The Auditor's Legal Liability to Third Parties

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Scope of Discussion

AN AUDIT by a public accountant culminates in a report or certificate in which he makes representations as to the scope of the audit and expresses an opinion concerning the financial statements of his client. It is the client who engages and pays the accountant to conduct the audit and render the opinion, and the accountant has no contractual relations with anyone other than the client and those who have succeeded to the client's contractual rights. Nevertheless, as every public accountant realizes, the principal, if not the only, value of his professional opinion to the client resides in its function of meeting the requirements and influencing the actions of third parties with whom the accountant has no contract. These third parties include lenders and investors—both present and potential—government agencies, stock exchanges and labor unions.

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It is the aim of this article to examine the present state of the law in this country, both judge-made and statutory, with respect to the right of a third party (there being no contractual relationship) to recover money damages from the public accountant when the third party has relied to his detriment upon the statements of the accountant in the audit report.

There are various other penalties of a legal nature to which a public accountant may be subjected. He is under certain obligations to his client, both contractual and otherwise, which are considerably more severe than any obligations that he may have to third parties, and he may be sued by the client for failing to fulfill them. He may be suspended from practice by his state board of accountancy or by some particular governmental agency if he fails to meet standards of professional conduct enforced by such board or agency. Certain disciplinary measures may be taken against him by professional accounting societies. All these responsibilities and penalties are excluded from consideration in this study. Excluded also is any consideration of the rights of a surety or surety company which reimburses the auditor's client, under a fidelity bond, for defalcations by the client's employees which the auditor has failed to discover. In such situations the surety is not a true third party, inasmuch as he merely succeeds to whatever rights the client had against the public accountant.

NATURE OF THE PROBLEM

In the lands where the common law prevails, the courts have long regarded members of the skilled professions as having special responsibilities to the public over and above the specific obligations which they may assume by contract with the persons who engage them. These special non-contractual duties are embodied in rules of legal liability which have crystallized over the years out of innumerable judicial decisions in a wide variety of factual situations. They have become a part of the common law of torts.

When a professional man, in the course of his practice, causes harm to someone other than the person who has engaged his services, the extent of his legal liability to the injured party is not always clear. This is so even when the defendant is a member of one of the older professions, since most of the decided cases have involved injuries to clients rather than to third parties. The lack of precedent is even more pronounced in the case of public accountants, whose status as a major professional group is relatively new. Moreover, the utility of the few decisions that do exist in this field is limited, as a basis for prediction, by the probability that each new case which arises will be distinguishable on its facts from all the cases that have gone before. Nevertheless, the best way to gain an understanding of the present state of the common law on accountants' liability to third parties is to study the cases involving this problem in chronological order, with brief excursions into related cases involving members of other professions. Moreover, it has been said with reference to the decisions on accountants' liability that ". . . an intimate knowledge of the facts and the law of these cases, and their possible implications, will do more than anything else to develop a technique of imaginative thinking and alertness in our work and an awareness of the importance of complying with our own standards."[1] Consequently, this is the plan that will be followed here. After the decided cases have been examined, we will consider the extent to which the common law has been altered by legislation.

The cases can be better understood if certain concepts are kept in mind. There are many kinds of torts. Some of them, like assault and

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[1] Levy, *Legal Hazards in Public Accounting*, JOURNAL OF ACCOUNTANCY, May 1955, p. 37, 39.

battery, involve personal injuries, while others, like trespass and conversion, involve interference with property rights. Viewed as a tort, a false or misleading certificate by a public accountant comes under the heading of "misrepresentation." The law recognizes two different categories of misrepresentation, according to the degree of culpability on the part of the person who makes them, although the resulting damage may be just as great in one case as in the other. One of these categories consists of misrepresentations made fraudulently, while the other consists of those made negligently. This distinction is very important in the cases on accountants' liability to third parties.

The tort of *fraud* involves "false representations, willfully or recklessly made for the purpose of tricking or leading another on to his damage."[2] Several elements must be present. First, there must be a false representation. Silence where there is a duty to speak is considered equivalent to a false representation. Second, the person making the representation must know or believe that it is false, or be in conscious ignorance of its truth and must make it with an intent to deceive. Finally, the plaintiff must have relied on the representation and must have suffered injury thereby.[3]

The tort of *negligence* may be defined as failure to use that degree of care which a person of ordinary carefulness would use under the circumstances. Among the "circumstances," of course, would be the defendant's status as a member of a skilled profession. For example, the making of a false representation with honest belief in its truth, but with lack of reasonable care in ascertaining the facts or in the manner of expressing the conclusion, would constitute negligence.[4] In view of the constant development of auditing standards and techniques and the inevitable factual differences from case to case, the meaning of "reasonable care" in the field of auditing cannot be definite or fixed.

THE LANDELL CASE

The first significant court decision in this country on the liability of public accountants to third parties was *Landell v. Lybrand*,[5] handed down by the Supreme Court of Pennsylvania in 1919. The accounting firm of Lybrand, Ross Brothers and Montgomery had audited the financial statements of a client corporation for the year 1911 and certified their accuracy. Landell, the plaintiff, alleged that he had relied on this audit report in purchasing shares of the client company's stock. He alleged

[2] Gross, *Responsibility of the Accountant under the Law Explained*, JOURNAL OF COMMERCE AND COMMERCIAL, May 24, 1951.

[3] PROSSER, TORTS 705-706 (1st ed. 1941).

[4] PROSSER, *op. cit. supra* note 3, at 733.

[5] 264 Pa. 406, 107 Atl. 783 (1919).

further that the stock was actually worthless, that the certificate was false and untrue, and that the negligence of the accounting firm was the cause of his loss. He conceded, however, that the report had been shown to him by somebody other than the accounting firm and that it had not been made with intent to deceive him in particular. The court held that even if his allegations were all true the plaintiff could recover nothing from the accountants, for the following reasons:

> There were no contractual relations between the plaintiff and defendants, and, if there is any liability from them to him, it must arise out of some breach of duty, for there is no averment that they made the report with intent to deceive him. The averment in the statement of claim is that the defendants were careless and negligent in making their report; but the plaintiff was a stranger to them and to it, and, as no duty rested upon them to him, they cannot be guilty of any negligence of which he can complain.[6]

The *Landell* case merely applied to public accountants the doctrine already prevailing in regard to the other skilled professions, namely, that the negligent making of a misrepresentation does not give rise to legal liability to third parties. This doctrine was perhaps best exemplified in the leading English case of *LeLievre v. Gould.*[7] Here a lender agreed to advance money to a builder on the basis of progress certificates to be supplied from time to time by an architect hired by the builder. The architect negligently overstated the progress of the building, and the lender was thereby led to advance funds which it never recovered. The lender sued the architect, but was dismissed without relief because there was no "privity of contract" between them. In such a case, said the court, there could be no recovery even for gross negligence, in the absence of fraud, notwithstanding the fact that the architect knew that the lender would advance money to the builder in reliance on the certificates. The court refused to impose strict liability, distinguishing between mere words in a certificate and a gun or other dangerous instrument. An Ohio case, *Thomas v. Guarantee Title and Trust Co.*,[8] decided by the Supreme Court of this state in 1910, was to the same effect. The court held that for mere negligence in making or certifying an abstract of title, a title abstractor can be held liable only to the person who employed him.

The rule established by cases such as these is subject to serious criticism, particularly in connection with liability for negligent auditing. The public accountant intends and expects that his certificate will be exhibited to third parties and not concealed, and that they will rely on it. He demands and receives payment for it primarily because of the reliance which

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[6] *Id.* at 408, 107 Atl. at 783.

[7] 1 Q.B.D. 491 (1893).

[8] 81 Ohio St. 432, 91 N.E. 183 (1910).

it induces. Under the *Landell* rule, he is nevertheless insulated from liability for damages arising out of such reliance.[9]

THE ULTRAMARES CASE

Immediate Background

The most important judicial decision ever handed down on the question of accountants' liability to third parties is *Ultramares Corp. v. Touche.*[10] It was decided by the New York Court of Appeals in 1931. The opinion was written by Judge Cardozo, whose contributions in the field of torts are unsurpassed in the history of the common law.[11] The great learning and facility of expression which Cardozo brought to the *Ultramares* case make it a storehouse of persuasive and quotable pronouncements, and perhaps it is partly because of this that the common law on accountants' liability has remained substantially unchanged ever since.[12]

Before going into the details of the *Ultramares* case, it would be well to take note of *Glanzer v. Shepard,*[13] an earlier New York case in which Cardozo also wrote the opinion. In that case a seller of beans engaged a public weigher to issue a weight certificate in duplicate and to present one copy to a designated buyer. The weigher's admitted negligence resulted in a false certificate, and the buyer, relying on this certificate, paid for the quantity of beans indicated on it. The buyer sued the weigher and was allowed to recover damages from him despite the absence of contractual relations between them. This, of course, represented a departure from the rule theretofore prevailing, but Cardozo sought to overcome the lack of "privity" with the following argument:

> The defendants, acting, not casually nor as mere servants, but in the pursuit of an independent calling, weighed and certified at the order of one with the very end and aim of shaping the conduct of another. Diligence was owing, not only to him who ordered, but to him also who relied.[14]

It was only natural, therefore, that there was much consternation in accounting circles when the *Ultramares* case came before Judge Cardozo, and that the American Institute of Accountants, represented by three attorneys, came into the case and presented arguments as amicus curiae.

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[9] PROSSER, *op. cit. supra* note 25, at 738.

[10] 255 N.Y. 170, 174 N.E. 441 (1931).

[11] Seavey, *Mr. Justice Cardozo and the Law of Torts,* 52 HARV. L. REV. 372 (1939).

[12] The holding was generally approved at the time. Seavey, *op. cit. supra* note 11, at 398.

[13] 233 N.Y. 236, 135 N.E. 275 (1922).

[14] *Id.* at 242, 135 N.E. at 277.

The Facts in the Case

The plaintiff in the *Ultramares* case was a lending institution which had made a series of loans to Fred Stern and Company, a corporation which imported and sold rubber. The defendants were the members of Touche, Niven and Company, an accounting firm engaged by Stern early in 1924 to prepare and certify a balance sheet showing the condition of the business as of December 31, 1923. The defendants had been similarly employed by Stern and Company for the three preceding years, and they knew that in the normal course of its operations it borrowed large sums of money and showed its certified balance sheets to banks, creditors, stockholders and others, as the occasion demanded. Accordingly, when the balance sheet was made up, they supplied Stern and Company with thirty-two copies, certified with serial numbers as counterpart originals. Prior to that time, however, the Stern Company had never borrowed from the Ultramares Corporation, and the accountants did not know that the balance sheet would be exhibited to this particular lender. As Cardozo said, "The range of the transaction in which a certificate of audit might be expected to play a part was as indefinite and wide as the possibilities of the business."[15] Here, it developed, was an important difference between this case and *Glanzer v. Shepard*.[16]

By the end of February, 1924, the audit was finished and the balance sheet was made up. Attached to it was this certificate signed by the defendants:

> We have examined the accounts of Fred Stern & Co., Inc., for the year ending December 31, 1923, and hereby certify that the annexed balance sheet is in accordance therewith and with the information and explanations given us. We further certify that, subject to provision for federal taxes on income, the said statement, in our opinion, presents a true and correct view of the financial condition of Fred Stern & Co., Inc., as at December 31, 1923.[17]

The certified balance sheet showed a net worth of some $1,071,000. As a matter of actual fact, the company was insolvent on December 31, 1923, although it was not declared a bankrupt until 1925. Stern and his subordinates, as officers of the firm, had falsified the books so as to set forth accounts receivable and other assets which were wholly fictitious and to omit accounts payable for merchandise which had been purchased and received. During 1924 Stern and Company requested and obtained a series of large loans from the plaintiff, including a loan of $165,000 in one month alone. As a condition of these loans the plaintiff demanded

[15] 255 N.Y. 170, 174, 174 N.E. 441, 442 (1931).
[16] 233 N.Y. 236, 135 N.E. 275 (1922).
[17] 255 N.Y. 170, 174, 174 N.E. 441, 442 (1931).

a balance sheet certified by public accountants, and Stern submitted one of the thirty-two counterpart originals certified by the defendants.

In 1926 the plaintiff sued the defendants to recover the loss of more than $187,000 which it had suffered by relying upon the audit certificate. The plaintiff alleged that both parts of the certificate contained misrepresentations, first where the accountants certified that to their own knowledge the balance sheet corresponded to the accounts, and second where they certified to a belief that the balance sheet presented a true and correct picture of the client's financial condition. The theory of the plaintiff's case was that the first sentence of the certificate, being a statement of fact, constituted fraud, while the second sentence, being an erroneous statement of opinion by persons in the business of expressing such opinions, constituted negligence.

Negligence

The court first held that the evidence adequately supported the finding of the jury that the audit had been negligently made. For instance, one Siess, a junior accountant, was assigned by the defendants to post the general ledger from the entries in the journal, which the client itself had not done since April, 1923. After this posting was finished on February 3, 1924, the total of the accounts receivable on December 31 appeared on the ledger as about $645,000. At some later hour on February 3, Stern's chief bookkeeper, one Romberg, placed below that total a further item of about $707,000, supposed to represent additional sales made by Stern in December, all of which were wholly fictitious. Opposite this entry Romberg placed other figures, such as "12-29," ostensibly indicating references to the journal for December. When Siess resumed his labors the next day, he noticed these entries in Romberg's handwriting, but since his job was merely to post the books, he included the new item in making up his footings. There never was any verification of the $707,000 ledger entry, either by Siess or by his superiors. In fact, it was not supported by any entries in the journal or in the "debit memo book" from which the journal was made up, and although there were seventeen invoices amounting in the aggregate to the $707,000, they differed in credit terms and otherwise from those usual in the business and they contained no shipping numbers or order numbers. According to the court, all these suspicious circumstances would have been revealed if an adequate verification had been attempted.

Other instances of negligence in the conduct of the audit were also mentioned by the court. Stern had given the auditors an inventory figure of some $347,000, but in checking this they discovered errors of some $304,000 and reduced the inventory figure to only $43,000. Furthermore, they made inquiries of various creditors and discovered that the same accounts receivable had been pledged to three or four different banks at the same time. Such circumstances as these, according to the court, threw such discredit upon the business and the books that reasonable and prudent auditors in the exercise of due care, would press their investigations much further than was done here, where the defendants were satisfied with weak explanations by Romberg.

Liability to Third Parties for Negligence

After ruling that it was entirely proper for a jury to find the accounting firm guilty of negligence, the court went on to consider whether this particular plaintiff, as a third party having no contract with the defendants, could recover damages for such negligence, as the third party plaintiff had succeeded in doing in *Glanzer v. Shepard*.[18] Cardozo outlined the problem as follows:

> The assault upon the citadel of privity is proceeding in these days apace. How far the inroads shall extend is now a favorite subject of juridical discussion. . . . In the field of the law of torts a manufacturer who is negligent in the manufacture of a chattel in circumstances pointing to an unreasonable risk of serious bodily harm to those using it thereafter may be liable for negligence though privity is lacking between manufacturer and user. . . . A force or instrument of harm having been launched with potentialities of danger manifest to the eye of prudence, the one who launches it is under a duty to keep it within bounds. . . . Even so, the question is still open whether the potentialities of danger that will charge with liability are confined to harm to the person, or include injury to property. . . . In either view, however, what is released or set in motion is a physical force. We are now asked to say that a like liability attaches to the circulation of a thought or a release of the explosive power resident in words.[19]

The eloquent judge proceeded to point out that in the *Glanzer* case, unlike the present one:

> . . . the transmission of the certificate to another was not merely one possibility among many, but the "end and aim of the transaction," as certain and immediate and deliberately willed as if a husband were to order a gown to be delivered to his wife. . . . The bond was so close as to approach that of privity, if not completely one with it. . . . In a word, the service rendered by the defendant in *Glanzer* v. *Shepard* was primarily for the information of a third person, in effect, if not in name, a party to the contract, and only incidentally for that of the formal promisee. In the case at hand, the service was primarily for the benefit of the Stern company, a convenient instrumentality for use in the development of the business, and only incidentally or collaterally for the use of those to whom Stern and his associates might exhibit it thereafter.[20]

[18] 233 N.Y. 236, 135 N.E. 275 (1922).

[19] 255 N.Y. 170, 180, 174 N.E. 441, 445 (1931).

[20] *Ibid.*

Whatever one may think of the validity of this distinction, which at least one admirer of Cardozo has called a distinction without a difference,[21] Cardozo was also impressed, perhaps unduly, by certain practical considerations, as the following language shows:

> If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences.[22]
>
> Liability for negligence if adjudged in this case will extend to many callings other than an auditor's. Lawyers who certify their opinion as to the validity of municipal or corporate bonds, with knowledge that the opinion will be brought to the notice of the public, will become liable to the investors, if they have overlooked a statute or a decision, to the same extent as if the controversy were one between client and adviser. Title companies insuring titles to a tract of land, with knowledge that at an approaching auction the fact that they have insured will be stated to the bidders, will become liable to purchasers who may wish the benefit of a policy without payment of a premium.[23]

Finally, Cardozo brought this phase of the court's holding to an end by stating that negligence would become a substitute for fraud if the defendants were held liable to this plaintiff for their negligent auditing, and that,

> The suitors thrown out of court because they proved negligence, and nothing else, in an action for deceit, might have ridden to triumphant victory if they had proved the self-same facts, but had given the wrong another label. . . . A word of caution or suggestion would have set the erring suitor right. Many pages of opinion were written by judges the most eminent, yet the word was never spoken. We may not speak it now. A change so revolutionary, if expedient, must be wrought by legislation.[24]

Fraud

It was too early, however, for Touche, Niven and Company and the American Institute of Accountants to breathe a sigh of relief. Although the accountants had escaped liability to the plaintiff for mere negligence, the court still had to consider the plaintiff's allegations of fraud. In regard to liability for fraud in general, it could be said that by 1930

> . . . the privilege of one bargaining party to cheat another had gradually been narrowed; the field of permissible sellers' lies had been made smaller. . . . In most states it was no longer a defense that the plaintiff was

[21] Seavey, *op. cit. supra* note 11, at 400.
[22] 255 N.Y. 170, 179, 174 N.E. 441, 444 (1931).
[23] *Id.* at 188, 174 N.E. at 448.
[24] *Id.* at 186, 174 N.E. at 447.

> a fool. But by and large, there had been no corresponding extension of liability to third persons.[25]

As the court's opinion in the *Ultramares* case pointed out, however, it was established law in New York that where a person makes a certificate for his client or employer with knowledge that the client or employer will show it to prospective creditors and investors, the person making the certificate owes a duty to such third parties to make it without fraud. Moreover, in the words of Cardozo, "fraud includes the pretense of knowledge when knowledge there is none."[26] Here the defendants certified as a fact, true to their own knowledge, that the balance sheet was in accordance with the books of account. Even if they had expressed this conclusion as a mere opinion rather than as a fact, however, the following statement by Cardozo indicates that they could have still been found guilty of fraud:

> Even an opinion, especially an opinion by an expert, may be found to be fraudulent if the grounds supporting it are so flimsy as to lead to the conclusion that there was no genuine belief back of it.[27]

Cardozo ruled that on the evidence produced in court the jury might well have found that the balance sheet did not correspond with the books and that the defendants actually had no knowledge on the subject.[28]

The defendants admitted that if they had looked at the seventeen invoices representing the fictitious ledger entry of $707,000, they would have found omissions and irregularities so many and unusual as to have called for further investigation, but they contended that by following a random testing and sampling procedure in examining accounts and the related invoices, they had done all that could reasonably be expected of them, even though none of the seventeen fictitious invoices, which represented over half of the total value of accounts receivable shown in the ledger, was among the 200 invoices actually examined. According to the court, however, verification by test and sample was "plainly insufficient . . . where inspection of the invoices was necessary, not as a check upon

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[25] Seavey, *op. cit. supra* note 11, at 402.

[26] 255 N.Y. 170, 179, 174 N.E. 441, 444 (1931).

[27] *Id.* at 186, 174 N.E. at 447.

[28] *Id.* at 192, 174 N.E. at 448.

"Correspondence between the balance sheet and the books imports something more, or so the triers of fact might say, than correspondence between the balance sheet and the general ledger, unsupported or even contradicted by every other record. The correspondence to be of any moment may not unreasonably be held to signify a correspondence between the statement and the books of original entry, the books taken as a whole. If that is what the certificate means, a jury could find that the correspondence did not exist and that the defendants signed the certificates without knowing it to exist and even without reasonable grounds for belief in its existence."

accounts fair upon their face, but in order to ascertain whether there were any accounts at all."[29]

By way of strengthening his conclusion that a jury could find the defendants liable to the plaintiff under the fraud theory, Cardozo invoked the principle that:

> . . . negligence or blindness, even when not equivalent to fraud, is none the less evidence to sustain an inference of fraud. At least this is so if the negligence is gross.[30]

The Court of Appeals, therefore, disposed of the case by affirming the judgment of the trial court, which had been rendered notwithstanding a jury verdict to the contrary, in favor of the accountants on the question of liability for negligence, but reversing the judgments of the lower courts in favor of the accountants on the question of fraud, and granting a new trial on the fraud issue. The effect of this decision was well summarized by the court itself as follows:

> Our holding does not emancipate accountants from the consequences of fraud. It does not relieve them if their audit has been so negligent as to justify a finding that they had no genuine belief in its adequacy, for this again is fraud. It does no more than say that if less than this is proved, if there has been neither reckless misstatement nor insincere profession of an opinion, but only honest blunder, the ensuing liability for negligence is one that is bounded by the contract, and is to be enforced between the parties by whom the contract has been made. We doubt whether the average businessman receiving a certificate without paying for it, and receiving it merely as one among a multitude of possible investors, would look for anything more.[31]

The Beardsley Case

While the case of *Beardsley v. Ernst*[32] does not rank with the *Ultramares* case as a landmark of legal development, it is of interest to Ohio accountants and lawyers, and particularly to those in the Cleveland area, because it was decided by the Court of Appeals for Cuyahoga County in

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[29] *Id.* at 192, 174 N.E. at 449. On this point Cardozo made the following additional comments: "How far books of account fair upon their face are to be probed by accountants, in an effort to ascertain whether the transactions back of them are in accordance with the entries, involves to some extent the exercise of judgment and discretion. Not so, however, the inquiry whether the entries certified as there are there in very truth, there in the form and in the places where men of business training would expect them to be. The defendants were put on their guard by the circumstances touching the December accounts receivable to scrutinize with special care. A jury might find that with suspicions thus awakened, they closed their eyes to the obvious, and blindly gave assent."

[30] *Ibid.*

[31] 255 N.Y. 170, 189, 174 N.E. 441, 448 (1931).

[32] 47 Ohio App. 241, 191 N.E. 808 (1934).

1934 and involved the accounting firm of Ernst and Ernst as the defendant.

Ernst and Ernst had certified the consolidated balance sheets and the consolidated income and surplus accounts of the International Match Corporation, headed by the Swedish match king, Ivar Krueger, for the years 1929 and 1930. The certified statements showed net income in excess of $20,000,000 each year, but it later developed that the true figures were in the vicinity of $8,000,000.

During 1931 the plaintiff, Martha R. Beardsley, allegedly in reliance upon the audit certificate, bought stocks and bonds of the International Match Corporation. In 1932 Mr. Krueger committed suicide, and it became known that the corporation was bankrupt and its stocks and bonds worthless. The plaintiff sued Ernst and Ernst for $2,340 (the amount of her loss) on the theory that they had been guilty of fraud within the meaning of the *Ultramares* case, by purporting to have knowledge of the facts when in truth they had no such knowledge.

The Ohio court indicated that it would follow the *Ultramares* case and permit third parties to recover from public accountants on the ground of fraud where the accountants certify that the balance sheet reflects the true condition of the books when in fact it does not, and the certification is either made knowingly or involves a pretense of knowledge when in fact there was no knowledge. In the present case, however, Ernst and Ernst had clearly stated in their certificates that it was based both upon an examination of the records and upon statements received from abroad with respect to the foreign companies constituting a part of the consolidated entity. This, according to the court, gave rise to an indisputable inference that the accountants had not examined the books and records of the foreign constituent companies and obviously did not know, or pretend to know, whether or not the information from abroad was accurate. Therefore, since no fraud was proved in relation to the examination actually made of the books and records in this country, the court held that Ernst and Ernst had not committed fraud and were not liable to the plaintiff.

The obvious moral of the *Beardsley* case is that public accountants should be very careful to make the report or certificate reveal the limitations of the audit actually performed.

THE O'CONNOR CASE

The next reported case on the liability of public accountants to third parties was *O'Connor v. Ludlam*,[33] decided in 1937 by a federal court of appeals. The defendants were the members of the accounting firm of

[33] 92 F.2d 50 (2nd Cir. 1937) *cert. denied*, 302 U.S. 758 (1937).

Haskins and Sells, which had audited the books of a client, G. L. Miller and Company, as of August 31, 1925, and had prepared and delivered to the client corporation a balance sheet purporting to show its financial position as of that date after giving effect to a proposed sale of 30,000 shares of preferred stock at par for $3,000,000. The defendants knew that the Miller company was going to use this balance sheet in selling the preferred stock to the public. The balance sheet, together with the following statement, appeared over the signature of the accounting firm:

> Our audit of the books and accounts of the G. L. Miller Company, Incorporated, discloses that the net earnings of the Company for the year ended December 31, 1924, were in excess of 2½ times the dividend requirements of the contemplated issue of 30,000 shares of 8% cumulative preferred stock, and that the net earnings for the eight months ended August 31, 1925, were in excess of 3 times the dividend requirements of said stock for the said eight months.[84]

In fact, the Miller company was adjudged bankrupt in 1926.

The plaintiffs were preferred shareholders who, in alleged reliance upon the certificate of Haskins and Sells, purchased stock in the Miller company after the audit report was made and before the adjudication of bankruptcy. Here, as in the *Beardsley* case, the plaintiffs alleged that the balance sheet was false and that the accounting firm had committed fraud in representing it to be true. The defendants testified at great length as to the auditing procedures which they had followed and offered evidence supporting their representations. There was much testimony by experts for both sides. The court noted with chagrin that it had to consider more than 4,000 printed pages of recorded testimony and several hundred documentary exhibits, consisting mainly of the defendants' working papers.

At the trial, which lasted thirteen weeks, it was brought out that there were five principal defects, or alleged defects, in the balance sheet and the accompanying statement by the auditors.

First, the balance sheet showed cash of some $4,664,000, but did not adequately reveal that some $1,377,000 of this was held by the company in trust for certain bondholders and not owned outright. The defendants contended that this was adequately disclosed to ordinary readers by an item of some $1,967,000 under the heading of "Funds for Bond Interest and Redemption" on the liability side of the balance sheet.

Second, the balance sheet showed notes and accounts receivable of some $2,987,000 as secured, when as a matter of law they were not secured. The defendants argued that they honestly, even if erroneously, believed them to be secured, and they cited certain provisions in the relevant documents which gave some plausibility to this contention. They

[84] *Id.* at 53.

further argued that a statement by an auditor that notes are secured is a mere expression of opinion rather than an assertion of knowledge, and in dealing with legal documents, an accountant can be guilty only of negligence, and not of fraud, where he honestly misconceives the legal significance of certain provisions in such documents.

Third, many of these notes receivable were the notes of subsidiaries or affiliates of the client company, but the balance sheet did not reveal this. There was conflicting expert testimony as to whether or not this was in conformity with good accounting practice.

Fourth, the balance sheet contained no mention of millions of dollars of contingent liabilities which, on the basis of prior experience of Miller and Company, were not at all unlikely to become actual liabilities. Here again there was conflicting expert testimony as to whether good accounting practice required disclosure of these contingent liabilities.

Fifth, the certificate of Haskins and Sells as to the net earnings of Miller and Company was apparently false.

After the trial judge had explained the law to the jury on the basis of the *Ultramares* case, the jury decided that the public accountants had not committed fraud despite the flaws in the balance sheet and the certificate. The plaintiffs appealed on the ground that the jury should have been given certain additional instructions the effect of which would have been to stretch the label of "fraud" over a wider range of acts and omissions. The court of appeals affirmed the judgment for Haskins and Sells, though not in a manner which justified any great rejoicing in the accounting profession, as the following language from the opinion shows:

> In conclusion, we may say that the trial was entirely fair to the appellants. A clear and accurate charge was delivered under which the jury might well have found a verdict for the plaintiffs. There was much in the evidence which tended to cast doubt upon the good faith of the accountants, but it did not persuade the jury. An appellate court cannot set at naught a jury's verdict merely because they might have reached a different conclusion had they been sitting as the jury. Finding no error in the charge as given and nothing clearly wrong in refusing requested instructions, we affirm the judgment.[35]

THE STATE STREET TRUST COMPANY CASE

Cardozo was no longer on the New York Court of Appeals in 1938, but the case of *State Street Trust Co. v. Ernst,*[36] decided by that court in that year, ranks second only to the *Ultramares* case itself as a guidepost to the common law on the liability of public accountants to third parties. It is the last major reported judicial decision on that issue. It purports

[35] *Id.* at 56.

[36] 278 N.Y. 104, 15 N.E.2d 416 (1938).

to be an application and interpretation of the *Ultramares* case, from which both sides sought to derive support. The plaintiff was one of several banks which had made loans to the Pelz-Greenstein Company during the year 1929 in reliance upon the financial statements of that company for the year 1928. The defendants were the members of Ernst and Ernst, the accounting firm which had audited and certified these statements. The plaintiff contended that Ernst and Ernst had committed negligence so gross as to justfy an inference of fraud. Pelz-Greenstein was petitioned into bankruptcy in 1930, and the plaintiff received back only a portion of its loan. The damages sought from Ernst and Ernst were equal to the difference. The jury returned a verdict for the plaintiff, but the trial judge set it aside and rendered a judgment in favor of the accountants, despite the fact that they had chosen to rest their case strictly on the law and not to offer any evidence or call any witnesses of their own. The issue before the court of appeals, therefore, was whether the plaintiff's evidence was, as the defendants contended, so inadequate that it could not possibly support a jury finding that they were guilty of gross negligence raising an inference of fraud.

The Pelz-Greenstein Company was engaged in the factoring business. They loaned money to wholesalers or mills and took, as security, pledges of the inventories and assignments of the future accounts receivable of the borrowers. Pelz-Greenstein obtained most of its own working capital by borrowing from banks. Early in 1929 Pelz-Greenstein applied to the plaintiff for a loan of $300,000, but the plaintiff refused to grant a time loan until it had received a certified balance sheet. On April 2, 1929, the defendants issued to Pelz-Greenstein ten counterparts with full knowledge that the counterparts were to be used in obtaining credit. This balance sheet showed a surplus of $83,000, when in fact, according to the plaintiff's uncontradicted evidence, there was a deficit of more than $500,-000 and, further, an obvious liklihood of substantial losses on more than $768,000 of uncollected accounts receivable. On April 9, Pelz-Greenstein presented one of the counterparts to the plaintiff and the loan was made. Attached to each counterpart was the following certificate:

> We hereby certify that we examined the books of account and record pertaining to the assets of Pelz-Greenstein Co., Inc., New York City, as of the close of business December 31, 1928, and, based on the records examined, information submitted to us, and subject to the foregoing notes [not here material], it is our opinion that the above condensed statement shows the financial condition of the company at the date stated and that the related income and surplus account is correct.[87] (Bracket matter inserted by court).

On May 9, one month after submitting the ten counterparts of the

[87] *Id.* at 110, 15 N.E.2d at 418.

"condensed statement" or "shortform report," Ernst and Ernst sent to Pelz-Greenstein a "letter of explanation" or "long-form report" containing the following statement: "This balance sheet is subject to the comments contained in the letter attached to and made a part of this report.[38] The letter also pointed out facts known to Ernst and Ernst at the time of preparing their certificate but not mentioned in the certified balance sheet. Only one copy of this letter was sent, and it did not come to the attenion of the plaintiff or anyone else until after the bankruptcy of Pelz-Greenstein.

The court of appeals, in a four to two decision, held against the accountants and granted the plaintiff a new trial, on the ground that the evidence did not justify the trial judge's holding that as a matter of law the plaintiff had failed to make out a case against the defendants even if all of the uncontradicted evidence introduced by the plaintiff was true. In support of its decision the court pointed out a number of acts and omissions by the defendants which could be found by a jury to constitute gross negligence raising an inference of fraud.

First, according to the court, the very act of sending ten copies of the short-form report to Pelz-Greenstein, knowing that this report would be used to obtain credit, though it did not reveal the qualifying circumstances known to the auditors at the time and mentioned by them a month later in the long-form report, could be found to be gross negligence equivalent to active misrepresentation.

Second, over one-fourth of Pelz-Greenstein's assets were represented by an account called "Commission Accounts Receivable — Secured by Merchandise." This account showed a balance of over $2,000,000 with an offsetting allowance for bad debts of only $20,000. But the accountants knew, as their long-form report showed, that 38% of the $2,000,000, representing the accounts of 27 of the 55 borrowers from Pelz-Greenstein, consisted of unpaid advances equal to 125% of the total sales of these 27 borrowers during 1928, thus indicating a stagnation of inventories and a high probability of substantial losses by Pelz-Greenstein. Moreover, the defendants had also audited the books of Pelz-Greenstein for the two previous years, and they themselves had pointed out similar factors in those years. According to the uncontradicted testimony of the plaintiff's expert witnesses, proper accounting practice required that the defendants either establish a very large reserve for bad debts or reveal that $768,000 of the accounts receivable had a 125% ratio of advances to sales. Furthermore, the defendants knew that these and other non-paying accounts were being padded year after year by the addition of monthly interest charges.

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[38] *Ibid.*

Third, an account called "Commission Account Balances — Inactive and in Liquidation" appeared on the balance sheet as an asset without any offsetting valuation reserve, although the plaintiff's experts testified that there should have been a reserve of at least $150,000 against these accounts. The defendants did place this item below the current asset section of the balance sheet, but the experts further testified that this in no way disclosed the probable noncollectibility of the account balances. The defendants knew (indeed, they noted it in their subsequent long-form report) that many of the accounts included in this item had lain dormant for years, with no collections or realizations upon security, but had nevertheless been regularly inflated over the years by steadily increasing interest charges. In one case, all this was done even though it appeared on the face of the books that the borrower was in bankruptcy. Ernst and Ernst argued that they were excused from investigating these accounts because Pelz-Greenstein's treasurer informed them by letter that the company had enough security in its possession to liquidate the accounts completely, but this statement was unsupported and uninvestigated. The plaintiff's experts testified that in such circumstances, proper accounting practice would require a thorough independent investigation as to what security, if any, Pelz-Greenstein held for the payment of these accounts.

Fourth, in an account called merely "Accounts Receivable," there was a balance of some $3,200,000, including over $32,000 of accounts designated as bankrupt on the defendants' working papers and not covered by credit insurance, plus some $14,000 of insured bankrupt accounts which had been in the hands of the insurance company for fifteen months or more without action. Yet the reserve for bad debts which had been set up against the entire $3,200,000 amounted to only $15,000. Failure to set up a reserve of at least $46,000 was, to the court, an obvious instance of gross negligence.

Fifth, a $10,000 demand note was listed as an asset without any offsetting reserve, although for two years it had been in the hands of an attorney for collection.

Sixth, a borrower whose account constituted over $800,000 of the assets of Pelz-Greenstein had monthly sales averaging about $129,000 and never exceeding $191,000 during the first eleven months of 1928, but its sales for December were shown on the books as having jumped to $491,000. It later developed that this included over $300,000 of wholly fictitious sales, and the very size of the December figure, according to the experts, should have led the defendants to make an investigation.

Seventh, there was evidence that certain allowances for "discounts" and "doubtfuls" shown against accounts receivable on the certified balance sheet had been arrived at by accepting the figures used in 1927 rather than on the basis of 1928 sales. Moreover, the 1927 allowances had been arbitrarily reduced from the amounts computed by usual accounting practices to much lower amounts, so as to show a 1927 profit in excess of the 1927 dividends.

After pointing out these instances of what a jury might properly find to be gross negligence raising an inference of fraud, the court went on to discuss the element of reliance, which is necessary for a recovery of damages on the basis either of negligence or of fraud. The defendants argued that the plaintiff had relied more on the reputation of Pelz-Greenstein than on the audit certificate, but the court said:

> It is undoubtedly true that, in making the loan, there was reliance upon the then reputations of Pelz and Greenstein. But this does not preclude reliance also upon defendants' certified balance sheet. . . . The fraudulent misrepresentations on the part of defendants need not be the sole inducing cause of the damage.[39]

COMMON-LAW LIABILITY TO THIRD PARTIES TODAY

In general terms, the common law today, as laid down in the *Ultramares* case and amplified in the *State Street Trust Company* case, can be summarized by stating that the public accountant is liable to third parties for fraud and is not liable to third parties for negligence. And if a jury finds that the negligence was gross, it may properly infer fraud from the existence of negligence. The cases discussed above give an idea of how these rules are likely to be applied in practice. It would seem that for practical purposes these cases have eliminated any distinction between fraud and negligence, for under the rules which they have established, a jury can "take care of the equities in the situation"[40] if the accountants have been guilty of seriously wrongful conduct. According to one writer, the effect of the *State Street Trust Company* case, as an extension of the *Ultramares* rule, is that "The curtains which failed to exclude the nose of the camel are now further parted to admit the head."[41]

This is in line with the modern trend in the decisions with regard to the liability of members of other skilled professions to third parties who may be expected to rely upon their words.[42] But the situation of public accountants is more perilous than that of most other professional makers of representations, in view of the unforeseeable extent of possible reliance by unknown third parties. It is mainly this consideration that led to anguished editorial cries in the *Journal of Accountancy* in 1950. In that year a series

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[39] *Id.* at 122, 15 N.E.2d at 423.

[40] Seavey, *op. cit. supra* note 11, at 404.

[41] *Ibid.*

[42] Seavey, *op. cit. supra* note 11, at 400.

of related suits, apparently not yet finally decided, were filed by certain lending institutions against the accounting firm which had audited the books of a bankrupt borrower.[43] On the basis of these editorials, it seems that the only "solution" that would satisfy the accounting profession would be the abolition of the doctrine which permits juries to infer fraud from negligence if the negligence is gross. The writer of one editorial mentioned "the specter of unlimited liability which haunts public-accounting practitioners" and complained that the *Ultramares* case was "novel judicial doctrine" and "opened up new problems which are no nearer solution now than they were in 1931."[44] The footnote contains representative excerpts from these editorials.

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[43] JOURNAL OF ACCOUNTANCY, April 1950, p. 277; September 1950, p. 187.

One of these cases was recently heard in a federal court of appeals. C.I.T. Financial Corporation v. P.W.R. Glover, 224 F.2d 44 (2d Cir. 1955). The court of appeals upheld a jury verdict for the accountants on the ground that "we do not believe we should attempt to go beyond the standards of the market place, as reflected in current judicial decisions." The court stated that it was inclined to agree with the trial judge's charge to the jury to the effect that in order to establish a duty on the part of the accountants to the third-party plaintiff for ordinary negligence, the plaintiff would have to convince the jury that the audit reports had been made for the "primary benefit" of the plaintiff, and cited the *Ultramares* and *O'Connor* cases on this point. Regardless of the correctness of this charge, however, the court indicated that the jury's verdict should stand because the jury had found that the defendants' representations had not been negligently false or misleading, so the charge could not have affected the outcome of the case.

The case is discussed at some length in Levy, *The C.I.T. Case,* JOURNAL OF ACCOUNTANCY, October 1955, p. 31.

[44] JOURNAL OF ACCOUNTANCY, April 1950, p. 277.

"The catastrophic possibilities of unfavorable findings under this doctrine, in addition to the unfavorable publicity arising out of litigation, have impelled accountants to settle the relatively infrequent negligence suits out of court. As a result, we know of no case which has been fully tried on its merits through the highest courts. Consequently the line between negligence and fraud, in relation to the liability of auditors, remains obscure."

"By being organized as partnerships rather than in corporate form, they [public accountants] expose their personal fortunes to these responsibilities." "If they were to aasume unlimited liabilities to 'third parties,' it would be necessary for accountants either to charge premiums as insurers or to stop expressing expert opinions on financial statements. Either course would seriously retard the machinery of credit and investment."

"The knowledge that many accounting firms carry liability insurance may tempt those who have suffered losses to try to recover from the accountants." "What is needed is the assurance that would be afforded by a reasonable judicial interpretation of the distinction between negligence and fraud, as these terms are applied to the duties of auditors. Until we have it, accountants may be plagued by strike suits and may be virtually blackmailed into settlements of unjust claims. The mere initiation of the suit is a shocking warning of the hazards to which professional accountants may be exposed. In the absence of willful fraud or connivance on the part of accountants, which so far as we know is not alleged in this case, it seems beyond the realm of common sense that any professional practitioner should be subjected to such ruinous

A more moderate tone was taken in an article which appeared in the *New York Certified Public Accountant* in 1949.[45] As the author of that article pointed out:

> The law of auditors' liability is still in the early stages of its growth. Its scope and limit . . . are necessarily uncertain and not fully defined . . . a changing commercial society has been altering earlier concepts and standards. . . . In such a new and relatively unexplored area, the courts and the profession are feeling their way and being guided perhaps more by changing conditions than by either judicial or accounting precedent.[46]

The writer was troubled by the fact that fraud could be established without evidence of deliberation, premeditation, scheming, or bad intentions of any kind, and he spoke of "the distressing uncertainty of what an average jury, without technical knowledge or accounting experience, may do with the evidence presented to it in terms of negligence, gross negligence, and of a rather special type of fraud,"[47] but he concluded that:

> Professional standards and practices are crystallizing in a pattern of greater uniformity and receiving more wide-spread acceptance. Coupled with the current trend in all areas of commercial and professional endeavor to a stricter legal as well as social responsibility, one may, therefore, reasonably expect that the law's future development will stress an extension and refinement of the accountant's responsibility to the public he serves.[48]

Although complaining loud and long about the judicial decisions against them, the certified public accountants of this country, as the preceding quotation suggests, have been doing much to decrease the likelihood of lawsuits by improving their own auditing standards and procedures. In fact, it might well be concluded that the accounting profession itself recognizes ethical responsibilities to third parties which are greater than the legal liabilities imposed by the courts, if certain excerpts from the *Codification of Statements on Auditing Procedure,* issued by the American Institute of Accountants in 1951, are any criterion.[49]

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liabilities. The amount of damages claimed appears fantastic in relation to what the fees paid to the accountants could have been."

[45] Kostelanetz, *Auditors' Responsibilities and the Law,* 19 NEW YORK CERTIFIED PUBLIC ACCOUNTANT 91 (Feb. 1949),

[46] *Ibid.*

[47] *Ibid.*

[48] Kostelanetz, *op. cit. supra* note 45, at 95.

[49] AMERICAN INSTITUTE OF ACCOUNTANTS, CODIFICATION OF STATEMENTS ON AUDITING PROCEDURE 18 (1951).

"The presentation of financial statements on the stationery or in a report of an independent certified public accountant without a definitive expression clearly indicating the representations he is making as to their fairness tends to create uncertainties in the minds of those who do not have special information regarding the preparation of the financial statements. In such cases, these third parties have no basis for determining what inferences are warranted by the association of his name with the financial statements and may place undue reliance upon them."

Of course, the penalties, if any, which are likely to be imposed by a professional body for violations of its code of ethics are less severe than those which can be imposed in courts of law for causing financial damage to others. If public accountants aspire to full professional status and a continuation of the high esteem in which they have been held by the business community, it does not seem unreasonable to expect them to take full legal responsibility for their own negligence, at least if that negligence seems "gross" to a jury, instead of relying entirely upon the internal self-policing of the profession under its code of ethics. After all, the very purpose of the public accountant in preparing and certifying a financial statement is to engender trust and confidence in that statement on the part of large numbers of "third persons." It hardly seems fair to exonerate him from liability to such third persons when he is successful in this aim. In any lawsuit against the accountant for either fraud or negligence, the third party, of course, must always prove a causal connection between the accountant's misrepresentation and the ensuing loss, but if he can do this, he should, in all good conscience, recover damages. As one legal writer has said, "A profession should not be permitted to reap the benefits of a position of trust and confidence without assuming the responsibilities which should rightfully accompany it."[50]

In practice, where there is substantial uniformity of opinion within a profession as to what constitutes reasonable and ethical conduct in the practice of that profession, a properly instructed jury, or a judge trying the facts where a jury trial has been waived, is not too likely to hold members of that profession to a higher standard of care. There was, after all, conflicting expert testimony in the *Ultramares* case; the accountants won the *Beardsley* and *O'Connor* cases; and the reason for the loss of the *State Street Trust Company* case by Ernst and Ernst may well have been, to a large extent, that they did not deign to offer expert testimony contradicting that of the plaintiff's experts.

THE SECURITIES ACT OF 1933

It will be recalled that Cardozo, in his *Ultramares* opinion, had said that if public accountants were to be made liable to third parties for ordinary negligence as well as for fraud, this would be a change so revolutionary that

"Since the independent certified public accountant cannot effectively control the use to which financial statements accompanied by his name be put, the adoption of practices which will minimize the possibilities of uncertainties and misinterpretations by third parties is obviously in the interest of all concerned and should aid in the avoidance of embarrassment and damage to the profession."

[50] Anon., *The Accountant's Liability — for What and to Whom,* 36 IOWA LAW REVIEW 319, 326-327 (1950).

it would have to be wrought by legislation and not by a mere court decision.[51] In the limited sphere in which it operates, Section 11 of the Federal Securities Act of 1933, as amended,[52] effects this change. Indeed, in certain respects it goes even further.

The third parties protected by the Securities Act are the purchasers of securities which are offered for sale to the public through the mails or in interstate commerce. Creditors other than bondholders are not protected. Before such an offer is made, the Act requires[53] that a so-called "registration statement" be filed with the Securities and Exchange Commission. This registration statement must include balance sheets and profit and loss statements of the company issuing the securities, both certified by an independent public or certified accountant, and both, ordinarily, as of a date not more than 90 days prior to the filing of the registration statement.[54]

In order to recover damages from the public accountant, the purchaser of the securities need prove only that the registration statement, at the time it became effective, contained an untrue statement of a material fact or a misleading omission of a material fact, unless the defendant can prove that at the time of the purchase the purchaser knew of such untruth or omission. The purchaser does not even have to prove that he relied upon the registration statement, unless he acquired the security after the issuer had published an earnings statement covering at least one year after the effective date of the registration statement. And even then he does not have to show that he actually read the registration statement.[55] In these respects it is easier for the third party to recover damages under the Securities Act than in a common-law action.

The accountant, however, cannot be sued under this statute unless he has given his consent to be named as having prepared or certified some part of the registration statement or some reporter used in connection therewith. Furthermore, he is not liable for damages if he sustains the burden of proof that he had, after reasonable investigation, a reasonable belief that his representations in the registration statement were true and not misleading. But he must have had this belief not merely as of the date of the financial statements, but as of the later date when the registration statement of which they formed a part became effective. Finally, if the accountant can

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[51] *Id.* at 322.

[52] 48 STAT. 74 (1933), 15 U.S.C. § 77K (1952).

[53] The language in which statutes are drawn does not often make for ease of comprehension. The ones under consideration here are no exception. Therefore, in the interest of lucidity, they will be described and paraphrased rather than quoted directly.

[54] 48 STAT. 78, 88, 91 (1933), 15 U.S.C. § 77(f), (g) and (aa) (25), (26), (27) (1952).

[55] 48 STAT. 82 (1933), 15 U.S.C. § 77(K) (a) (4) (1952).

prove that the plaintiff's losses resulted in whole or in part from causes other than false statements or misleading omissions in the financial statements, he may escape liability or reduce the amount of damages.[56]

The net effect of these provisions would seem to be that the public accountant is still not liable to the third party if he can show compliance with generally accepted auditing standards and can, in addition, sustain the burden of proof which the statute shifts to him with respect to certain matters such as the lack of a causal connection between his work and the plaintiff's injury. Surprisingly enough, there has yet to be reported a court case brought under this statute against an accountant, based on alleged false statements or misleading omissions as of the date of a financial statement.[57]

THE SECURITIES EXCHANGE ACT OF 1934 AND OTHER STATUTES

The Federal Securities Exchange Act of 1934[58] provides for the regulation of stock exchanges and lays down certain requirements with respect to the securities listed and traded on such exchanges, including annual reports to the Securities and Exchange Commission containing financial statements certified by independent public accountants. For present purposes, this statute resembles the Securities Act of 1933 in that third parties who are given rights are the purchasers and sellers of securities, but recovery of damages is more difficult under the 1934 Act in several respects.

The plaintiff must prove that the accountant's representation was false or misleading with respect to some material fact at the time when it was made and in the light of the circumstances then prevailing. This, of course, is prior to the effective date of the report to the Commission, but it is subsequent to the end of the accounting period. Thus, under both statutes the accountant must consider developments after the end of the accounting period. The plaintiff must also prove that he relied upon the accountant's representation in buying or selling a security at a price which was affected by such representation.

On one point, however, the 1934 Act follows the pattern of the 1933 Act, that is, in shifting the burden of proof to the defendant. The accountant may avoid liability if he can prove that he acted in good faith and had no knowledge that his statement was false or misleading. Since he could prove these things and still be negligent by common-law standards, it has been suggested that the 1934 Act, apart from its provisions as to the burden

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56 48 STAT. 82 (1933), 15 U.S.C. § 77(K) (1952).

57 LEVY, ACCOUNTANTS' LEGAL RESPONSIBILITY 47 (New York: American Institute of Accountants, 1954).

58 48 STAT. 881 (1934), 15 U.S.C. § 78 (1952).

of proof, merely enacts the rule of the *Ultramares* case, under which the accountant is liable to third parties only for fraud.[59]

The Federal Public Utility Holding Company Act of 1935[60] contains provisions on accountants' liability similar to those of the 1934 Securities Exchange Act.

One interesting aspect of all these Federal statutes is that the misstatements and omissions for which they impose legal liability may be either over-statements or understatements of a company's financial position. A person who already owns stocks or bonds of the auditor's client, and is induced to sell them at too low a price because the certified balance sheet or income statement contains material understatements, may recover damages from the auditor.

The so-called "blue sky" laws of the various states do not specifically affect the legal responsibilities of public accountants to third parties, although some of them make it a felony, punishable by means of a criminal prosecution, for an accountant to make representations with actual knowledge that they are false.[61] For the most part, these laws merely provide for the licensing of stock brokers and dealers and for inspection of the securities by state authorities. The Florida statutes, however, provide that the same civil remedies provided by the federal securities laws shall be available to purchasers of securities to which the Florida statutes apply.[62]

THE SHONTS CASE

The only reported judicial decision on the liability of public accountants to third parties under the federal securities acts involved the troublesome issue of transactions and events occurring after the end of the accounting period. The case in question, *Shonts v. Hirliman*,[63] was decided by the United States District Court for the Southern District of California in 1939, and was apparently never appealed.[64] The plaintiffs were purchasers of stock in Condor Pictures, Incorporated, and the defendants were the members of the auditing firm of Webster, Atz and Company.

The plaintiffs alleged that the registration statement of Condor Pictures

[59] LEVY, ACCOUNTANTS' LEGAL RESPONSIBILITY 50 (1954). See note 57 *supra* for publication information.

[60] 49 STAT. 838 (1935), 15 U.S.C. § 79 (1952).

[61] LEVY, ACCOUNTANTS' LEGAL RESPONSIBILITY 50 (1954). See note 57 *supra* for publication information.

[62] *Ibid.*

[63] 28 F. Supp. 478 (S.D. Cal. 1939).

[64] Rappaport, *Accountants' Responsibility for Events Occurring after the Statement Date: the Shonts Case*, JOURNAL OF ACCOUNTANCY, March 1953, p. 332, 334.

was false and misleading in that neither it nor an amendment to it revealed the existence of a lease obligating Condor Pictures to use the premises of a certain studio for at least 100 days during the year at a minimum rental of $35,000.[65] Actually Condor Pictures did not become bound by this leasing arrangement until January 31, twelve days after Webster, Atz and Company had issued their certificate, so that at the time the certificate was signed it contained no misstatements or omissions. Nevertheless the plaintiffs, relying upon the provision in the Securities Act of 1933 imposing liability for misstatements or omissions existing at the time the registration statement becomes effective, sought to hold the auditors liable because the leasing arrangement was not set up on the books of Condor Pictures as a contingent liability.

In seeming disregard of the language of the statute, the court held for the accountants and dismissed the case against them, stating that:

> The rental arrangement was not called to their 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.[66]

One authority, writing of the *Shonts* case, says:

> If the surprisingly low accounting standards which seemed to satisfy the court in this case are followed as the norm required by Section 11, that section will turn out not to have advanced far beyond the "gross neglegence" standard which the New York court was willing to apply even at common law. The fact is that the district court set a standard of care far below that which is customary for the profession and necessary for the detection of possible contingent liabilities to be listed in the registration statement. Few reputable accounting firms would be satisfied with a mere perusal of matters coming to their attention through inspection of the "books at their disposal."[67]

Writers in the accounting journals[68] have cautioned their readers about placing too much reliance on the *Shonts* case and have conjectured upon the measures that an auditor should take to avoid liability for happenings between the financial statement date and the effective date of the registration statement. It seems to be agreed that there will be no liability if the auditor stays in touch with the financial affairs of his client during this interval by reading the minutes of shareholder, director

[65] *Ibid.* The amendment was dated February 1, 1937, but was declared by the S.E.C. to be effective as of January 19, 1937, the date of the auditor's certificate.

[66] 28 F. Supp. 478, 483 (S.D. Cal. 1939).

[67] LOSS, SECURITIES REGULATION 1020 (1951).

[68] Powell, *Procedures the Auditor Should Carry Out to Determine Events after Statement Date,* JOURNAL OF ACCOUNTANCY, June 1953, p. 709; Rappaport, *op. cit. supra,* note 64.

and committee meetings, inspecting internal financial statements prepared by the client, interviewing responsible officials of the client and taking other measures short of a continued audit.[69]

The *Shonts* case, of course, merely scratched the surface of the problems of construction residing in the civil liability sections of the federal securities acts.

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[69] Powell, *op. cit. supra*, note 68.