was not a fair copy of or extract from the report or valuation of the expert. . . .

<sup>87</sup> The mechanics for registration of new issues of securities is set out in §§ 5, 7 and 11 of the 1933 act. Section 5 makes it unlawful to use the mails or interstate commerce to sell any security not registered with the SEC. Section 7 and Schedule B set forth the information to be filed with the Commission. Section 11 provides civil liability for noncompliance or faulty compliance with §§ 5 and 7.

<sup>88</sup> § 11(a)(1).

<sup>89</sup> These persons include, *inter alia*, (1) every person who signs the registration statement; (2) directors or partners of the issuer at the time of filing; (3) every person named in the registration statement to become a director; (4) underwriters; (5) experts (e.g., accountants, appraisers, engineers).

<sup>90</sup> Section 11(a) provides for a standard of absolute liability for the persons liable under the section. Section 11(b), which provides the defenses to liability under § 11(a), explicitly limits these defenses to persons "other than the issuer." The only defense open to the issuer is to show that the person who purchased the stock knew at the time of the purchase of the misstatement or omission. § 11(a).

<sup>91</sup> The accountant is responsible only for misstatements or omissions in that part of the registration statement attributable to him. Under § 11(b), the accountant may insulate himself from liability by taking the following steps: (1) before the registration statement becomes effective, he must resign from the position attributed to him in the statement and notify the SEC; or (2) if the registration statement has become effective without his knowledge, he must resign from the position attributed to him in the statement and give reasonable public notice that such part of the registration statement became effective without his knowledge.

<sup>92</sup> § 11(a).

characterized as the "bête noir [*sic*] which was going to stifle legitimate financing."<sup>93</sup> It can be shown, however, that section 11 was vastly overestimated as a vehicle for recoveries by the general buying public against issuers and experts.<sup>94</sup>

The issue of accountants' liability under section 11 has been raised in only one case. In *Shonts v. Hirleman*,<sup>95</sup> plaintiffs brought an action against both the accountants and directors of the corporation in which they purchased stock. The complaint alleged misrepresentations and omissions of material facts in the registration statement in relation to a rental agreement between the issuer and another corporation. The rental agreement was entered into subsequent to the time of certification and the filing of the registration statement, but prior to the date the registration statement became effective. The registration statement was amended by the issuer to disclose the rental agreement. It failed to disclose, however, the issuer's obligation to pay a minimum annual rental of \$35,000. Although there was no evidence of the rental agreement in the corporate books prior to the date of certification of the registration statement, there was such evidence after the certification, but before the date the registration statement became effective. Plaintiffs sought to impose liability on the accountants on the ground that the accountants had negligently certified a registration statement that misrepresented the corporation's financial position by understating its contingent liability.

The court held that there could be no recovery against the accountants as there was no omission or misrepresentation of material fact at the time that the registration statement was certified by the accountants. The court noted that the accountants had not prepared the amendment to the registration statement and stated:

The rental arrangement was not called to their [the accountants'] attention. There was no entry on the books at their disposal, from which, by further inquiry, they might have discovered that there was such an undertaking. Absent these, they cannot be charged with a misrepresentation which was made later—long after their certification.<sup>96</sup>

It is submitted that the *Shonts* decision does violence to the intent and purpose of the securities legislation to provide for full and fair disclosure. More significantly, it incorrectly interprets section 11 to find that an accountant's duty to follow reasonable and thorough accounting practices<sup>97</sup> ends with the date of certification of the registration statement by the accountant: that the accountant has no duty to continue his investigation after the date of certification, and correspondingly no duty to disclose any change in corporate position after that date. Nowhere in section 11 is the date of certification mentioned as a guide to determine the extent of the accountant's duties.

<sup>93</sup> 3 Loss 1721.

<sup>94</sup> *Id.*

<sup>95</sup> 28 F. Supp. 478 (S.D. Cal. 1939).

<sup>96</sup> *Id.* at 483.

<sup>97</sup> It has been suggested that the court in *Shonts* was satisfied with "surprisingly low accounting standards." 3 Loss 1733. See generally L. Rappaport, SEC Accounting Practice and Procedure (2d ed. 1963).

Rather, under the language of section 11, the accountant has a defense only if he believed, after reasonable investigation, that the statements made were true and not misleading *at the time that the registration statement became effective*.<sup>98</sup> This statutory language would appear to impose on accountants a continuing duty of care beyond the date of certification, and to impose upon them the duty to disclose changes in corporate position between the date of certification and the date when the registration statement becomes effective. This construction of the section comports with the obvious congressional intent to ensure that the information in the registration statement, *as disseminated to the public*, honestly and correctly reflects the financial position of the corporation.

2. *Section 12 of the Securities Act.*<sup>99</sup> Section 12(1) of the 1933 act imposes civil liability on any person who offers or sells a security without filing a registration statement with the commission. Liability is imposed, under section 12(2), on one who offers or sells securities by means of a prospectus that includes a misrepresentation of a material fact or fails to disclose a material fact. The literal statutory language of both sections would appear to exclude accountants from liability as liability is imposed only on one who "offers or sells" securities; and such person is liable only to "the person purchasing such security from him." The great weight of authority supports this conclusion.<sup>100</sup>

The United States District Court for the Southern District of New York, however, has interpreted section 12 so as to expand the class of possible defendants to persons beyond technical "sellers." In *Wonnemann v. Stratford Secs. Co.*,<sup>101</sup> plaintiff bought some stock from defendant brokerage firm. Plaintiff alleged that the stock was sold in violation of section 12(1), in that there was no registration statement filed with the commission. Although his order was taken by an agent of the firm, plaintiff sued both the firm and its directors as individuals. A motion for summary judgment was made by the

<sup>98</sup> § 11(b)(3)(B)(i).

<sup>99</sup> Section 12 reads:

Any person who—

(1) offers or sells a security in violation of section 77e of this title, or

(2) offers or sells a security (whether or not exempted by the provisions of section 3, other than paragraph (2) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,

shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction 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, or for damages if he no longer owns the security.

<sup>100</sup> See 3 Loss 1712-21.

<sup>101</sup> [1957-1961 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 90,923 (S.D.N.Y. 1959).

directors, on the ground that they, as individuals, were not the "sellers" within the meaning of section 12, and therefore did not fall within the ambit of the statute. The court denied the motion, stating that the defendants "must show that they did not participate in the sale and not merely that they did not actually sell the securities to plaintiff."<sup>102</sup> The criteria, according to the court, was not the technical status of defendant as "seller," but his participation in the sale. The opinion did not define what constitutes "participation in the sale," although it implied that supervisors, advertisers, directors, officers and others could all be found to have participated in the sale.<sup>103</sup>

Under the *Wonnemann* rationale, accountants could be held to have "participated" in a sale of stock, and hence, whenever there is a misrepresentation or omission of material fact in the prospectus, to be in violation of section 12(2).<sup>104</sup> Liability under section 12(2) is similar to that under section 11 in that it will be imposed for negligent as well as for intentional misrepresentations or omissions. The inclusion of accountants in the class of possible defendants under section 12(2) effectively places on accountants the duty of full disclosure and reasonable care in the preparation of prospectuses, as well as registration statements.

While the imposition of disclosure requirements on accountants in the preparation of prospectuses as well as registration statements would comport with the purpose of the legislation, to do so under section 12 would amount to judicial legislation. The statutory language manifests an intent on the part of Congress that liability, in these circumstances, be imposed only on sellers, and that privity of contract be a requisite for suit under this section.

3. *Section 18 of the Securities Exchange Act.*<sup>105</sup> Of the three sections of the Securities Exchange Act which expressly impose civil liability,<sup>106</sup> only section 18 has any relation to accountants acting in their professional capacity.

<sup>102</sup> Id. at 92,963.

<sup>103</sup> Id.

<sup>104</sup> While *Wonnemann* is concerned with a § 12(1) violation, the extension of the class of possible defendants is equally applicable to § 12(2), as the statutory language "one who offers or sells" applies to both subsections.

<sup>105</sup> Section 18 reads:

(a) Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this title or any rule or regulation thereunder or any undertaking contained in a registration statement as provided in subsection (d) of section 15 of this title, which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading. A person seeking to enforce such liability may sue at law or in equity in any court of competent jurisdiction. In any such suit the court may, in its discretion, require an undertaking for the payment of the costs of such suit, and assess reasonable costs, including reasonable attorneys' fees, against either party litigant.

<sup>106</sup> §§ 9, 16(b) and 18. Section 9 imposes liability on persons responsible for certain enumerated market manipulations. Section 16(b) imposes liability on corporate "insiders" who acquire "short swing" profits.

## STUDENT COMMENT

This section has been called a "very much attenuated § 11."<sup>107</sup> It imposes liability on those persons who make, or cause to be made, a misleading statement in any document filed with a national exchange. Such persons would include accountants. Recovery under section 18, however, runs only to those who buy or sell the security at a price effected by the misrepresentation or omission in question. Moreover, the plaintiff must show reliance on the defendant's conduct and that he (the plaintiff) did not know that the statements made were false or misleading. Further, the defendant will not be liable if he can show that he "acted in good faith and had no knowledge that such statement was false or misleading." In effect, this defense makes only *intentional* misrepresentations or omissions actionable. Thus, while section 18 extends liability to misrepresentations or omissions in any document filed with a national exchange, it reinstates the requirements of scienter, causation and reliance, all of which were discarded in section 11. In fact, as Professor Louis Loss has stated in relation to section 18:

Except for avoiding any question that the person making the false statement or causing it to be made can be sued by the buyer or seller notwithstanding the absence of privity between them, it is hard to see what advantage § 18 gives the investor that he does not have in common law deceit.<sup>108</sup>

Because of the limited scope of liability, section 18 has not been a successful vehicle for recoveries by investors for false or misleading statements in documents filed with a national exchange.

### C. *Implied Civil Liabilities*

In addition to the civil liabilities which are expressly provided for in the 1933 and 1934 acts, the courts have found other liabilities to be implied in the legislation. The basic source of these implied liabilities is found in rule 10b-5,<sup>109</sup> promulgated by the Securities Exchange Commission under section 10b of the 1934 act. Because of the general wording of the section and rule, and the broad interpretation of the rule given by the courts, the liabilities imposed under rule 10b-5 are broad and fill, to some extent, the gaps left by the express civil liabilities sections. Although, as a general rule, the express liabilities sections have been poor vehicles for recoveries by investors, rule 10b-5 has been a potent weapon for effectuating the purpose of the legislation and enforcing the duty of disclosure. The determination of the outer limits of the duty of accountants to make full and fair disclosure, therefore, can only be made by looking to rule 10b-5.

1. *Rule 10b-5.* Section 10b of the 1934 act prohibits the use of manipulative or deceptive devices in the purchase or sale of any security. It authorizes the SEC to formulate rules and regulations to enforce this proscription. Rule 10b-5, promulgated in 1942, provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or

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<sup>107</sup> 3 Loss 1751.

<sup>108</sup> *Id.* at 1752.

<sup>109</sup> 17 C.F.R. § 240.10b-5 (1964).

of the mails or of any facility of any national securities exchange,

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

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

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

Neither the rule nor section 10b expressly state that civil liability is to be imposed on those who violate the rule. The courts, nevertheless, have consistently implied a civil remedy.<sup>110</sup> The United States Supreme Court, however, has yet to hear a 10b-5 case and, until it does, the issue cannot be considered closed.

While the courts which have considered the question are consistent in implying a civil remedy, they vary in their interpretation of what elements are necessary to maintain a cause of action under the rule. An early case<sup>111</sup> held that a "semblance of privity" was a requisite to a cause of action. Yet, the great weight of authority has rejected the necessity of privity,<sup>112</sup> finding that liability does not depend upon the defendant's status as a "buyer" or "seller" but rather upon his connection with the sale. The elimination of the requirement of privity would clearly put accountants within the ambit of the rule.<sup>113</sup>

In *H.L. Green Co. v. Childree*,<sup>114</sup> a United States district court held that accountants could have a sufficient connection with a purchase or sale of securities to make them potential defendants under the rule. Plaintiff purchased stock, relying on a financial statement issued by defendant accountants.<sup>115</sup> Plaintiff alleged that the accountants knowingly prepared the statements to misrepresent the financial status of the corporation. The defendants moved to dismiss the suit, claiming that they were not liable under

<sup>110</sup> Civil liability under the rule was first implied in *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946). For a comprehensive listing of cases brought under rule 10b-5, see *Ruder, Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?* 57 Nw. L. Rev. 627, 687-90 (1963).

<sup>111</sup> *Joseph v. Farnsworth Radio & Television Corp.*, 99 F. Supp. 701 (S.D.N.Y. 1951), *aff'd per curiam*, 198 F.2d 883 (2d Cir. 1952). *Accord, Heit v. Weitzen*, [1964-1966 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 91,701 (S.D.N.Y. 1966) (semble).

<sup>112</sup> See 3 Loss 1767.

<sup>113</sup> In a case decided under § 17 of the 1933 act, almost identical with rule 10b-5, accountants were held to be within the ambit of the section. *United States v. White*, 124 F.2d 181 (2d Cir. 1941). It should be noted that some courts have been willing to imply civil liability in § 17 of the 1933 act. *Osborn v. Mallory*, 86 F. Supp. 869, 879 (S.D.N.Y. 1949). It has been suggested, however, that the implication of civil liability under § 17 poses great conceptual difficulties. See 3 Loss 1790. Because of the near identity of the language of § 17 and rule 10b-5, there is no separate discussion of civil liability under § 17.

<sup>114</sup> 185 F. Supp. 95 (S.D.N.Y. 1960).

<sup>115</sup> The transaction involved a merger of two corporations. The court held, however, that the stock acquisition constituted a "purchase" within the meaning of rule 10b-5. *Id.* at 96.

10b-5, as they were not the sellers. The court held the complaint sufficient, stating:

The complaint alleges that these defendants [accountants] knowingly did acts pursuant to a conspiracy to defraud. Their status as accountants and the fact that their activities were confined to the preparation of false and misleading financial statements and representations does not immunize these defendants from civil suit for their alleged participation.<sup>116</sup>

Although in *Green* it was alleged that the conduct of the accountants was intentional, courts have faced the question whether liability can be imposed under rule 10b-5 for negligent, as well as for intentional, conduct. This question has divided the courts. Early in the development of a civil remedy under the rule, the Second Circuit, in *Fischman v. Raytheon Mfg. Co.*,<sup>117</sup> held that it was necessary to allege and prove "fraud" in order to maintain a suit under the rule.<sup>118</sup> The court did not define what it meant by "fraud." Subsequently, a district court in the circuit read *Fischman* to require intentional conduct for a 10b-5 violation.<sup>119</sup>

While the Second Circuit has held that intent is a requisite element of a suit under the rule, the Ninth Circuit has rejected this interpretation and has found 10b-5 to be directed at negligent as well as at intentional misrepresentations and omissions.<sup>120</sup> While 10b-5 has been characterized as an "anti-fraud" rule,<sup>121</sup> the rule, and section 10b, are written in broad terms:

The phrasing of the section and the omission of any specific language requiring "intention" or "willfulness" suggests that conduct may be "manipulative" or "deceptive" within the meaning of the section without being intentional.<sup>122</sup>

Subsection (3) of the rule prohibits "any act, practice, or course of business which would operate as a fraud or deceit." From the wording, it would appear that this subsection is concerned with conduct and the result of the conduct, not the state of the actor's mind (intent). As such, negligent conduct which would tend to mislead, deceive or defraud would be violative of the rule. It is submitted, therefore, that the inclusion of negligent, as well as intentional, conduct within the ambit of 10b-5 liability would best effectuate the

<sup>116</sup> *Id.*

<sup>117</sup> 188 F.2d 783 (2d Cir. 1951).

<sup>118</sup> *Id.* at 786-87.

<sup>119</sup> *Thiele v. Shields*, 131 F. Supp. 416, 419 (S.D.N.Y. 1955). The Second Circuit has traditionally been one of the most conservative circuits in defining liability under the rule. It has delimited liability by both a privity and scienter requirement. Both these requirements seem to have been repeated in a rather confused decision in the United States District Court for the Southern District of New York. *Heit v. Weitzen*, [1964-1966 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 91,701 (S.D.N.Y. 1966).

<sup>120</sup> *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961). The Seventh Circuit has also held rule 10b-5 to apply to negligent conduct. *Kohler v. Kohler Co.*, 319 F.2d 634, 637 (7th Cir. 1963), *aff'd* 208 F. Supp. 803, 823 (E.D. Wis. 1962). For a general discussion of negligent conduct under rule 10b-5, see Note, *supra* note 83, at 682-90.

<sup>121</sup> See Note, *supra* note 83, at 683.

<sup>122</sup> *Id.*

legislative purpose of providing the public with complete and accurate information. This purpose is to be achieved through the imposition of the duty to disclose. To impose such a duty without also imposing a corresponding duty of care in the act of disclosing would conflict with that ultimate legislative purpose.

The interpretation of subsection (3) of the rule to imply an affirmative duty of disclosure is the most significant departure from the common law that the courts have made in this field. At common law, as has been noted, an action in deceit would lie for both misrepresentations and half-truths. In the absence of special facts, a fiduciary relationship or an executory contract of sale, the common law imposed no duty to disclose material facts known by one party but not the other. While the law was concerned with the truthfulness of what was said, complete silence was not objectionable. In determining what conduct would operate as a fraud or deceit under subsection (3), the courts have not felt constrained by traditional common law concepts.<sup>123</sup> In *Trussel v. United Underwriters*,<sup>124</sup> it was stated:

We do not assume that offenses against these provisions [subsections (1) and (3)] are, by any means, identical with common law deceit. The definition of "fraud" . . . in securities statutes is very much attenuated.<sup>125</sup>

As the court interpreted subsection (3), a duty of disclosure is imposed on persons who would not have that duty under the common law:

We have no doubt but that "manipulative or deceptive device or fraud" includes various types of fraud which would not always be cognizable as common law deceit, e.g., a "fraud" based wholly on a failure to speak in a non-fiduciary situation.<sup>126</sup>

In addition, the imposition of a duty to disclose clearly operates to effectuate the legislative purpose:

This congressional concern with placing responsibility on the party having the greater access to material information has been acknowledged in cases involving complete non-disclosure under 10b-5(3). Liability in such cases is based on a breach of duty owed by the defendant to the plaintiff—the duty to disclose. Although this obligation has been characterized as "fiduciary" or "quasi-fiduciary," the duty to disclose under 10b-5(3) does not depend upon the traditionally delineated relationship. Rather, the obligation can arise in isolated sales transactions between total strangers, linked only as buyer and seller. The primary factor which gives rise to the duty is the unequal access to material information.<sup>127</sup>

<sup>123</sup> See, e.g., *The Prospects for Rule X-10B-5: An Emerging Remedy for Defrauded Investors*, 59 *Yale L.J.* 1120 (1950).

<sup>124</sup> *Trussel v. United Underwriters Ltd.*, [1961-1964 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 91,373 (D. Colo. 1964).

<sup>125</sup> *Id.* at 94,567.

<sup>126</sup> *Id.* at 94,569.

<sup>127</sup> Comment, *Negligent Misrepresentations Under Rule 10b-5*, 32 *U. Chi. L. Rev.* 824, 840-41 (1965).

The affirmative duty to disclose extends primarily to corporate "insiders"—those persons who, because of their position, have access to facts not available to the general public.<sup>128</sup> Accountants would seem clearly within this class of persons. Their unique position gives them access to the most intimate financial details of the corporation—details particularly relevant to the determination of whether to buy or sell securities. The accountant's certification, moreover, is intended to influence the investing public.<sup>129</sup> Inherent in the concept of an independent public accountant's certification is the assumption that the result will be an objective and professional evaluation of the financial condition of the corporation. It is manifest, therefore, that one reason for having an audit by an independent accountant rather than a company auditor is that the investing public is more likely to accept, and hence be influenced by, the accountant's evaluation. Thus, the duty to fully and accurately disclose all relevant information must be imposed upon accountants, in order to completely effectuate the legislative purpose.

2. *Fischer v. Kletz—A Suggested Approach.* While it seems clear that a duty to disclose is imposed on accountants under 10b-5, it must still be determined in what circumstances that duty will be invoked. This issue breaks down into two basic questions: (1) What facts is an accountant required to disclose? (2) At what point in time will the accountant be relieved of this duty? The first of these two questions is relatively easy to answer. The nature of an accountant's audit is to represent the financial condition of the corporation. It is manifest, therefore, that the accountant must disclose all financial data necessary for an accurate determination of the corporation's financial condition. Moreover, it is recognized by the accounting profession that the ultimate purpose of the annual audit is to represent the potential earning power of the corporation.<sup>130</sup> Thus, factors which would not ordinarily be reflected on the balance sheet but which are relevant to the earning power of the corporation should also be disclosed. Such "non-accounting" factors would include labor conditions, market conditions, management expertise, etc.<sup>131</sup> Under general accounting principles it is recognized that disclosure of these "non-accounting" factors is necessary in certain circumstances. Thus, it has been suggested that it would be incumbent upon an accountant to disclose a major change in market conditions so that the certified balance sheets accurately reflect the corporate earning potential.<sup>132</sup>

On the other hand, where the accountant is in no position to make an authoritative judgment on certain factors, there should be no duty on him to disclose.<sup>133</sup> For example, the death of a corporate officer is a "non-accounting" factor which could reflect on the corporate earning potential; but it

<sup>128</sup> Section 16(a) of the 1934 act specifically imposes a duty on "insiders" to disclose all trading. Liability is imposed for "short swing" profits under § 16(b).

<sup>129</sup> It should be noted that public accountants are being reimbursed for their responsibility to be accurate and nonnegligent. This should impose upon them a higher standard of care. See Note, *supra* note 84, at 686.

<sup>130</sup> See Wilcox, *Accountant's Responsibility for Disclosure of Events After the Balance-Sheet Date*, 89 J. Account. 286, 290 (1950).

<sup>131</sup> For a general discussion of generally accepted accounting practice and the duty to disclose, see *id.* at 288.

<sup>132</sup> *Id.*

<sup>133</sup> *Id.* at 293.

is a fact which the accountant should not be required to disclose, as he lacks the professional capability to judge its effect on earning potential.

The fixing of a point in time at which the accountant will be relieved of his continuing duty to disclose presents a more difficult question. It is this precise question that is raised in *Fischer v. Kletz*.<sup>134</sup> In the *Kletz* case, it will be recalled, defendant accountants certified a financial statement which reflected a substantial net income for the fiscal period in question, while, in fact, there had been a substantial loss. Subsequent to this certification and the dissemination of this information to investors in the corporation's annual report,<sup>135</sup> the accountants became aware of the true financial status of the corporation. The accountants notified the corporation of the error but failed to make any attempt at public disclosure of the misleading nature of the annual report. Plaintiffs bought stock and debentures in the corporation relying on the annual report. Shortly thereafter the corporation went into bankruptcy, and plaintiffs sued defendant accountants alleging that the defendants had violated a duty to publicly disclose the error in the annual report and that their failure to so disclose constituted a course of business which operated as a fraud, in violation of Section 18 of the Securities Exchange Act and rule 10b-5.

Defendants PMM moved to dismiss, pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure, for failure to state a claim upon which relief could be granted. In a lengthy opinion, the district court dismissed the defendants' motion, both as to section 18 and rule 10b-5, holding that under certain facts, defendant accountants could be liable to the plaintiffs.

In a rather cursory treatment of section 18 liability, the court noted that there was a factual disagreement between the parties as to whether defendants PMM had knowledge of the falsity of the financial statements prior to the filing of the statements with the Securities Exchange Commission. Consequently, the judge deemed it advisable "to defer resolution of the issue of PMM's Section 18 liability until the facts are more fully developed."<sup>136</sup>

The discussion of rule 10b-5 liability was more extensive. The court was concerned with two major questions: (1) Whether there could be liability under 10b-5 if it appeared that the defendant "did not directly gain from its failure to disclose the discovery of the falsity of the financial statements;"<sup>137</sup> and (2) whether privity was necessary for plaintiff to recover. In 10b-5 actions privity has been a consistently difficult concept for the courts in the Second Circuit.<sup>138</sup>

In analyzing the first question, the court noted that several cases have found liability under 10b-5 without any finding of direct financial gain to the defendant in question. In *H.L. Green Co. v. Childree*,<sup>139</sup> it was held that accountants could be liable for false information disseminated to the public in

<sup>134</sup> 28 F. Supp. 478 (S.D.N.Y. 1967).

<sup>135</sup> The same certified financial statements had been filed with the Securities Exchange Commission in a Form 10-K Report.

<sup>136</sup> 266 F. Supp. at 189.

<sup>137</sup> Id. at 190.

<sup>138</sup> See note 119 supra.

<sup>139</sup> 185 F. Supp. 95 (S.D.N.Y. 1960).

certified financial statements, although the accountants realized no direct financial benefit from the purchase or sale of the security. In *Pettit v. American Stock Exch.*,<sup>140</sup> it was held that the stock exchange could be liable under rule 10b-5 for failing to take disciplinary action against practices which were violative of the federal securities regulations when the exchange had knowledge of the abusive practices. In neither of these cases was the court troubled by the fact that the defendant in question realized no direct financial gain from the alleged breach of duty. In *Kletz*, however, the court failed to reach a final resolution of the problem. It characterized the issue as "novel and difficult" and preferred to defer final resolution of the problem until there was "further factual and legal development of it by the parties and the SEC."<sup>141</sup>

It is surprising that the *Kletz* court raised this question at all. Nowhere in rule 10b-5 is there any intimation that to be liable a defendant must realize some financial gain from his breach of duty. That interpretation would assume a restitutional theory of liability under rule 10b-5 similar to that of Section 16(b) of the Securities Exchange Act.<sup>142</sup> Such a theory would appear to contradict the purpose of the securities legislation and its interpretation by the courts. The primary purpose of the federal scheme of securities regulation is to ensure that the public receive full and accurate information regarding securities issued. This purpose would not be effectuated by limiting the duty to disclose full and accurate information to those persons who have a financial interest in the transaction. Moreover, the language of the rule delimits the duty to disclose in different terms: the duty is imposed on *all* persons who have a connection with the transaction. It is submitted, therefore, that this consideration has no basis in determining liability under rule 10b-5.

In considering the second question—privity—the court found that there was no privity or even a semblance of privity between the plaintiffs and the defendants PMM.<sup>143</sup> Although noting that previous decisions in the Second Circuit had made privity a requisite to recovery under the rule, the court refused to dismiss the complaint for lack of privity.<sup>144</sup> Instead, the court preferred to test the validity of the complaint upon the determination of whether the accountants had any connection with the transaction.<sup>145</sup> Again, however, the court deferred resolution of this issue "in view of the inadvanced state of discovery in our case."<sup>146</sup> It is submitted that the court easily could have found the requisite connection between PMM and the transaction. As discussed above,<sup>147</sup> while the issue has never been fully litigated, several courts have had little difficulty in finding a connection between accountants and the sale of securities in similar situations. It is clear that there can be

<sup>140</sup> 217 F. Supp. 21 (S.D.N.Y. 1963).

<sup>141</sup> 266 F. Supp. at 194.

<sup>142</sup> Under Section 16(b) of the Securities Exchange Act, a corporation may recover short swing profits made by an insider on the corporation's securities.

<sup>143</sup> 266 F. Supp. at 192.

<sup>144</sup> *Id.* at 192-93.

<sup>145</sup> *Id.* at 193.

<sup>146</sup> *Id.*

<sup>147</sup> *Supra* notes 111-13 and accompanying text.

no broad decisional or statutory definition of the requisite connection, and that each case must be decided on its merits. The fact that PMM certified statements for dissemination to the public which would surely be influenced in purchasing the corporation's securities should be enough to establish the necessary connection with the transaction. This conclusion is reinforced by the fact that the accounting profession recognizes that part of their function is to represent the earning potential of the corporation, and that these representations will be used to influence the investing public.

Nowhere in the *Kletz* opinion does the court come to grips with the question whether rule 10b-5 requires disclosure of facts acquired after the certification and distribution of financial statements. It is impossible to determine whether the omission of any discussion of this question resulted from a failure of the court to recognize that this was, in fact, a question; or whether the court merely assumed that such a duty was imposed under the rule. It is submitted that while such a duty to disclose should be imposed under the rule, this duty is not obvious, and warrants discussion. The remainder of this comment will suggest an approach to finding a duty to disclose after-acquired facts under rule 10b-5.

In any discussion of an accountant's duty to disclose, there are three dates which must be distinguished:

(1) *The Balance-Sheet Date*—This is the date which ends the fiscal period for which the audit is being made. Thus, if an audit is being made for the fiscal year extending from June 1, 1966, through May 31, 1967, the balance-sheet date is May 31, 1967.

(2) *The Date of Certification*—This is the date on which the accountant certifies the audit. The date of certification may be significantly later than the balance-sheet date. Thus, an audit for the fiscal year ending May 31, 1967, may be certified on September 1, 1967.

(3) *The Date of Distribution*—This is the date on which the prospectus, annual report, statement, etc., in which the accountant's audit is incorporated, is distributed to the public. Thus, an audit for the fiscal year ending May 31, 1967, certified on September 1, 1967, may be distributed on October 1, 1967.

It is clear that the nature of an audit necessitates the disclosure of all relevant facts up through the balance-sheet date. It is equally clear that facts of which the accountant becomes aware after the balance-sheet date but before the date of certification must also be disclosed. For example, if there is a change in market conditions between the balance-sheet date and the date of certification, the accountant is required to disclose this change. This is because the ultimate purpose of the audit is not merely to restate the corporation's financial position for the preceding year, but to represent the potential earning power of the corporation for the future. Although the change in the market will not make the audit misrepresentative of the previous fiscal period, it will make the audit misrepresentative of the corporation's earning potential.<sup>148</sup>

It would also appear that facts which come to the attention of the

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<sup>148</sup> Wilcox, *supra* note 130, at 292.

accountant after the date of certification but before the date of distribution should be disclosed. In this regard, it may be helpful to recall some of the duties imposed on accountants under section 11 of the 1933 act. Under section 11, the accountant must follow reasonable and thorough accounting procedures beyond the date of certification and up to the date when the registration statement becomes effective.<sup>149</sup> The accountant is charged with the duty to disclose changes in corporate position between these dates to the SEC. It is not hard to analogize between the duties imposed by section 11 of the 1933 act and rule 10b-5. It would seem inconsistent, to say the least, that the effectuation of the legislative purpose of full and fair disclosure necessitated an imposition on accountants of a continuing duty to disclose in regard to representations made in a financial statement filed with the commission, but not so in regard to all other documents filed with a national exchange.

Since, under generally accepted accounting principles, and under section 11 of the 1933 act, accountants have a duty to continue reasonable accounting procedures up to the date of distribution, there should be little difficulty for a court to find that 10b-5 imposes a duty to disclose facts which come to the accountant's attention before the date of distribution. Thus, if after certification but before distribution an accountant acquires new facts and fails to disclose them, or, should he negligently fail to acquire them, it appears that he should be liable under 10b-5.

Neither the securities legislation nor the accounting profession, however, require an accountant to continue his audit or checking procedures beyond the date of distribution. Thus, an accountant would not be liable for failure to discover facts after the date of distribution. If, however, the accountant does acquire knowledge of facts which make the distributed audit misrepresentative, does the accountant have any duty of disclosure under 10b-5? It is submitted that the imposition of such a duty would be consistent with both the general purpose of the securities legislation and the disclosure requirement under 10b-5. Again, it may be helpful to analogize to other sections of the legislation. Under section 11(b)(2) of the 1933 act, if any registration statement which the accountant knows to be false or misleading becomes effective without his knowledge, the accountant will be civilly liable unless he severs his relations with the issuer and gives public notice that the registration statement became effective without his knowledge. While the analogy is not exact, the disclosure provisions in section 11 manifest a legislative intent that when false or misleading information is distributed to the public, steps should be taken to make the public aware of the misleading nature of the information. This concern is consistent with the general legislative purpose of insuring that the public will be provided full and accurate information regarding securities.

It is submitted that the advantages gained by a disclosure requirement beyond the date of distribution under rule 10b-5 outweigh the disadvantages. Such a duty, however, would be a limited one. There would be no duty to conduct reasonable investigation to acquire information beyond the date of

<sup>149</sup> The date the registration statement becomes effective is analogous to the date of distribution in this discussion.

distribution, but the accountant would be required to make reasonable public disclosure of any information that is acquired if failure to disclose would make the information already distributed misleading. The disadvantage of inconvenience to accountants would be minimal. Any court which interpreted 10b-5 to impose such a duty ought carefully to define what constitutes reasonable public disclosure. Certainly, a notice in a publication of national distribution (e.g., *The Wall Street Journal*, *Barrons*) could be found to constitute a reasonable method of disclosure.<sup>150</sup> This requirement would assure that misleading information distributed to the public will be corrected whenever possible.

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<sup>150</sup> Other methods could be considered equally reasonable, such as sending notification to all persons initially receiving the misleading financial statements; notifying the SEC and/or the national exchanges.