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I. Introduction

MODERN technology has produced an unprecedented record of growth and development in this country since the turn of the century. Progress, however, has brought with it a maze of rules, regulations and other complications inherent in keeping order within such a mammoth society. Ideally suited and trained to solve the myriad financial headaches spawned by such an atmosphere is the accountant.

The financial services rendered by the accounting profession to the business community consist not only of auditing and financial reporting but also of tax practice and management consulting. The primary function of the profession, however, still remains the examination of the financial statements of clients and the expression of an expert opinion—in the form of a report—on the fairness with which they present financial positions and results of operations.[1] It is on these reports that the entire business community relies in conducting its affairs. Because of the great reliance placed on such reports, impartiality of authorship is often a requisite; accordingly, the principal burden of preparing or certifying such reports rests largely with the independent public accountant.

Inaccuracies in computing financial worth or profitability of operations can cause immeasurable loss to those who rely upon such reports. To recoup resultant losses, the aggrieved party often seeks redress from the person benefited, and lately, with greater frequency, has in addition sought to impose liability on the calculator of the figures, the accountant. Presently, there are approximately 100 such suits (involving many millions of dollars) pending against CPA firms alone. These suits have been instituted by disgruntled "investors and creditors who contend that the auditors failed to perform their watchdog function properly and, as a result, cost them (the plaintiffs) money."[2]

Various reasons have been suggested in an attempt to explain this rash of suits:

(1) the hope of banks and other financial institutions to make accounting firms a source of salvage when credit losses occur; (2) the general growth of the American economy and the related increase in loss potential in the event of a business failure; and (3) the publicity accompanying the six-million dollar lawsuit against Peat, Mar-

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1. See S. Levy, Accountants' Legal Responsibility 6 (1954).
2. Wall Street Journal, Nov. 15, 1966, at 13, col. 2.

wick, Mitchell & Co., the nation's largest public accounting firm, brought by the two largest banks in the United States, the Bank of America and the Chase Manhattan Bank.[3]

Regardless of the reasons, however, the plain fact remains that the cost of liability coverage sold to accounting firms has risen by as much as 30 per cent and more.[4] Moreover, many of the insurers who wrote such coverage relatively freely in the past now handle it only as an accommodation for big accounts or in a limited manner.[5]

Although liability can also arise out of the accountant's improper performance in rendering tax and management consulting services,[6] this article will concern itself only with the liability arising from improper auditing and financial reporting. Such liability inures in favor of not only the client on whose behalf the services are rendered but, in many instances, third parties.

The accountant's relationship with the client arises out of a contract, though his undertakings may differ greatly from retainer to retainer.[7] While the retainer may set forth only the duties to be performed, incorporated into every such contract of his employment (whether expressed or implied) "is the duty to perform the accounting services bargained for with the skill to be expected of a reasonably prudent man with this training and knowledge."[8] Should the accountant's conduct fall below these professional standards "he may be held liable to his client for breach of contract, or in tort for breach of the general duty to exercise due care, arising out of the contract relationship."[9]

Auditors' liability to third parties, however, not only is permeated with greater uncertainties, but also presents an area of far greater potential liability to the accountant than arises from the accountant-client relationship. Accordingly, the balance of this article will be devoted to a discussion of the extent of such liability.

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3. Note, Potential Liability of Accountants to Third Parties for Negligence, 41 St. John's L. Rev. 588, 597 (1967) (footnotes omitted).

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

5. Id. at 13, col. 4.

6. See Annot., 54 A.L.R.2d 324, 344 (1957).

7. Hawkins, Professional Negligence Liability of Public Accountants, 12 Vand. L. Rev. 797, 798 (1959).

8. Note, The Accountant's Liability—For What and to Whom, 36 Iowa L. Rev. 319, 320 (1951) (footnote omitted). See also Gammel v. Ernst & Ernst, 245 Minn. 249, 72 N.W.2d 364 (1955), which compares the standards of reasonable care applicable to accountants with those applied to lawyers, doctors, architects, engineers and other professional men engaged in furnishing skilled services for compensation, and concludes they are the same.

9. Levitin, Accountants' Scope of Liability for Defective Financial Reports, 15 Hastings L.J. 436, 437-38 (1964) (footnote omitted).

II. AUDITORS' LIABILITY TO THIRD PARTIES

Although the general topic of auditors' liability to third persons has been ably considered,[10] such liability to third persons is hardly in total resolve.[11] Unlike the relationship existing between the accountant and his client, there is generally no contractual obligation between the accountant and a third person to perform promised services with due care. Accordingly, liability at common law against the accountant has been sought primarily by the aggrieved third party for varying degrees of negligence and deceit. While the common law has generally defined and limited the accountant's responsibility for negligence, it has decidedly emphasized his exposure to third persons on the grounds of fraud, misrepresentation or deceit.[12] As the rules developed, however, the law of negligent misrepresentation and the law of fraud often became inextricably entangled. Moreover, the development of the common law influenced the enactment of federal legislation "which has broadened the responsibility for negligence where the claims of investors or securities purchasers are involved."[13] There also exists some state legislation imposing varying degrees of third party liability upon the accountant, but this article will explore these statutes only as they are incidentally reflected in reported cases.

A. *Liability Based Upon Negligence*

Initially, clinging to ancient historical concepts, the common law recognized no liability for negligence, except as between parties in privity.[14] Under this doctrine, a plaintiff could not maintain an action in tort for harm caused by a defendant's negligent performance of a contract, unless the plaintiff was in privity of contract with the defendant.[15]

With respect to negligent acts causing physical injury to persons, this

10. See generally Bradley, Auditor's Liability and the Need for Increased Accounting Uniformity, 30 Law & Contemp. Prob. 898 (1965); Hawkins, Professional Negligence Liability of Public Accountants, 12 Vand. L. Rev. 797 (1959); Levitin, Accountants' Scope of Liability for Defective Financial Reports, 15 Hastings L.J. 436 (1964); MacMillan, Sources and Extent of Liability of a Public Accountant, 15 Chi.-Kent L. Rev. 1 (1936); Meek, Liability of the Accountant to Parties Other Than His Employer for Negligent Misrepresentation, 1942 Wis. L. Rev. 371; Rouse, Legal Liability of the Public Accountant, 23 Ky. L.J. 3 (1934); Seavey, Candler v. Crane, Christmas & Co.—Negligent Misrepresentation by Accountants, 67 Law Q. Rev. 466 (1951); 31 Colum. L. Rev. 858 (1931); 16 Cornell L.Q. 419 (1931); 33 Ill. L. Rev. 349 (1938); 26 Ill. L. Rev. 49 (1931); 29 Mich. L. Rev. 648 (1931); 3 N.Y.U. Intra. L. Rev. 11 (1947); 16 N.Y.U.L.Q. Rev. 436 (1939); 6 Rutgers L. Rev. 478 (1952); 13 St. John's L. Rev. 310 (1939); 6 U. Chi. L. Rev. 127 (1938).

11. The Specter of Auditors' Liability, J. Accountancy, Sept. 1965, at 33 (Editorial).

12. S. Levy, supra note 1, at 29.

13. Id.

14. Winterbottom v. Wright, 152 Eng. Rep. 402 (Ex. 1842).

15. Savings Bank v. Ward, 100 U.S. 195 (1879).

strict requirement of privity was gradually weakened toward the latter part of the nineteenth century by such cases as *Heaven v. Pender*.[16] In *Heaven*, the defendant, a dockowner, contracted with a shipowner for the placing of a staging on defendant's dock outside the latter's ship. Plaintiff, while in the employ of a ship painter who had contracted with the shipowner to paint the outside of the ship, was injured when the staging collapsed as he climbed on it to paint the ship. Despite lack of privity, the dockowner was held liable for the injuries sustained by the painter.

The first assaults on this "citadel of privity" in the United States were made by negligence cases involving articles that were inherently dangerous and were likely to "put human life in imminent danger."[17] These were followed by *MacPherson v. Buick*,[18] which held that "[i]f the nature of a thing is such that it is reasonably certain to place life and limb in peril when negligently made . . . . [and] there is added knowledge that the thing will be used by persons other than the purchaser . . . without new tests . . ."[19] then liability for negligent manufacture will not be limited to parties in contract privity. These cases, however, generally involved negligence resulting in tangible physical harm to person or property, and not mere loss to intangible economic interests.[20] The extension to intangible economic interests was soon made by *Glanzer v. Shepard*.[21]

In *Glanzer*, the defendant was a public weigher who, at the vendor's request, supplied the vendee with a certificate stating the determined weight of a shipment of beans. The buyer paid an excessive purchase price because of his reliance on the defendant's certificate, which contained a negligent overstatement of the weight. The court imposed liability on the defendant for the pecuniary loss of the buyer, on the ground that the plaintiff's use of the certificate was not an incidental consequence, but was the sole purpose of the weighing. The court felt that since the defendant intended the plaintiff to rely on the certificate, the defendant's duty of care was not limited to the other party to the contract but exended to the plaintiff as well.[22]

In 1931, however, *Ultramares Corp. v. Touche*[23] came before the New

16. 11 Q.B.D. 503 (C.A. 1883).

17. Thomas v. Winchester, 6 N.Y. 397, 409 (1852). In this case the defendant, who was a dealer in medicines, sold a druggist poison which he had negligently labelled as extract of dandelion. The druggist, in good faith, used the poison so mislabelled in filling a prescription. The court held the original vendor liable for the injuries suffered by the patient.

18. 217 N.Y. 382, 111 N.E. 1050 (1916).

19. Id. at 389, 111 N.E. at 1053.

20. Levitin, supra note 10, at 440.

21. 233 N.Y. 236, 135 N.E. 275 (1922).

22. Id. at 238-39, 135 N.E. at 275-76.

23. 255 N.Y. 170, 174 N.E. 441 (1931).

York Court of Appeals. The defendants, independent auditors, were hired by Fred Stern & Co., Inc. ("Stern") to prepare and certify a balance sheet exhibiting Stern's condition as of December 31, 1923. From prior dealings, defendants knew that Stern used such statements in obtaining the extensive credit required to finance its operations. Accordingly, when the defendants prepared the balance sheet, they supplied Stern with thirty-two certified copies thereof.

The balance sheet, as certified, showed assets of $2,550,671.88, liabilities of $1,479,956.62 and a net worth of $1,070, 715.26. In reality, Stern was insolvent on the balance sheet date. Plaintiff loaned money to Stern in reliance upon the balance sheet. When Stern was declared a bankrupt soon thereafter, plaintiff sued the accountants in common law fraud and negligence. The trial court dismissed the fraud action, but submitted the question of negligence to the jury. After the jury returned a substantial plaintiff's verdict on the negligence count, it was set aside by the trial court. The appellate division affirmed the dismissal of the fraud action, but reinstated the negligence verdict.[24] The court of appeals reversed the reinstatement of the negligence verdict, but ordered a new trial in connection with the fraud count.

Although the evidence was more than sufficient to support the jury's negligence verdict, the court of appeals, in refusing to recognize such liability, stated:

> 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.[25]

In rejecting such liability for negligence, however, the court was careful not to overrule *Glanzer*, distinguishing it as follows:

> 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.[26]

The validity of this distinction between *Ultramares* and *Glanzer*, which has been challenged by numerous authorities,[27] is questionable, partic-

24. 229 App. Div. 581, 243 N.Y.S. 179 (1st Dep't 1930).
25. Ultramares Corp. v. Touche, 255 N.Y. 170, 179-80, 174 N.E. 441, 444 (1931).
26. Id. at 183, 174 N.E. at 445-46.
27. See Levitin, supra note 10, at 445; Meek, Liability of the Accountant to Parties Other

ularly since the court in *Glanzer* specifically stated: "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."[28]

The distinction generally drawn between *Glanzer* and *Ultramares* is that the identity of the persons likely to rely on the defendants' certified balance sheet was unknown in *Ultramares*, while reliance was known to be limited to one identified party in *Glanzer*.[29] Unlike *Glanzer*, therefore, *Ultramares* involved the danger of limitless liability, a burden the court did not wish to impose upon the accounting profession.[30] In spite of some criticism of *Ultramares*, it is principally for this public policy reason[31] that the weight of authority in this country still supports the general proposition that an accountant is not liable to third parties for mere negligence.[32] This trend has been justified on the ground that most suits of this kind are now framed in terms of fraud,[33] where the scope of liability to third persons is broader than in negligence.[34] However, the law is still largely unsettled on the question of what conduct on the part of the accountant will be held to be fraud, gross negligence or mere negligence.[35] Furthermore, since the three are often conceptually intertwined, the law regarding the duty owed by accountants to third persons becomes even more confused.[36]

In England, the development of the law in this area has been different. In *Candler v. Crane, Christmas & Co.*,[37] the accountants, during the course of preparing a balance sheet for the client, were told by him to exhibit it to a prospective investor when completed. The accountants

Than His Employer for Negligent Misrepresentation, 1942 Wis. L. Rev. 371, 383-88; Note, The Accountant's Liability—for What and to Whom, 36 Iowa L. Rev. 319, 320-21 (1951); Note, Potential Liability of Accountants to Third Parties for Negligence, 41 St. John's L. Rev. 588, 592 (1967).

28. Glanzer v. Shepard, 233 N.Y. 236, 239, 135 N.E. 275, 276 (1922).

29. See Note, The Accountant's Liability—for What and to Whom, 36 Iowa L. Rev. 319, 326 (1951).

30. Id.

31. See Note, Potential Liability of Accountants to Third Parties for Negligence, 41 St. John's L. Rev. 588, 593 (1967).

32. Hawkins, supra note 7, at 815-16.

33. Id.

34. S. Levy, supra note 1.

35. Annot., 54 A.L.R.2d 324, 327 (1957).

36. See Duro Sportswear, Inc. v. Cogen, 131 N.Y.S.2d (Sup. Ct. 1954), aff'd mem., 285 App. Div. 867, 137 N.Y.S.2d 829 (1st Dep't 1955); Bradley, Liability to Third Persons for Negligent Audit, 1966 J. Bus. L. 190; Bradley, Auditor's Liability and the Need for Increased Accounting Uniformity, 30 Law & Contemp. Prob. 898, 916 (1965); Seavey, Mr. Justice Cardozo and the Law of Torts, 52 Harv. L. Rev. 372, 394-404 (1939).

37. [1951] 2 K.B. 164.

complied, and in reliance on the balance sheet, the investor purchased an interest in the company. After the company became insolvent, it appeared that the accountants were extremely careless in the preparation of the balance sheet. In holding for the defendants, the court, in a 2-to-1 decision, citing *Ultramares*, ruled that accountants are not liable for negligent misrepresentation to third persons. It has been properly pointed out, however, that the analogy to *Ultramares* was poorly drawn, and that if American authority was to be used, it should have been *Glanzer*.[38]

An interesting question arises: would *Ultramares* impose liability on the accountants under the facts present in *Candler*? In *Glanzer*, the public weigher was held liable to a third person for negligent weight. *Ultramares* distinguished *Glanzer*, without reversing it. Accordingly, it is possible that liability for mere negligence could be found if the particular third party, or a limited group of which he was a member, was known to the accountants with sufficient definiteness as the party for whose primary benefit the certified statement was intended.[39] A prudent creditor, therefore, who wishes to rely on a certified financial statement of a debtor, should request that it be furnished to him directly by the accountant, and that the accountant be informed of its intended use. The accountant, in such a situation, might consider disclaiming liability, outlining the limits of his audit or otherwise qualifying his statement. Whether such defensive measures by the accountant are possible as a practical matter depends upon the extent to which he wishes to strain his relationship with the client.[40]

In a critical dissenting opinion in *Candler*, Lord Denning concluded that the accountant's duty should extend to cases "where the accountant prepares his accounts and makes his report for the guidance of the very person in the very transaction in question."[41] Otherwise, he felt, the auditor's opinion "which should be a safeguard, becomes a snare for those who rely on it."[42] Over a decade later, *Candler* was also criticized by the House of Lords in *Hedley Byrne & Co. v. Heller & Partners*,[43] which involved negligent credit references given by a debtor's banker (defendant) to the plaintiff creditor. Although the court decided in favor of the defendant, primarily on the basis of the defendant's express disclaimer of liability, the *Hedley* decision has been interpreted to apply to accountants:

38. Seavey, Candler v. Crane, Christmas & Co.—Negligent Misrepresentation by Accountants, 67 Law Q. Rev. 466, 478 (1951).

39. See S. Levy, supra note 1, at 43. See also Duro Sportswear, Inc. v. Cogen, note 75 infra, and accompanying text.

40. See Note, Potential Liability of Accountants to Third Parties for Negligence, 41 St. John's L. Rev. 588, 599-600 (1967).

41. [1951] 2 K.B. 164, 183.

42. Id. at 185.

43. [1964] A.C. 465.

But accountants may now be held in law to owe a duty of care to persons other than those with whom they are in a contractual or fiduciary relationship and may be liable for neglect of that duty if, but only if, *they know or ought to know that a financial report, account or statement prepared by them has been prepared for a specific purpose or transaction, will be shown to a particular person or class of persons,* and may be relied on by that person or class of persons in that particular connection.[44]

This reference to a foreseeable class bears a close resemblance to section 552 of the *Restatement of Torts*.[45] Since the breadth of section 552, however, is admittedly unsupported by the weight of the cases,[46] revision thereof is contemplated. The proposed new section 552, as it appears in Tentative Draft Number 12 of the *Restatement of Torts, Second,* "has narrowed the range of liability for negligent misrepresentation, abandoning the 'foreseeable class of persons' test of the old *Restatement*. . . ."[47] In effect, the proposed revision limits liability to, *inter alia,* those for whose benefit and guidance the accountant intended to supply the information, or knows the recipient so intends to supply it.[48] The Reporter's notes to this section, however, admit some dissatisfaction with the section and express hope that it can be improved. The notes also query

whether there is any limitation in terms of the size of the group to whom the defendant knows that the recipient intends to communicate the information. What if

44. Accountant's Liability to Third Parties—the Hedley Byrne Decision, J. Accountancy, Oct. 1965, at 66-67 (emphasis added).

45. Section 552 provides:

INFORMATION NEGLIGENTLY SUPPLIED FOR THE GUIDANCE OF OTHERS. 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.

46. Restatement (Second) of Torts, Explanatory Notes § 552, at 54 (Tent. Draft No. 11, 1965).

47. Bradley, supra note 36, at 192.

48. Restatement (Second) of Torts § 552 (Tent. Draft No. 12, 1966) provides:

(1) One who, in the course of his business, profession or employment, or in a transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.

(2) Except as stated in Subsection (3), the liability stated in Subsection (1) is limited to loss suffered

(a) by the person or one of the persons for whose benefit and guidance he intends to supply the information, or knows that the recipient intends to supply it; and

(b) through reliance upon it in a transaction which he intends the information to influence, or knows that the recipient so intends, or in a substantially similar transaction.

(3) The liability of one who is under a public duty to give the information extends to loss suffered by any of the class of persons for whose benefit the duty is created, in any of the transactions in which it is intended to protect them.

an art expert certifies a painting as a genuine Vermeer, knowing that the dealer to whom he gives the certificate intends to publish it in a bulletin to be sent to 1,000 prospective purchasers in the hope of making the sale? Is he liable for negligence to the man who buys? The Reporter would say yes.[49]

Such a conclusion, however, is hardly alarming. Whether the painting were exhibited to 1,000 or 1,000,000 prospective purchasers, only the ultimate purchaser should have cause to complain.

Of greater concern, however, is whether the proposed *Restatement* and other similar authorities include the situation where the merger of two multi-stockholdered corporations of some substance is planned and the accountant is asked to prepare and/or certify the basic financials of one of the parties which will determine the merger value of that party. Will a merely negligent overstatement of the financial condition of the audited company in such a situation subject the accountant to liability to the entire group of stockholders of the other corporation? It has been suggested that the exculpatory rule of *Ultramares* might not apply to such a situation because the auditor "is apprised of the merger, and the use of the statement is not merely an incidental or collateral use of the financial statements audited in regular course by an auditor who does not know of any specific intended use."[50] Another hypothetical question can be raised: suppose, instead of the anticipated multi-purpose use of the balance sheet in *Ultramares*, a balance sheet—with the specific knowledge of the auditors—were exhibited by the client solely for the purpose of obtaining an open line of credit of indeterminate size from a specific bank or group of banks. Would this make a negligent auditor potentially liable to each member of this group in an indeterminate amount merely because he knew the specific purpose and the person or class of persons who would rely on his certification?

If *Ultramares* is to continue to be controlling on such questions, it is submitted that the court in that case was not solely interested in narrowing the scope of liability to those for whose primary benefit the report was issued, but, more importantly, was concerned with the public policy of protecting the accounting profession from a potentially ruinous liability. Whether this protective policy should continue to prevail has been questioned.[51] Indeed, it has been suggested that "in the light of the economic maturity of the independent accounting profession, further dependence on judicial tenderness seems ill-founded."[52]

49. Restatement (Second) of Torts § 552, at 16 (Tent. Draft No. 12, 1966).

50. Bradley, supra note 36, at 194.

51. See Note, Potential Liability of Accountants to Third Parties for Negligence, 41 St. John's L. Rev. 588, 600-01 (1967).

52. Bradley, supra note 36, at 195.

B. *Liability Based Upon Deceit*

Just as the accountant owes a duty of honesty to his client, so, it has been repeatedly held, does he owe such a duty to certain third persons, even in the absence of privity. In the leading English case on deceit, *Derry v. Peek*,[53] the defendants were directors of a tramway corporation. In this capacity, they issued a prospectus to induce the public to subscribe for stock in the corporation. Although the prospectus erroneously stated that the company had the right to use steam or mechanical motive power instead of horses, the trial court found as a fact that the defendants honestly believed the truth of their statement. In holding such honest belief a complete defense to an action in deceit, the House of Lords stated that fraud, a necessary element of a cause of action in deceit, is proved when

> a false representation has been made (1) knowingly, or (2) without belief in its truth, or (3) recklessly, careless whether it be true or false. Although I have treated the second and third as distinct cases, I think the third is but an instance of the second, for one who makes a statement under such circumstances can have no real belief in the truth of what he states.[54]

The element of *scienter*, therefore, which is essential to the action of deceit, can be established not only by proof of actual knowledge of the falsity of a representation, but also by proving that there was a conscious lack of knowledge of its truth or falsity, or by establishing recklessness equivalent to a lack of genuine belief in the truth of the statement made.[55] Nor is it essential that the statement be false under every conceivable inference. To constitute deceit, it is sufficient that the statement admits of more than one interpretation and that the maker knew that it would probably be understood in its false sense.[56] Moreover, the court in *Derry* was careful to point out that although negligence per se is not a substitute for deceit, it may nevertheless be evidence that the defendant did not have an honest belief in the truth of his assertion.[57]

Derry has purportedly been followed in the majority of American jurisdictions,[58] and specific application of it to the accounting profession can

53. [1889] 14 App. Cas. 337.

54. Id. at 374.

55. Note, The Accountant's Liability—for What and to Whom, 36 Iowa L. Rev. 319, 321-22 (1951).

56. Meek, Liability of the Accountant to Parties Other Than His Employer for Negligent Misrepresentation, 1942 Wis. L. Rev. 371, 372.

57. 14 App. Cas. at 375-76.

58. See W. Prosser, Torts § 102 (3d ed. 1964), which states, however, that if "one looks to the facts of the cases rather than the formulae adopted by the courts, it is by no means clear that Derry v. Peek is supported by the weight of American authority." Id. § 102, at 714. For some of the American jurisdictions which have modified the Derry rule and extended the action of deceit to (1) negligent misrepresentations and/or (2) innocent misrepresentations,

be found in *Ultramares*.[59] In considering the validity of the cause of action for fraud, the court in *Ultramares* analyzed the accountants' two sentence certificate, which read:

> 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.[60]

It concluded that the first sentence of the certificate involved a representation of fact, and the second, an expression of an opinion. Thus, it found that the accountants "certified as a fact, true to their own knowledge, that the balance sheet was in accordance with the books of account."[61] As to this representation, the court stated that if "their statement was false, they are not to be exonerated because they believed it to be true."[62] Whether the court intended this doctrine to be dispositive of the fraud allegations is not quite clear.[63] Indeed, it has been suggested that:

> This language should not be interpreted to mean that when the defendants certified the balance sheet as true to their own knowledge they warranted its truth. It simply means that if the defendants said it was true to their own knowledge, and they had no knowledge on the subject, i.e., whether the balance sheet accurately reflected the actual condition of the business, there would be no sincere belief, and therefore, the statement would amount to fraud.[64]

Regardless of the court's intent, however, as a result of its position that good faith was no defense if a false statement was certified as true to the accountants' own knowledge, the accounting profession soon changed the wording of its certificates. No longer is the word "certify" used. Instead, accountants now state the results of their examination in the form of an opinion and not a fact. Furthermore, an accountant who relies upon sources of knowledge other than his own should specifically indicate that in his report.[65] Thus there is no pretense of knowledge as to the accuracy of the information received.[66]

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see Bohlen, Misrepresentation as Deceit, Negligence, or Warranty, 42 Harv. L. Rev. 733, 734-35 (1929); Levitin, Accountants' Scope of Liability for Defective Financial Reports, 15 Hastings L.J. 436, 451 (1964).

59. 255 N.Y. 170, 174 N.E. 441 (1931).

60. Id. at 174, 174 N.E. at 442 (emphasis added).

61. Id. at 189, 174 N.E. at 448.

62. Id. (citations omitted).

63. Levitin, supra note 58, at 454.

64. Note, Potential Liability of Accountants to Third Parties for Negligence, 41 St. John's L. Rev. 588, 594 (1967).

65. Levitin, supra note 58, at 454.

66. See, e.g., Beardsley v. Ernst, 47 Ohio App. 241, 243, 191 N.E. 808, 809 (1934), where

In addressing itself to the opinion portion of the defendants' certification, the court in *Ultramares* stated that 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."[67] Moreover, in distinguishing negligence from fraud, the court stated:

> Directors of corporations have been acquitted of liability for deceit though they have been lax in investigation and negligent in speech . . . . This has not meant, to be sure, that negligence may not be evidence from which a trier of the facts may draw an inference of fraud . . . but merely that if that inference is rejected, or, in the light of all the circumstances, is found to be unreasonable, negligence alone is not a substitute for fraud.[68]

In reversing the lower courts and granting a new trial as to the fraud action, the court of appeals concluded:

> In certifying to the correspondence between balance sheet and accounts the defendants made a statement as true to their own knowledge, when they had, as a jury might find, no knowledge on the subject. If that is so, they may also be found to have acted without information leading to a sincere or genuine belief when they certified to an opinion that the balance sheet faithfully reflected the condition of the business.[69]

Significantly, the court also rejected defendants' contention that whatever "wrong was committed by the defendants was not their personal act or omission, but that of their subordinates."[70] The court stated:

> These subordinates, so far as the record shows, had no interests adverse to the defendants', nor any thought in what they did to be unfaithful to their trust. The question is merely this, whether the defendants, having delegated the performance of this work to agents of their own selection, are responsible for the manner in which the business of the agency was done. As to that the answer is not doubtful.[71]

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the auditors certified that they "have examined the books of account and record of International Match Corporation and its American Subsidiary . . . and have received statements from abroad with respect to the foreign constituent companies . . . . Based upon our examination and information submitted to us it is our opinion that the annexed Consolidated Balance Sheet sets forth the financial condition of the combined companies . . . ." After the plaintiff had purchased stocks and bonds in said corporation in reliance on the auditors' certification of the balance sheet, it was discovered that International Match Corporation was bankrupt. The plaintiff instituted suit against the accountants for fraudulent misrepresentations in connection with the foreign subsidiaries. In distinguishing Ultramares, the court in Beardsley pointed out that the auditors of International Match Corporation fully disclosed that their opinion was based on statements received from abroad, indicating that they had not examined the records of the foreign subsidiaries and thus could not have known whether or not said statements were accurate. Id. at 243, 191 N.E. at 810.

67. 255 N.Y. at 186, 174 N.E. at 447.
68. Id. (citations omitted).
69 Id. at 192-93, 174 N.E. at 449-50.
70. Id. at 193, 174 N.E. at 450.
71. Id. (citations omitted).

Several years after *Ultramares*, the New York Court of Appeals had an opportunity to review the accountants' third party liability for fraud in *State Street Trust Co. v. Ernst.*[72] In that case, Pelz-Greenstein ("Pelz") was engaged in the factoring business and obtained most of its working capital from borrowings. The defendant accountants certified[73] for Pelz 10 copies of the latter's balance sheet reflecting assets of approximately $8,000,000, debts of less than $5,000,000, unimpaired capital of over $3,000,000 and a surplus of about $83,000. In fact, however, Pelz was insolvent; and about a year after the date of defendants' certification, Pelz was petitioned into bankruptcy.

Relying on the balance sheet, the plaintiff had extended credit to Pelz. Shortly thereafter, the defendants submitted solely to Pelz a balance sheet (similar to the ones originally certified) together with a covering letter which contained comments and explanations thereof. This letter contained statements of facts discovered by defendants in the course of their audit, hence known by them at the time they certified the original balance sheets. So important was this covering letter in the minds of the defendants that attached to the accompanying balance sheet was a notation indicating that the balance sheet was subject to the comments contained in the letter. No such notation, however, appeared on the originally certified balance sheets. Evidence was also adduced at the trial that certain receivables, aggregating approximately $2,000,000 and representing about 25% of Pelz's assets, were greatly overvalued, in that over $768,000 of such accounts were alarmingly stagnant. Although the defendants were aware of this general condition and had informed Pelz of the condition of these receivables in their after-issued covering letter, they did not reveal it on the originally certified balance sheets. Instead, a reserve which was less than insignificant, and grossly inadequate to meet anticipated losses from such defaulting receivables, was provided for in the original statements. At the close of the trial the jury returned a plaintiff's verdict which was set aside by the trial judge, who directed a verdict for defendants. The appellate division unanimously affirmed. The court of appeals, in a 4-2 decision, reversed the judgments and ordered a new

72. 278 N.Y. 104, 15 N.E.2d 416 (1938).

73. The certification in State Street, unlike that in Ultramares, contained no allegation that the statement was in accordance with the books. Instead, the defendant accountants certified: "We hereby certify that we examined the books of account and record [sic] pertaining to the assets and liabilities 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." Id. at 110, 15 N.E.2d at 418.

trial, because it found abundant evidence from which a jury could infer fraud on the part of the defendants. Reiterating the principles set forth in *Ultramares*, the court reasoned:

We have held that in the absence of a contractual relationship or its equivalent, accountants cannot be held liable for ordinary negligence in preparing a certified balance sheet even though they are aware that the balance sheet will be used to obtain credit. (Ultramares Corporation v. Touche, 255 N.Y. 170.) Accountants, however, may be liable to third parties, even where there is lacking deliberate or active fraud. A representation certified as true to the knowledge of the accountants when knowledge there is none, a reckless misstatement, or an opinion based on grounds so flimsy as to lead to the conclusion that there was no genuine belief in its truth, are all sufficient upon which to base liability. 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.[74]

Despite *State Street*'s adherence to the principles of *Ultramares*, some concern has been raised by the more recent case of *Duro Sportswear, Inc. v. Cogen.*[75] In *Duro*, an accountant was asked to certify a balance sheet that he knew would form the basis of the purchase by one stockholder of the interest of another in the corporation. The certified statement was substantially erroneous. In holding the accountant liable for damages to the purchaser who relied upon the report, the court specifically rejected a finding of fraud and based liability on a finding of gross negligence on the part of defendant. Although *Duro* was apparently based upon a mis-

74. State Street Trust Co. v. Ernst, 278 N.Y. 104, 111-12, 15 N.E.2d 416, 418-19 (1938). It is noteworthy that the majority opinion in State Street was written by Judge Finch, who, while sitting in the appellate division, dissented from the judgment of that court for the plaintiff in Ultramares, stating: "The professional man, be he accountant or otherwise, certifies for his client and not for all the world. If the client makes it clear to such a man that the statement is to be used in a particular transaction in which a third party is involved, such circumstance should create a duty from the professional man to such third party. If the accountant is to be held to an unlimited liability to all persons who may act on the faith of the certificate, the accountant would be obliged to protect himself by a verification so rigid that its cost might well be prohibitive and a limited but useful field of service thus closed to him. The smallness of the compensation paid to the defendants for the services requested is in striking contrast to the enormity of the liability now sought to be imposed upon them. If in the case at bar the plaintiff had inquired of the accountants whether they might rely upon the certificate in making a loan, then the accountants would have had the opportunity to gauge their responsibility and risk, and determine with knowledge how thorough their verification of the account should be before assuming the responsibility of making the certificate run to the plaintiff." 229 App. Div. 581, 587, 243 N.Y.S. 179, 186 (1st Dep't 1930), rev'd, 255 N.Y. 170, 174 N.E. 441 (1931).

75. 131 N.Y.S.2d 20 (Sup. Ct. 1954), aff'd mem., 285 App. Div. 867, 137 N.Y.S.2d 829 (1st Dep't 1955).

interpretation of *Ultramares* and *State Street*,[76] the result is justified under *Glanzer*; for, in both *Duro* and *Glanzer*, the issuer knew the specific party who would rely on the report and the specific use to which the report would be put.

Having established that there is a general duty to third persons not to misrepresent wilfully, we must consider the breadth of such duty. It is clear that the general scope of liability in deceit is broader than in mere negligence, which involves no intent to deceive. Accordingly, the fault of the maker of the negligent misrepresentation is sufficiently less that a narrower responsibility for its consequences is justified. While *Ultramares* is best known for its negligence holding, it is equally significant in its enlargement of the scope of liability for deceit.[77] It extended liability for fraud to persons whose identity was unknown to the defendant and whom it was not the primary purpose of defendant to defraud.[78]

Under the traditional English view,[79] which was adopted by the *Restatement of Torts*,[80] liability for fraud is limited to those persons in whom the defendant intended to induce reliance, and only if they relied in the manner intended. Under *Ultramares*, however, the plaintiff need not show that the defendant intended to induce his reliance; instead, it appears sufficient to show that the defendant should reasonably have foreseen this possibility.[81] Recognizing that the present Restatement's position is too narrow, the revisers are contemplating expansion of the scope of such liability under section 531, as follows:

ONE WHO MAKES A FRAUDULENT MISREPRESENTATION IS SUBJECT TO LIABILITY FOR PECUNIARY LOSS

(a) TO THE PERSONS OR CLASS OF PERSONS WHOM HE INTENDS *OR HAS REASON TO EXPECT* TO ACT OR TO REFRAIN FROM ACTION IN RELIANCE UPON THE MISREPRESENTATION; AND

(b) FOR PECUNIARY LOSS SUFFERED BY THEM THROUGH THEIR RELIANCE IN THE TYPE OF TRANSACTION IN WHICH HE INTENDS OR HAS REASON TO EXPECT THEIR CONDUCT TO BE INFLUENCED.[82]

While thus extending the scope of liability, the revisers note that they

76. See Note, Potential Liability of Accountants to Third Parties for Negligence, 41 St. John's L. Rev. 588, 593 (1967).

77. Seavey, supra note 36, at 402.

78. Id. at 404.

79. See Peek v. Gurney, [1873] L.R. 6 Eng. & Ir. App. 377; W. Prosser, Torts § 102, at 717 (3d ed. 1964).

80. Restatement of Torts § 531 (1938).

81. Levitin, supra note 58, at 455.

82. Restatement (Second) of Torts § 531, at 95 (Tent. Draft No. 10, 1964) (emphasis added).

express "no opinion as to whether the liability stated in this Section may extend to other persons or other types of transactions, if reliance upon the representation in acting or in refraining from action may reasonably be foreseen."[83]

The accountants' common law liability for fraud has also been considered recently in *Fischer v. Kletz*,[84] a case of potential landmark significance.[85] Unlike most cases of deceit, which involve affirmative misrepresentations by the defendant, the plaintiffs there attacked the accountants' nondisclosure, or silence, as the basis of the misrepresentation.

In *Fischer*, the accountants, Peat, Marwick, Mitchell & Co. ("PMM"), certified the financial statements of Yale Express System, Inc. ("Yale") included in Yale's 1963 annual report to stockholders which was distributed in April, 1964. Several months thereafter, a Form 10-K Report, containing the same financial statements as the annual report, was filed by Yale with the SEC as required by that agency's rules and regulations. Early in 1964, Yale engaged PMM to conduct certain "special studies" of its finances. In the course of these special studies, the accountants discovered that the figures previously certified in the annual report were substantially false and misleading. They failed, however, to disclose these facts to the exchanges on which Yale was traded, to the SEC or to the public at large until May, 1965 when the special studies were released. It was this nondisclosure of subsequently discovered facts that formed the basis of plaintiffs' common law action against PMM.

In deciding that the common law action of deceit was not insufficient as a matter of law, the court in *Fischer* considered the extent of the duty to disclose after-acquired information. PMM contended that such a duty exists only to a "party to a business transaction," and thus is inapplicable to an independent auditor.[86] To this the court countered:

> The parties and the SEC have not supplied, nor has the court found, any cases which analyze the issue raised by this contention within a factual framework involving nondisclosure of information which makes a prior representation false. As the ensuing discussion will show, however, this does not mean that plaintiffs' cause of action for deceit must be dismissed at this stage of this litigation, nor does it preclude a rational analysis of the issue raised by defendant.

83. Id. at 96.

84. 266 F. Supp. 180 (S.D.N.Y. 1967).

85. Also considered were alleged violations of §§ 10(b) and 18 of the Securities Exchange Act of 1934; see pp. 216, 218-19 infra. Specifically before the court was the defendants' cross-motion to dismiss certain paragraphs in the plaintiffs' complaint; for purposes of deciding this, the court primarily accepted the truth of plaintiffs' allegations in the complaint.

86. Fischer v. Kletz, 266 F. Supp. 180, 186 (S.D.N.Y. 1967).

In cases involving affirmative misrepresentations, it is now the settled rule that a misrepresenter can be held liable, regardless of his interest in the transaction.

. . . .

In my view, accepting the pertinent allegations of the complaint to be true, PMM must be regarded as bound *at this preliminary stage of the litigation* by this rule of law. Though concededly "disinterested" in the sense that it achieved no advantage by its silence, PMM is charged in the complaint for losses realized by plaintiffs as a result of its nondisclosure. This is sufficient, at least in the pleading sense, under the cases discussed, save for one remaining problem—whether or not plaintiffs must plead and ultimately prove intent by PMM to deceive by its silence.[87]

On this issue of PMM's intent, the court stated:

Careful reflection upon the ramifications of the basic rules of deceit liability constrain me to reject this argument, pending full resolution of the facts of this case.

Liability in a case of nondisclosure is based upon the breach of a duty imposed by the demands of "good faith and common honesty." Loewer v. Harris, 57 F. at 373. The imposition of the duty creates an objective standard against which to measure a defendant's actions and leaves no room for an analysis of the subjective considerations inherent in the area of intent. Thus, to base liability in part upon subjective standards of intent of the nondisclosing defendant would blur and weaken the objective basis of impact of nondisclosure upon the plaintiff. In the alternative, if this rationale be deemed unacceptable, it can be persuasively urged that in a nondisclosure case, intent can be sensibly imputed to a defendant who, knowing that plaintiff will rely upon his original representations, sits by silently when they turn out to be false.[88]

In recognizing a cause of action for deceit, the court was not unmindful of the issues of public policy that had to be resolved, stating:

In the light of the foregoing discussion, I find no sound reasons to justify barring plaintiffs from the opportunity to prove a common-law action of deceit against PMM. It is true that each case cited and discussed above is factually distinguishable from the case at bar. But the distinctions create no presently discernible, substantial differences of law or policy. The common law has long required that a person who has made a representation must correct that representation if it becomes false and if he knows people are relying on it. This duty to disclose is imposed regardless of the interest of defendant in the representation and subsequent nondisclosure. Plaintiffs have sufficiently alleged the elements of nondisclosure on the part of this "disinterested" defendant. Accordingly, they must be given an opportunity to prove those allegations.

To conclude thus is not to ignore the manifold difficulties that a final determination of liability on the part of public accountants for nondisclosure would create for professional firms and other business entities (and, indeed, individuals) similarly situated. Some obvious questions can be briefly set forth as examples of such potential problems. How long, for instance, does the duty to disclose after-acquired information last? To whom and how should disclosure be made? Does liability exist if the after-acquired knowledge is obtained from a source other than the original supplier of information? Is there a duty to disclose if an associate or employee of the accounting

87. Id. at 186-88 (emphasis added).

88. Id. at 188.

> *firm discovers that the financial statements are false but fails to report it to the firm members?*
>
> *These and similar questions briefly indicate the potentially significant impact upon accountants, lawyers and business entities in the event that a precise rule or rules of liability for nondisclosure are fashioned and recognized in the law. On the other side of the coin, however, as the bulk of the discussion hereinbefore has shown, investors in publicly-held companies have a strong interest in being afforded some degree of protection by and from those professional and business persons whose representations are relied upon for decisional purposes. In my view, resolution of the issues posed by the complaint allegations here in question must be made with these important but conflicting interests in mind.* Proper reconciliation of these interests or policy considerations, however, can only be made after full development of the facts of this case during the discovery process and at trial.[89]

Moreover, suppose the after-acquired information was obtained as a result of a special study made by the accountants under circumstances which would normally give rise to its protection as a privileged communication. To what extent would the accountants' obligation to disclose conflict with the client's right to assert such privilege?[90]

The ultimate solutions the law will find to these weighty problems are beyond the scope of present speculation. Whatever the outcome, however, there can be little doubt of the far-reaching ramifications each extension of such liability carries with it. Moreover, although conceptually the scope of third party liability is clearly greater for fraud than for purely negligent misrepresentations, the effect of holding that a jury might infer fraud from negligent misrepresentations is largely to diminish, in practice, the distinction between the two. As it has been aptly put, if "the defendant has been guilty of seriously wrongful conduct, we can trust to the jury to take care of the equities in the situation."[91]

C. *Liability Under Federal Securities Laws*

Between 1920 and 1933, American investors purchased nearly fifty billion dollars of new securities issues.[92] On the average, the public purchasers of such securities were not supplied with sufficient information concerning their purchases so as to make an informed investment. By 1933, approximately half of these newly issued securities—about twenty-five billion dollars worth—had become worthless.[93] Accordingly, the Securities Act of 1933[94] ("Securities Act" or "1933 Act") was passed to

89. Id. at 188-89 (emphasis added).

90. See Katsoris, Confidential Communications—The Accountants' Dilemma, 35 Fordham L. Rev. 51 (1966).

91. Seavey, supra note 36, at 404.

92. Pines, The Securities and Exchange Commission and Accounting Principles, 30 Law & Contemp. Prob. 727 (1965).

93. Id.

94. 48 Stat. 74 (1933), as amended, 15 U.S.C. §§ 77a-77aa (1964).

provide full and fair disclosure of the character of securities sold to the public through the mails or in interstate commerce. The very next year Congress enacted the Securities Exchange Act of 1934[95] ("Exchange Act" or "1934 Act"). Whereas the 1933 Act is concerned primarily with the initial distribution of securities, the 1934 Act was enacted primarily to deal with post-distribution trading. Both of these acts require the filing of financial data; both are administered by the SEC;[96] and both contain civil liability provisions, which in the aggregate substantially expand the accountants' common law liability to third persons for misrepresentations. While the accountants' principal exposure to civil liabilities under these two Acts will be explored briefly, this paper will not deal with the accountants' potential civil liabilities incurred in the performance of their duties under other federal securities law.[97]

1. The Securities Act of 1933

The Securities Act "was designed not only to prevent fraud in the sale of securities and to provide investors with adequate information but also to protect legitimate enterprises seeking to obtain capital honestly through factual disclosure against dishonest competition."[98] This Act requires the inclusion in the registration statement (prospectus) of balance sheets and profit and loss statements "in such detail and such form" as the SEC shall prescribe,[99] and provides that such financial statements shall be certified by an "independent public or certified accountant."[100]

The Securities Act provides for civil liability in sections 11, 12 and 15.[101] Of the three, only section 11 directly involves the accountant. Subdivision (a) of that section provides that whenever a registration statement becomes effective, containing

> an *untrue statement* of a *material* fact or [which has] *omitted* to state a *material* fact required to be stated therein or necessary to make the statements therein not mis-

95. 48 Stat. 881 (1934), as amended, 15 U.S.C. §§ 78a-78hh (1964).

96. The SEC was created by the Securities Exchange Act of 1934. For the one year prior thereto, the Securities Act of 1933 was administered by the Federal Trade Commission.

97. E.g., Public Utility Act of 1935, 49 Stat. 803 (1935), as amended, 15 U.S.C. §§ 79 to 79z-6 (1964); Trust Indenture Act of 1939, 53 Stat. 1149 (1939), as amended, 15 U.S.C. §§ 77aaa-77bbb (1964), as amended (Supp. II, 1965-66); Investment Company Act of 1940, 54 Stat. 789 (1940), as amended, 15 U.S.C. §§ 80a-1 to 80a-52 (1964); Investment Advisers Act of 1940, 54 Stat. 847 (1940), as amended, 15 U.S.C. §§ 80b-1 to 80b-21 (1964), as amended (Supp. II, 1965-66).

98. Pines, supra note 92, at 727.

99. Schedule A, paras. 25-26, 48 Stat. 90 (1933), as amended, 15 U.S.C. § 77aa(25)-(26) (1964).

100. Id.

101. 48 Stat. 82 (1933), as amended, 15 U.S.C. § 77k (1964); 48 Stat. 84 (1933), as amended, 15 U.S.C. § 77l (1964); 48 Stat. 84 (1933), as amended, 15 U.S.C. § 77o (1964).

leading, *any person acquiring such security* . . . *may*, either at law or in equity, in any court of competent jurisdicton, *sue*—

. . . .

(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 . . . .[102]

A simple, all-inclusive definition as to what error or omission is material is an impossibility. What is material in one factual pattern may be insignificant in another. Accordingly, materiality must generally be determined on a case-to-case basis. By Section 22,[103] jurisdiction to enforce such liability is conferred concurrently on the federal district and territorial courts, and the state and territorial courts. In addition, this section contains broad venue and process provisions in connection with these suits. The measure of damages collectible under section 11 is outlined in great detail in subdivision (e) thereof.[104] In no case can the amount recovered exceed the price at which the security was offered to the public.[105] While enacting these elaborate damage provisions, however, Congress gave a defendant, such as an accountant, an important defense, whereby damages may be reduced to the extent he proves that they did not result from his misconduct.[106] Moreover, section 13 of the Securities Act bars actions under section 11 unless "brought within one year after

102. 48 Stat. 82 (1933), as amended, 15 U.S.C. § 77k(a) (1964) (emphasis added). See Rule 2-05 of SEC Reg. S-X, 17 C.F.R. § 210.2-05 (1967), which provides: "If, with respect to the certification of the financial statements of any person, the principal accountant relies on an examination made by another independent public accountant of certain of the accounts of such person or its subsidiaries, the certificate of such other accountant shall be filed (and the provisions of §§ 210.2-01 and 210.2-02 shall be applicable thereto); however, the certificate of such other accountant need not be filed (a) if no reference is made directly or indirectly to such other accountant's examination in the principal accountant's certificate, or (b) if, having referred to such other accountant's examination, the principal accountant states in his certificate that he assumes responsibility for such other accountant's examination in the same manner as if it had been made by him."

103. 48 Stat. 86 (1933), as amended, 15 U.S.C. § 77v(a) (1964).

104. 48 Stat. 82 (1933), as amended, 15 U.S.C. § 77k(e) (1964). Generally, such damages are the difference between the purchase price (not exceeding the price at which the security was offered to the public) and "(1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and the value thereof as of the time such suit was brought." Id.

105. 48 Stat. 82 (1933), as amended, 15 U.S.C. § 77k(g) (1964).

106. 48 Stat. 82 (1933), as amended, 15 U.S.C. § 77k(e) (1964).

the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence," but in no event shall any such action be brought to enforce a liability against the accountant under section 11 "more than three years after the security was bona fide offered to the public."[107]

Although section 11 is a significant expansion of the accountants' common law third party liability, the number of suits brought by investors under the section has been relatively small.[108] How then do the substantive requisites of section 11 generally compare with those of common law liability? The accountants' liability to investors under the Securities Act is but a further expansion of the assault on the "citadel of privity." Specifically, section 11 inures to the benefit of purchasers who were unaware of the untruth or omission at the time of their acquisition.[109] The section does not require that the mails have been used, nor does it matter whether the purchaser bought his securities in interstate or intrastate commerce.[110] Subject to the limitations provisions of section 13, he has standing to sue regardless of whether he purchased his securities at the time of the original offer or at some later date.[111] Consequently, not only is it immaterial that privity is totally lacking between the accountant and the investor, but it is also of no consequence that the misrepresentation was neither addressed to him nor intended to influence him.

Proof of reliance, so essential to the imposition of common law third party liability in both negligence and deceit, is eliminated under the section, except that:

> 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.[112]

107. 48 Stat. 84 (1933), as amended, 15 U.S.C. § 77m (1964).

108. This has been attributed not only to the care with which the legal and accounting professions prepare registration statements, but also the SEC's vigilance in examining same. 3 L. Loss, Securities Regulation 1690 (1961).

109. See Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951). A suit under § 11, however, is limited to the purchasers of securities that are the direct subject of the prospectus and registration statement. Accordingly, purchasers of common stock cannot sue under § 11 by reason of a prospectus and registration statement for the sale of preferred stock.

110. 3 L. Loss, supra note 108, at 1731.

111. H.R. Rep. No. 85, 73d Cong., 1st Sess. 22 (1933).

112. 48 Stat. 82 (1933), as amended, 15 U.S.C. § 77k(a) (1964).

The rationale behind this is that in all likelihood the purchase and price of the security bought after the publication of such an earning statement will be based on that statement rather than upon the information in the registration statement.[113]

Nor does the alleviation of plaintiff's burden end there. The term *scienter*—the backbone of a fraud action—is conspicuously absent from the terminology of section 11. Accordingly, no proof of fraud or deceit is necessary.[114] Indeed, under the strict and absolute liability provisions of the section, the plaintiff need not even show mere negligence on the accountants' part. Generally, he must only demonstrate his standing to sue and the falsity or misleading character of the financial statements. Once he has sustained this burden, it is incumbent upon the defendant to come forward with the defenses provided him under the Act.

As to defendants generally (other than the issuer), with respect to parts of the registration statement purporting to be made on the authority of experts (other than the defendant in question) or of official persons, they need only show, *inter alia*, that they had no reasonable ground to believe, and did not believe, that the statements 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.[115] As to the expert himself (such as an accountant), he is provided with immunity from liability if he can show that "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 that the part of the registration statement in question did not fairly represent his statement as an expert.[116] The Act defines this standard of "reasonable investigation" and "reasonable ground" for belief as "that required of a prudent man in the management of his own property."[117]

This very standard was in issue in *Shonts v. Hirliman*,[118] a suit under

113. H.R. Rep. No. 1838, 73d Cong., 2d Sess. 41 (1934).

114. Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951).

115. 48 Stat. 82 (1933), as amended, 15 U.S.C. 77k(b)(3)(c),(D) (1964).

116. 48 Stat. 82 (1933), as amended, 15 U.S.C. § 77k(b)(3)(A) (1964). The Act also specifically sets up exculpatory provisions if the accountant wishes to sever his connection or duties before the effective date of that portion of the registration allocated to him, 48 Stat. 82 (1933), as amended, 15 U.S.C. § 77k(b)(1) (1964), or if he discovers, after such effective date, that part of such statement became effective without his knowledge. 48 Stat. 82 (1933), as amended, 15 U.S.C. § 77k(b)(2) (1964).

117. 48 Stat. 82 (1933), as amended, 15 U.S.C. § 77k(c) (1964).

118. 28 F. Supp. 478 (S.D. Cal. 1939).

section 11 by purchasers of registered securities to recover damages from (among others) the accountants who certified the financial statements in the registration statement. It was alleged that these financials made no mention of a material fact, namely, the obligation of the registrant to pay a minimum rental of $35,000—an undertaking that was being discussed, but not actually incurred until after the accountants' last certification. In exonerating the auditors for their failure to show this amount as a contingent liability, the court reasoned:

> No misstatement or omission appears in the registration statement until after the last certificate of Webster, Atz & Co., dated January 19, 1937. Prior to January 31, 1937, there were merely discussions of rental, and no definite undertaking by either side or guarantee of a minimum, which was binding on the company. The failure of the certificate of Webster, Atz & Co. to set up the rental undertaking and the minimum guarantee of $35,000 as a contingent liability, is not the omission of anything which existed then. 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.[119]

Whether the norm set by *Shonts* meets the test of reasonableness "required of a prudent man in the management of his own property," has been questioned.[120] In this connection, it has been stated:

> As far as the independent accountant is concerned, it appears that the law imposes a duty which does not end with the signing of his certificate and consent and the filing of the registration statement. It means that after the filing and up to the effective date, the accountant must take reasonable steps to ascertain whether anything has happened in the interim which materially affects the statements he certifies. This is a responsibility which, it is true, he shares with others, but it is not a good defense to say that his responsibility is only secondary, that the primary responsibility is the registrant's. Suppose, for example, that on the date of the statements and on the filing date an important lawsuit was pending, as to which no provision had been or could be made for an adverse decision. Shortly after the filing date, a decision is handed down against the registrant. Under the law, unless this information is included in the registration statement, it might be construed as an omission of a material fact which would subject those participating in the registration to the liabilities provided in the statute.
>
> *It seems clear that the obligation of the certifying accountant does not end with the filing of the registration statement; he may not thereafter relax his vigilance and simply sit back and wait for the SEC's memorandum of comments, and, ultimately, the effective date. On the other hand, the independent accountant as a practical matter cannot be expected to keep his audit going continuously until the effective date; this may take weeks or even months. I have not interpreted the clause "at the time such part of the registration statement became effective" as requiring the accountant to continue his examination of the books and records to the effective date. It should be his practice, however, to keep in touch with the financial affairs of his client in some manner.*[121]

119. Id. at 483.

120. See 3 L. Loss, supra note 108, at 1733.

121. Rappaport, Accountant's Responsibility for Events Occurring after the Statement Date: the Shonts Case, J. Accountancy, March, 1953, at 333 (emphasis added).

2. The Securities Exchange Act of 1934

With the economic disaster of the Great Depression still taking its toll, it was obvious to the 73rd Congress that healthy, honest and constructive investments in securities could be encouraged only by eliminating many of the dangerous and unfair practices that had bred prior speculation. It was recognized that such dangerous speculation was not caused solely by defects and abuses in the stock exchange machinery, but was equally festered by an inadequate central control of a national credit system which too easily provided funds for speculation, by inadequate corporate reporting which kept the public in ignorance and by exploitation of that ignorance by a self-perpetuating management with inside information.[122] It was against this background that the Securities Exchange Act of 1934 was enacted.

The Exchange Act requires the filing of registration applications and annual and other reports with the SEC by companies whose securities are listed upon the national exchanges. By virtue of the 1964 Securities Acts amendments,[123] such reporting requirements have been extended to most issues traded in the over the counter market.[124] As with most filings under the 1933 and 1934 Acts, the financial statements must be prepared in accordance with SEC Regulation S-X, and generally must be certified by independent public or certified accountants.[125]

Accountants' liability for misleading statements under the Exchange Act is generally founded upon the specific provisions of section 18,[126] and the implied provisions of section 10(b)[127] and SEC rule 10b-5.[128]

Although the venue requirements of both the 1933 and 1934 Acts are liberal, section 27 of the Exchange Act (unlike section 22 of the Securities Act which gives state courts concurrent jurisdiction with the federal courts[129]) grants exclusive jurisdiction to the federal courts over violations of the 1934 Act or rules or regulations thereunder.[130] However, section 28 of the 1934 Act also provides:

> The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted

122. See H.R. Rep. No. 1383, 73d Cong., 2d Sess. (1934).

123. 78 Stat. 565 (1964).

124. See Phillips & Shipman, An Analysis of the Securities Acts Amendments of 1964, 1964 Duke L.J. 706.

125. See Lee & Hall, Accounting Aspects Securities Acts Amendments of 1964, 20 Bus. Law. 325 (1965).

126. 48 Stat. 897 (1934), as amended, 15 U.S.C. § 78r (1964).

127. 48 Stat. 891 (1934), as amended, 15 U.S.C. § 78j(b) (1964).

128. 17 C.F.R. § 240.10b-5 (1967).

129. 48 Stat. 86 (1933), as amended, 15 U.S.C. § 77v(a) (1964).

130. 48 Stat. 902 (1934), as amended, 15 U.S.C. § 78aa (1964). See also 3 L. Loss, supra note 108, at 2005.

to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of.[131]

a) *Section 18*

Section 18 provides in part:

Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this chapter or any rule or regulation thereunder . . . 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.[132]

Like section 11 of the 1933 Act, it requires that the plaintiff did not know the statement was false or misleading, and that the misleading or false portion be material. Moreover, section 18 requires reliance on the part of the plaintiff, but, unlike section 11 of the 1933 Act, there is no provision that reliance may be established without proof that the plaintiff read the particular document. In addition, section 18 exonerates the defendant if he acted in good faith, without knowledge of the misleading or false character of the statement. Concerning this defense, Professor Loss has stated: "Aside from the shift in the burden of proof to the defendant, this seems to be first cousin to *scienter*."[133]

Unlike section 11 of the 1933 Act, section 18 is available to sellers as well as buyers; however, such plaintiffs must prove that they purchased or sold the security at a price which was affected by such statement. It is this requirement of causation that may explain the minimal use of this section:

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, where (if he has a right of action at all) he might at least be able to avoid proving, under traditional concepts of causation and reliance, that he had bought or sold at a price affected by the false statement.[134]

In any event, section 18 suits are barred unless instituted within "one year after the discovery of the facts constituting the cause of action and within three years after such cause of action accrued."[135]

131. 48 Stat. 903 (1934), as amended, 15 U.S.C. § 78bb(a) (1964).
132. 48 Stat. 897-98 (1934), as amended, 15 U.S.C. 78r(a) (1964).
133. 3 L. Loss, supra note 108, at 1752.
134. Id.
135. 48 Stat. 897 (1934), as amended, 15 U.S.C. § 78r(c) (1964).

Section 18 liability was also recently sought in *Fischer v. Kletz*.[136] There the plaintiffs alleged that the accountants knew before the filing with the SEC of the Form 10-K report by the client that the financial statements, certified by the defendants, were false, and that by allowing the statements to be filed, the accountants in effect caused a false certificate to be filed with the SEC. Since the accountants denied any such knowledge at the time the 10-K Report was filed, the court denied, without prejudice, the defendants' pretrial cross-motion to dismiss the section 18 liability "until the facts are more fully developed."[137]

b) *Section 10(b) and Rule 10b-5*

Unlike the specificity of section 18, section 10(b) very simply provides that:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> . . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.[138]

Pursuant to this authority, SEC rule 10b-5 was promulgated, which provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would

136. 266 F. Supp. 180 (S.D.N.Y. 1967). See also pp. 206-08 supra; pp. 218-19 infra.

137. 266 F. Supp. at 189.

138. 48 Stat. 891 (1934), as amended, 15 U.S.C. § 78j(b) (1964). Note that unlike § 11 of the 1933 Act, § 10(b) of the 1934 Act applies not only to purchasers of securities, but also to sellers. Accordingly, a stockholder's derivative action is maintainable to recover damages under § 10(b) where the corporation has been injured as a result of a sale, issuance or purchase of its own shares. See Ruckle v. Roto Am. Corp., 339 F.2d 24 (2d Cir. 1964). Nor is § 10(b) limited to damages arising from misrepresentations that overstate financial condition or operations. Id. Moreover, the act or omission complained of under § 10(b) must be material—that is whether a reasonable person would attach importance to the fact misrepresented in determining his choice of action in the transaction in question. List v. Fashion Park, Inc., 340 F.2d 457 (2d Cir.), cert. denied, 382 U.S. 811 (1965); SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262, 280 (S.D.N.Y. 1966).

operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[139]

Although neither section 10(b) nor rule 10b-5 explicitly provide for any civil liabilities, it is well established that by making the conduct it describes unlawful, section 10(b) creates a civil remedy.[140] Once having found civil liability under the section, courts were confronted with the fact that the language of section 10(b) and rule 10b-5 is so vague as to create almost completely undefined liability. Thus, it has been authoritatively stated:

> Literally all that the rule seems to require is proof of (1) some fraud or material misstatement (which, by construction, may be satisfied by the defendant's silence when he has a duty to speak) in connection with the purchase or sale of a security and (2) use of the mails or of some interstate or stock exchange facility. Indeed, the plaintiff is not limited to proving an untrue statement or an omission but has recourse to the possibly broader "fraud" language of the first and third clauses of the rule.[141]

Despite the fact that the headnote to section 10(b) reads "Manipulative and deceptive devices," no mention is made in the section, or in rule 10b-5, of the elements of common law deceit—reliance, scienter and causation. Accordingly, their application to private actions under section 10(b) and rule 10b-5 is not entirely clear.[142] Although privity no longer appears to be an essential ingredient of the cause of action,[143] some semblance of causal relation[144] and reliance[145] still seems essential. Whether scienter is still required to state a claim under the three clauses of rule 10b-5 is presently being authoritatively questioned.[146]

In addition, section 10(b)—unlike section 11 of the 1933 Act and section 18 of the 1934 Act—makes no provision for the furnishing of an undertaking for the payment of the costs of a suit instituted under its provisions. Moreover, neither section 10(b) nor rule 10b-5 specifies any

139. 17 C.F.R. § 240.10b-5 (1967).

140. See 3 L. Loss, supra note 108, at 1763.

141. Id. at 1764-65.

142. See SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262, 277.

143. Comment, Civil Liability Under Section 10B and Rule 10B-5: A Suggestion for Replacing the Doctrine of Privity, 74 Yale L.J. 658, 663-65 (1965).

144. 2 CCH Fed. Sec. L. Rep. ¶ 22781.08 at 16,635.

145. Id.; 3 L. Loss., supra note 108, at 1765-66. But cf. Comment, Civil Liability Under Section 10B and Rule 10B-5: A Suggestion for Replacing the Doctrine of Privity, 74 Yale L.J. 658, 673-75 (1965), where traditional concepts of reliance seem inappropriate in the case of misleading omissions, since the plaintiff "will have knowledge only of silence."

146. See A. Bromberg, Securities Law—Fraud—SEC Rule 10b-5, § 2.6(1) (1967); Comment, supra note 145, at 674; Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961); SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262, 277 (S.D.N.Y. 1966). But see 3 L. Loss, supra note 108 at 1766; Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951); Weber v. C.M.P. Corp., 242 F. Supp. 321, 324 (S.D.N.Y. 1965).

applicable statute of limitations, or the availability of the defenses of waiver, estoppel or laches; discussion of these, however, is beyond the scope of this article.[147]

Specific application of section 10(b) to accountants was made in *H. L. Green Co. v. Childree.*[148] In that case, a corporation that had exchanged its stock in a merger for stock of the audited company sued the auditors under rule 10b-5, alleging that they had knowingly prepared false financial statements and made other misrepresentations with intent to induce plaintiff to enter into the merger. In denying the defendants' motion to dismiss the cause of action, the court stated:

> The complaint alleges that these defendants 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.[149]

A more recent application of section 10(b) liability to accountants was also sought in *Fischer v. Kletz.*[150] In considering such liability arising out of the accountants' certification of Yale's annual report financials and subsequent silence as to their after-acquired information, the court pondered such issues as:

(i) the relationship between plaintiffs and defendant-accountants;
(ii) whether it is necessary that the accountants realized some gain from the malfeasance;
(iii) whether it is necessary that the accountants conspired with, or aided or abetted others;
(iv) whether the accountants' activities must be in connection with the purchase or sale of securities;

and finally concluded:

> From the foregoing discussion, it can readily be seen that *that branch of PMM's motion to dismiss any claims based on Section 10(b) and Rule 10b-5 raises novel and difficult issues.* Because of the importance of the questions involved and the need for further factual and legal development of them by the parties and the SEC, I deem it best to deny this branch of PMM's motion without prejudice to renewal at trial.[151]

The plaintiffs in *Fischer* also sought to impose 10(b) liability on the accountants on the basis of the false 10-K report, alleging that the latter

147. As to the issue of limitation, see 3 L. Loss, supra note 108, at 1771-77; A. Bromberg, supra note 146, at § 2.5(1). As to the issue of defenses, see Comment, Applicability of Waiver, Estoppel, and Laches Defenses to Private Suits Under the Securities Act and S.E.C. Rule 10B-5: Deterrence and Equity in Balance, 73 Yale L.J. 1477 (1964).

148. 185 F. Supp. 95 (S.D.N.Y. 1960).

149. Id. at 96.

150. 266 F. Supp. 180 (S.D.N.Y. 1967). See also pp. 206-08, 216 supra.

151. 266 F. Supp. at 194 (emphasis added).

"aided and abetted" Yale (in defrauding its creditors) in two ways: "first, by remaining silent when it was known that the interim reports were false and, second, by recommending or sanctioning the issuance of the reports."[152] In failing to grant the defendants' cross-motion as to the insufficiency of these allegations, the court concluded:

It is, however, inappropriate to make a determination of the "aiding and abetting" issue at this time. Discovery is presently in a relatively inadvanced stage. While plaintiffs can now show only minimal interaction between PMM and Yale in relation to the interim statements, they must be given an opportunity to further explore this facet of the Yale-PMM relationship. *"The very fact that this case arises in a newly developing area of law cautions that the court should refrain from abstract and premature legal determinations fashioned in an evidentiary vacuum."*[153]

III. Where Do We Go from Here?

The current trend among creditors and investors is to attempt to impose liability for their respective losses on the accountant. Such liability is often termed essential if the financial community is to put any reliance upon the accountant's certificate. Its need has also been couched in various terms of moral duty, namely, that as between the innocent investor or creditor and the accountant upon whose report they rely, risk of loss should fall on the accountant. Moreover, as the arguments go, this great public need can be funded by greater insurance coverage and higher fees. On the other hand, however, cries are raised that an accountant cannot, as a practical matter, be an insurer of the financial statements he certifies.[154] Unfortunately, this controversy leaves the accountant in a state of turmoil as to the practical economics of practicing his profession.

Accountants' professional civil liability to third persons is nestled in two great bodies of substantive law—(i) the common law and statutory codifications or alterations thereof of the states, and (ii) the statutory obligations imposed by the federal securities laws. As to the former, differences exist among the states, which are compounded by traditional concepts of conflicts of laws. Accordingly, it has been suggested that a model statute be enacted in all the states which "would articulate the

152. Id. at 195.

153. Id. at 197 (emphasis added) (citation omitted).

154. In reporting a speech of Walter E. Hanson (senior partner of Peat, Marwick, Mitchell & Co.) delivered before the New York State Bar Association, the New York Times quoted:

"'The ingenuity of man . . . is unlimited. The cost of inviolate controls is prohibitive. If there is creative deception—if information is withheld—there is nothing within reason that the independent accountant, or anyone else, can do, even with the help of a computer, to assure the timely disclosure of such activity.'" Heinemann, Accountant Role Undergoing Tests, N.Y. Times, March 27, 1966, at 1, col. 5.

nature of the accountant's liability in areas not now covered by the securities legislation."[155]

Although such a result would indeed be welcome, the chances of attaining such uniformity are unfortunately negligible. Suffice it to say, for purposes of this article, that this area of the law must remain in the hands of judicial interpretation which, so far, has been generally acceptable to the accounting profession. Hopefully, by maintaining high standards commensurate with the skills of the profession, by the use of appropriate disclaimers or qualified certificates, and through flexible insurance coverage, the accountants can continue to live within the common law and statutory framework of the states' substantive laws.

A more troublesome area, however, is the broader liability imposed by the federal securities laws in favor of investors. Moreover, there are those who urge that these laws should be extended even further to inure to the benefit of creditors generally. Whether this is a desirable objective is a debatable question. Regardless, however, of the broad channels into which the currents of public policy will guide us, some reflection should be cast upon the dilemma facing those engaged in practicing SEC accounting.

A. *Should the Government Assume the Certification of SEC Financials?*

The requirement that the bulk of SEC financials be certified by independent public or certified accountants is neither accidental nor recent. The accountants' role as to such certification has been summarized, as follows:

The passage of the Securities Act, however, is an important landmark in the development of the concept of the responsibility of the independent accountant to the investor and the public. The original draft of the Securities Act did not require certification by independent accountants. A representative of the accounting profession appeared at the hearings on the bill before the Committee on Banking and Currency of the United States Senate to suggest revisions of the bill. He pointed out that the bill as drafted imposed "highly technical responsibilities upon the Commission as to accounting principles, their proper application and their clear expression in financial statements," and suggested the bill be revised to require that "the accounts pertaining to such balance sheet, statement of income and surplus shall have been examined by an independent accountant and his report shall present his certificate wherein he shall express his opinion as to the correctness of the assets, liabilities, reserves, capital and surplus as of the balance sheet date and also the income statement for the period indicated."

The committee considered at length the value to investors and to the public of an audit by accountants not connected with the company or management and whether the additional expense to industry of an audit by independent accountants was justified by the expected benefits to the public. The committee also considered the advisability and feasibility of requiring the audit to be made by accountants on the staff of the agency administering the Act.

155. Note, The Accountant's Liability—for What and to Whom, 36 Iowa L. Rev. 319, 330 (1951).

In the report on the bill the Senate committee stated that it was intended that those responsible for the administration and enforcement of the law should have full and adequate authority to procure whatever information might be necessary in carrying out the provisions of the bill, but *it was deemed essential to refrain from placing upon any Federal agency the duty of passing judgment upon the soundness of any security.* The proposal to require certification by independent public accountants was incorporated in the bill as passed.[156]

The question arises, however, whether the public accountant has outlived his usefulness as a financial watchdog.[157]

With increasing frequency, the accountant's status of "independence" is being challenged. It has been suggested, with some merit, that in performing various other services for a client (for example, management consulting) he becomes inextricably associated with its management and tends to lose a certain degree of objectivity.[158] In the past, the SEC has dealt with this problem of "independence" by issuing numerous rulings on the subject.[159] There appears to be no reason why it cannot continue to deal with this problem in the same manner.

Assuming, therefore, the independence of the public accountant, one can hardly conclude that government auditors would perform this public trust more proficiently. It is even questionable whether the government could perform such certification services more cheaply, particularly in view of the public accountant's greater familiarity with the clients' affairs, gained while performing related accounting functions. Moreover, such a change would arouse great antipathy among vast sectors of the business community that would not like government auditors investigating every nook and cranny of their supposedly unregulated affairs under the guise of performing an auditing function.

Although changes in administering auditing procedures and the establishment of more reliable criteria of reporting should constantly be explored, the inherent dangers of relying upon financial statements will not be lessened by replacing the independent public auditor with one who is government employed. The present system of certification by independent public auditors does not prevent the SEC from exercising its broad authority to determine the propriety of the financial statements filed with it.[160] Besides, it is unlikely that the government would be willing to under-

156. SEC Accounting Ser. Release No. 81, Dec. 11, 1958, 23 Fed. Reg. 9777 (emphasis added) (footnotes omitted).

157. See Pines, The Securities and Exchange Commission and Accounting Principles, 30 Law & Contemp. Prob. 727, 751 (1965).

158. See Cohen, The SEC and Accountants: Co-Operative Efforts to Improve Financial Reporting, J. Accountancy, Dec., 1966, at 56, 67.

159. See SEC Accounting Ser. Release No. 81, supra note 156, dealing with the Independence of Certifying Accountants, Compilation of Representative Administrative Rulings in Cases Involving the Independence of Accountants.

160. See, e.g., SEC Accounting Ser. Release No. 96, Jan. 10, 1963, 28 Fed. Reg. 586. See

write the losses incurred by investors in the event of a false or misleading statement. Furthermore, it is no more feasible than before for the government to be put in the impractical position of passing judgment upon the soundness of any security. In short, the conclusion that SEC financial statements should be certified by independent public accountants is as compelling today as it was some thirty-five years ago.

B. *Accountants' Certificates and Generally Accepted Accounting Principles*

The accountant's certificate under SEC Regulation S-X[161] must contain (i) a representation as to the audit conducted:

> The accountant's certificate (i) shall state whether the audit was made in accordance with generally accepted auditing standards; and (ii) shall designate any auditing procedures generally recognized as normal, or deemed necessary by the accountant under the circumstances of the particular case, which have been omitted, and the reasons for their omission.[162]

and, (ii) the expression of an opinion:

> The accountant's certificate shall state clearly: (1) The opinion of the accountant in respect of the financial statements covered by the certificate and the accounting principles and practices reflected therein; (2) the opinion of the accountant as to any material changes in accounting principles or practices or method of applying the accounting principles or practices, or adjustments of the accounts, required to be set forth by § 210.3-07; and (3) the nature of, and the opinion of the accountant as to, any material differences between the accounting principles and practices reflected in the financial statements and those reflected in the accounts after the entry of adjustments for the period under review.[163]

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also SEC Accounting Ser. Release No. 4, April 25, 1938, 11 Fed. Reg. 10913, which provides, inter alia: "In cases where financial statements filed with this Commission pursuant to its rules and regulations under the Securities Act of 1933 or the Securities Exchange Act of 1934 are prepared in accordance with accounting principles for which there is no substantial authoritative support, such financial statements will be presumed to be misleading or inaccurate despite disclosures contained in the certificate of the accountant or in footnotes to the statements provided the matters involved are material. In cases where there is a difference of opinion between the Commission and the registrant as to the proper principles of accounting to be followed, disclosure will be accepted in lieu of correction of the financial statements themselves only if the points involved are such that there is substantial authoritative support for the practices followed by the registrant and the position of the Commission has not previously been expressed in rules, regulations, or other official releases of the Commission, including the published opinions of its chief accountant."

161. Regulation S-X, 17 C.F.R. § 210 (1967), contains the uniform accounting rules for the majority of the SEC's registration and report forms under the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935 and the Investment Company Act of 1940.

162. 17 C.F.R. § 210.2-02(b)(1) (1967).

163. 17 C.F.R. § 210.2-02(c) (1967).

Moreover, any exceptions the accountant makes in connection with the certificate shall be clearly identified, specifically and clearly stated, "and, to the extent practicable, the effect of each such exception on the related financial statements given."[164]

Although certifications vary in form and language, the following is typical:

> We have examined the balance sheet of XYZ Corp. as at . . . and the related statement of income and retained earnings for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.
>
> In our opinion, the accompanying balance sheet and statement of income and retained earnings present fairly the financial position of XYZ Corp. at . . . and the results of its operations for the year then ended, in conformity with generally accepted accounting principles[165] applied on a basis consistent with that of the preceding year.

Generally accepted accounting principles are those which have substantial authoritative support. The determination of whether accounting principles are "generally accepted" requires the exercise of judgment on the part of the public accountant, as well as knowledge as to what principles have found general acceptance, though some have received only limited usage. The sources for determining whether an accounting practice has substantial authoritative support have been summarized as follows:

> 1. In the practices commonly found in business. This does not follow from the mere fact that a practice exists, but from the fact that experience of the business has demonstrated that the practice produces dependable results for the guidance of management and for the information of investors and others.
>
> 2. The requirements and views of stock exchanges as leaders in the financial community; similarly the views and opinions of commercial and investment bankers would be entitled to weight.
>
> 3. The regulatory commissions' uniform systems of accounts and accounting rulings exercise a dominant influence on the accounting practices of the industries subject to their jurisdiction. The commissions sometimes depart from generally accepted ac-

164. 17 C.F.R. § 210.2-02(d) (1967).

165. The significance of the concept of "generally accepted accounting principles" stems from the AICPA's requirement that the auditor's report "shall state whether the financial statements are presented in accordance with general accepted principles of accounting." Committee on Auditing Procedure, AICPA, Auditing Standards and Procedures 40 (Statement on Auditing procedure No. 33, 1963). Moreover, AICPA, Code of Professional Ethics § 2.02(e) defines as an act discreditable to the profession the failure to direct attention to a material departure from "generally accepted accounting principles." See also SEC Accounting Ser. Release No. 4, April 25, 1938, 11 Fed. Reg. 10913.

counting principles and, in such cases, it may be necessary for the certified public accountant to make appropriate qualifications in his report.

4. The regulations and accounting opinions of the Securities and Exchange Commission have the controlling authority over reports filed with the Commission. The Commission and its chief accountants have demonstrated a high degree of objectivity, restraint and expertness in dealing with accounting matters. The regulations and opinions issued to date are entitled to acceptance by their merit as well as on the basis of the statutory authority of the Commission.

5. The affirmative opinions of practicing and academic certified public accountants constitute authoritative support for accounting principles or practices. These may be found in oral or written opinions, expert testimony, textbooks and articles.

6. Published opinions by committees of the American Accounting Association and of the American Institute of CPAs.[166]

As a result of this, acceptable alternative accounting principles have often developed in the treatment of identical subject matter.

In his *Inventory of Generally Accepted Accounting Principles for Business Enterprises,* Paul Grady[167] lists over twenty-five sets of such alternative methods,[168] some of which are "truly 'either-or' choices of management while others are applicable or not applicable depending on the circumstances."[169] However, the application of different accounting principles in the treatment of the same transaction can cause significant variance in reporting. For example:

Late in 1962 the tiny Albemarle Paper Mfg. Co. had put together a fancy financial deal to acquire far-larger Ethyl from its two joint owners, General Motors and Standard Oil of New Jersey. The deal was virtually the same for both giant sellers: Each owned 50% of Ethyl's shares, each had held them for 38 years, each would net about $40 million on the sale. But when Jersey and GM stockholders opened their annual reports a few months later, the deal could not have looked more different.

GM recorded the proceeds as *income* for the year, even before a penny of operating expenses was deducted. All the way down its income statement, to the net earnings figure at the bottom, the subtotals were inflated. Jersey went to the other extreme. It never showed the Ethyl profit on its earnings statement at all, not even under "nonrecurring income" below the net income figure. Instead, it buried its profit on Ethyl back in the "statement of stockholders' equity," a section of an annual report few people bother to read.

The contrast was spectacular. Here were the two largest industrial corporations in the world, with over 2 million stockholders and most of the financial community looking on. Yet each came up with a radically different treatment of earnings from the identical transaction. What's more, the treatments had been duly certified by two of the nation's most respected accounting firms, Haskins & Sells for GM and Price Waterhouse for Jersey.[170]

166. P. Grady, Inventory of Generally Accepted Accounting Principles for Business Enterprises 52-53 (AICPA Accounting Research Study No. 7, 1965).

167. A retired partner of Price Waterhouse & Co., and former Director of Accounting Research of the American Institute of Certified Public Accountants.

168. P. Grady, supra note 166, at 373-79.

169. Id. at 373.

170. Forbes, May 15, 1967, 28 at 34. But see APB, AICPA, Reporting the Results of Operations (Opinion No. 9, 1966).

Similarly, a leading financial publication recently compared two profit statements of the same company for the same period. Although it purportedly used generally accepted accounting principles for both, it applied more conservative accounting principles in the one than the other. The operations of the same company, thus reported under such differing generally accepted accounting principles, revealed:

GOLDEN FLEECE MANUFACTURING CO.
CONSOLIDATED INCOME STATEMENT

	Method A (Conservative)	Method B (Liberal)
Net Sales	$240,809,200	$243,924,600
Cost of Goods Sold	201,287,300	199,248,200
Gross Profit	39,521,900	44,676,400
Other Operating Income		1,191,000
	39,521,900	45,867,400
Selling, General & Administrative Expenses	24,210,700	26,468,300
	15,311,200	19,399,100
Other Income (Expenses):		
Interest Expense	(1,810,900)	(1,873,400)
Net Income—Subsidiaries	538,900[sic]	
Amortization of Goodwill	(170,000)	
Miscellaneous	(269,000)	(229,200)
	(1,711,900)	(2,102,600)
Net Income Before Taxes	13,599,300	17,296,500
State Income Taxes	638,000	812,900
Federal Income Taxes—Deferred		348,900
Federal Income Taxes—Current	5,238,000	6,440,000
Charges Equivalent to Tax Reductions from:		
Investment Tax Credits	775,000	
Tax Loss Carryovers	990,000	297,000
	7,641,000	7,898,800
Net Income	5,958,300	9,397,700
Earnings Per Share	$1.99	$3.14

Source: Practising Law Institute, December, 1966, Conference on Corporate Accounting Problems.[171]

The SEC itself is not totally blameless on this issue of varying accounting principles. In connection with the 7% Investment Credit,[172] the SEC permits[173] the resultant tax saving either to be reflected currently in the year the credit arises, or to be amortized over the productive life of the

171. Forbes, supra note 170, at 28-29.
172. See Int. Rev. Code of 1954, §§ 38, 46-48.
173. SEC Accounting Ser. Release No. 96, Jan. 10, 1963, 28 Fed. Reg. 586.

underlying asset.[174] Moreover, the rate-making policies of other administrative agencies have added to the confusion.[175]

174. See Metz, Accounting Profession Vexed by Lawsuits, Weighs Responsibility to Shareholders, N.Y. Times, Nov. 20, 1966, § 3, at 14, col. 4. "When Congress passed the 7 per cent credit for investment in business equipment, this accounting problem arose: Should the 7 per cent credit that permitted businessmen to reduce their taxes by up to 7 per cent of the cost of equipment be reflected in earnings in the year in question?

The Accounting Principles Board decided that it should not be so reflected, but that it should be charged off a bit at a time over the life of the equipment—a conservative approach.

The S.E.C., reportedly spurred by the Administration, ruled that for its purposes either method would be considered satisfactory. The Administration was anxious to have the credit spur investment in plant and equipment, and the higher earnings that resulted from an immediate reflection in earnings was designed to build business confidence.

Thus, despite the best efforts of the Accounting Principles Board, two methods were permitted and the difficulty of comparing two corporations in the same industry became that much harder when each used different methods." Id. See also APB, AICPA, Accounting for the "Investment Credit" (Opinion No. 2, 1962), as amended by APB Opinion No. 4 (1964). But see Proposed APB Opinion: Accounting for Income Taxes (Sept. 14, 1967) which, in concluding that hereafter such credit should only be amortized, states: "The Board recognizes that each of the differing viewpoints expressed concerning the manner in which the investment credit should be accounted for possesses merit. However, it has concluded that the circumstances surrounding the investment credit do not justify alternative treatments. It also is aware that at present many, perhaps a majority of, companies account for the credit on a flow-through basis. However, the flow-through method, because it reflects the entire effect of the credit in the year in which it is obtained, can result in substantial fluctuations in net income unrelated to current revenue-producing activities. The recent statutory increase in the amount of allowable credit may result in a significant increase in the magnitude of these fluctuations." Id. at 12. As of the time this article went to press, the APB had not taken final action on this proposed opinion.

175. Not all the accounting rules promulgated by the various administrative agencies necessarily conform to "generally accepted accounting principles." For example, in reporting its income to its stockholders, the Union Pacific Railroad Company ("U.P.") substracts from the income which it reports to the ICC (under the latter's accounting rules) a very substantial sum ($20,700,000.00 in calendar year 1966) for deferred taxes it anticipates it will pay in future years because of the accelerated depreciation it currently claims for income tax purposes. U.P. thus feels that this reduction—which lowered its 1966 earnings from $4.76 per share to $3.84 per share—was "necessary to conform accounting for current Federal income taxes to generally accepted accounting principles." Union Pacific R.R., Seventeenth Annual Report 30 (1966). See APB, AICPA, New Depreciation Guidelines and Rules (Opinion No. 1, 1962), and APB, AICPA, Status of Accounting Research Bulletins (Opinion No. 6, at 43, 1965). Paragraph 20 of APB Opinion No. 6 amends Accounting Research Bulletin ("ARB") No. 44 (dealing with Declining Balance Depreciation), as follows: "ARB 44 (Revised)—Declining-balance Depreciation 20. Pending further study, paragraph 9 is revised to read as follows:

9. When a company subject to rate-making processes adopts the declining-balance method of depreciation for income tax purposes but adopts other appropriate methods for financial accounting purposes in the circumstances described in paragraph 8, and does not give accounting recognition to deferred income taxes, disclosure should be made of this fact."

However, this amendment to ARB No. 44 was dissented to by one-third of the members of the APB: "The intent of paragraph 20 of this Opinion is to continue the requirement for

In today's markets, reported earnings often become the common denominator of the price of securities. Although numerous companies use conservative accounting principles, many managements, conscious of performance, will often turn to more liberal accounting principles to bolster their financial performance.[176] It has thus been stated:

> Under the present accounting rules, there is a very fine line between "maximizing" and plain, old-fashioned manipulation. Take the well publicized Westec scandal that broke last summer. When the facts were known, it was quite clear that Westec Corp.'s acquisition-minded management had been pushing the flexible accounting principles to the breaking point in order to keep earnings and the price of its stock as high as possible. Westec took directly into income nonrecurring profits on sales of oil properties; it treated oil production payments sold to an insurance company as current income rather than deferring them until oil was actually produced; it included in its earnings for a given year the profits of companies not acquired until the following year. Just nine months after reporting 1965 earnings of $4.9 million and assets of $56 million, Westec was in bankruptcy, its stock down 33% before trading was suspended.[177]

C. *Efforts Toward More Uniform Reporting*

Arguments for and against greater uniformity in reporting have been summed up as follows:

> Critics of the existence of acceptable alternative principles of accounting have asserted that the financial results of operations of companies in the same industries are frequently not susceptible of meaningful, and indeed produce misleading, comparisons by the great body of public investors. They further argue that, while disclosure and consistency are desirable for reporting purposes, they are not a satisfactory substitute for more uniform accounting principles. Defenders of acceptable alternatives do not agree that there is such a diversity of accounting principles as to vitiate comparisons between one company and another, and assert that advances in the development and improvement of accounting principles "will come about not by

disclosure of the accounting practice followed but to omit the previous requirement for disclosure of the effect of the practice. Thus, in their opinion, the Accounting Principles Board is inappropriately sponsoring the viewpoint that investors and other users of financial statements should be told of the practice but need not be furnished the information to judge its significance." Id. at 43-44. See also Proposed APB Opinion: Accounting for Income Taxes (Sept. 14, 1967) which discusses inter alia, the treatment of actual tax savings through the use of accelerated depreciation, and concludes that the full amount of income taxes should be deducted from income in the period that the income is reported, regardless of when the tax is actually paid.

176. See Forbes, supra note 170, at 39, 42.

177. Forbes, supra note 170, at 30-31. Civil actions have been brought against Westec's accountants and others for violations of the antifraud and antimanipulative provisions of the federal securities laws. Ten of such actions, originally brought in the Federal District Court for the Southern District of New York, have been transferred to the Southern District of Texas, Houston Division, the situs of (i) other similar or related proceedings, (ii) Westec's principal place of business, and (iii) Westec's Chapter X Reorganization proceeding. Schneider v. Sears, 265 F. Supp. 257 (S.D.N.Y. 1967).

building a Procrustean bed but by refinement of existing practices and seeking better ones."[178]

Concerned, however, over the unnecessary variances in the presentation of financial reports (particularly in unregulated industries[179]), the Accounting Principles Board[180] ("APB") of The American Institute of Certified Public Accountants ("AICPA") has endeavored to narrow the areas of difference and inconsistency in practice. Several years ago, the Council of the AICPA, in an attempt to put some teeth[181] in the APB's proclamations, issued a special bulletin[182] applicable to financial state-

178. Pines, supra note 157, at 748.

179. As to uniformity in regulated industries, see Price, Walker & Spacek, Accounting Uniformity in the Regulated Industries, 30 Law & Contemp. Prob. 824 (1965).

180. See Sprouse & Vagts, The Accounting Principles Board and Differences and Inconsistencies in Accounting Practice: An Interim Appraisal, 30 Law & Contemp. Prob. 706, 707-08 (1965): "Prior to 1959 there existed a Committee on Accounting Procedure, created in 1938 by the American Institute of Accountants (as the AICPA was then called) to deal with accounting matters. Before that there had been some significant discussions and correspondence with the New York Stock Exchange, and in 1934 six accounting rules were adopted directly by vote of the membership, but there was no continuing systematic procedure for the establishment of accounting principles. During the twenty years of its existence, the Committee on Accounting Procedure published fifty-one Accounting Research Bulletins as part of a program of research and publication of recommendations about the use of certain accounting procedures. The Bulletins tended to present ad hoc solutions to unrelated specific problems and frequently recognized the acceptability of two or more procedures for accounting for identical transactions occurring under identical circumstances. Furthermore, the Bulletins presented recommendations only; with the exception of the six rules adopted by the AICPA membership vote, the conclusions contained in the Bulletins were not binding on the Institute membership. Accordingly, procedures not embraced in the Bulletins might also be considered to be 'generally accepted.' Dissatisfaction with this approach led to a report of the Special Committee on Research Program to the Council of the AICPA which was approved in April 1959. With this approval was established the Accounting Principles Board (APB), composed at first of eighteen, and then of twenty-one, members. These are largely accountants in active practice. Characteristically, each of the 'big eight' accounting firms is represented; the rest of the seats are distributed among representatives of smaller firms plus a few members from business firms, the academic community and government. The Board promptly adopted 'Charter Rules' to detail its procedure and objectives."

The "Big Eight" public accounting firms are: Arthur Andersen & Co.; Ernst & Ernst; Haskins & Sells; Lybrand, Ross Bros. & Montgomery; Peat, Marwick, Mitchell & Co.; Price Waterhouse & Co.; Touche, Ross, Bailey & Smart; and Arthur Young & Co. While the "Big Eight" public accounting firms employ about 15% of all CPAs, it is estimated that—as of recently—they did approximately 80% of SEC certifications. With the 1964 amendments to the 1934 Act extending its reporting requirements to smaller companies, however, it is anticipated that much of this new work will go to smaller accounting firms.

181. While the opinions of the AICPA and its boards and committees are most persuasive as to whether a principle is generally accepted, AICPA sanctions for breaches thereof can generally extend only to its members; and, as to them, even expulsion does not necessarily revoke their CPA status.

182. AICPA, Disclosure of Departures from Opinions of the Accounting Principles Board (Special Bull., 1964).

ments for fiscal years beginning on or after January 1, 1966, requiring the following disclosure:

If an accounting principle that differs materially in its effect from one accepted in an Opinion of the Accounting Principles Board is applied in financial statements, the reporting member must decide whether the principle has substantial authoritative support and is applicable in the circumstances.

If he concludes that it does not, he would either qualify his opinion, disclaim an opinion, or give an adverse opinion as appropriate.

If he concludes that it does have substantial authoritative support: (1) he would give an unqualified opinion and (2) disclose the fact of departure from the Opinion in a separate paragraph in his report or see that it is disclosed in a footnote to the financial statements and, where practicable, its effect on the financial statements.[183]

Investor confusion has also greatly concerned the SEC. Commission Chairman Manuel F. Cohen, in addressing the 79th annual meeting of the AICPA, cautioned:

I believe the highest priority should be given to the elimination of unsound practices and unjustified variances in financial reporting. We are aware that your Accounting Principles Board expects to publish its Opinion on pensions shortly and is pressing hard to complete studies on important subjects including interperiod allocation of corporate income taxes, accounting for research and development, intercorporate investments, and sundry other matters. But when a rapidly expanding new business changes from one "acceptable" and "conservative" method of accounting for development expenses and depreciation to another such method and the result is a small profit rather than a substantial loss, it is obvious that a good deal of work remains to be done before "generally accepted accounting principles" command the degree of public confidence we would all like them to have.[184]

In a similar vein, J. Arnold Pines, Associate Director of the Division of Corporate Regulation of the SEC, has written:

While the accounting profession should be supported in its efforts to promote uniformity in accounting principles, it seems fair to ask whether too much reliance is being placed by corporate managements, by the accounting profession at large, by the investing public—and by the Commission itself—on the professional accounting organizations. While such reliance has been the Commission's policy for at least twenty years, the efficacy of that policy, like that of any other long-standing policy, deserves periodic re-examination and reassessment. It would seem that now would be a most appropriate time for such a new appraisal.[185]

IV. Observations and Conclusion

It is somewhat puzzling that many public accountants—faced on the one hand with clients who often wish to "maximize" results, and on the other with the responsibility of determining whether a proffered principle

183. Sprouse & Vagts, The Accounting Principles Board and Differences and Inconsistencies in Accounting Practice: An Interim Appraisal, 30 Law & Contemp. Prob. 706, 709 (1965).

184. Cohen, supra note 158, at 58.

185. Pines, supra note 157, at 751.

is widely accepted, or a statement is misleading[186]—are leading the fight against greater uniformity in SEC financial reporting. Opponents of uniformity argue:

> "There can never be one set of inflexible rules in the name of uniformity," contends John W. Queenan, managing partner of Haskins & Sells. "Companies that appear on the surface to be the same may actually operate much differently. One company may use the newest equipment; its competitor may get by with heavy maintenance of old equipment. It should be the job of accounting to reflect these differences in operating conditions."
>
> An oft-cited example to back up the argument for flexibility is that of the company which elects not to include the results of a money-losing subsidiary in its reported earnings. Management is pouring money into the subsidiary, which promises eventually to be highly profitable. But the accountants argue that if management were forced to include it in current earnings, showing a heavy investment with no return, it might decide to forego a very beneficial enterprise.[187]

However, in presenting highly technical variations, it is of no use to the average investor that, through footnotes or elsewhere on the statement, perfunctory disclosure is made of the type of principle used. Indeed:

> Here is where Arthur Andersen's Spacek takes his fellow accountants to task. "My brethren say, just tell the investors what the facts are and let them be on their guard," he says. "I say 'booby trap.' We cannot just present statements to investors and say, 'You ought to be able to find the booby traps.' "[188]

The trained analyst and the sophisticated investor are capable of comparing and determining true value, whether there is uniformity or not. Given all the facts, they can make the proper adjustments among varying principles and arrive at an objective conclusion. Certainly, as to such persons, the client is not as unduly strapped as one would be led to believe. Accordingly, uniformity should not generally affect a client seeking private financing from a group of banks or insurance companies. Similarly, no banker, in considering a mortgage on a $10,000,000 unencumbered, prime piece of real estate, will refuse a substantial commitment solely because the asset was properly carried on the corporation's balance sheet for only $1,000,000.

In fact, it has been observed that:

> Professional investors, the men who manage large portfolios of stocks, regard published earnings with the utmost skepticism. One Wall Streeter who specializes in arranging mergers and acquisitions says: "The only reason we look at a company's competition is to get an idea of what phase a company is in vis-à-vis its industry and subjectively analyze its management."
>
> What he is saying is that officially reported earnings and assets, no matter how illustriously certified, do not play a major role in his decision-making. And yet most

186. See, e.g., Teich v. Arthur Andersen & Co., 24 App. Div. 2d 749, 263 N.Y.S.2d 932 (1st Dep't 1965) (mem.), which involved both of these problems.

187. Forbes, supra note 170, at 29.

188. Id. at 34.

investors must depend on information this sophisticated investor regards as almost useless.[189]

Thus, it is on the investing public—a rapidly growing group already numbering over twenty million[190]—that enforced uniformity would have its main effect. It is to uniformity that regulatory agencies look to aid them in administering the problems of their respective jurisdictions. By no means is uniformity a panacea; but, why not give the public investor —who on the average is far less astute to adjust variables—the same assistance granted these agencies? If maximum flexibility was important in SEC financials, abuses have undercut its usefulness by breeding situations such as in Westec.

Regardless of the pros and cons of greater uniformity, however, the APB of the AICPA is making commendable steps in that direction. Moreover, the SEC, under its broad supervisory powers, seemingly has the authority to bring about more uniform accounting rules by merely expanding its Regulation S-X.[191] If the SEC, impatient with the accountants' housecleaning, did undertake such expansion, it would leave the profession saddled with increased uniformity, but still bedded down with much of the uncertainty of whether their certified financials contained misrepresentations or were otherwise misleading. Nor is this uncertainty eliminated merely because a statement is prepared according to generally accepted accounting principles, for their use does not necessarily immunize it from being misleading to the average investor.[192]

There are those who feel that the accountant can find ample protection in liability insurance. On the other hand, as has been reliably observed:

> It will be said that accountants' liability insurance can take care of the problem. But this is an illusion. The cost of such insurance is based on experience. This includes the costs—which can be huge—of successful defense against unjust claims. The more lawsuits there are against accountants, even if most of them fail, the higher the premiums. The cost must be met from auditors' fees, and therefore is indirectly a levy on the business community. At some point, if present trends continue, this cost may become prohibitive.[193]

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189. Id. at 44.

190. Close-Up of Today's Stock Market, U.S. News and World Report, July 3, 1967, at 62.

191. See 48 Stat. 85 (1933), as amended, 15 U.S.C. § 77s(a) (1964).

192. See Bradley, Auditor's Liability and the Need for Increased Accounting Uniformity, 30 Law & Contemp. Prob. 898, 909-14 (1965).

193. Editorial, The Specter of Auditors' Liability, J. Accountancy, Sept. 1965, at 33, 34. In recently commenting on the 2.1 million dollar settlement offer by Lybrand, Ross Bros. & Montgomery to dispose of the civil action instituted against it (and others) by the trustee of Continental Vending Machine Co., principally based upon fraud and the preparation of false and misleading statements, it was reported: "A spokesman for Lybrand-Ross said the settlement offer was made to 'terminate the incredible drain on time of (the firm's) top partners in the legal proceedings which have now gone on for two years, with no end in

Although coverage is becoming increasingly difficult to obtain,[194] individual coverage has approximated as high as $15,000,000.[195] The adequacy of even such a figure, however, is questionable in an era demanding greater disclosure[196] and possible expansion of SEC protection.[197] Consider the potential liability in a public offering of ten million shares at $50 per share, if an inadvertent material omission rendered the financials in the registration statement misleading and the price of the shares dropped $20 each shortly after the issue was sold out.

It appears that in the interest of the public investor; greater reporting uniformity seems inevitable. It seems advisable, therefore, that instead of bickering within itself, the accounting profession as a whole should strive toward achieving reporting principles which would not only be more meaningful to the average investor, but would also help to narrow the incidents of accountants' liability. One solution would be to integrate all the accountants' obligations and liabilities provisions—at least those of the 1933 and 1934 Acts—into one composite chapter. Such integration should be with a view toward satisfying two important needs: (i) to furnish the average investor with more accurate, objective and comparable data, and (ii) to outline more clearly the limits of the auditor's liability under the federal securities laws.

No amount of study or discussion will result in complete agreement—even among its staunchest proponents—on the contents of such a chapter. However, such a chapter could consist of two principal components, one advising the accountant as to what is expected of him ("duties and guidelines section") and the other outlining the scope of civil liabilities for the breach of such duties ("liabilities section").

The following suggestions are offered as illustrative of the features to be considered in drafting the chapter's duties and guidelines section:

a) The establishment of more uniform accounting principles that will be considered proper for SEC purposes, with a provision that any

sight' . . . [and] to end the 'very substantial legal expenses.'" Wall Street Journal, Oct. 6, 1967, at 18, col. 3. See also the decision of the Council of the AICPA concerning "a proposed effort to amend the Securities Act of 1933 to provide some limitation on the virtually unlimited liability presently imposed on independent accountants under the statute." The CPA, Oct, 1967, at 1.

194. Wall Street Journal, Nov. 15, 1966, at 13, col. 4.

195. See Bradley, Liability to Third Persons for Negligent Audit, 1966 J. Bus. L. 190, 195.

196. E.g., the SEC's controversial intention to put an end to "conglomerate" financial reporting, which is the practice of lumping the revenues and earnings of a diversified company into a single set of figures, leaving the investor in the dark as to the individual operation of each division. See also Statement of the APB: Disclosure of Supplemental Financial Information by Diversified Companies (Sept. 1967).

197. Suggestions have been made to extend the securities laws to inure to the benefit of creditors, in addition to investors in securities.

departure therefrom must be conspicuously noted and the effects thereof explained.[198]

b) An outline of the accountant's responsibilities in connection with information acquired after certification.[199]

c) Specification of the accountant's duties, if any, in connection with interim reports which he need not certify, but which he may know or suspect are faulty.[200]

d) An attempt, by examples if necessary, to define more clearly the term "material," since this elusive term presently plays a vital role (and should continue to do so) in determining liability under the 1933 and 1934 Acts. Although the aggregate of such examples would not be all-inclusive, this approach has been successfully employed elsewhere where terms were cumbersome to define,[201] and might assist the accountant in determining what to include or omit in the financials he certifies.[202]

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198. The ultimate definition, amendment, deletion, or supplementation of such principles might well be left to a joint panel, established by the chapter, consisting of SEC personnel and representatives of the accounting profession and business. Moreover, although some industries are under the direct regulation of federal agencies other than the SEC, this panel should have exclusive jurisdiction regarding the establishment of accounting rules under which all companies report to their investors. See also APB Opinion No. 4 (1964) (dissenting opinion). "Mr. Spacek dissents from the conclusion in paragraph 10. He believes this Opinion illustrates the accounting profession's complete failure in its responsibility to establish accounting principles that will provide reliable financial statements that are comparable among companies and industries, for use of the public in making personal investment decisions. He states there is no justification for sanctioning two contradictory practices to accommodate SEC and other regulatory bodies and some CPAs who have approved reporting the investment credit as, in effect, profit from acquisition rather than from use of property. This flouts Congress's clear intent in granting the investment credit, 'to reduce the net cost of acquiring depreciable property.' Alternative procedures under this Opinion can increase by up to 25 per cent the earnings otherwise reported. In this Opinion and in SEC's stated position, Mr. Spacek finds no word of concern for the investor, to whose protection both CPAs and SEC supposedly are dedicated. He believes this Opinion approves accounting of the type that precipitated the 1929 financial crisis, and that history is being repeated by actions of the very authorities created to prevent such catastrophes. He feels this breakdown in safeguards created to protect investors has resulted from fragmentation of responsibility for establishing accounting principles, and the only remedy is to create a Federally established Court of Accounting Principles with a prescribed basis for its decisions; this court would be independent of the profession and regulatory commissions, and its decisions would be binding on all, thus rescuing investors from their present abandonment." Id. at 24-25. See also notes 172-174 supra, and accompanying text.

199. See Fischer v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1967), pp. 206-08, 216, 218-19 supra.

200. See pp. 216, 218-19, supra; Taylor, The Published Interim Report and the CPA, J. Accountancy, Sept. 1965, at 55.

201. See, e.g., Int. Rev. Code of 1954, § 61(a), which defines the term "gross income."

202. See APB, AICPA, Accounting for the Cost of Pension Plans (Opinion No. 8, ¶ 46,

Although consideration might also be given to the establishment of auditing procedures required in the certification of SEC financials, it is perhaps more desirable that auditing standards should be left flexible and up to the profession.

Under the liabilities section of the chapter, the following should be considered:

1) The creation of one all-inclusive rule governing accountants' liability, clearly defined in scope and content, and broad enough to replace the substantive variations existing between section 11 of the 1933 Act, and sections 10(b) and 18 of the 1934 Act.

2) Provision for the posting of security in a manner similar to that of section 11 of the 1933 Act, in order to discourage nuisance suits.

3) Establishment of one statute of limitations, broad and flexible enough to accommodate varying circumstances.

4) While retaining broad venue and process provisions, granting jurisdiction over such causes of action solely to the federal courts, as does section 27 of the 1934 Act.

5) Creation of a defense which—insofar as SEC financials are concerned—absolves the accountant from liability in any forum, to the extent that he follows the procedures outlined in or established under the duties and guidelines section of the chapter.[203]

6) The establishment of a pre-clearance board to which the accountant can look for guidance and immunity in the event a unique situation arises, not then covered by the chapter's provisions and regulations promulgated thereunder.[204]

No pretense is made that the above topics are all-inclusive, or that each individually holds the key to achieving the dual purpose of aiding the investor before he is hurt (for the right to sue does not always assure adequate relief), and tightening the sphere of the auditor's liability. It is submitted, however, that the principle behind such a chapter would achieve both of these ends. Moreover, if the auditor's guidelines are more clearly defined, practical insurance coverage should be more readily available to meet the anticipated expanding disclosure requirements of the future.

1966), which deals with the importance of certain disclosures concerning pension plans; see also Phoenix and Bosse, Accounting for the Cost of Pension Plans—APB Opinion No. 8, J. Accountancy, Aug. 1967, at 27.

203. Although the establishment of some sort of fixed or variable over-all monetary ceiling on the accountants' SEC liability might also be desirable to the accounting profession, such special treatment would only precipitate demands by other experts seeking similar curbs on their own liabilities, thus deleting necessary investor protection.

204. Such a board might consist of the same personnel as the panel mentioned in note 198, supra.